Operation of monetary policy

This article covers the period from July to September 1993.

Introduction

It was judged appropriate to leave official interest rates unchanged during the third quarter, given the evidence on prospects for price inflation and with the recovery in activity continuing and apparently becoming more broadly based. The central projections in the Bank's August *Inflation Report* envisaged inflation staying within its target range in the first quarter of 1994—when pre-announced indirect tax increases are due to take effect—although getting closer to the top of the range. No early progress towards the lower half of the target range was projected. In the meantime, the Bank maintained a close watch on indicators of prices, activity and monetary growth, as well as on the exchange rate.

Domestic economy

Although the twelve-month growth rate of the Retail Price Index excluding mortgage interest payments (RPIX) was slightly higher in July and August than projected in the August *Inflation Report's* central forecast, it was well within the indicated range. But the August RPI data showed that post-sale price rises were larger than expected, so some increase in underlying inflation could not be ruled out.

The growth of M0 remained above its 0%–4% monitoring range between July and September, but appeared more consistent than in previous quarters with the growth in the value of retail sales and with the expected effect of lower interest rates in reducing the opportunity cost of holding cash balances. The growth of broad money, by contrast, remained close to the bottom of its monitoring range. This was consistent with disintermediation by savers into higher-yielding assets and by corporate borrowers into capital markets, although net sterling capital market issues by UK borrowers, at £5.9 billion, were a third less than in the previous quarter. Lending to households remained largely for house purchase, which picked up in line with activity in the housing market.

Other price and cost developments did not show any signs of an early increase in pressure on retail prices. It seemed that the effect of sterling's depreciation on import prices might largely have run its course, and the trade data suggested that the increase in import prices may not in any case have been as great as once supposed. (The *Inflation Report* gives greater detail.) Overseas, the inflation outlook was benign and commodity price pressures were weak.

Output grew by 0.6% in the second quarter, after 0.5% in the first quarter; this was thought to be broadly in line with the growth of capacity in the economy. After the substantial labour-shedding in the fourth quarter of 1992, the growth in output was enough to tighten labour market conditions a little, but unemployment nevertheless rose slightly in July and August. There were some signs by the end of the quarter that the gradual fall in pay settlements might be coming to an end. But there was also some expectation that upward pressure on settlements might be subdued because of the high proportion of the increase in employment accounted for by part-time workers.

The production and retail sales data which were published in July (relating to May and June respectively) showed rather larger increases than had been expected. Some of the increases, however, were thought likely to prove temporary. That explanation seemed to be confirmed by the following month's data, which indicated that the pace of recovery remained moderate. When the second quarter GDP data were released, they showed that domestic demand continued to be driven by growth in consumer expenditure, financed by another sharp fall in the savings ratio. The main source of growth of retail sales continued to be sales of household goods, with other items apparently sensitive from month to month to price discounts.

The external trade position was difficult to gauge, particularly in the absence of monthly data on trade with other EC countries. Net external trade was estimated to have made a positive contribution to growth after sterling's membership of the ERM was suspended. In the second quarter this was wholly attributed to a decline in imports which was difficult to explain; it may have been that import volumes had been underestimated (by more than export volumes) and import prices overestimated since the new collection methods for EC trade data were introduced. The outlook for exports and GDP depended quite heavily on domestic demand in continental Europe and on the exchange rate; and when sterling appreciated in July, market concern about the effect on exports led to increased expectations of a reduction in domestic interest rates. Nevertheless, the Bank's Agents reported that dollar markets continued to be a source of growth, with UK products much more competitive than a year earlier.

Foreign exchange markets

In the foreign exchange market sterling remained relatively steady in effective terms, with depreciation against the Deutsche Mark largely offset by appreciation against the dollar. This reflected the lack of domestic economic news over the summer to alter the market's view that a modest recovery was under way, although in September sterling proved susceptible to domestic political uncertainties.

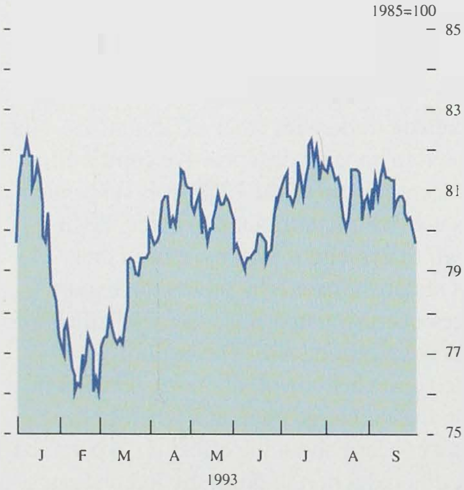
Both sterling and the dollar appreciated in July as tensions built up again within the ERM. Substantially lower short-term interest rates were expected, either led by an easing of German interest rates, or following the decoupling of the other currencies from the Deutsche Mark. On the other hand, the economic data in the United Kingdom, although not uniform, encouraged expectations of sustained growth with low inflation, and bore out official statements that interest rate cuts elsewhere in Europe were unlikely to be followed in the United Kingdom. Nevertheless, as sterling appreciated both against the Deutsche Mark and in effective terms towards the end of July, concern about export orders voiced by the CBI led to some market expectations of a further interest rate cut.

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

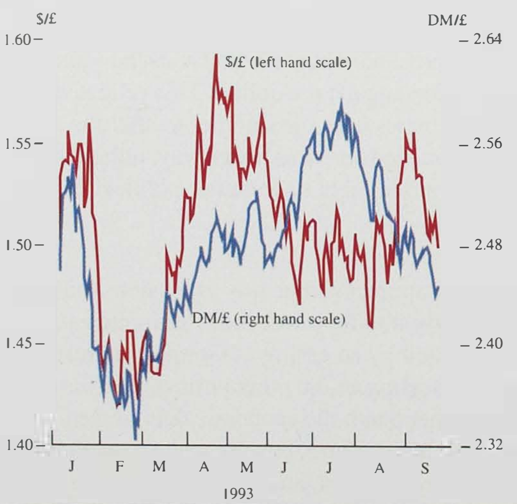
1993	Interest rates (per cent per annum): Sterling interbank rates(c): 1 month	3 months	6 months	12 months	Short sterling future (d): 3 months	Gilt yields (b) (per cent per annum): Conventionals: Short	Medium	Long	Index-Linked: Long	Exchange rates: ERI	$/£	DM/£
1 July	$5\frac{29}{32}$	$5\frac{29}{32}$	$5\frac{27}{32}$	$5\frac{27}{32}$	5.79	6.80	7.64	8.11	3.57	80.9	1.5077	2.5563
30 July	$5\frac{31}{32}$	$5\frac{7}{8}$	$5\frac{11}{16}$	$5\frac{19}{32}$	5.55	6.52	7.30	7.81	3.45	81.5	1.4810	2.5792
13 August	$5\frac{15}{16}$	$5\frac{7}{8}$	$5\frac{21}{32}$	$5\frac{17}{32}$	5.71	6.27	6.84	7.36	3.35	80.0	1.4582	2.4986
15 September	$5\frac{29}{32}$	$5\frac{29}{32}$	$5\frac{27}{32}$	$5\frac{27}{32}$	5.80	6.48	7.07	7.43	3.23	81.2	1.5547	2.4715
30 September	$6\frac{1}{16}$	$5\frac{31}{32}$	$5\frac{27}{32}$	$5\frac{3}{4}$	5.65	6.33	6.89	7.28	3.20	79.7	1.4982	2.4443

(a) Close of business rates in London.
(b) Gross redemption yield. Representative stocks: short—$7\frac{1}{4}$% Treasury 1998; medium—8% Treasury 2003; long—8% Treasury 2013; index-linked—$2\frac{1}{2}$% Index-Linked Treasury 2016 (real yield assuming 5% inflation).
(c) Middle-market rates.
(d) Implied future rate: until 13 August, the September contract, thereafter the December contract.

Sterling effective index



Sterling exchange rates



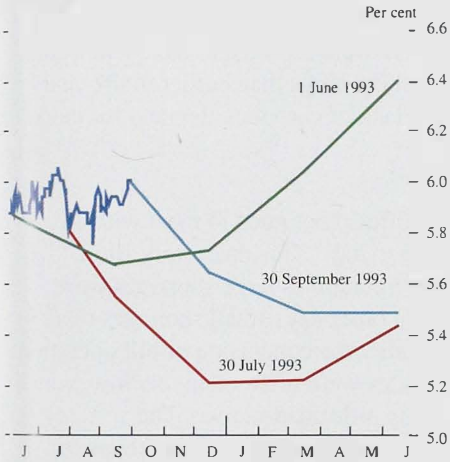
As pressures mounted in the ERM, attention was focused on publication of weaker than expected French GDP and unemployment data and the reduction of French short-term interbank rates below those in Germany. These led the market to conclude that the authorities in France and in some other ERM member nations wanted to reduce interest rates more rapidly than seemed likely in Germany, in order to stimulate domestic activity. As selling pressure mounted, attention therefore focused on the Bundesbank council meeting in the final week of July at which a cut of at least 25 basis points in the discount rate was widely expected. However, only the Lombard rate was reduced, by 50 basis points, while the discount and repo rates were left unchanged; the market did not think that this was enough to resolve the policy tensions within the ERM. Selling pressure became intense, and precipitated substantial rises in French and other official interest rates and heavy official intervention in support of the weaker ERM currencies. In the early hours of 2 August, EC Finance Ministers agreed to increase the width of the ERM bands to 15% about existing central rates. The Deutsche Bundesbank and the Nederlandsche Bank agreed separately to keep the bilateral exchange rate between the Deutsche Mark and the Dutch guilder within the existing $2\frac{1}{4}$% fluctuation band.

As uncertainty surrounding the ERM currencies subsided, the attractions of sterling and the dollar as safe havens diminished; these currencies weakened as market expectations grew of large repurchases of Deutsche Marks by European central banks to repay short-term liabilities and to rebuild official currency reserves, and as markets concluded that German rates would now be slow to fall. Moreover, the authorities in other ERM countries proved cautious in reducing interest rates below pre-crisis levels. Sterling therefore softened against the stronger Deutsche Mark and was weakened further by the release of UK data in September—which dented slightly the market's optimism about the prospects for growth with low inflation—and by the onset of the party conference season.

Official money-market operations

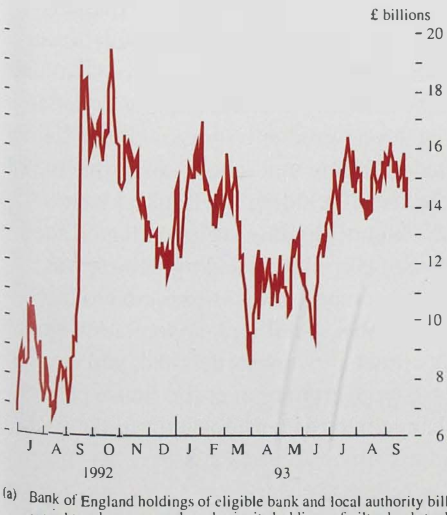
Although official interest rates remained unchanged during the quarter, money-market rates reflected the market's lingering concern about the durability of the recovery and expectations of a further downward movement in rates at some time, which would not endanger the inflation objective. But downward pressure on market rates during the quarter was not sufficiently serious to hinder the Bank's operations. The operations were accordingly largely routine

Sterling interest rate expectations[(a)]



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

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.

and were predominantly focused to the relief of daily shortages, which continued to prove stubborn on occasion.

Given the market's concern about the recovery, market rates were sensitive to any signs that it might be faltering, or that the exchange rate might appreciate to levels which threatened export orders and their contribution to the recovery. But at the beginning of the quarter, in the absence of such signs, a rate cut was perceived to be some time distant. Expectations of a near-term cut were further reduced by the stronger than expected activity data published in July (albeit distorted by unusual seasonal factors), despite weaker than expected price inflation and no signs of labour market pressure on costs. But sterling's appreciation at the end of July, together with concern about export orders voiced by the CBI and subsequent media comment, substantially increased the expectation that there would be a near-term cut in interest rates, if sterling appreciated strongly after the expected change to the ERM operating rules. Expectations reached a peak on 2 August, immediately after the ERM bands were widened. The Bank offered some resistance in its early round of money-market operations and, as interest rates were not immediately reduced on the Continent, so domestic market rates firmed again. As it became apparent that official interest rates in ERM member countries would not fall rapidly and that German rates would fall less quickly than previously expected, sterling lost ground to the ERM currencies. As a result, expectations of any cut before the fourth quarter evaporated.

There was nothing in the batch of economic data released in August to suggest recovery was faltering, and market rates firmed after the Chancellor was reported to be content with the prevailing level of interest rates. The CBI monthly trends report also indicated increased domestic orders and suggested that recovery might have become less reliant on the contribution of external trade. Consequently, the probability attached by the futures market to a fall in rates diminished and the expected trough in rates was pushed further away—to March rather than December.

By the end of September, the markets were not ruling out a rate cut to accompany fiscal tightening in the Budget, but thought that it was more likely to occur after the New Year. Although the higher than expected RPI data caused market rates to firm, other price and cost developments generally were thought to leave scope for a further reduction of official rates in due course, especially as activity data increased concern about the strength of recovery. Rumours in the foreign exchange market of an official rate cut during the party conferences were given little credence in domestic markets, particularly as sterling was weakened by the rumours.

Technical conditions in the money market remained difficult during the quarter. Overfunding early in July meant that the stock of assistance rose rapidly to nearly £16 billion. Although the funding position was broadly flat in August and September, other factors affecting bankers' balances (including a fall in the note circulation) meant that the stock of assistance fell to about £14 billion. The Bank re-offered the temporary facilities for the sale and repurchase by banks, gilt-edged market-makers and the ten largest building societies, of gilts and export and shipbuilding credit-related paper. And on 8 September their maturity was shortened to one month in order to make them more flexible for those who did not wish to tie up gilt collateral for a long period.

Table B
Influences on the cash position of the money market

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

	1993/94			
	Apr.-June	July	Aug.	Sept.
Factors affecting the market's cash position				
Under/overfunding (+/-)(a)	-3.8	-2.9	-0.2	-0.1
Other public sector net borrowing from banks and building societies (-)(b)	-0.2	-0.3	+0.9	+0.4
of which, local authorities' deposits with banks and building societies(+)	—	—	+0.7	+0.4
Currency circulation(-)	-0.5	-1.2	+0.6	+0.3
Other	-0.7	+2.2	-0.1	—
Total	**-5.2**	**-2.2**	**+1.2**	**+0.7**
Increase (+) in the stock of assistance	+4.9	+2.6	-1.5	-0.4
Increase (-) in £ Treasury bills outstanding (c)	+0.2	—	+0.2	-0.2
Increase in bankers' balances at the Bank	-0.2	+0.3	-0.1	—

(a) From 1993/94 central government net debt sales to banks and building societies are included in funding.
(b) From 1993/94 banks' and building societies' transactions in local authorities' and public corporations' listed sterling stocks and bonds are included in funding.
(c) Other than those held outright by the Bank and government accounts but including those purchased by the Bank on a repurchase basis.

Gross official sales of gilt-edged stock

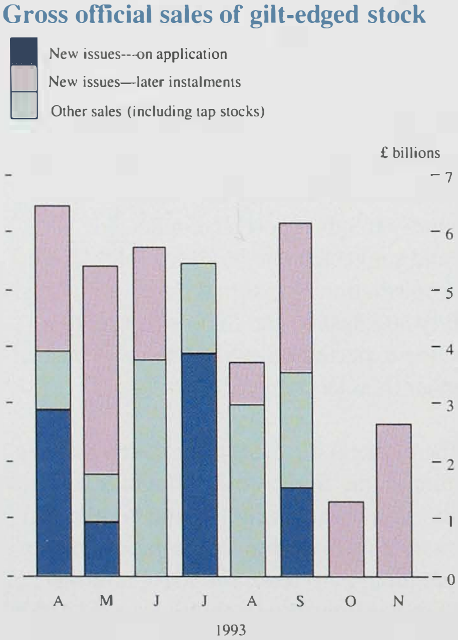


Table C
Official transactions in gilt-edged stocks

£ billions: *not seasonally adjusted*

	1993/94			
	Apr.-June	July	Aug.	Sept.
Gross official sales (+)(a)	+17.6	+5.4	+3.7	+6.1
Redemptions and net official purchases of stock within a year of maturity(-)	-0.9	-1.0	-0.1	-0.5
Net official sales(b)	+16.7	+4.4	+3.7	+5.6
of which, net purchases by:				
Banks(b)	+2.0	—	-0.2	+0.9
Building societies(b)	+0.6	-0.3	+0.2	+0.3
Overseas sector	+4.3	+1.9	+1.4	+0.8
M4 private sector(b)	+9.8	+2.9	+2.3	+3.5

(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.

Large daily shortages were nevertheless common as assistance provided through daily bill operations matured. This, combined with a further shrinking of the bill market in August, made operating conditions difficult on occasion. Despite bills offering cheaper funds than money-market related borrowing facilities, some corporate borrowers may have wished to guard against the possibility of a base rate cut by borrowing at a floating, rather than fixed, rate, while some acceptors were reported to have required higher commission rates on bill drawings than earlier in the year. There also remained a general lack of corporate demand for bank finance.

The Bank's invitation of bills offers continued to meet with an inconsistent response from day to day. This made very short interbank rates unpredictable. Sometimes large shortages were relieved early in the day, but on other days small shortages were only fully relieved by lending after the conclusion of bill operations. On such occasions overnight rates were often relatively low, which made the sale of higher-yielding bills unattractive. The concentration of the shortage outside the discount market also continued to make the pattern of operations uncertain on occasion.

The Treasury bill tenders had been reduced to £100 million of 91 and 182-day bills in September 1992, and therefore could not be used as a further means of reducing the drain on the money market. On 13 August, the 182-day tender was suspended and the amount of 91-day bills on offer increased to £200 million to take advantage of greater liquidity at that maturity.

Gilt-edged funding

After the first three months of the financial year, gross official gilt sales of £17.6 billion had been made. Further sales of £18.7 billion were secured during the quarter, with future calls spread as far ahead as November in order to moderate the effect of overfunding on the stock of money-market assistance.

Market conditions during the quarter were propitious for funding, as gilts shared in the substantial rally in government bond markets worldwide. Conventional gilts benefited from successively lower than expected retail price inflation in the second quarter. Combined with evidence that the effect of sterling's depreciation was not as great as anticipated, and that strong productivity growth and falling earnings growth had resulted in falling unit labour costs, this meant that short-term inflation forecasts (including the Bank's) were revised downwards. The amount of funding secured allayed some market fears about the funding task, while fiscal tightening was anticipated in the Budget in November and was expected to be accompanied by lower interest rates. Sterling's appreciation against the ERM currencies in July attracted overseas demand, and sterling assets generally benefited from uncertainty over the future path of European interest and exchange rates as tensions built in the ERM towards the end of July.

The Bank took the opportunity to tap this demand in order to advance the funding programme, but also sought to manage the new supply so that it did not prevent an orderly decline in yields. It was therefore appropriate in July to maintain the established pattern of end-month auctions. The size was maintained at £3.25 billion, but

Table D
Issues of gilt-edged stock

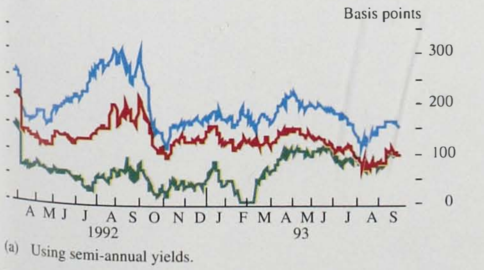
Stock	Amount issued (£ millions)	Date announced	Date issued	Method of issue	Price at issue (per £100 stock)	Details of payment	Yield (a) at issue	Yield (a) when exhausted	Date exhausted
2½% Index-Linked 2024	150	2. 7.93	2. 7.93	To Bank	111.7500	In full	3.61 (b)	3.60 (b)	13. 7.93
2½% Index-Linked 2009	150	2. 7.93	2. 7.93	To Bank	154.3750	In full	3.44 (b)	3.44 (b)	13. 7.93
4⅛% Index-Linked 2030	200	14. 7.93	14. 7.93	To Bank	113.5625	In full	3.54 (b)	3.53 (b)	28. 7.93
2½% Index-Linked 2003	100	14. 7.93	14. 7.93	To Bank	164.1250	In full	3.16 (b)	3.22 (b)	30. 7.93
7¼% Treasury 1998 'B'	900 (c)	14. 7.93	14. 7.93	To Bank	102.2500	Partly paid(d)	6.67	6.64	15. 7.93
7% Treasury 2001	3,250	20. 7.93	29. 7.93	Auction	97.1875(e)	Partly paid(f)	7.46 (g)	7.46	29. 7.93
2½% Index-Linked 2020	300	30. 7.93	30. 7.93	To Bank	137.2500	In full	3.49 (b)	3.46 (b)	3. 8.93
8% Treasury 2013	200	30. 7.93	30. 7.93	To CRND					
8% Treasury 2013	500	30. 7.93	30. 7.93	To Bank	101.8750	In full	7.81	7.74	3. 8.93
7¼% Treasury 1998 'B'	500	30. 7.93	30. 7.93	To Bank	102.8750	Partly paid(h)	6.51	6.40	3. 8.93
2½% Index-Linked 2024	200	6. 8.93	6. 8.93	To Bank	116.5625	In full	3.40 (b)	3.36 (b)	11. 8.93
7¾% Treasury 2012-2015	100	6. 8.93	6. 8.93	To Bank	101.7500	In full	7.57	7.47	9. 8.93
2½% Index-Linked 2013	200	6. 8.93	6. 8.93	To Bank	135.3750	In full	3.33 (b)	3.27 (b)	27. 8.93
8½% Treasury 2007 'C'	1,300 (i)	6. 8.93	6. 8.93	To Bank	108.5000	Partly paid(j)	7.50	7.43	11. 8.93
2½% Index-Linked 2020	400	11. 8.93	11. 8.93	To Bank	141.3125	In full	3.34 (b)	3.31 (b)	31. 8.93
8¾% Treasury 2017	200	11. 8.93	11. 8.93	To Bank	115.0938	In full	7.39	7.32	12. 8.93
7¾% Treasury 2006	200	11. 8.93	11. 8.93	To Bank	104.2188	In full	7.25	7.19	17. 8.93
8% Treasury 2003	200	11. 8.93	11. 8.93	To Bank	107.8125	In full	6.89	6.82	17. 8.93
7¼% Treasury 1998 'B'	200	11. 8.93	11. 8.93	To Bank	103.7500	Partly paid(k)	6.29	6.25	12. 8.93
8% Treasury 2009	200	27. 8.93	27. 8.93	To CRND					
8% Treasury 2009	400	27. 8.93	27. 8.93	To Bank	107.1250	In full	7.24	7.20	31. 8.93
9% Conversion 2000	200	27. 8.93	27. 8.93	To CRND					
9% Conversion 2000	400	27. 8.93	27. 8.93	To Bank	112.5938	In full	6.59	6.53	8. 9.93
2½% Index-Linked 2016	200	6. 9.93	6. 9.93	To Bank	147.1250	In full	3.27 (b)	3.26 (b)	8. 9.93
2% Index-Linked 2006	200	6. 9.93	6. 9.93	To Bank	175.5625	In full	3.04 (b)	3.04 (b)	13. 9.93
4⅛% Index-Linked 2030	250	13. 9.93	13. 9.93	To Bank	121.9375	In full	3.19 (b)	3.20 (b)	5.10.93
6¾% Treasury 2004	3,250	21.9.93	30. 9.93	Auction	97.3750 (l)	Partly paid(m)	7.09 (g)	7.09	30.9.93

(a) Gross redemption yield, per cent.
(b) Real rate of return, assuming 5% inflation.
(c) Of which 200 reserved for CRND.
(d) With £20% payable on issue. £35% on 16 August and balance on 13 September.
(e) Lowest accepted price for competitive bids. The non-competitive allotment price was £97–06%
(f) With £17–06% payable on issue, £40% on 6 September and balance on 11 October.
(g) Yield at lowest accepted price for competitive bids.
(h) With £20–20% payable on issue, £35% on 16 August and balance on 13 September.
(i) Of which 300 reserved for CRND.
(j) With £25% payable on issue, £35% on 13 September and balance on 8 November.
(k) With £21–16% payable on issue. £35% on 16 August and balance on 13 September.
(l) Lowest accepted price for competitive bids. The non-competitive allotment price was £97–20%.
(m) With £47–12% payable on issue and balance on 15 November.

with a relatively small down-payment. The auction benefited from rising tension in the ERM and was 2.29 times covered with no tail.

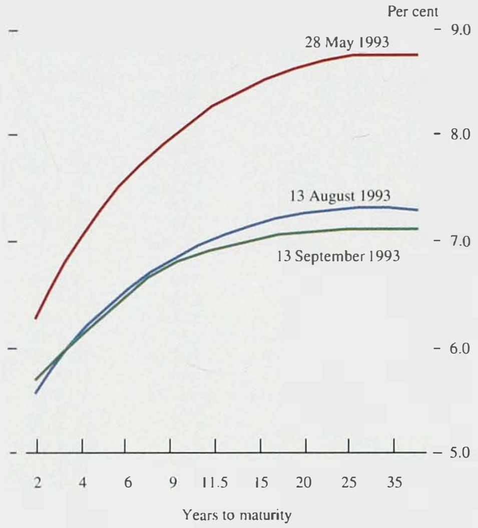
A large package of stocks issued at the end of July met strong demand as bond markets rallied following the widening of the ERM bands. The absence of any substantial reduction of interest rates among the former narrow-band countries disappointed the market, but enabled gilts to outperform both bunds and OATs. By the end of the second week of August the rally showed signs of losing momentum as confidence wavered about the sustainability of the low yields which, at 20 years' maturity, had fallen by more than 120 basis points since the end of May. On 12 August this resulted in substantial price volatility—the prices of long-dated stocks opened ¾ point higher, but at worst were two points lower—which continued the following day. Earlier in that week it had seemed likely that, despite the holiday period, an auction at the end of August might help to restrain the market and thereby prevent prices rising to a level from which a subsequent correction would make further funding difficult. But, as the rally lost momentum, the need for restraint was less and the Bank took advantage of the extent of funding so far secured to announce that there would not be an auction at the end of August. This proved to be successful in helping the market to consolidate and, although the market subsequently underperformed the French and German markets and suffered from receding expectations of a base rate cut, further tap sales were possible as the market caught up with the rally in the US market. Substantial sales of index-linked stocks were made possible by demand driven by the prospect of lower yields on the Continent.

Ten-year benchmark bond yield spreads(a)



(a) Using semi-annual yields.

Par yield curves for British government stocks



By mid-September, with no new inflation news, the rally appeared again to be waning, so presenting considerable scope for profit-taking. A fall in the market was ultimately precipitated by weakening in the US and other markets, but was exacerbated by the higher than expected rise in RPI inflation. By the end of September, however, the market had partially recovered, enabling the Bank to hold another auction at the end of September, according to the established timetable. This auction established a new current-coupon stock—the 6¾% Treasury 2004—as a ten-year benchmark for 1994.