Operation of monetary policy

- *Figures published in the third quarter showed that inflation continued to moderate, but there were some signs of increasing cost and price pressures in the pipeline.*
- *Economic activity had been strengthening, here and abroad: in the second quarter, UK GDP was shown to be growing well above trend, and the margin of spare capacity in the economy to be smaller than previously thought, though there were indications of a moderation in growth in later data.*
- *Following his early September meeting with the Governor, the Chancellor decided on 9 September that official interest rates should be raised by ½%; the change was implemented by the Bank on 12 September.*
- *The move was immediately welcomed by the financial markets as a clear signal of the authorities' commitment to counterinflation. Sterling strengthened and long-term bond yields fell.*
- *The exchange rate strength continued up to and beyond the end of the quarter, but UK bond yields rose again as international bond markets weakened.*

Overview

Decisions on monetary policy are based on a wide range of indicators. The Bank's current assessment of the latest economic indicators is given in the November *Inflation Report*; this article reviews the operation of monetary policy in the third quarter of 1994.

Statistics published during the quarter showed that the growth of consumption had slowed, but that output was growing faster than at any time in the previous five years. It appeared that the margin of spare capacity in the economy was smaller than had previously been thought. Investment and, especially, net exports had accelerated, with UK trade performance reflecting continued expansion in the United States and the Far East, and stronger-than-expected recovery in Western Europe. Current inflation remained low. The 12-month increase in the retail price index excluding mortgage interest payments (RPIX) fell to 2.2% in July, the lowest rate since the series was first compiled in 1975; and it was only marginally higher in August. But there was evidence of incipient inflationary pressure in the faster growth of import and manufacturers' input prices, and from surveys which showed both that capacity utilisation had risen and that greater numbers of producers expected to be able to raise prices in the following months. A fast rate of growth in narrow money was consistent with this picture.

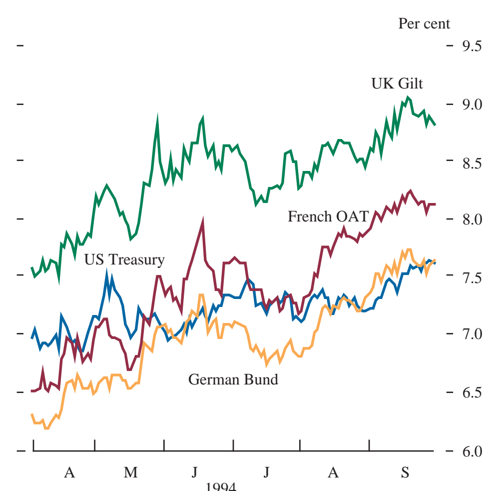
Against this background, the Chancellor decided after his meeting with the Governor in early September that rates should be raised by ½%. The immediate market reaction to this was a strengthening of sterling and a fall in bond yields, suggesting that the market viewed the move as evidence of the Government's commitment to counterinflation.

Conditions in financial markets at home and abroad continued to be influenced by news and expectations about growth and inflation, and by the monetary authorities' actual or expected responses. In the third quarter, the main issues were the pace of monetary policy tightening in the United States, and whether there was any prospect of a further easing in monetary policy in Europe.

The indications from data releases in the United States were mixed, with labour cost and consumer price inflation continuing to be subdued, but a significant pick-up in producer prices. There was some evidence of slower growth in activity, perhaps in response to earlier monetary tightening but perhaps also as a result of capacity constraints. The Federal Reserve tightened policy once more during the quarter, raising official rates by ½% on 16 August (when they indicated that this was expected to be sufficient, at least for a time, to meet the objective of sustained, non-inflationary growth). The move had been widely anticipated, but its scale was at the upper end of market expectations and helped briefly to steady the bond market and the dollar, both of which had fallen earlier in the year. The course of the dollar during the quarter was also significantly affected by news on the US-Japanese trade talks. Towards the end of the quarter, renewed signs of strength in the economy led the money markets to anticipate an early further tightening; US bond yields also reached new highs for the year.

In continental Europe, data releases showed that growth in the second quarter had been much stronger than had generally been expected, with GDP in both Germany and France expanding by 1%. Consumer price inflation in the major economies appeared to have stopped falling, but upward pressures seemed weak. The Bundesbank left its Lombard and discount rates unchanged in the quarter, and the repo rate—which had been gradually reduced earlier—remained fixed from late July onwards.

Ten-year government bond yields(a)

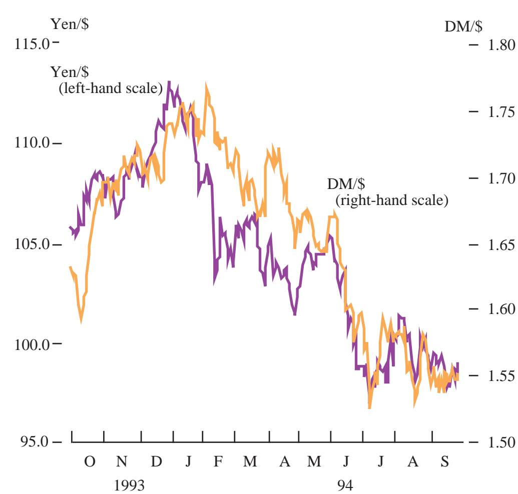


(a) Gross redemption yield.

Nevertheless, the strengthening of the German economy reinforced market expectations of an eventual turning-point in German interest rates. The three-month rate for December implicit in futures contracts rose from 5.1% to 5.3% and ten-year bond yields rose from 7.2% to 7.6%. The heavy remaining borrowing requirement of the federal government and other official bodies (after the cancellation of bond auctions in the second quarter) also weighed on German bonds. Yields in Germany were higher than in the United States for a significant part of the quarter.

Many other European central banks followed the Bundesbank's pattern of unchanged official rates and only small falls in intervention rates. But in Sweden and Italy, official rates were raised by ½% on 11 August. Both moves were partly designed to check emerging inflationary pressures, but against a background of exchange rate depreciation, large fiscal deficits and political uncertainty, they were initially received sceptically in the markets. Both countries' currencies weakened and bond yields rose sharply; this had adverse consequences for other European bond markets, including gilts. In Australia, the bond and foreign exchange markets welcomed a pre-emptive tightening undertaken at the same time as the US rise and against a background of strength in the exchange rate, fiscal consolidation and low inflation.

Dollar exchange rates



Foreign exchange markets

A main feature of the quarter was the dollar's continuing weakness compared both with its historical value and with its value at the start of the year. But overall it did not depreciate further, and for most of the period traded in ranges around DM 1.56 and ¥99. Sterling remained largely on the sidelines tracking the dollar, until it strengthened following the interest rate increase on 12 September.

After it had become apparent that the concerted intervention undertaken at the end of June had failed to underpin the dollar, it fell sharply until the middle of July. It touched a post-war low of ¥96.45 on 12 July, before rallying to over ¥100 by the end of July. The inability of the US and Japanese authorities to reach a bilateral trade agreement remained a key factor behind the dollar's weakness against the yen. Exchange rate and capital market weakness became more closely linked as overseas investors—particularly from Japan—were increasingly unwilling to commit funds to dollar-denominated assets.

The dollar also fell against the Deutsche Mark at the start of July. When the Federal Reserve Open Market Committee (FOMC) meeting of 5–6 July and the Group of Seven (G7) meeting in early July produced no policy action to halt or reverse the fall, the dollar reached a low for the year of DM 1.52 against the Deutsche Mark—also on 12 July. It then rallied briefly when a modest fall in German M3 revived hopes of a further cut in interest rates by the Bundesbank. From then until mid-August, it remained fairly steady at these lower levels.

The Deutsche Mark was firm, apparently buoyed by growing perceptions that the German recovery was stronger than had been forecast earlier in the year and that the Bundesbank's move to fixed-rate repos (set at 4.85% from 27 July onwards) meant that Germany was at or near the trough of the interest rate cycle. Currency movements in the run-up to the FOMC meeting on 16 August were volatile; the dollar fell by three pfennigs after the unexpected interest rate rises in Sweden and Italy led to large inflows into the Deutsche Mark.

As on earlier occasions this year when US interest rates were raised, the dollar gained little sustained support from the ½% increase in the federal funds and discount rates announced after the FOMC meeting. On this occasion, the decision by the Bundesbank on 18 August to leave the repo rate unchanged after its summer recess disappointed hopes, which had gradually been building, that an easing of German interest rates would shift interest rate differentials in favour of the dollar. The dollar was also influenced by continuing bond market weakness and by political controversy surrounding the Whitewater hearings.

The dollar rallied briefly—along with the US bond and equity markets—at the end of August, but then fell back to trade in a narrow range around DM 1.55. When the Federal Reserve did not raise rates following the September FOMC, the bond markets and the dollar retained their prevailing levels. Expectations that there would be an interest rate rise in October if data showed continued strong growth enabled the dollar to trade steadily against the Deutsche Mark, which was undermined by concern about the outcome of the October federal elections.

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

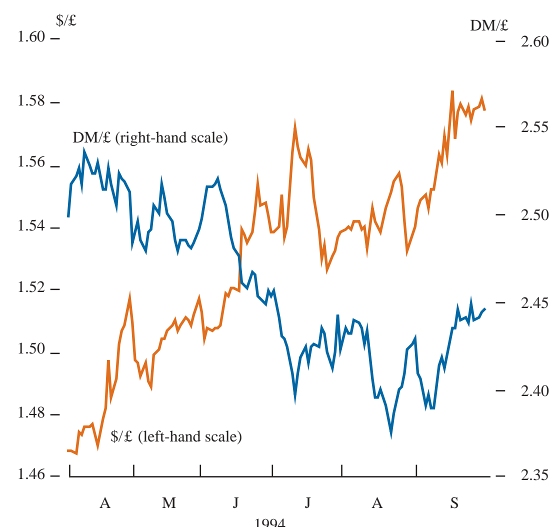
	Interest rates (per cent per annum)					Gilt yields (b) (per cent per annum)				Exchange rates		
	Sterling interbank rates (c)				Short sterling future (d)	Conventionals			Index-Linked			
1994	1 month	3 months	6 months	12 months	3 months	Short	Medium	Long	Long	ERI	$/£	DM/£
1 July	5 1/32	5 3/16	5 15/32	5 3/16	6.29	8.32	8.62	8.55	3.97	79.6	1.5355	2.4568
14 July	4 31/32	5 5/32	5 13/32	6 1/32	6.00	7.79	8.10	8.12	3.88	79.1	1.5632	2.4123
29 July	5 21/32	5 29/32	6 7/32	6 3/4	6.73	8.29	8.48	8.42	4.00	79.0	1.5262	2.4300
2 August	5 3/16	5 15/32	5 13/16	6 15/32	6.57	8.09	8.25	8.25	3.91	79.2	1.5383	2.4282
9 September	5	5 13/32	5 27/32	6 3/4	6.33	8.50	8.84	8.68	3.86	78.8	1.5432	2.4046
12 September	5 19/32	5 27/32	6 3/16	7 3/32	6.70	8.51	8.73	8.57	3.87	78.4	1.5517	2.3853
20 September	5 15/32	5 29/32	6 9/16	7 1/2	6.97	8.83	9.03	8.84	3.98	79.7	1.5702	2.4453
30 September	5 13/32	5 27/32	6 15/32	7 13/32	6.80	8.64	8.80	8.64	3.87	79.9	1.5772	2.4454

(a) Close-of-business rates in London.
(b) Gross redemption yield. Representative stocks: short—6% Treasury 1999; medium—6 3/4% Treasury 2004; 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: December 1994 contract.

Against the yen, the dollar eased to ¥97.60 in the middle of September, as a result of renewed concern over the progress of the trade talks before the 30 September deadline. But as the deadline approached, it recovered amid anticipation that there might be sufficient agreement to avoid the near-term imposition of sanctions.

Sterling remained on the sidelines for much of the summer, with its course generally linked to that of the dollar. In July and August, it traded some way below the levels seen earlier in 1994, with its effective rate index (ERI) at times falling below 79. During this period, as a result of the dollar's weakness, sterling fell below DM 2.40 in mid-July and again in late August and early September. It reached a 17-month low of DM 2.3713 towards the end of August. Sterling rose against the dollar, however, briefly breaking through the $1.55 level in early August, having traded at around $1.50 for much of the year. But it met strong technical resistance there, and was undermined as its fall in effective terms and against the Deutsche Mark prompted commentators to question the authorities' attitude to the currency and their willingness, in the face of incipient inflationary pressures, to increase interest rates.

Sterling exchange rates



Sterling rose sharply following the interest rate increase on 12 September; the market viewed the decision as confirmation of the strength of the authorities' commitment to counterinflation. It reached DM 2.4248 in New York on that day, around four pfennigs higher than its opening level in London. Sterling strengthened further—at times testing DM 2.45—as expected interest rate differentials, particularly in the medium term, moved sharply in its favour. By the end of September, interest rate futures contracts suggested that the differential between three-month sterling and Deutsche Mark rates in June 1995 was expected to be 30 basis points higher than had been expected at the end of August. Against the dollar, the expected differential widened by 20 basis points; and sterling rose to around $1.58 by the end of the quarter. The ERI rose from 78.6 on 9 September to finish the quarter at 79.9.

Sterling's effective index

The reaction of the foreign exchanges to the Swedish and Italian interest rate increases on 11 August was negative. The Swedish krona fell against the Deutsche Mark from Skr 4.92 to Skr 5.02, while the lira also dropped sharply—from L1,006 to L1,025. These market reactions contrasted with the generally positive responses to the UK and Australian rate rises—where the markets took the view

that the authorities were acting prudently and from a position of relative strength, with subdued inflation, continuing growth and an improving fiscal position. The absence of any immediate trigger in UK data releases or financial market developments emphasised the fact that the move resulted from the authorities' medium-term assessment.

There was little movement within the ERM during the third quarter. With most of their economies at a similar stage in the economic cycle and with the uncertainty over the dollar, the ERM currencies generally tracked the Deutsche Mark. The width of divergence in the ERM band hardly changed, and ended the quarter at around 5.5%. There was, however, some turbulence as a result of the foreign exchanges' reaction to the interest rate rises in Sweden and Italy, which weakened the Danish krone, the peseta and the escudo.

Official money-market operations

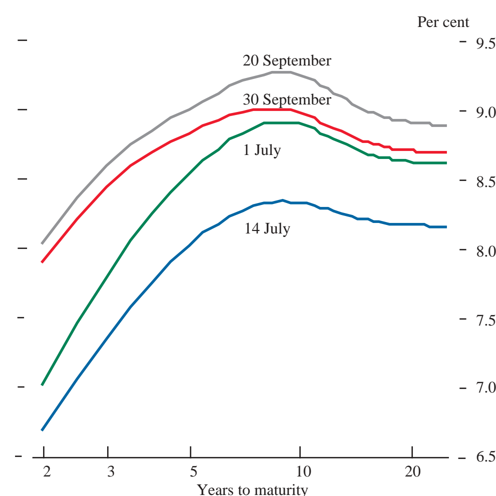
At the beginning of the quarter, many participants in the money markets expected the next move in official rates to be upward. But the low figures for current inflation suggested that any such move might still be some time away. Three-month money-market rates remained below base rates, and in the first three weeks of July short-sterling futures contracts rallied, implying lower expectations of three-month rates in subsequent months.

In the week beginning 25 July, however, the mood changed. The GDP figures published in the previous week had showed strong growth in the second quarter; the results of the CBI Survey published on 26 July pointed to continued increases in output and more widespread expectations of price increases. And the meeting between the Chancellor and the Governor on 28 July focused attention on the possibility of a change in the monetary stance.

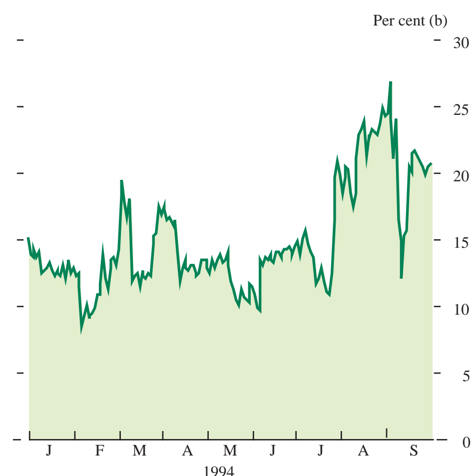
Money-market rates rose in the course of the week; three-month interbank rates moved above base rates on 27 July. Rates on bills eligible for use in the Bank of England's operations also rose. (The differential between the yield on such bills and interbank rates had narrowed considerably over previous months, as the size of daily shortages had fallen and market conditions had eased.) By 28 July, market rates on Treasury bills were only just below base rate. On 29 July, the last business day of the month, market rates rose further, particularly at around the time of the mid-morning British Bankers Association (BBA) interbank fixing, when a wide range of rates were quoted. By midday, three-month interbank rates were at about $5^{5}/_{8}$%. Bids in that day's Treasury bill tender reflected the movement in other market rates. The average price at which bids were accepted implied a yield of $5^{11}/_{16}$%, which was misinterpreted by some as implying a signal about official interest rate intentions—even though the Bank's market operations that day were conducted both before and immediately after the tender at unchanged rates.

Some market participants criticised the Bank for not cancelling the tender. But to have done so would itself have been open to misinterpretation, as an overt indication of resistance by the authorities to rising market rates. The market calmed after the weekend, as it was acknowledged that there had been a considerable overreaction to the outcome of the tender result and as the Bank continued to deal at established rates.

Par yield curves for British government stocks

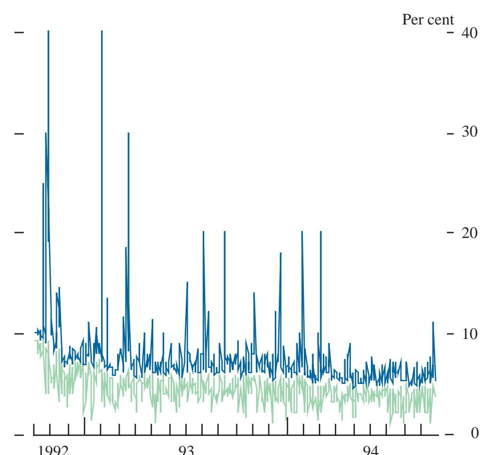


Implied volatility of short sterling futures(a)



(a) Implied volatility of short sterling futures contracts.
(b) The expected standard deviation of annualised price movements in LIFFE's short sterling futures (nearest maturity contract).

High and low overnight interest rates(a)



(a) Intra-day high and low for overnight interest rate (scale capped at 40%).

Table B
Influences on the cash position of the money market

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

	1994/95			
	Apr.–June	July	Aug.	Sept. (d)
Factors affecting the market's cash position				
Under/overfunding (+/-) (a)	6.0	-2.5	2.8	1.5
Other public sector net borrowing from banks and building societies (-) (b)	-0.2	0.3	-0.2	0.4
of which, local authorities' deposits with banks and building societies (+)	*-0.4*	—	—	*0.3*
Currency circulation (-)	1.2	-1.2	0.7	-0.7
Other	3.0	-1.3	3.6	-0.9
Total	**10.0**	**-4.7**	**6.9**	**0.3**
Increase (+) in the stock of assistance	-7.6	5.9	-5.8	-0.9
Increase (-) in £ Treasury bills outstanding (c)	2.4	1.0	1.3	-0.5
Increase in bankers' balances at the Bank	—	0.2	-0.1	-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.
(d) Estimate; final figures published on 3 November.

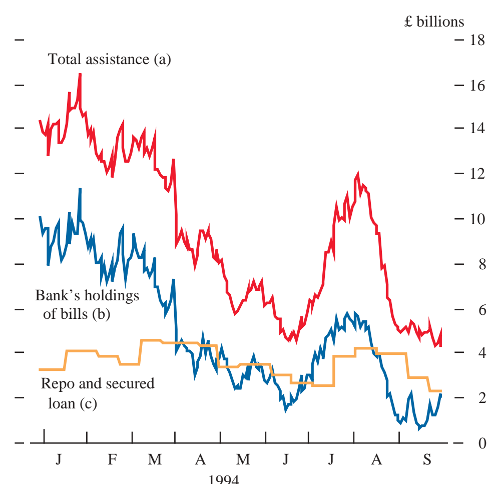
Three-month interbank rates remained a little proud of base rates throughout August, but towards the end of that month and into September longer period rates and those implied by futures began to ease. A number of economic indicators suggested that growth might be slackening and that inflation remained very low; a consensus developed in the money market that the evidence might provide sufficient reason for the authorities to delay raising rates until later in the year.

The precise timing of the interest rate announcement on 12 September therefore surprised the market. It was widely welcomed as an indication of the authorities' determination to follow the course necessary to achieve the inflation target. Near-term rates immediately came into line with official rates at $5^3/_4$%. As at previous turning-points, the first upward movement in rates heightened expectations of further rises to come, and period rates also rose. The three-month rates implied by short-sterling futures contracts rose by 23 basis points for June 1995 and by about 7 basis points beyond June 1996, with implied forward rates falling only beyond 1998. Short-sterling futures rates remained high, and ended the period at 6.78% for December and 8.32% for June 1995. But the absolute levels of these implied forward rates were hard to square with even the most pessimistic market anecdote about the likely level of official rates over this horizon. Short-sterling futures rates probably also reflected the low level of business that was done at longer maturities, the continuing high volatility implied by options contracts (which suggested that a significant risk premium might be being incorporated in longer-term rates), and their use as a hedging instrument for short-maturity gilts.

Overnight rates were generally below base rates and quite stable. The average intra-day range—the difference between the high and the low each day—was 2.6 percentage points, compared with 3.1 percentage points during the first quarter and 3.4 percentage points in 1993. The stock of assistance provided to the money market by the Bank rose in July (partly because of seasonal overfunding), but fell back by the end of the quarter. This was partly matched by changes in the use made of the Bank's twice-monthly repo and secured lending facility, and therefore only in part by changes in the Bank's holdings of bills. By easing the Bank's daily operations in this way, the repo facility has contributed to greater stability of short-term rates. The market preferred at times to sell short-dated bills to the Bank in the daily operations (sometimes preferring the day-to-day operations to the repo facility because short rates in the market were below the repo rate). This meant that the shortage turned over more frequently, but did not directly affect the average stock of assistance. The further rise in eligible bill rates relative to interbank rates led to fewer bills being drawn.

Daily shortages averaged around £650 million; this was a little higher than in the previous quarter but they were generally relieved comfortably. The shortages tended to be a little lower in the second half of the period, partly as a result of underfunding (no auction was, for example, held in August). There were, however, a total of 15 days when the shortage was sufficiently large to warrant an early round of operations and the invitation to counterparties to offer bills on a repurchase basis. On such occasions, the Bank normally sets a maturity date (or dates) around two to three weeks away, taking into account the expected size of the shortage or surplus that would

Money-market assistance



(a) Bank of England's holdings of bills, market advances and funds supplied under the repo and secured loan facilities.
(b) Bank of England's holdings of eligible bank and local authority bills outright and on a repurchase basis; and of sterling Treasury bills 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.

Table C
Official transactions in gilt-edged stocks

£ billions: *not seasonally adjusted*

	1994/95 Apr.–June (a) Total	July	Aug.	Sept.
Gross official sales (+) (b)	7.6	3.6	0.8	2.6
Redemptions and net official purchases of stock within a year of maturity (-)	3.2	—	1.0	—
Net official sales (c)	4.4	3.6	-0.2	2.6
of which net purchases by:				
Banks (c)	—	1.5	-1.8	0.1
Building societies (c)	—	—	-0.4	0.2
Overseas sector	-0.9	—	-0.5	-0.8
M4 private sector (c)	5.2	2.0	2.5	3.0

(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 purhcase and resale agreements.
(c) Excluding transactions under purchase and resale agreements.

otherwise prevail on the maturity date. There were no surpluses during the quarter.

A reduction of around £1 billion in the net take-up at the repo facility on 7 September meant that the money-market shortage the following day was enlarged by that amount. As a result, the shortage on 8 September was £1,350 million. As normal in these circumstances, the Bank invited an early round of operations and offered a bill repo maturing on 26/27 September. These operations were interpreted by some in the market as a signal that a decision had been taken at the previous day's meeting between the Chancellor and the Governor to leave interest rates unchanged. But the Bank was simply following its normal practice for a shortage of this size. An early round of operations has been held on every recent occasion when the money-market shortage has been of such a size, and on every such occasion a bill repo of a similar maturity has been included.

Three-month Treasury bill tenders were held each Friday for £500 million. The full effect of the increase in size of the tender from £200 million in April has now been felt—the outstanding amount of Treasury bills was £7.2 billion at the end of September.

Gilt-edged funding

There was a positive mood in the gilt market during the first few weeks of the quarter. Domestic indicators confirmed continuing low inflation, and new government PSBR forecasts showed a reduced requirement for gilt sales in the current financial year. Medium and long-term yields fell, and spreads over other markets narrowed. In these conditions, tap issues of both conventional and index-linked stocks were made and quickly exhausted.

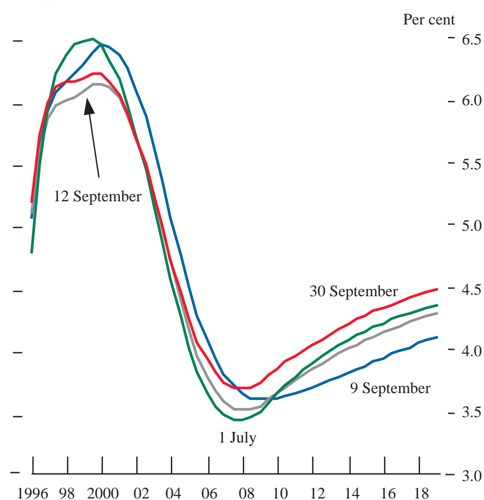
The auction on 27 July was for £2 billion of 6¼% Treasury 2010, the first long-dated conventional stock to be auctioned since January. Despite considerable prior market comment about the incipient demand for long-dated stock from domestic institutions, the auction was only 1.29 times covered—though the tail (the difference between the yields corresponding to the average and the lowest-accepted prices) was only one basis point, indicating that bidding by the market had been highly concentrated. Gilt prices fell slightly when the result of the auction was announced, and fell

Table D
Issues of gilt-edged stock

	Amount issued (£ millions)	Date announced	Date issued	Method of issue	Price at issue (per £100 stock)	Details of payment	Yield (a) at issue	Yield (b) when exhausted	Date exhausted
7¼% Treasury 1998	200	13.7.94	13.7.94	Tap	98.4375	Fully paid	7.73	7.71	14.7.94
7¼% Treasury 1998	100	13.7.94	13.7.94	To CRND	98.4375	Fully paid	7.73		
8% Treasury 2003	200	13.7.94	13.7.94	Tap	97.8125	Fully paid	8.35	8.33	14.7.94
8% Treasury 2003	150	13.7.94	13.7.94	To CRND	97.8125	Fully paid	8.35		
8¾% Treasury 2017	200	13.7.94	13.7.94	Tap	105.8125	Fully paid	8.19	8.17	14.7.94
2½% Index-Linked 2003	100	13.7.94	13.7.94	Tap	161.3125	Fully paid	3.78 (b)	3.78 (b)	20.7.94
2½% Index-Linked 2020	100	13.7.94	13.7.94	Tap	131.1250	Fully paid	3.90 (b)	3.89 (b)	14.7.94
6¼% Treasury 2010	2,000	19.7.94	28.7.94	Auction	81.7500 (c)	Fully paid	8.30 (d)	8.30	28.7.94
7% Treasury 2001	250	8.8.94	8.8.94	Tap	92.6250	Fully paid	8.37	8.88	15.9.94
7% Treasury 2001	150	8.8.94	8.8.94	To CRND	92.6250	Fully paid	8.37		
8½% Treasury 2007	250	8.8.94	8.8.94	Tap	100.4688	Fully paid	8.43	8.80	15.9.94
8½% Treasury 2007	150	8.8.94	8.8.94	To CRND	100.4688	Fully paid	8.43		
2½% Index-Linked 2009	100	8.8.94	8.8.94	Tap	152.1875	Fully paid	3.83 (b)	3.84 (b)	15.8.94
2½% Index-Linked 2024	100	8.8.94	8.8.94	Tap	110.1250	Fully paid	3.84 (b)	3.85 (b)	15.8.94
2% Index-Linked 2006	100	25.8.94	25.8.94	Tap	168.8750	Fully paid	3.70 (b)	3.87 (b)	29.9.94
2½% Index-Linked 2016	150	25.8.94	25.8.94	Tap	139.5000	Fully paid	3.75 (b)	3.90 (b)	29.9.94
8½% Treasury 2005	2,000	20.9.94	29.9.94	Auction	97.0625 (e)	Fully paid	8.91 (d)	8.91	29.9.94

(a) Gross redemption yield, per cent.
(b) Real rate of return, assuming 5% inflation.
(c) Lowest-accepted price for competitive bids. The non-competitive allotment price was £81.84375.
(d) Yield at lowest-accepted price for competitive bids.
(e) Lowest-accepted price for competitive bids. The non-competitive allotment price was £97.15625.

Implied forward inflation rates(a)



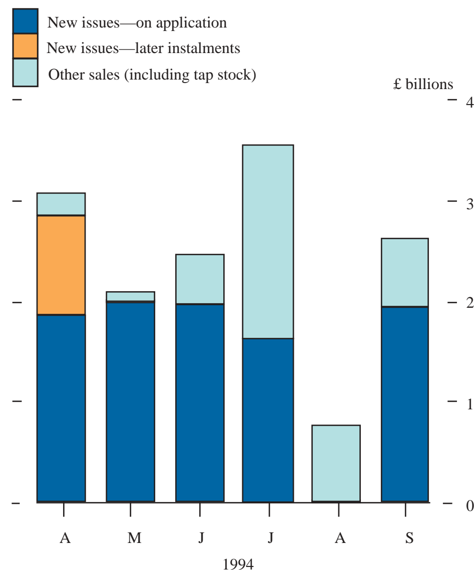
(a) Expectations of the 12-month change in the RPI in future years derived from the differential between yields on conventional and index-linked stocks.

Table E
Ten-year government bond yields

	UK yield	Differential compared with: (a) United States	Germany	France
1 July	8.62	129	155	102
2 Aug.	8.25	114	146	109
9 Sept.	8.84	140	125	76
12 Sept.	8.73	126	118	67
30 Sept.	8.80	119	117	68

(a) In basis points.

Gross official sales of gilt-edged stock



further after higher-than-expected US durable goods orders caused declines in bond markets worldwide. Gilt futures in particular were sold heavily, especially after an important technical support level had been breached; and cash prices fell by over two points at the long end.

The market was defensive for much of August, with conventional yields rising fractionally even though no auction was held. The strengthening picture of a more buoyant economy had helped to raise equity prices and to drive dividend yields below yields on index-linked stocks. This increased the relative attraction of such stocks and two index-linked tap issues were made and exhausted.

The conventional market did not improve in the first part of September, despite data suggesting weaker growth and continuing low inflation. But the rise in official interest rates on 12 September—though its timing came as a surprise to the market—was welcomed. Short-term yields rose in line with money-market rates, but medium and long-term stocks rallied as the move was interpreted as a clear signal of the strength of the authorities' counterinflationary commitment. The downward movement in the implied forward inflation curve on 12 September suggests the interest rate rise led markets to lower their long-term inflation expectations.

The improvement proved short-lived, however, largely under the influence of international developments, though the PSBR figure published for August was also rather higher than the market had expected. Bond markets worldwide fell, prompted by US figures for production and capacity utilisation published on 16 September. There was also growing uncertainty prior to the Federal Reserve's FOMC meeting on 27 September and the German federal elections on 16 October. But during the last weeks of the quarter, gilts outperformed other major bond markets. The differential between the yields on ten-year gilts and US Treasuries narrowed from 140 basis points on 9 September to 119 basis points on 30 September; and the differential compared with German yields from 125 to 117 basis points over the same period.

The September auction stock was 8½% Treasury 2005, which will probably form next year's ten-year benchmark stock. The amount (£2 billion) was at the lower end of the indicated range, but the cover—at 1.74—was comfortable and the result improved market sentiment. The Bank sold stock from its holdings into the secondary market and two index-linked taps were exhausted shortly afterwards. In the quarter as a whole, gross sales of £7.0 billion were made, bringing the total for the financial year to £14.5 billion.