Operation of monetary policy

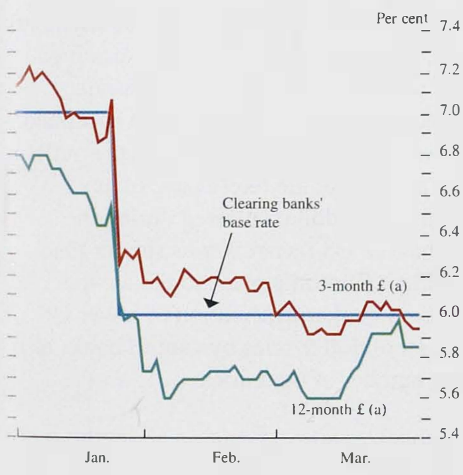
This article covers the period from January to March 1993.

Introduction

The extent of domestic disinflationary pressures became more apparent during the first quarter. The inflation outturn at the end of 1992 was lower than expected as was output and, with renewed labour shedding, it was less likely that inflation would exceed its target range, even temporarily, in the near term. So a further monetary easing was judged possible without risk to the inflation target, and had become appropriate as a means of sustaining the confidence necessary for economic recovery. It was put into effect with a one percentage point reduction in interest rates on 26 January.

Sterling weakened in anticipation of interest rate cuts after the release of weak economic data in January and, by 22 January, had lost nearly all of its gains made early in the new year. It lost further ground after the interest rate cut and in February fell briefly to all-time low levels, both against the deutschmark and in effective terms, as market expectations of further cuts developed. Thereafter, however, news of stronger economic activity provided the basis for its recovery.

Short-term interest rates

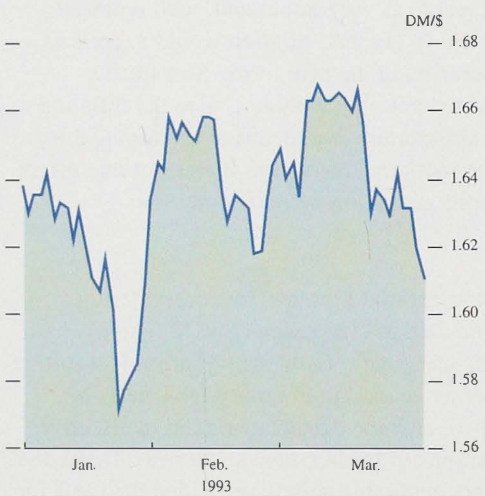


(a) Middle-market rates at the close in the London interbank market.

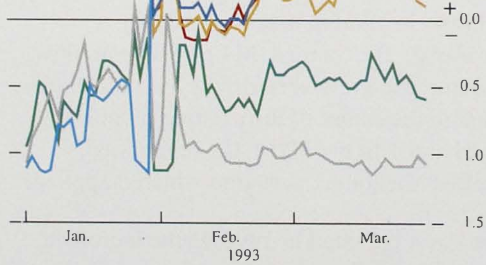
M0 and M4 continued to behave divergently. The 12-month rate of growth of M0 had been on an upward trend since September and exceeded 4% in February. M0 proved to be a reliable indicator of increasing price pressures in 1988–90. Its interpretation now is complicated by the slowdown in the growth of the velocity of M0 since 1990. For the reasons set out in the Medium Term Financial Strategy (MTFS), a higher rate of growth of M0 than hitherto may have become consistent with low inflation. The MTFS gave a monitoring range of 0%–4% for the 12-month growth rate of M0—no longer using the description 'target' range now that inflation is explicitly targeted—but noted that a possible change in its velocity trend would have to be borne in mind in assessing M0's performance in the year ahead. By contrast, M4 growth was slow. Lending to the private sector also grew very slowly as companies repaid borrowing. Although the centre of the existing monitoring range for M4 was retained at 6% in the MTFS, the range was widened to 3%–9% to reflect the longer period to which it applied.

Under the full fund policy as it operated in 1992/93 the increased PSBR had little net impact on broad money. Purchases of gilts made by the main creators of broad money (banks and building societies) did not count as funding and had to be offset by further official sales to the funding sector. This drained a corresponding amount of liquidity from the private sector, and constrained banks' and building societies' ability to manage their liquid assets. It also had the consequence in the money market of building up the stock of assistance and was of sufficient scale, especially in the final quarter of 1992/93, to produce difficulties in managing the stock. The authorities' intention to retain the full fund policy was confirmed in the Budget, but it was announced that banks and building societies would no longer be excluded from the funding sector and that their purchases of gilts in 1992/93, which totalled £6.8 billion, would be taken into account in funding operations in the next two to three years. Funding during the final quarter of 1992/93 secured £1.7 billion of calls for 1993/94 in addition to the £1.2 billion of calls previously secured; but a late and unexpected increase in the 1992/93 PSBR resulted in a small underfund for the year as a whole.

Deutschmark/dollar exchange rate



Narrow band positions[(a)]



(a) Relative to the centre of the narrow band. New central rates were established on 1 February 1993.

The international financial environment

The dollar had maintained an upward trend against the deutschmark in the fourth quarter of 1992 but failed to make further sustained advances in the first quarter of 1993. The DM-$ interest rate differential was widely expected to narrow further, with sustained recovery apparently under way in the United States and the outlook for German activity deteriorating. But the likely pace of any narrowing remained uncertain. The dollar suffered during the quarter, as emerging signs that the US recovery was slower than expected together with President Clinton's plans to reduce the budget deficit encouraged some market expectation of lower US interest rates. Market rumours of dollar sales by central banks also capped its appreciation on a number of occasions.

Early in the year the Bundesbank expressed caution about the speed with which interest rates could fall, and the outcome of wage negotiations and the Solidarity Pact were seen by the market as major uncertainties. The DM/$ rate tended to be driven by changing expectations of German interest rate movements: the deutschmark depreciated after unexpected interest rate cuts, which encouraged expectations of faster future cuts, but appreciated when subsequent cuts came less quickly than had been anticipated.

In the ERM, the Danish krone, the French franc and the Irish punt began the year at the bottom of the narrow band. Very early in the new year, pressure returned to the French franc but eased when it was announced on 7 January that the German repo rate would fall at the following week's tender and Belgian and Dutch rates subsequently eased. The Irish punt, however, suffered from renewed rumours of devaluation and reached its floor against the Belgian and Dutch currencies early in January. Pressure on the punt intensified after the reduction in UK rates on 26 January. Official overnight interest rates were raised again to 100%, where they had been at the beginning of the month, but the punt was nevertheless devalued by 10% over the weekend of 30–31 January.

Attention switched immediately to the Danish krone while the Belgian franc moved below its usual trading range against the deutschmark. The krone was supported on 4 February by a rise of two percentage points in the Danish discount rate and by concerted intervention by the central banks of the narrow band currencies, and tensions eased later that day after the earlier and larger than expected reduction in German Lombard and discount rates. But the narrow band remained stretched, as the possibility of further cuts in German rates was seen to diminish; the easing was thought merely to have accommodated the earlier easing of repo and short-term market rates and the repo rate fell only modestly in the following weeks.

Following the conclusion of the Solidarity Pact in Germany, the 50 basis points reduction in the discount rate announced on 18 March was much as the markets expected, but there was disappointment that the Lombard rate was unchanged and that the repo rate was not subsequently reduced. A number of other European countries were nevertheless able to make downward adjustments to their interest rates. But French money-market rates retained a larger than usual margin over German rates before the French National Assembly elections on 20 and 27 March because of some market concerns about the likely new administration's commitment to the 'franc fort' policy. Pressure abated after the first round of elections and the market subsequently drew comfort from the new administration's stated support for the franc's existing parity and its commitment to growth-enhancing policies.

The US fiscal package announced in mid-February was welcomed by the bond market and US ten-year bond yields fell decisively below 6% for the first time in over twenty years. German federal government bond yields continued to fall in the first quarter but the yield curve from two-years' maturity developed a slight upward slope. Ten-year yields fell with short-term interest rates but uncertainty about the fiscal position and inflation limited their fall. At ten-years' maturity the spread against gilts ranged between 100 and 150 basis points.

Official money-market operations

Sentiment in the domestic money market was governed during the quarter by changing perceptions of domestic economic activity and inflation. The outlook for interest rate cuts overseas—most notably in Germany—was generally important only in so far as it affected prospects for the exchange rate. As anecdote, optimism and then evidence of recovery accumulated during the quarter so expectations of lower interest rates receded, but not without first intensifying after disappointing activity data released in January. In the absence of great downward pressure on market rates, the Bank's operations were mainly directed to relieving difficult technical conditions.

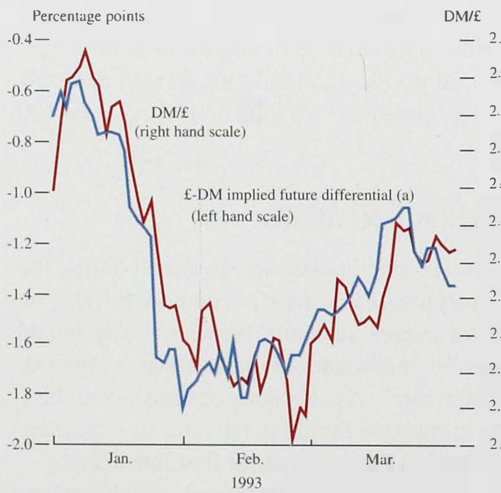
At the beginning of January futures prices reflected the view that official rates were unlikely to be substantially reduced for some time. A modest easing was thought possible around the time of the Budget in March, especially if substantial tax increases were announced. The market was encouraged by reports of good post-Christmas retail trade and of stronger private car sales in December which were apparently corroborated by the narrow money data. However, this optimism about increased consumer spending was not confirmed by official data, notably retail sales in December, and the improvement in consumer and business confidence still appeared fragile in the face of falling production and the large rise in unemployment at the end of 1992. It became evident in January that M4 had fallen in November; in nominal terms its 12-month growth rate fell to a level not previously recorded and even in real terms its growth was weak. Lending for house purchase fell below even the depressed levels seen immediately after the end of the stamp duty holiday in September, and building societies' lending commitments were weak. Turnover was very low and house prices resumed a downward trend in December . It also seemed likely that neither M4 nor lending would have grown very strongly in December. The retail sales data did not by themselves alter much the market's view about likely future rate

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

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			
	1 month	3 months	6 months	12 months	3 months	Short	Medium	Long	Long	ERI	$/£	DM/£
4 January	7 5/32	7 1/8	6 31/32	6 25/32	6.56	7.20	8.17	8.76	3.87	79.7	1.5005	2.4571
26 January	6 7/32	6 1/4	6 3/32	6 1/16	5.92	6.88	8.08	8.85	3.80	79.5	1.5388	2.4267
5 February	6 3/8	6 3/32	5 13/16	5 19/32	5.74	6.72	7.99	8.69	3.77	77.7	1.4507	2.3961
12 February	6 9/32	6 5/32	5 27/32	5 11/16	5.80	6.71	7.87	8.59	3.66	76.2	1.4207	2.3555
25 February	6 9/32	6 5/32	5 29/32	5 23/32	5.97	6.62	7.83	8.45	3.60	76.3	1.4317	2.3387
12 March	6 1/16	5 29/32	5 23/32	5 19/32	5.48	6.47	7.56	8.28	3.57	77.3	1.4345	2.3887
16 March	6 3/32	5 31/32	5 27/32	5 21/32	5.65	6.63	7.68	8.37	3.59	77.7	1.4450	2.3985
31 March	5 31/32	5 15/16	5 7/8	5 27/32	5.78	6.72	7.71	8.35	3.51	79.4	1.5062	2.4254

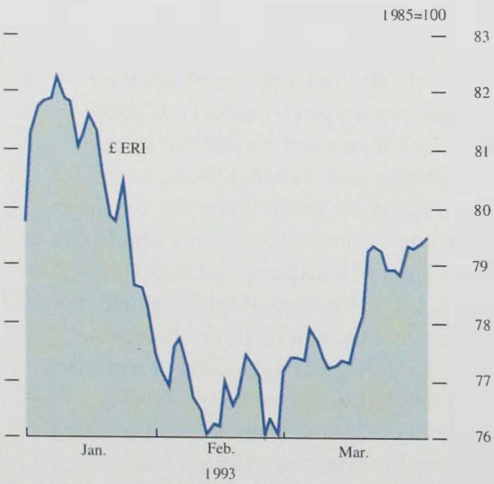
(a) Close of business rates in London.
(b) Gross redemption yield. Representative stocks: short—7¼% Treasury 1998; medium—8% Treasury 2003; long—9% Treasury 2012; index-linked—2½% Index-Linked Treasury 2016 (real yield assuming 5% inflation).
(c) Middle-market rates.
(d) Implied future rate: until 28 February the March contract, thereafter the June contract.

Interest and exchange rates



(a) Differential implied by 3-month sterling and eurodeutschmark futures contracts for June 1993.

Sterling effective index(a)



(a) At close of business in London.

cuts, but the release of the industrial production and unemployment data perceptibly changed the probability attached by the markets to a cut with the Budget, although no cut was generally expected until after further economic data had been released in mid-February.

With scope to reduce interest rates without risk to the inflation target, the Bank announced ahead of its early round of operations on 26 January that its minimum lending rate would be 6% that day. Clearing banks' base rates were reduced in line. The timing of the rate cut surprised markets and expectations of a further cut of up to one percentage point with the Budget gained ground, spurred by a press report on 31 January that a further two percentage point cut in rates was being considered.

Sterling's weakness then halted the decline in money-market rates. Expectations of a rate cut with the Budget remained, but were diminished by the news that producer's input prices, retail sales and M0 had risen by more than expected in January and that (seasonally adjusted) unemployment had not reached three million. Statements by the Chancellor and the Deputy Governor as well as the Bank's *Inflation Report* also tended to reduce expectations of further rate cuts.

Although sterling also benefited from this change of sentiment, it remained vulnerable and fell to its lowest ever levels against the deutschmark and in effective terms on 25 February. This partly reflected the general strengthening of the deutschmark, and some expectation that any cut in US rates (after the release of the fiscal package) might be followed in the United Kingdom. Concern that the European Communities (Amendment) Bill might not be passed into law was also a factor. In the money market, period rates firmed, although there was no expectation that higher official rates would be needed.

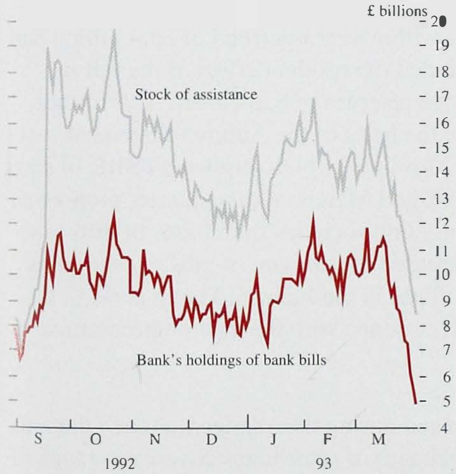
Activity data released in March before the Budget further encouraged the view that recovery might be under way. On the foreign exchanges, sterling benefited and rose decisively above its low points. But the lingering belief that rates would be cut with the Budget and the Government's defeat in committee on 8 March on an amendment to the European Communities (Amendment) Bill restrained its rise.

In the money market there was little or no surprise that rates were not cut in the Budget on 16 March. But the view expressed by the

Chancellor that the prevailing level of interest rates was consistent with economic recovery caused cash and implied futures rates to firm. This firming continued with further encouraging data on unemployment and retail sales and the small but unexpected rise in retail price inflation in February. Nevertheless, in the absence of any stimulus to activity in the Budget, there was still some belief that interest rates would fall further, particularly if sterling benefited from the substantial movement in German rates expected in due course.

In the foreign exchange market the Budget was generally well received and sterling found ready market demand above DM 2.40. Further encouraging data, including the recorded fall in unemployment in February, helped sterling to rise—to DM 2.43 at the end of March—having breached a significant resistance point against the dollar at $1.50.

Money-market assistance[a] and the Bank's bill holdings



(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.

The cash position of the money market

The success of gilt funding operations in the first nine months of 1992/93 meant that the public sector was £5.9 billion overfunded at the end of December (including the overfund carried forward from previous years). Moreover, the banks and building societies (then outside the funding sector) had bought gilts worth £3.1 billion (excluding repos). This caused the stock of money-market assistance to stand at £12.5 billion at the end of December. There was a further drain on money-market liquidity and so a rise in the Bank's bill holdings in January when the CGBR was in surplus, and there were substantial official gilt sales, again both to the funding sector and to banks and building societies. The stock of assistance did not fall significantly until mid-March, when heavy government expenditure resulted in a large within-month underfund.

Temporary facilities offered to banks, building societies and gilt-edged market-makers (GEMMs) in September to reduce the drain on private sector holdings of bills which would otherwise have resulted from official foreign exchange intervention, reduced by around £3 billion the amount of assistance in the form of bills held by the Bank. These facilities were reoffered on 1 February and 8 March and renewed, in smaller amounts. As the rest of the assistance matured it contributed to already large daily money-market shortages. By lengthening the maturity of repos offered, the Bank was able to reduce the immediate contribution of maturing assistance to daily shortages. Two bill repos were exceptionally offered on 5 January, the shorter for four weeks and the longer not maturing until 1 March.

Table B
Influences on the cash position of the money market

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

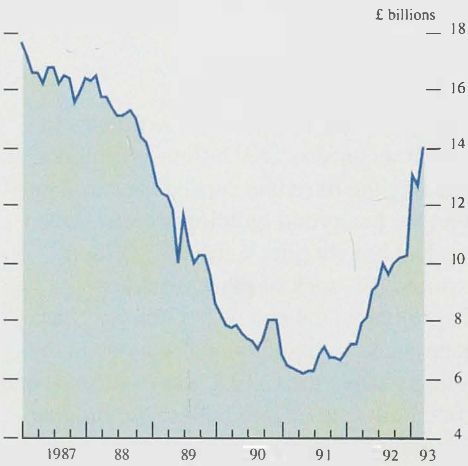
	1993 Jan.	Feb.	Mar.	1992/93
Factors affecting the market's cash position				
Under/overfunding (+/-)	-4.1	+1.7	+9.3	+1.5
Central government net debt sales to banks and building societies(a)(b)(-)	-2.9	+0.4	-1.3	-6.7
Other public sector net borrowing from banks and building societies(-)	+0.4	-0.2	-2.0	-1.9
of which, local authorities' deposits with banks and building societies(+)	+0.4	+0.1	-1.4	+0.5
Currency circulation(-)	+1.6	—	+0.5	-0.9
Other	+0.8	—	—	+2.0
Total	**-4.3**	**+1.8**	**+6.5**	**-6.0**
Increase (+) in the stock of assistance	+3.7	-1.4	-6.3	+1.9
Increase (-) in £ Treasury bills outstanding (c)	+0.6	-0.3	-0.2	+4.2
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) Other than those held outright by the Bank and government accounts but including those purchased by the Bank on a repurchase basis.

The Bank's holdings of bank bills peaked at £12.1 billion early in February. As in the fourth quarter, the frequency of large shortages and the ensuing demand for bills in money-market operations caused their price to rise, making borrowing by drawing bills more attractive relative to borrowing on interbank related terms. The size of the eligible bank bill market therefore grew to a peak of substantially over £23 billion in mid-February. On 29 January a large amount of maturing bills contributed to a large shortage of £2.4 billion. When it became apparent that new bills drawn that morning were largely of one month's maturity the Bank offered two repos, the shorter for only two weeks, in order to facilitate their sale to the Bank and to ease pressure on short interbank rates. But the shortage proved to be awkwardly placed outside the core of the sterling money market and overnight interbank rates traded as high as 100% before the shortage was relieved. On 26 February maturing assistance of more than £2.4 billion contributed to a forecast shortage of £2.9 billion, but on this occasion expectations of an interest rate cut had diminished and banks were well positioned so that the shortage was relieved relatively easily through bill operations.

As exchequer flows to the market increased in March, so shortages diminished. On 8 March a surplus was forecast and was mopped up by the sale of Treasury bills for the first time since April 1990.

Banks' and building societies' holdings of gilt-edged stocks(a)



(a) Including stock sold to the Bank under sale and repurchase agreements.

Gilt funding operations

By the end of December a within-year overfund of £5.4 billion had been achieved, which included the residual effect of the fall in underlying foreign exchange reserves in September. But further gilt sales were required on the basis of the Autumn Statement forecast of the PSBR of £37 billion, which implied a PSBR of some £11 billion between January and March. As the quarter progressed the extent of banks' and building societies' purchases of gilts became apparent; this increased the amount of gilts to be sold to the funding sector by £4 billion in the January-March period. It was therefore necessary to continue with the auction programme as well as tap sales.

The pattern of market demand during the quarter was such that, in addition to the auction, packages of tranchettes covering a range of maturities were often more easily absorbed than tranches of a single stock. During the quarter the Bank sold tranchettes worth £4.2 billion (nominal).

An auction was held on 27 January of £2,500 million of 8½% Treasury 2007 which was intended to increase the size and

Table C
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
2½% Index-Linked 2009	150	27. 1.93	27. 1.93	To Bank	147.1250	In full	3.69 (b)	3.67 (b)	1. 2.93
2½% Index-Linked 2001	100	27. 1.93	27. 1.93	To Bank	162.6875	In full	3.29 (b)	3.30 (b)	28. 1.93
8% Treasury 2003	300	27. 1.93	27. 1.93	To Bank	24.4375	Partly paid (c)	8.08	8.06	28. 1.93
8½% Treasury 2007 'B'	2,500	19. 1.93	28. 1.93	Auction	97.7500 (d)	Partly paid (e)	8.78 (f)	8.78	28. 1.93
2½% Index-Linked 2024	150	1. 2.93	1. 2.93	To Bank	105.4375	In full	3.82 (b)	3.82 (b)	4. 2.93
2% Index-Linked 1996	100	1. 2.93	1. 2.93	To Bank	197.6875	In full	2.30 (b)	2.29 (b)	4. 2.93
10% Treasury 2001	200	1. 2.93	1. 2.93	To Bank	112.8750	In full	7.82	7.80	3. 2.93
9¾% Exchequer 1998	300	1. 2.93	1. 2.93	To Bank	111.7500	In full	6.91	6.87	3. 2.93
9% Treasury 2012	250	12. 2.93	12. 2.93	To Bank	103.5000	In full	8.63	8.59	15. 2.93
3½% Funding 1999–2004	50	12. 2.93	12. 2.93	To Bank	71.5000	In full	7.20	7.18	15. 2.93
8% Treasury 2003	300	12. 2.93	12. 2.93	To Bank	25.7500	Partly paid (g)	7.89	7.87	15. 2.93
9% Conversion 2000	200	12. 2.93	12. 2.93	To Bank	109.0625	In full	7.32	7.30	15. 2.93
4⅛% Index-Linked 2030	150	16. 2.93	16. 2.93	To Bank	107.8750	In full	3.69 (b)	3.69 (b)	24. 2.93
9% Conversion 2011 'C'	1,200	16. 2.93	16. 2.93	To Bank	15.0000	Partly paid (h)	8.51	8.47	24. 2.93
9% Conversion 2011 'C'	150	16. 2.93	16. 2.93	To CRND					
2½% Index-Linked 2013	100	1. 3.93	1. 3.93	To Bank	128.4375	In full	3.51 (b)	3.51 (b)	10. 3.93
8¾% Treasury 2017	250	1. 3.93	1. 3.93	To Bank	103.2500	In full	8.44	8.42	3. 3.93
9¾% Treasury 2002	100	1. 3.93	1. 3.93	To CRND					
9¾% Treasury 2002	250	1. 3.93	1. 3.93	To Bank	113.3750	In full	7.74	7.74	3. 3.93
7¼% Treasury 1998	400	1. 3.93	1. 3.93	To Bank	102.8125	In full	6.59	6.56	5. 3.93
9½% Conversion 2004	100	8. 3.93	8. 3.93	To CRND					
9½% Conversion 2004	300	8. 3.93	8. 3.93	To Bank	112.2500	In full	7.87	7.87	10. 3.93
9% Conversion 2000	100	8. 3.93	8. 3.93	To CRND					
9% Conversion 2000	300	8. 3.93	8. 3.93	To Bank	110.8438	In full	7.00		31. 3.93
6¾% Treasury 1995–98	100	8. 3.93	8. 3.93	To Bank	100.8125	In full	6.34	6.31	9. 3.93
2½% Index-Linked 2016	100	17. 3.93	17. 3.93	To Bank	137.6875	In full	3.54 (b)	3.53 (b)	18. 3.93
2½% Index-Linked 2003	150	17. 3.93	17. 3.93	To Bank	163.5000	In full	2.99 (b)		On tap(i)

(a) Gross redemption yield, per cent.
(b) Real rate of return, assuming 5% inflation.
(c) With £24.4375% payable on issue, £25% on 15 February and balance on 5 April.
(d) Lowest accepted price for competitive bids. The non-competitive allotment price was £97.96875%.
(e) With £37.75% payable on issue, £30% on 22 February and balance on 15 April.
(f) Yield at lowest accepted price for competitive bids.
(g) With £25.75% payable on issue, £25% on 15 February and balance on 5 April.
(h) With £15% payable on issue, £35% on 11 March and balance on 4 May.
(i) On 6 May.

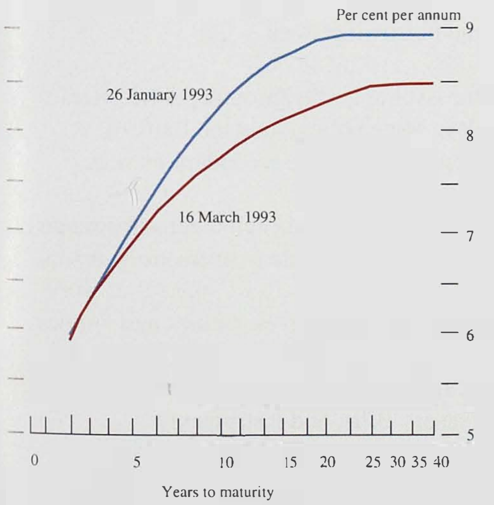
Table D
Official transactions in gilt-edged stocks

£ billions: *not seasonally adjusted*

	1992/93 Apr.-Dec.	Jan.	Feb.	Mar.
Gross official sales (+)(a)	+25.6	+4.0	+4.3	+2.8
Redemptions and net official purchases of stock within a year of maturity(-)	-5.5	-0.7	-1.0	—
Net official sales (b)	+20.1	+3.3	+3.3	+2.8
of which, net purchases by:				
Non-funding sector	+3.0	+2.9	-0.4	+1.3
Banks (b)	+1.9	+2.5	-0.1	+1.0
Building societies (b)	+1.1	+0.4	-0.2	+0.3
Funding sector	+17.1	+0.4	+3.7	+1.5
Overseas sector	+0.5	-0.1	+1.0	+1.1
M4 private sector (b)	+16.6	+0.5	+2.6	+0.3

(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.

therefore the liquidity of the stock, and make it the largest deliverable into the futures contract under the new 10–15 year contract specification. The final call was put into April because the funding position for the current financial year at that stage appeared comfortable. The rate cut the day before the auction caused a sharp upward movement in prices which meant that GEMMs had to bid in the auction at prices higher than that at which they had sold the stock in when-issued trading. Uncertainty after the cut also reduced the market's appetite for the stock, so that the tail (the difference between the highest and average accepted yield) was the largest on record, at three basis points, and the cover, at 1.18, was the lowest for five years. Retail interest, as reflected by the number of non-competitive bids, remained strong with bids worth £2.7 million.

Substantial tap sales of conventional stocks were made both as hopes of a cut in interest rates were raised by weak activity and inflation data released in mid-January and after the reduction of interest rates on 26 January. Index-linked stocks met with demand, partly on increased inflation concerns following the rate cut and sterling's sharp depreciation.

The lower than expected outturn for RPI inflation in January and the larger than expected public sector debt repayment in January were announced in February and assuaged some market concerns about both inflation and the scale of funding, enabling the issue and rapid exhaustion of a further £800 million package of conventional tranchettes in mid-February and the issue of a tranche of long-dated stock. Payments on the tranche were spread into May. A £1 billion package of tranchettes of a range of maturities was issued on 1 March and enough was sold to enable the issue of a further £700 million package on 8 March, £400 million of which was exhausted that week. Thereafter the market lost momentum as the Budget approached.

The PSBR forecast for 1992/93 was revised in the Budget to £35 billion, compared with £37 billion in the Autumn Statement. This, and the change to the funding sector (see the note on page 211) encouraged the market, but it was set back by the PSBR forecast for 1993/94, of £50 billion, which was at the upper end of market expectations. In these circumstances it was not appropriate to issue stock immediately after the Budget.

The announcement of an auction to be held on 31 March (but with payment in the new financial year) provided a focus for the market. The stock was a new current-coupon 20-year stock which took advantage of historically low yields at that maturity. At £3 billion it was the biggest auction to date but in the event was very successful, being covered 1.96 times and with no tail. The market was encouraged by this result, especially by the good cover despite the auction's size. This enabled the issue the same afternoon of a further £600 million tranchette of the 10-year benchmark stock which was sold out the next day.

Guides to Gilts

The Bank of England has published two guides to gilts and the gilt market.

Investing in Gilts: A guide for the small investor

This booklet provides basic information about gilts for the small investor. It explains:

- What gilts are.
- What gilts prices mean, and why they change.
- The yield which investors receive on gilts.
- How index-linked gilts work.
- How stocks may be bought and sold, both through the Bank of England when a gilt is issued by the Government and offered to the general public, and in the market.
- The service offered by the National Savings Stock Register.
- Taxation arrangements.
- The service provided by the Bank of England Registrar's Department.

Some useful addresses are provided at the end.

To help new investors unfamiliar with gilts, the booklet is illustrated with pictures of the stock certificate which an investor receives after buying a stock, the dividend warrant and tax voucher which are received when interest is paid on a gilt, and the application form which should be completed by an investor wishing to buy gilts at an auction.

British Government Securities: The Market in Gilt-Edged Securities

This publication has been written for those with a professional interest in gilts, whether as investors or as participants in the market. The following areas are covered:

- The principal players in the gilt market and the current regulatory and supervisory arrangements.
- The different types of gilts available.
- Gilt prices and yields, including accrued and rebate interest, partly paid stocks and index-linked stocks.
- Buying and selling gilts in the market.
- Settlement and registration, including the Central Gilts Office (CGO), the Bank of England Registrar's Department and the National Savings Stock Register.
- Lending and borrowing stock.
- Methods for issuing stocks through public offers and tap sales; issue policy; and the Bank of England's operations in the secondary market.
- The taxation of income and capital gains from gilts, and the exemptions available to overseas investors.
- The markets in gilt derivatives: futures and options.
- Other UK Government issues which are marketable: sterling Treasury Bills, and instruments denominated in ECU and foreign currencies.

The appendices include lists of the gilt-edged market-makers and Stock Exchange money brokers, inter-dealer brokers, the settlement banks for the Central Gilts and Moneymarkets Office and the CGO members offering custody services; further details on double taxation agreements between the United Kingdom and foreign countries; sources for further information on futures and options, gilts prices, gilt issues, and the Bank of England's gilt operations; and a short bibliography of relevant official publications. A glossary defines many of the terms used in the gilt market, and finally a list is provided of amounts outstanding of each available stock and their prices and yields at the end of March 1993.

Obtaining the booklets

'Investing in Gilts: A guide for the small investor' may be obtained free from the Bank of England, PO Box 96, Gloucester, GL1 1YB, or by calling Freephone 0800 616814.

'British Government Securities: The Market in Gilt-Edged Securities' may be obtained free by writing to the Bank of England at the Gloucester address.

Funding

Funding policy determines how the public sector manages its debt. When there is a public sector deficit it determines how it will be financed.

Policy has evolved over a number of years. In the 1960s neither interest rate nor credit policy was the dominant consideration. But in the 1970s when broad money targets were adopted the relationship between broad money and the finance of the public sector gained particular importance. Funding policy came to support the use of short-term interest rates in the pursuit of the government's inflation objective.

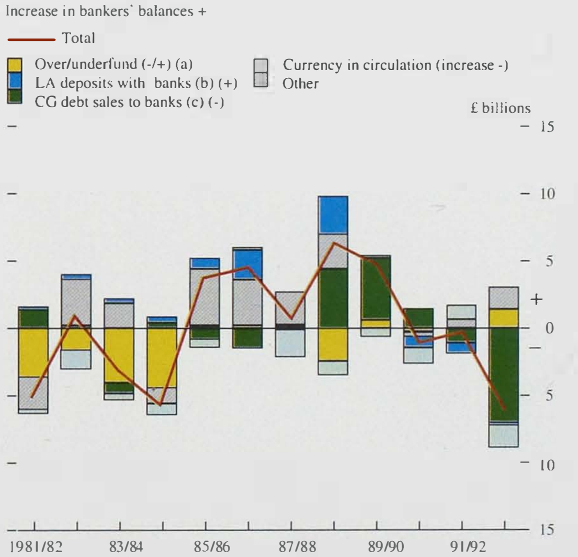
Broad money is related in an accounting sense to the finance of the public sector in the counterparts presentation of money. This relates broad money (liabilities of the banking system) to the assets of the banking system,(1) which include, as well as sterling lending to the private sector, banks' claims on the public sector. This public sector 'contribution' reflects in turn the PSBR plus the change in the foreign exchange reserves, less net debt sales to non-banks; other things being equal, the more the public sector deficit is funded by debt sales to non-banks, the lower is government borrowing from banks and the lower the level of private sector deposits with banks and so of broad money. But the relationship is complicated when other things are not equal; if, for example, the public sector makes a positive contribution then there will be a flow of funds to the private sector which may be held on deposit and so increase M4. But this may be used to reduce the private sector's borrowing and so may be reflected in another counterpart to money, rather than in money itself.

When private sector demand for credit grew very rapidly in the early 1980s funding assisted pursuit of the broad money target. At times more debt was sold than was necessary to fund the public sector deficit. This process of 'overfunding' left the public sector with a cash surplus and the banking sector with a cash shortage which was reconciled in the Bank's money-market operations by purchases of the banks' more liquid assets, namely eligible bills. One consequence was increased daily shortages in the money market when bills held by the Bank matured; this at times created problems in the conduct of money-market operations. Another consequence was continuing tightness in the liquidity of the banking system, even though there was scope for the supply of eligible bills to respond to changes in their relative price when demand for them was heavy.

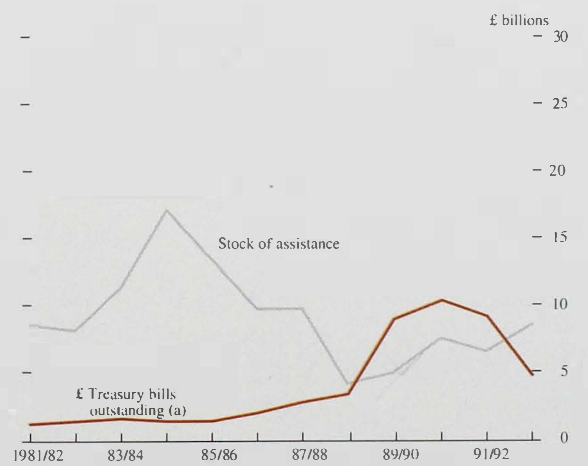
By the mid-1980s the unpredictability of the relationship between broad money and nominal income led broad money targets to be abandoned. So the targeting process could no longer determine the desired quantity of funding. A replacement was found in the full fund policy, adopted in 1985. The policy—adopted at a time when private sector credit demand remained strong—was to avoid the finance of the public sector 'contributing' (in terms of the broad money counterparts identity) an additional expansionary influence on private sector liquidity, by ensuring that debt sales to non-banks fully offset the total of the PSBR, any underlying increase in the foreign exchange reserves, and maturing debt. But the precise definition of the policy has been kept under regular review, and there have been some, largely technical, changes in its formulation.

From mid-1990 there was a sustained decline in the growth of broad money, as private sector demand for credit declined. As a result monetary conditions were very

Factors affecting the cash position of the money market



(a) Until 1987/88 defined in terms of non-bank funding sector; thereafter the non-bank and non-building society funding sector.
(b) Includes building societies from 1988/89.
(c) Excluding sterling Treasury bills and excluding repurchase transactions with the Bank.



(a) Other than those held outright by the Bank and government accounts but including those purchased by the Bank on a repurchase basis. End-period level.

(1) The word 'banks' is used generically. Until 1988 it refers to M3 institutions only. From 1989 it refers to the M4 institutions, namely banks and building societies.

different by the end of 1992 from those prevailing when the full fund policy was adopted. But the automatic stabiliser of a large and growing PSBR did not result in a large public sector 'contribution' to private sector liquidity, such as might have compensated in part for the weakening contribution of private sector borrowing, because funding policy meant that the prospective 'contribution' was almost wholly offset by additional debt sales. Moreover, banks and building societies began to add significantly to their gilt holdings—particularly in the first quarter of 1993—which had an expansionary impact on the stock of money-market assistance.

The intention to retain the full fund policy was confirmed in the Budget this year but with banks' and building societies' purchases of gilts no longer excluded from counting as funding. While they are net buyers of gilts the public sector will make a positive contribution to private sector liquidity by reducing the total of gilts sales to non-banks. When they are net sellers, more official sales will be required. The pattern of debt sales may therefore differ over the lending cycle, restraining the growth of liquidity when it is fast but increasing it when it is weak; but the total amount will be unchanged unless there is a trend in banks' and building societies' holdings.

Purchases of gilts made by banks and building societies in 1992/93, which totalled £6.8 billion, will be taken into account in implementing funding policy over the next two to three years.