Operation of monetary policy

- *Economic and monetary statistics released in the first quarter indicated continued moderate growth without an increase in inflationary pressures.*
- *Against this background, and re-assessing the possible impact in April of Budget measures that constituted a marked tightening of the fiscal stance, interest rates were lowered by $^1/_4$% on 8 February.*
- *The timing and size of the move surprised the markets and led to a weakening in sterling, and in the gilt-edged and equity markets. In turbulent international conditions, there were sharp falls in almost all world bond markets, but gilt yields rose more than yields elsewhere.*
- *The Bank maintained a broadly neutral stance in its official money-market operations. Technical conditions in the money markets tightened in late February and early in March, but the new repo and secured loan facilities helped to ease the strains.*

Monetary policy is based on an assessment of a wide range of indicators. The Bank's current assessment is given in the May *Inflation Report*; this article describes the operation of monetary policy in the first quarter of 1994.

It was announced on 13 April that in future the minutes of the monthly monetary meeting between the Chancellor of the Exchequer and the Governor will be published, with a delay of about six weeks; the minutes of the January, February and March meetings were published at the same time.

Overview

The first quarter revealed clearer indications of robust growth without immediate inflationary pressures in the United States (but an increased possibility of higher inflation in the longer term), falling inflation and some signs of an end to the recession in Germany, and no real evidence of recovery in Japan; against this international background, economic activity in the United Kingdom continued to recover gradually and inflationary pressures remained subdued. The quarter was also marked by turbulence in both overseas and domestic financial markets.

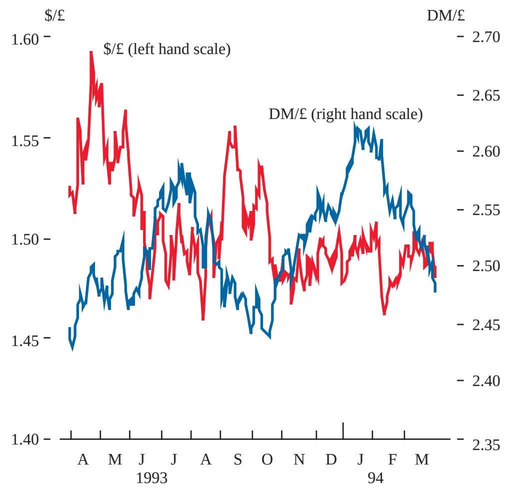
The level of UK inflation at the end of 1993 and in January 1994 was somewhat lower than expected. The underlying measure of inflation (RPIX, which excludes mortgage interest payments) rose only slightly in January, to a 12-month rate of 2.8%. The news on inflation, together with an assessment of the likely impact of the Budget measures, led the Bank to lower its forecast of inflation over the medium term published in February in the *Inflation Report*. The inflation rate in February, which was published on 23 March, was a little higher than market expectations, and there were signs of slightly higher growth in underlying earnings. External influences on inflation were mixed: the price of oil remained low during the quarter (at around $13–14 a barrel), but non-oil commodity prices rose by 6% in sterling terms when account was taken of the pattern of UK commodity imports. Both input and output price increases were contained.

Figures for economic activity suggested a continuing moderate recovery in line with the projections given in the November Budget. The statistics released in January generally confirmed the earlier indications of an improving profile of activity in the fourth quarter, though widespread concern remained that the fiscal adjustment due in April might affect confidence and restrain domestic demand. Retail sales in Q4 were 3.6% higher than a year earlier, and surveys suggested that consumers' confidence to make larger purchases was growing. Manufacturing production rose slightly compared with the third quarter, and was 2.4% higher than a year earlier. According to CBI surveys, the number of manufacturing firms operating below capacity fell between October and January. And although companies had been slow to increase investment during the recovery, there was an increase over the course of 1993, and survey evidence suggested stronger investment intentions at the beginning of this year.

M0 growth remained above its 0%–4% monitoring range during the quarter; the progressive reductions in interest rates in 1992 and 1993 had reduced the cost of holding cash in terms of interest foregone. Data around the start of the year suggested some increase in narrow money growth, but the need to adjust for sizable seasonal variations made this difficult to interpret. M4 growth also picked up over the quarter, but remained in the lower half of its monitoring range. There was weak growth in lending by banks and building societies, but some increase in mortgage demand reflected in a rise in building society commitments. In the property market, house prices fell in December and January, but picked up in February; commercial property prices showed signs of recovery.

Taking all these factors into account, no significant adjustment in the monetary stance was thought necessary. But the subdued picture on inflation at the end of 1993 and in January led the Governor and Chancellor to adopt a 'bias towards easing'. The inflation data, together with its assessment of the Budget, led the Bank to lower its medium-term inflation forecast in February, although the risks with the new forecast were judged to be greater on the upside than the downside. At their February monetary meeting, the Chancellor and Governor agreed that interest rates could be reduced slightly. On 8 February, the Bank accordingly implemented a quarter-point reduction in rates to 5¼%, setting Minimum Lending Rate at that level for the day.

Sterling exchange rates



Foreign exchange markets

Having appreciated rapidly against the Deutsche Mark over the Christmas period, the dollar began the new year strongly, largely as a result of expectations that interest rate differentials would quickly move in its favour. It soon encountered resistance, however, and traded in a range around DM 1.75 during January and early February, amid market rumours of dollar sales by European central banks. The Bundesbank's decisions to leave its official rates unchanged on 6 and 20 January and on 3 February led the markets to the view that German monetary easing was likely to take place more slowly than they had previously assumed. But underlying sentiment towards the dollar remained positive, as further evidence of the strength of the US recovery emerged—in particular, the indications of very strong GDP growth in the fourth quarter. A better-than-expected improvement in German consumer price inflation also helped the dollar against the Deutsche Mark. Against the yen, however, the dollar fell back steadily in January, as prospects of a bilateral trade deal seemed to recede.

Intra-ERM exchange rates remained broadly stable throughout the quarter, and several members were able to narrow their interest rate differentials with Germany. However, the Spanish central bank's intervention to assist a troubled financial institution temporarily reduced confidence in the peseta, and the ERM band widened briefly to around 8%.

Sterling also began the new year buoyantly, rising against both the dollar and the Deutsche Mark, and moving up from around 81.5 to around 83.0 in effective terms by mid-January. Statistics showing strong M0 growth and falling unemployment were interpreted as reducing the probability of a cut in interest rates. Sterling's appreciation gained strength as the view that official intervention might be restraining it became less widely-held. But concerns about the unsettled political environment began to weigh on sterling, and it fell quite sharply as weaker-than-expected retail sales data published on 19 January led to renewed expectations of an early interest rate cut.

Sterling effective index

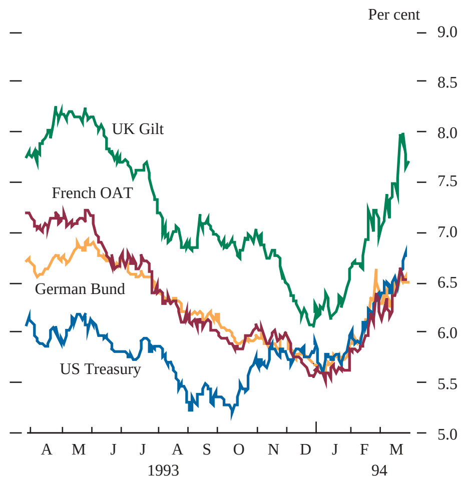
In early February, there was a rapid change in conditions in the foreign exchange markets. The timing of the 1/4% rise in the US federal funds rate on 4 February surprised the markets and the dollar rose some three pfennigs. It then met bouts of profit-taking as pessimism about the forthcoming US-Japanese trade talks grew, triggering sales of dollars against yen. When this pessimism was confirmed by the failure of the summit on 12–13 February to resolve the trade differences, the dollar fell very sharply towards ¥100, as the market anticipated unilateral US efforts to promote a stronger yen. The dollar recovered some of this ground over the following few weeks, in part as a result of rumours of intervention by the Bank of Japan.

A cut in UK interest rates had been expected by some in the foreign exchange markets before the introduction of the Budget measures in April. Even so, when rates were cut on 8 February, sterling slipped sharply against the dollar and Deutsche Mark, and its effective index fell by 1.0 to around 81. In part, this was because of the proximity of the cut to the US rate increase four days before; the cut's size and timing, given a difficult political background, encouraged expectations of a further cut in the near future. In March, the political environment grew more unsettled and, together with the release of weaker retail sales figures for February and worse-than-expected trade data, this added to sterling's softer tone. Even against a weakening dollar, sterling encountered resistance that prevented it from rising above the $1.50 level.

The dollar steadied briefly after the Bundesbank surprised markets by cutting its discount rate to 5 1/4% on 17 February. However, its decision to leave the repo rate unchanged was seen as more significant; it suggested to the markets that it would continue its cautious approach to monetary easing, and the dollar resumed its downward trend. The markets were unsettled and volatile throughout this period, however, judging that the rise in US interest rates showed US inflationary pressures to be more serious than previously thought.

The markets' view of the Bundesbank's caution seemed to be confirmed by its series of modest cuts in the repo rate in the first

Ten-year government bond yields(a)



(a) Gross redemption yield.

half of March and its decision on 17 March to leave official interest rates unchanged. But when the Federal Reserve effected a further $^1/_4$% increase in the federal funds rate on 22 March, the move steadied the exchanges, though the publication of the minutes of the February Federal Open Market Committee suggested that some members had wanted a more rapid initial tightening.

Developments in the bond markets

International markets

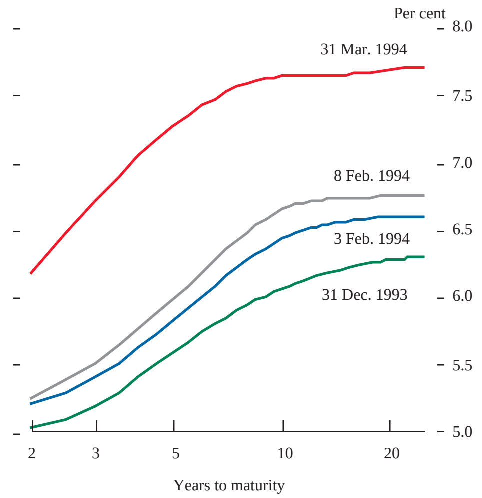
UK government bond markets were strongly influenced by events overseas during the first quarter. Evidence that the US economy had grown strongly in the fourth quarter and concern to pre-empt any consequent inflationary pressure led the Federal Reserve to raise its target federal funds rate by 25 basis points to $3^1/_4$% on Friday 4 February; a tightening had been widely expected after comments by the Chairman of the Federal Reserve. The market interpreted these developments as an indication of future inflationary pressures and as confirming the end of the long period of rising bond prices; US bond prices had begun to fall in the autumn, but the Federal Reserve's action accelerated the sell-off.

A steep fall in the prices of the US Treasury bonds on the Friday afternoon was followed in other bond and equity markets after the weekend. When the bilateral trade negotiations between the United States and Japan broke down the following weekend (12–13 February), the sharp fall in the dollar against the yen imposed losses on investors who had earlier taken short positions in yen (expecting a trade agreement to obviate the need for yen appreciation to reduce the Japanese current account surplus) and long positions in dollars (expecting a rise in US interest rates relative to those in other industrial countries).

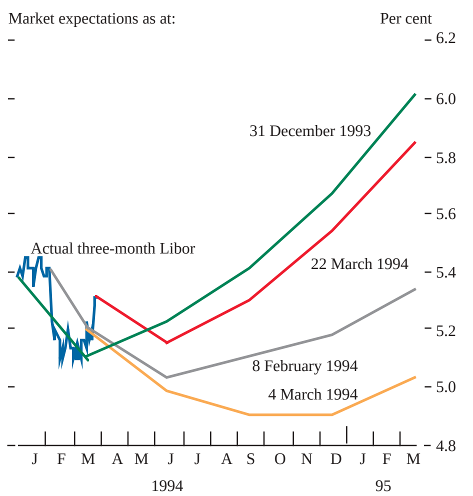
Changes in yields in European markets have recently been increasingly correlated with those in US Treasury bond markets; last summer, American investors aggressively bought European bonds, as US yields fell quickly across the yield curve. This increased integration may have had a short-term role in price developments. As one element—and though their importance is sometimes overstated (see the box in the article on financial market developments for details)—the activities of mutual funds and leveraged funds contributed to the contagious effect of the fall in US bonds. Many had taken long positions in European bonds in the expectation of further falls in interest rates, after the widening of the ERM bands in August 1993. But the pace of monetary easing in Europe slowed in the first quarter and these holders of government securities were disappointed. Some funds are also known to have suffered large losses in the currency markets following the yen's sharp appreciation on 14 February; in some cases, funds governed by stop-loss limits had to close positions to limit their losses on a particular trade, or to provide funds to cover earlier losses in other markets (including foreign exchange). This added to the downward pressure on bond prices, which were also affected by the prospect of increased bond supply in several countries needed to finance larger public borrowing requirements.

In early March, European bond markets were further affected by the publication of German M3 figures for January. The size of the annualised increase over the Q4 base (more than 20%), and worries

Par yield curves for British government stocks



Sterling interest rate expectations(a)



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

over possible strike action in Germany, suggested that the pace of interest rates reductions there (and so elsewhere in Europe) would be slow. European bond markets began to move lower and, combined with losses on the sharp move in the dollar-yen exchange rate, events gave rise to widespread rumours of serious financial losses among some leveraged funds, which added further to the general level of volatility.

A second $^{1}/_{4}$% increase in the federal funds rate on 22 March stabilised conditions temporarily, but speculation towards the end of March that US employment figures would indicate continuing strong growth prompted concern that the monetary tightening already introduced would not be enough to check inflationary pressures.

Domestic markets

For much of February and March, the gilt market and sterling were strongly influenced by developments in international financial markets. Gilts, however, weakened by more than the European average: ten-year gilt yields rose by 114 basis points between 3 February (just before the first US rate rise) and 31 March, compared with rises of 38 basis points in Germany and 62 in France. Larger-than-average rises were also experienced by other countries whose gains in monetary policy credibility have been recent (such as Canada and Sweden).

Markets had discounted a UK interest rate cut at some stage in the early months of 1994. They were, however, surprised by its precise timing on 8 February, shortly after a quarter-point rise in the federal funds rate and in the light of the cautionary note in the Bank's February *Inflation Report.* This suggested that because expectations had yet to adjust to the fall in inflation over the previous two years, the chances of inflation overshooting the central projection were greater than those of an undershoot.

Some market participants took the view that a further quarter-point cut might be made to offset the impact of the fiscal tightening due to take effect in April. This belief contributed to falls in sterling and in some gilt prices following the cut; the speculation subsequently strengthened, following favourable indicators on inflation published in late February and data suggesting a weakening in the pace of recovery.

Market expectations of a further rate cut gradually declined, as gilts and sterling remained vulnerable in turbulent international financial markets. The figures for inflation in February, published on 23 March, showed a fall in the twelve-month headline rate from 2.5% to 2.4%, but the market focused on the monthly rise of 0.6% and the underlying annual rate of 2.8%, which exceeded its expectations of around 2.5%. There was also concern at the increase in the annual rate of earnings growth from 3% to $3^{1}/_{4}$%.

At the same time, there was little sign that economic activity was being inhibited by the impending tax increases. Although consumer confidence declined in February and March, survey evidence suggested that industrial confidence was picking up and export orders were growing. Unemployment resumed its downward trend in February, after an unexpected rise in January.

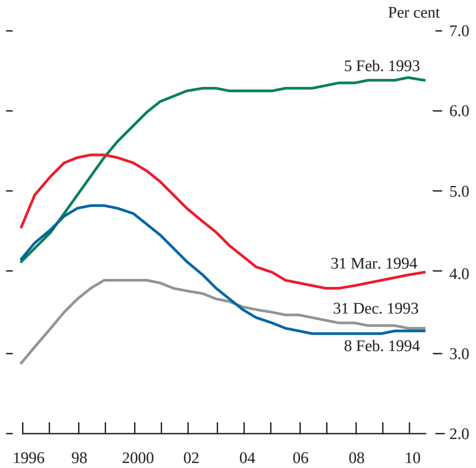
Table A
Interest rates, gilt yields and exchange rates; selected dates(a)

	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			
1994	1 month	3 months	6 months	12 months	3 months	Short	Medium	Long	Long	ERI	$/£	DM/£
4 January	5 7/16	5 3/8	5 1/4	5 3/16	5.25	5.79	6.26	6.52	2.95	82.0	1.4778	2.5726
7 February	5 7/16	5 13/32	5 3/8	5 3/8	5.41	6.00	6.56	6.77	3.10	81.9	1.4813	2.6080
8 February	5 7/32	5 7/32	5 3/16	6 3/16	5.20	5.92	6.59	6.81	3.11	82.1	1.4846	2.6113
24 February	5 5/32	5 3/16	5 7/32	5 5/16	5.20	6.52	7.05	7.29	3.35	80.9	1.4980	2.5606
3 March	5 1/16	5 3/32	5 3/32	5 9/32	5.13	6.53	7.15	7.30	3.38	81.1	1.4850	2.5538
7 March	5 1/8	5 3/32	5 3/32	5 7/32	5.07	6.35	6.91	7.12	3.29	81.2	1.4875	2.5646
16 March	5 1/8	5 1/8	5 1/8	5 9/32	5.13	6.64	7.21	7.43	3.35	80.6	1.4893	2.5254
31 March	5 7/32	5 5/16	5 13/32	5 11/16	5.47	7.08	7.48	7.68	3.46	79.3	1.4841	2.4804

(a) Close-of-business middle-market rates in London.
(b) Gross redemption yield. Representative stocks: short—6% Treasury 1999; medium—6 3/4% Treasury 2004A; long—8% Treasury 2013; index-linked—2 1/2% Index-Linked Treasury 2016 (real yield assuming 5% inflation).
(c) Middle-market rates.
(d) Implied future rate: until 24 February the March contract, thereafter the June contract.

Although retail sales fell by 0.5% in February, this followed a strong rise of 0.9% in January, and they were still 2.5% higher than a year earlier. By the end of the quarter, the short sterling futures contract indicated that the next change in rates was thought more likely to be an increase than a further cut, and that the market expected rates to rise progressively in the rest of 1994 and through 1995.

Implied inflation term structure(a)



(a) Expectations of the 12-month change in the RPI in future years derived from the differential between yields on conventional and index-linked stocks. See the August 1993 *Quarterly Bulletin*, page 322, for further explanation.

In February, the adverse factors affecting international bond markets led yields on both conventional and index-linked gilts to rise significantly. In March as global market conditions continued to be volatile, conventional gilts underperformed other European markets—the spread between the ten-year gilt and the German Bund widened by around 30 basis points (see chart on page 106). Index-linked yields, however, did not rise with conventional gilt yields, but to a large extent stabilised—with the 2 1/2% 2016 gilt yield rising from 3.35% to 3.46%.

Official money-market operations

For most of the quarter, the Bank adopted a broadly neutral stance in its money-market operations. There were brief periods of speculation about an interest rate cut in January, most notably after the release of the December RPI and retail sales data on 19 January, when the three-month rate implied by the futures contract for March fell from 5.31% to 5.17%. The next day, the Bank declined to offer an early round of assistance, despite a money-market shortage of £1.2 billion. The market's reaction allowed the Bank to resume a broadly neutral stance.

The Bank reduced interest rates by 1/4% on 8 February by setting the Minimum Lending Rate at 5 1/4%. The 1/4% reduction in the Bank's bill dealing rates was the first change of this size since November 1984. A move of 1/4% was thought appropriate in view of the balance of risks; 25 basis-point changes in official interest rates are quite common in other industrialised countries with comparable levels of inflation and interest rates. Following the cut, bank base rates were reduced by 1/4%, but only a small number of mortgage lenders responded with an immediate reduction in their mortgage rates.

Although the market had been expecting a cut in official rates at some point in the early months of 1994, its precise timing and size

The repo and secured loan facilities

On 12 January, the Bank announced new permanent repo and secured loan facilities to replace the temporary facilities which, since September 1992, had been made available to the large banks, gilt-edged market-makers and the ten largest building societies. The new facilities allow financial institutions, as before, to obtain funds from the Bank through the sale and repurchase (repo) of gilts, or through loans secured against government-guaranteed export and shipbuilding credit.

The new facilities incorporate several important new features. Operations are now carried out on a regular timetable: counterparties are invited to apply on the Wednesdays after the first and third Mondays of each month for funds to be made available the following day. They may apply for funds until the next or next-but-one rollover date, that is normally for two or four weeks. The interest rate charged is the yield equivalent to the Bank's discount rate for band 2 (15 to 33-day) commercial bills. The facilities are available to discount houses for the first time; and the limit on the amount of funds for which banks and building societies can apply has been lifted.

Since their introduction, there has been a greater use of the new facilities: on the first occasion they were made available, £4 billion were provided compared with £3.2 billion on the last occasion that the temporary facilities were offered. At the end of the quarter, £4.4 billion of assistance was being provided through the facilities.

Funds provided through repo facilities

£ millions

Date	Total funds provided	Total outstanding	*of which maturing at* Next rollover	Next-but-one
20 Jan.	3,979	3,979	3,842	137
10 Feb.	3,667	3,804	2,621	1,183
24 Feb.	2,194	3,377	3,358	19
10 Mar	4,500	4,519	4,129	390
24 Mar.	3,979	4,369	4,191	178

The Bank made it clear in its consultations before introducing the new facilities that in due course it would wish to undertake its gilt repo operations under a Master Agreement, signed with each counterparty and incorporating margin arrangements. After further consultation with the market, the legal agreement was introduced with effect from 20 April. The repo facility is now available to all members of the UK banking sector, discount houses, GEMMs and building societies. The Bank is prepared to repo the non-sterling marketable debt of HM Government as well as gilts.

Table B
Influences on the cash position of the money market

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

	1993/94 Apr.–Dec.	1994 Jan.	Feb.	Mar.
Factors affecting the market's cash position				
Under/overfunding (+/-)(a)	-12.2	-3.8	+3.8	+9.2
Other public sector net borrowing from banks and building societies(-)(b)	+2.4	+1.1	+0.3	-1.9
of which, local authorities' deposits with banks and building societies(+)	*+2.8*	*+0.8*	*+0.6*	*-2.0*
Currency circulation(-)	-3.4	+2.7	-0.1	-2.1
Other	+5.7	-0.5	-2.4	-5.1
Total	**-7.5**	**-0.5**	**+1.7**	**+0.1**
Increase (+) in the stock of assistance	+6.4	+0.1	-1.8	-0.5
Increase (-) in £ Treasury bills outstanding (c)	+1.0	+0.4	+0.2	+0.1
Increase in bankers' balances at the Bank	—	—	+0.2	-0.3

(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.

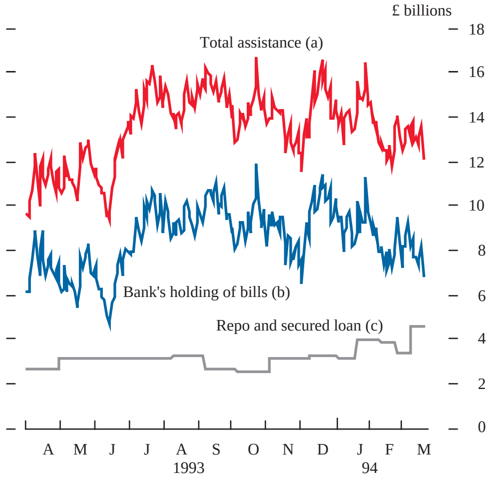
had not been fully discounted. Both the March and June short-sterling futures contracts rose by the full extent of the 1/4% cut; by the close on 8 February, the June contract discounted a three-month rate of 5.03% (compared with 5.29% the day before), reflecting a widely-held view that a further 1/4 point cut was likely by the middle of the year. Speculation intensified during the following week, after the release of data showing a further fall in the underlying rate of inflation in January and a rise in unemployment, and following the Bundesbank's decision on 17 February to cut its discount rate from 5 3/4% to 5 1/4%. On 18 February, the June sterling futures contract rose to a level discounting three-month rates of 5% by June. The Bank offered no noon round of assistance that day and no early round the next, and expectations subsequently stabilised.

In late January, technical money-market conditions tightened and for a period of several days bills were not readily forthcoming in the regular operations. On 27 January, the combination of the settlement of the January gilt auction, speculation that the Bundesbank might reduce its official rates and that this would facilitate lower UK rates, and reluctance on the part of several market participants to sell bills before the end of the month led borrowing from the Bank at 2.45 pm to be unusually high, at £915 million.

The new repo and secured loan facilities (see the box) were successfully introduced during the quarter. By adding to the range of instruments that financial institutions can use to obtain funds from the Bank of England, the facilities have increased the flexibility of operations and helped to smooth money-market conditions.

Daily conditions in the money markets were tighter in the last week of February and the first week of March. A slightly reduced level of assistance was provided through the new repo and secured loan facility at the rollover on 24 February, and bills were in shorter supply than in January and not readily forthcoming in operations. Significant assistance at 2.45 pm was once more needed on several days, including a record £995 million provided on 1 March. The tighter conditions pushed up short-period rates and increased the attractiveness of the funds available through the new repo facility; an additional £1.15 billion was provided at the rollover on 10 March.

Money-market assistance



(a) Bank of England's holdings of bills, market advances and funds supplied until 19 January 1994 under the temporary facilities; since that date under the repo and secured loan facilities.
(b) Bank of England's holdings of eligible bank, local authority and sterling Treasury bills outright and on a repurchase basis.
(c) Bank of England's holdings of gilt-edged stocks on a repurchase basis, and loans made against export and shipbuilding credit-related paper until 19 January 1994 held under temporary facilities; since that date under the repo and secured loan facilities.

The short-sterling futures contracts weakened sharply in late March, and interest rates on cash of more than three months' maturity rose. This followed disappointment at the February RPI data, and coincided with the fall in sterling. Volatility in the gilt market—against the background of the general disturbance in international bond markets—also had a powerful influence, since some holdings of short-maturity gilts were hedged by sales of short sterling futures. But the rise in rates at three-months maturity and beyond had little impact on daily operations; in the last two weeks of the quarter, short-term money-market rates were generally close to the Bank's dealing rate.

Treasury bill tenders were held every Friday for £200 million of 91-day bills—the amount and maturity on offer since 13 August last year. The bills continued to be in high demand; each issue was covered at least three times, although tenders were generally less strongly oversubscribed during March than in the first half of the quarter. The differential in the discount rate between Treasury bills and commercial bills narrowed from about $^1/_8$% at the beginning of January to as little as $^1/_{32}$% in late March. The stock of eligible bills declined during the quarter; following little change in January, there was a marked decline after the end of the main corporation tax paying period.

Gilt-edged funding

Gross official gilt sales of £7.75 billion in the first quarter brought the total amount raised during the financial year to £54.6 billion. In addition, a 50% call on the February auction stock (7% 2001A) was secured for 1994/95. There were a total of 10 gilt auctions in 1993/94.

The gilt market had ended 1993 with a period of exceptional strength. The new year began with a correction, partly reflecting developments overseas, particularly in the US Treasury market; this ruled out tap sales. To maintain the funding programme's momentum, the pattern of auctions was broadly the same as in the previous year. At the auction in late January, the market responded favourably to the announcement of a new stock maturing in 2010. The auction's size, at £2$^3/_4$ billion, was at the lower end of expectations; this was positively received as a signal that the borrowing already undertaken allowed the pace of funding to be moderated. It contributed to a strong rally when lower-than-expected inflation and PSBR data for December were

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
6¼% Treasury 2010	2,750	18. 1. 94	27. 1. 94	Auction	98.4688(b)	Partly paid(c)	6.40 (d)	6.40	27. 1. 94
7% Treasury 2001 'A'	2,500	15. 2. 94	24. 2. 94	Auction	101.0625(e)	Partly paid(f)	6.81 (d)	6.81	24. 2. 94
Floating-rate Treasury 1999	2,500	22. 3. 94	31. 3. 94	Auction	99.8800(g)	Fully paid	. . (h)	. .	31. 3. 94

. . not applicable.

(a) Gross redemption yield, per cent.
(b) Lowest-accepted price for competitive bids. The non-competitive allotment price was £98.75.
(c) With £48.46875% payable on issue and balance on 14 March.
(d) Yield at lowest-accepted price for competitive bids.
(e) Lowest-accepted price for competitive bids. The non-competitive allotment price was £101.625.
(f) With £51.0625% payable on issue and balance on 11 April.
(g) Lowest-accepted price. There was no non-competitive allotment price. The average price accepted was £99.92.
(h) The rate of interest is reset on a quarterly basis by reference to money-market rates.

announced on 19 January. The auction was satisfactory, with cover slightly lower than the market had expected (at 1.2 times), but a tail (the difference between the average and highest-accepted yield) of only two basis points. Prices in the secondary market consolidated around the auction level.

Market conditions were, however, much more turbulent in February after the ¼% rise in the federal funds rate. After the reception given to the ¼% reduction in UK rates and the volatility in international markets, the announcement of an auction in February on the usual schedule was welcomed as a sign of stability. The individual stock chosen, 7% Treasury Stock 2001, also met with approval since it allowed a large and liquid benchmark in the seven-year maturity to be created. Conventional gilts, particularly at the long end, weakened in the run-up to the auction despite positive indicators on both UK and US inflation. In the event, it was covered 1.48 times, but with a longer tail (six basis points) than for any auction since June 1993, indicating an unusually high degree of market uncertainty about the right market level. In a period of a few days, similar government bond auctions in Italy and Japan were likewise thinly covered, and the Spanish authorities declined all bids at two of their auctions.

Gilt prices continued to fall in March, and weakened more than government bonds in other major European markets. On the days of unusually sharp falls in February and March, the Bank bought small amounts of stock from the market-makers, at or below market prices, in order to assist them in their market-making function by enabling them to manage their books and unwind cross positions. Prices in the index-linked sector stabilised more quickly than in conventional gilts, and the Bank took the opportunity to exhaust the outstanding tranchettes of three index-linked Treasury stocks (4⅝% 1998, 2½% 2013 and 4⅛% 2030).

The Bank's announcement on 18 March that the stock in the auction on 30 March would be a floating-rate gilt was well-received; the market took the view that this would allow the authorities to maintain the momentum of the funding programme while extending the range of instruments available. £2½ billion of the new stock was issued. The issue will mature in 1999, and the coupon will be fixed in accordance with the prevailing level of the London interbank bid rate (LIBID) minus ⅛%. Coupons will be paid four times a year—in contrast to the usual six-month coupons paid on conventional gilts—to take advantage of the depth and liquidity of the interbank market at the three-month maturity. The coupons are fixed according to the LIBID rates reported to the Bank by the

Annual remit for the Bank's operations in the gilt market(1)

The Chancellor of the Exchequer has decided to set an annual remit for the Bank of England's operations in the gilt market to clarify the division of responsibilities between the Treasury and the Bank, and to explain the Government's intentions to the markets. The remit will be published before the start of each financial year.

The Government aims each year to sell enough gilts and National Savings products fully to fund the PSBR, maturing debt that needs to be refinanced, and any net increase in the foreign exchange reserves. There is no change to the Government's funding policy as set out in last November's Medium Term Financial Strategy.

The Treasury is responsible for all borrowing for the National Loans Fund, under the terms of the National Loans Act 1968. The Bank of England has long been the Government's adviser and agent in the gilt market, where the bulk of these funding operations are carried out.

The Chancellor will also give the Bank guidelines for the detailed operation of its remit. In the past, individual decisions on funding were taken after discussion between Treasury Ministers and officials, and the Bank of England. In future, any operations that the Bank proposes which fall within the remit and the guidelines will normally be approved by Treasury officials. The Bank will provide a monthly report to Treasury Ministers on its progress, and there will be regular review meetings between the Treasury, the Bank and the Department for National Savings.

The remit for 1994/95

Funding requirement

As set out in the November 1993 Financial Statement and Budget report, the Government will continue to operate a full-fund policy.

The PSBR for 1994/95 was forecast in the Budget to be £38 billion. Some £9 billion of gilts are expected to mature in market hands and need to be refinanced. Maturing and withdrawn National Savings products will be netted off the National Savings contribution to funding, rather than included in the funding requirement. It is not possible at this stage accurately to forecast net changes over the year in the foreign currency reserves, so these will be assumed to remain unchanged on balance. Any overfunding in 1993/94 will reduce the funding requirement in 1994/95, and any underfunding increase it. The funding outturn for 1993/94 is not yet known.

The funding requirement for 1994/95 is currently forecast to be around £47 billion, adjusted for any over or underfunding carried forward from 1993/94, and subject to any changes in the reserves.

National Savings

The net contribution of National Savings to funding (including accrued interest) is assumed to be around £3½ billion. This is not a target, but an estimate based on experience in previous years and forecasts for 1994/95.

Other debt sales

Net sales of government debt instruments other than gilts and National Savings are expected to make a negligible contribution to funding.

Sales of gilts to banks and building societies

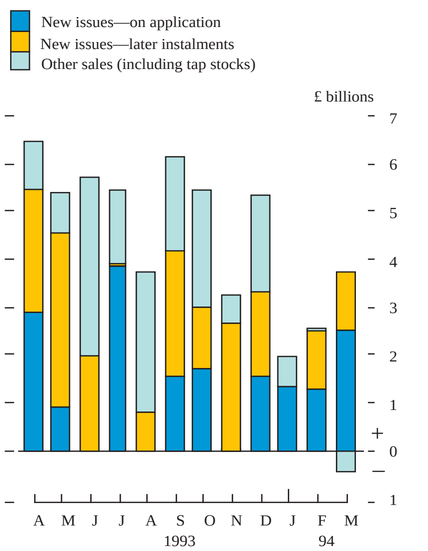
As announced at Budget time, the sales of gilts to banks and building societies in 1992/93 will be taken into account before the end of 1994/95. These amount to £6.8 billion.

Quantity of gilt sales

The Bank of England will aim to meet the remainder of the funding requirement by selling gilts to the private sector on the Government's behalf. On the basis of the Budget forecast, this

(1) The annual remit and the Bank's market notice were published on 17 March. The PSBR in 1993/94 was £46 billion; there was overfunding (net of the underfunding carried forward from 1992/93) of £2.3 billion. The requirement for gilt sales in 1994/95 will, as a consequence, be reduced by that amount.

Gross official sales of gilt-edged stock



20 banks with the largest outstanding eligible liabilities on the 31 December immediately preceding the relevant interest determination date. The issue was expected to be particularly attractive to wholesale participants; with this in mind, the minimum bid size was set at £50,000 rather than the usual £1,000 and there was no non-competitive bidding process. The auction was very well covered (2.28 times) at an average price of £99.92 per £100, despite the exceptionally-turbulent conditions in the gilt market. The success of the auction contributed to a rally in the conventional market at the end of the month, partly reflecting a view in the market that it would be possible to add further issues of the floating-rate gilt during 1994/95.

The progress towards the 1993/94 funding target made during the buoyant market conditions in the second half of 1993 enabled the authorities to reduce the pace of funding in the more difficult market conditions in early 1994. Although there were three auctions during the quarter, there were no new 'tap' issues; sufficient gilt issues were made during 1993 to enable 'full funding' means selling approximately £37 billion of gilts, adjusted for any under or overfunding carried forward from 1993/94, and any change in the reserves.

Pace of funding

The Bank should aim to sell at a broadly even pace through the year.

Methods of sale

Auctions will continue to form the backbone of gilt-edged funding. They will be held at broadly monthly intervals, each normally on the last Wednesday of a calendar month. Each auction should be between £2–4 billion of stock. The remainder of gilt sales may be made by *ad hoc* taps and tenders.

Review

This remit may be reviewed and, if appropriate, revised by HM Treasury from time to time. Revisions will be published.

Bank of England market notice

The Bank of England released a separate market notice setting out how it intends to conduct sales of gilt-edged stock in 1994/95:

Gilt-edged funding 1994/95

This market notice sets out how the Bank intends to conduct sales of gilt-edged stock in the year ahead, consistently with the remit set by the Chancellor, published today.

The Chancellor's remit confirms that the Government intends to continue to pursue the full-fund policy as previously defined. On the basis of the funding arithmetic set out in the remit, the implied gross sales of gilt-edged stock will be around £37 billion, subject to adjustment for any over or underfunding carried forward from 1993/94 and any change in the reserves.

Funding will be pursued at a broadly even pace through the year. The Bank will continue to deploy the full range of selling techniques and funding instruments, including index-linked. Thus the Bank will continue with the mixed approach to gilt-edged sales which has worked well in the past few years, combining a programme of auctions with official sales of stock 'on tap' in the secondary market. The main features of this approach are as follows.

As the Chancellor's remit explains, gilt-edged auctions will continue to provide the backbone of funding. As in 1993/94, auctions will continue to be held at broadly monthly intervals, each normally on the last Wednesday of a calendar month, though as hitherto flexibility will be retained to vary the timing of auctions where appropriate in the light of events. The size of individual auctions will be in the range of £2–4 billion.

The stock will be auctioned on a bid-price basis, open to all-comers without commission, with provision for non-competitive bids of up to £500,000. The stocks offered, which may extend over the full maturity range, may be new stocks or additional tranches of existing stocks and may be in either fully or partly-paid form.

The timetable for auctions will remain unchanged. Thus the first auction announcement, of the date of an auction together with an indication of the broad maturity range, will be made not less than ten days beforehand; the second announcement providing full details will be given not less than seven days ahead of an auction.

The authorities will continue generally to refrain from issuing stock of a similar type or maturity to the auction stock for a reasonable period after the auction, and will only do so if there is evident market demand for further such stock.

The programme of auctions will continue to be supplemented by sales of stock by the Bank 'on tap' on the secondary market through its day-to-day operations with the gilt-edged market-makers. 'Tap' sales may take the form of sales of existing stock from official holdings or of packages of tranchettes (or a single, larger tranche) of newly-created stock.

The Bank also has available the option of offering stock by minimum price tender, underwritten by the authorities at a minimum tender price, though use of this technique is likely to be infrequent given the continuing programme of auctions.

Table D
Official transactions in gilt-edged stocks

£ billions: *not seasonally adjusted*

	1993/94 (a)			
	Apr.–Dec.	Jan.	Feb.	Mar.
Gross official sales (+)(b)	46.8	2.0	2.6	3.2
Redemptions and net official purchases of stock within a year of maturity(-)	-3.9	—	-1.3	-0.4
Net official sales (c)	43.0	2.0	1.2	2.7
of which, net purchases by:				
Banks (c)	5.7	1.0	-0.3	0.1
Building societies (c)	1.2	0.3	0.4	-0.5
Overseas sector	14.6	1.2	1.5	0.2
M4 private sector (c)	21.4	-0.5	-0.3	2.7

(a) Later instalments are included in the month when they fall due, not in the month when the sale is secured.
(b) 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.
(c) Excluding transactions under purchase and resale agreements.

(as set out in the November 1993 Budget) to be completed slightly before the end of the financial year. By the end of the quarter, overfunding in 1993/94 net of underfunding carried over from 1992/93 totalled £2.3 billion—the 1994/95 funding requirement will be reduced by this amount.

Following HM Treasury's announcement last December, the Bank has been repaying tranches of the ECU 5 billion revolving bank credit arranged in September 1992. Repayments amounting to the equivalent of $5.8 billion were made between December and April, as tranches of the credit reached their rollover dates. Nearly $1.7 billion of these were financed from the reserves, with the remainder—just over $4 billion—met from the forward purchase of foreign exchange set aside for the purpose. The revolving credit facility, which had an original maturity of three years, has now been cancelled.