Operation of monetary policy

- *Economic statistics in the fourth quarter of 1993 (especially those released in November and December) tended to reinforce an impression of steady growth and low inflation in the British economy.*

- *In view of the improved prospects for low inflation, and taking account of the planned Budget measures, a ½% interest rate cut was implemented on 23 November.*

- *The interest rate cut and the Budget, along with the improving UK economic statistics, were well received in the markets: sterling strengthened, gilts and equities rallied to new highs, and expectations for nominal interest rates and inflation declined.*

- *The Bank maintained a generally neutral stance in its market operations, but was less accommodating in the first half of December when the market began to anticipate an early further cut in rates in the wake of the Budget.*

Background

Monetary policy is based on the assessment of a wide range of indicators. The Bank's current assessment is given in the February *Inflation Report*.

Early in the fourth quarter, there were some signs that the fall in inflation might be coming to an end. Summer sales discounts were reversed, and the twelve-month increase in the retail price index excluding mortgage interest payments (RPIX) rose from 2.8% in June to 3.3% in September. Wage inflation appeared to have stopped falling, and lower unemployment suggested less downward pressure on settlements in 1994. As a result, there was some concern that predictable increases in prices in spring 1994 (reflecting increases in indirect taxes and the disappearance from the 12-month rate of 1993's change in local taxation) might push up wage settlements and make it harder to keep inflation within the 1%–4% target range.

The October data on consumer demand, on the other hand, suggested that the recovery was continuing, but modest. Retail sales volume grew by 0.5% between August and September, in spite of the end of the summer sales. The housing market also showed signs of picking up, so reducing the incidence of negative equity and its possible adverse effect on consumer confidence. Although surveys suggested that business confidence continued to rise, the data for manufacturing output were less encouraging, and weak export order books reflected the continued recession in Europe and Japan.

In the money markets, remaining doubts about the recovery kindled expectations of some future cut in rates, the expected timing of which shifted between the near-term future and the end-November Budget. These expectations were strengthened by the Bundesbank's decision to cut its rates on 21 October, which was seen as paving the way for interest rate cuts in the rest of Europe. Over the following days, more reflective press comment and statements by the UK authorities made it clear that there was no hurry here to follow rate cuts elsewhere in Europe. Nonetheless, the episode strengthened expectations of at least a ½% rate cut by mid-December.

November's data releases, however, were significantly more encouraging about both activity and the medium-term prospects for low inflation, with the trade and inflation figures indicating substantial improvements. Labour market statistics showed continued subdued wage growth and a fall in unemployment of nearly 50,000.

The ½% rate cut on 23 November was well received in the market. There was some surprise at its timing—before rather than with or after the Budget—but also a widespread welcome for the Chancellor's decision that the Bank should decide the precise timing of this and future rate cuts. The size of the cut was seen as prudent in the light of earlier economic statistics, and the Chancellor's statement that the cut took full account of the planned Budget measures helped to consolidate market expectations of a moderate fiscal tightening in the Budget.

The Budget itself was well received in the markets: the greater-than-expected fiscal tightening lowered inflationary expectations and reduced the prospective supply of gilts over the medium term. This spurred a further rally in the gilts market and generated expectations of sustainably lower interest rates over the longer term.

December's data releases further reinforced the impression of steady growth with low inflation, although the market often appeared to interpret the data selectively, in a way that would support the case for a further rate cut. The absence of a further rate cut after the lower-than-expected November inflation figures did, however, push rate cut expectations into the New Year; while late December's substantial rise in notes and coin in circulation, and anecdotal evidence of buoyant retail sales around Christmas, made the market less certain about the prospects for further interest rate cuts.

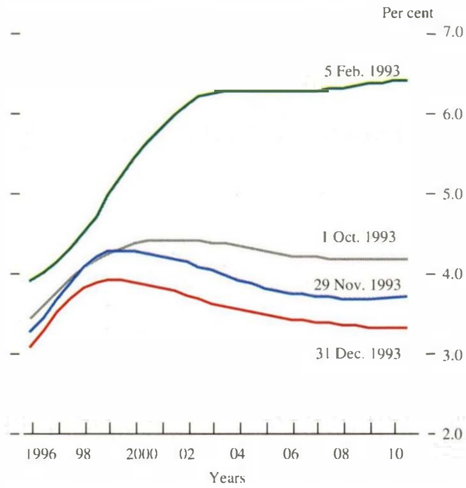
Over the quarter, the price of LIFFE's short sterling interest rates futures (see chart) rose, implying expectations of a sustained period of lower interest rates. At the beginning of October, a rate cut of ½% or 1% was expected by spring, but a reversal was foreseen by end-1994. By the end of the quarter, when rates had been trimmed by ½%, the market was expecting a further ½% cut by summer, and was not expecting this to be reversed until well into 1995.

Foreign exchange markets

During the quarter, the foreign exchange markets were dominated by the firm tone of the dollar and the weakness of the Deutsche Mark, as the increasingly gloomy market view of the German economy and renewed optimism over the US economy led to a reassessment of likely interest rate differentials.

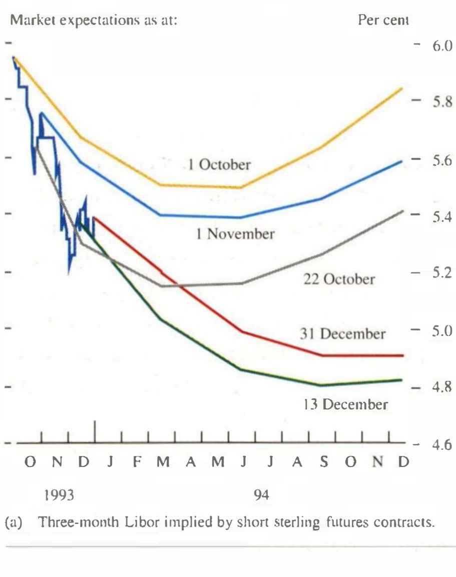
Major factors behind the Deutsche Mark's weakness were the Bundesbank's unexpected announcement of cuts in the discount and Lombard rates to 5.75% and 6.75%, and in the repo rate to 6.40%, on 21 October. The Deutsche Mark fell and longer-term

Implied inflation term structure(a)



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

Sterling interest rate expectations(a)



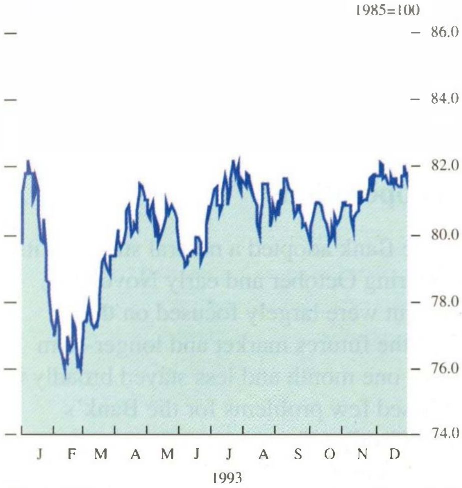
(a) Three-month Libor implied by short sterling futures contracts.

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

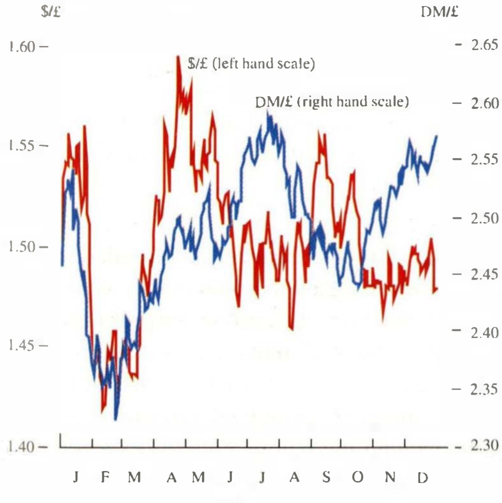
	Interest rates (per cent per annum)					Gilt yields (b) (per cent per annum)				Exchange rates		
	Sterling interbank rates (c)				Short sterling future (d)	Conventionals			Index-Linked			
1993	1 month	3 months	6 months	12 months	3 months	Short	Medium	Long	Long	ERI	$/£	DM/£
1 October	6	5 15/16	5 13/16	5 3/4	5.66	6.36	6.90	7.29	3.21	80.2	1.5060	2.4550
22 October	5 27/32	5 17/32	5 7/16	5 3/8	5.29	5.99	6.68	7.11	3.14	79.9	1.4772	2.4702
1 November	5 7/8	5 3/4	5 5/8	5 9/16	5.58	6.23	6.89	7.24	3.19	80.9	1.4782	2.5073
22 November	5 13/16	5 9/16	5 13/32	5 3/8	5.44	6.09	6.75	7.12	3.17	81.0	1.4760	2.5173
23 November	5 15/32	5 13/32	5 5/16	5 5/16	5.39	6.05	6.73	7.08	3.18	81.4	1.4808	2.5262
29 November	5 13/32	5 3/8	5 5/16	5 9/32	5.19	6.02	6.68	6.96	3.15	81.8	1.4870	2.5428
1 December	5 3/8	5 5/16	5 1/4	5 7/32	5.15	5.86	6.50	6.75	3.08	81.7	1.4830	2.5438
13 December	5 11/16	5 3/8	5 5/32	5 1/16	5.03	5.61	6.32	6.55	3.04	81.5	1.4918	2.5393
31 December	5 7/16	5 3/8	5 9/32	5 5/32	5.19	5.58	6.09	6.38	2.91	81.8	1.4780	2.5688

(a) Close of business middle-market rates in London.
(b) Gross redemption yield. Representative stocks: short—7¼% Treasury 1998; medium—8% Treasury 2003; long—8% Treasury 2013; index-linked—2½% Index-Linked Treasury 2016 (real yield assuming 5% inflation).
(c) Middle-market rates.
(d) Implied future rate: until 23 November, the December contract, thereafter the March 1994 contract.

Sterling effective index



Sterling exchange rates



German Bund yields rose. Comments from Bundesbank officials that there would not be another easing soon provided reassurance and Bunds rallied briefly. Nevertheless, long yields, which had fallen some 0.25% since the start of October, recovered some 0.15% by the start of November before declining further later in the quarter.

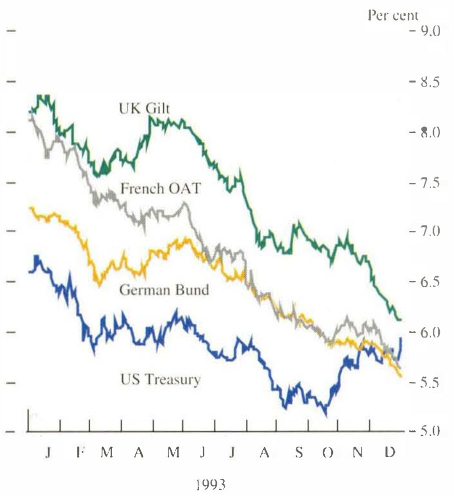
The Bundesbank's rate cut released the pressure on the other ERM currencies, and allowed all ERM members to reduce official interest rates by up to ½%. At the same time, deviations from central rates started to narrow, bringing all other ERM currencies back into their pre-August fluctuation bands against the Deutsche Mark for part of December.

Sterling's exchange rate index appreciated by 2% over the quarter to end-1993 at 81.8. To some extent its movements reflected developments elsewhere, with a 1.8% fall against the stronger dollar offset by a 4.6% rise against the generally weaker Deutsche Mark. Sterling rose after the Conservative Party Conference in mid-October, and was helped by some rather better-than-expected economic data, which gave rise to a more confident view of the prospects for the UK economy, and set it apart a little from continental European economies. In conjunction with reports of opposition to a rate cut in the United Kingdom from the Chancellor and the Governor, this brought the market to conclude that the United Kingdom was unlikely to follow the Bundesbank cut on 21 October in the near term.

Sterling's progress was, however, restrained as business and consumer confidence surveys were seen as raising the probability of an interest rate cut to offset the anticipated fiscal tightening in the Budget. Nevertheless, statistics released during November appeared to illustrate a continuing, moderate and non-inflationary recovery, and sterling began to firm a little, especially against the Deutsche Mark. Market uncertainties over UK official rates were resolved by the ½% rate cut on 23 November, and by the Chancellor's statement that the cut took full account of planned Budget measures. The move was seen as appropriate for the current state of the economy, and helped sterling appreciate by ½% on the day.

The tighter-than-expected Budget on 30 November boosted sterling to highs for the quarter against the Deutsche Mark near DM 2.57, and in effective terms above 82.0. It slipped down again in light Christmas trading, following the good November RPI data and

Ten-year government bond yields(a)



(a) Daily gross redemption yield.

despite improving unemployment statistics and reports of strong retail sales. Overall, however, sterling remained firm, and recovered against the Deutsche Mark with the stronger dollar as the New Year approached.

Part of sterling's strength during November and December was also the result of the Deutsche Mark's continued weakness, which reflected poor indicators on German unemployment and output, the Bundesbank's further reductions in the repo rate, and worries about developments in Russia. The weakness in the Deutsche Mark was a major factor behind a further narrowing of the divergences within the ERM bands during the latter stages of the period. This was reinforced by the timing and extent of interest rate cuts in other ERM countries, which suggested that policy continued to be geared towards keeping exchange rates more closely in line with their parities against the Deutsche Mark.

The market's expectation of a continuing economic recovery in the United States was supported by strong retail sales and output figures, and especially by the better-than-expected October non-farm employment statistics released on 3 December. The dollar was stable for most of December, but appreciated further—especially against the yen—in late December, as the positive economic outlook for the United States was contrasted with continuing pessimism over Japan and the Tokyo stock market.

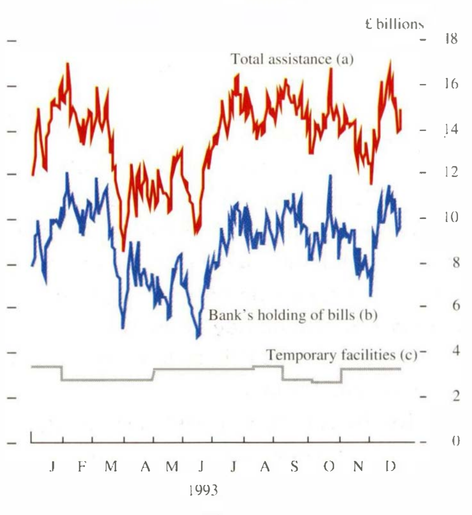
Official money-market operations

During most of the quarter, the Bank adopted a neutral stance in its money-market operations. During October and early November, market expectations of a rate cut were largely focused on the Budget. This mostly affected the futures market and longer-term interbank rates, while rates for one month and less stayed broadly in line with official rates, and posed few problems for the Bank's operations. During the brief episodes of more intense rate cut speculation (during the party conference season, after the German rate cuts, and after the October RPI figures), the market's offers of bills in the early round of operations were scaled back modestly, to tighten conditions in short dates and to reinforce the policy stance.

A minimum lending rate of 5½% was announced in the 9:45 am round of money-market operations on 23 November, to effect the ½% interest rate cut. A rate cut had been fully discounted in the markets, although some had expected a 1% cut, and most had expected the cut to be announced with or shortly after the Budget. The generally positive market reaction meant that, in the week leading up to the Budget, a continued neutral operational stance was sufficient to keep market rates in line with the new level of official rates.

The fiscal tightening announced by the Chancellor exceeded most market expectations. The Budget's growth assumptions were regarded by some as inconsistent with the current level of official interest rates, prompting a resurgence of rate cut expectations, which focused on a further rate cut before Christmas. This affected not only the futures market; short-term interbank rates rose, while rates for three months and beyond fell below 5¼%, as expectations of a rate cut led market participants to seek to borrow short and lend long.

Money-market assistance



(a) Bank of England holding of bills, funds supplied in temporary facilities and market advances.
(b) Bank of England holdings of eligible bank and local authority bills outright and on a repurchase basis; and sterling Treasury bills on a repurchase basis.
(c) Bank of England holdings of gilt-edged stocks on a repurchase basis, and loans made against export and shipbuilding credit-related paper.

Table B
Influences on the cash position of the money market

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

	1993/94 Apr.–Sept.	Oct.	Nov.	Dec.
Factors affecting the market's cash position				
Under/overfunding (+/-)(a)	-7.0	-2.9	+0.5	-3.0
Other public sector net borrowing from banks and building societies(-)(b)	+0.8	+0.1	+1.0	+0.6
of which, local authorities' deposits with banks and building societies(+)	*+1.1*	*+0.1*	*+1.2*	*+0.5*
Currency circulation(-)	-0.8	-0.9	+0.7	-2.4
Other	+1.3	+3.1	-0.7	+2.0
Total	**-5.7**	**-0.6**	**+1.5**	**-2.7**
Increase (+) in the stock of assistance	+5.6	+0.5	-2.1	+2.4
Increase (-) in £ Treasury bills outstanding (c)	+0.2	+0.1	+0.6	+0.2
Increase in bankers' balances at the Bank	+0.1	+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.

In these circumstances, the Bank adopted a less accommodating stance than earlier in the quarter. The market's offers of bills in the morning round were scaled back more substantially than before, and sometimes the Bank withdrew its offer to repo bills from the noon round of operations, so deferring much of the alleviation of daily shortages until the 2 pm round of bill offers or the 2:45 pm round of lending operations. These operations made it more expensive for market participants to speculate on the possibility of a near-term rate cut. When the better-than-expected RPI figures published on 15 December were not followed by a rate cut, the horizon for rate cut expectations receded into the New Year, and one-month and three-month rates reverted to levels consistent with the stance of policy. This allowed the Bank to return to a neutral operational stance for the rest of the year.

The occasionally difficult technical conditions in the money market were partly the result of continued overfunding, which kept the stock of assistance high at an average of £14.1 billion. When expectations of imminent rate cuts intensified, market participants were often reluctant to sell (or even repo) bills to the Bank, and much of the necessary assistance had to be provided through lending in the 2:45 pm round of operations.

The stock of eligible bills remained roughly constant during the quarter, even though industrial and commercial companies were repaying other borrowing from banks (while raising record amounts through bond and equity issues—see pages 23–33).

The temporary facilities available to banks, gilt-edged market makers and the ten largest building societies, for the sale and repurchase (repo) of gilts and loans related to export and shipbuilding credit, were rolled over throughout the quarter. In December, the Bank began consultations with the market which led in January to the introduction of permanent repo arrangements.

Treasury bill tenders continued to be held every Friday (including Christmas eve and New Year's eve) for £200 million of 91-day bills —the standard amount and maturity on offer since 13 August. Treasury bills continued to be in high demand; tenders were routinely three to four times oversubscribed, and Treasury bills continued to command a lower discount rate than commercial bills, although the differential narrowed from $^3/_8$% at the start of the quarter to $^1/_8$% at the end of the year.

Table C
Official transactions in gilt-edged stocks

£ billions: *not seasonally adjusted*

	1993/94 (a) Apr.–Sept.	Oct.	Nov.	Dec.
Gross official sales (+)(b)	+32.9	+5.4	+3.2	+5.3
Redemptions and net official purchases of stock within a year of maturity(-)	-2.5	—	-0.9	-0.4
Net official sales(c)	+30.4	+5.4	+2.3	+4.9
of which, net purchases by:				
Banks(c)	+2.8	+1.0	+1.2	+0.6
Building societies(c)	+0.8	+0.3	+0.1	+0.1
Overseas sector	+9.9	+1.3	-0.3	+1.4
M4 private sector(c)	+16.8	+2.8	+1.2	+2.9

(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.

Gilt-edged funding

Gross official gilt sales of £14 billion during the fourth quarter brought the total cash raised for the first nine months of the financial year to £48.8 billion. In addition, £1.5 billion of funding was secured for the next quarter with payment for the final instalment for the December auction falling due in February.

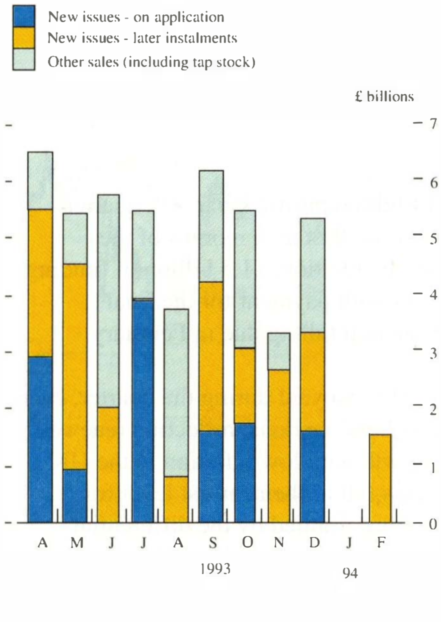
The gilt market was exceptionally buoyant during the quarter, even more so than other government bond markets, reflecting renewed confidence in prospects for growth with low inflation in the UK economy. As a result, gilt yields fell to their lowest level for decades; and inflation expectations implied by the differential between conventional and index-linked gilt yields fell to the lowest level since index-linked gilts were first issued in 1981.

Table D
Issues of gilt-edged stock

	Amount issued (£ millions)	Date announced	Date issued	Method of issue	Price at issue (per £100 stock)	Details of payment	Yield (a) at issue	Yield (a) when exhausted	Date exhausted
9% Conversion 2011 'D'	1,000 (b)	1.10.93	1.10.93	Placing	116.7500	Partly paid (c)	7.30	7.27	5.10.93
7% Treasury 2001	350	8.10.93	8.10.93	Tap	101.9375	Partly paid (d)	6.68	6.68	12.10.93
7% Treasury 2001	100	8.10.93	8.10.93	To CRND					
8¾% Treasury 2017	350	8.10.93	8.10.93	Tap	118.0000	In full	7.16	7.15	12.10.93
8¾% Treasury 2017	100	8.10.93	8.10.93	To CRND					
2½% Index-Linked 2011	250	8.10.93	8.10.93	Tap	168.6250	In full	3.14 (e)	3.13 (e)	15.10.93
2½% Index-Linked 2003	150	20.10.93	20.10.93	Tap	167.8750	In full	3.00 (e)	3.00 (e)	21.10.93
2½% Index-Linked 2020	250	20.10.93	20.10.93	Tap	146.6875	In full	3.16 (e)	3.18 (e)	17.11.93
7¾% Treasury 2006	500	22.10.93	22.10.93	Tap	106.6875	In full	6.95	6.94	17.11.93
7¾% Treasury 2006	200	22.10.93	22.10.93	To CRND					
6% Treasury 1999	3,500	19.10.93	28.10.93	Auction	98.8438 (f)	Partly paid (g)	6.25 (h)	6.25	28.10.93
6% Treasury 1999	400	8.12.93	8.12.93	Tap	100.8125	In full	5.83	5.81	9.12.93
8% Treasury 2013	400	8.12.93	8.12.93	Tap	114.8125	In full	6.64	6.61	9.12.93
8% Treasury 2013	200	8.12.93	8.12.93	To CRND					
4⅝% Index-Linked 1998	200	8.12.93	8.12.93	Tap	113.5625	In full	1.87 (e)		
2½% Index-Linked 2024	200	8.12.93	8.12.93	Tap	124.9375	In full	3.09 (e)	3.09 (e)	10.12.93
6¾% Treasury 2004 'A'	3,000	30.11.93	9.12.93	Auction	101.8125 (i)	Partly paid (j)	6.51 (h)	6.51	9.12.93
2½% Index-Linked 2001	150	30.12.93	30.12.93	Tap	176.3125	In full	2.47 (e)	2.47 (e)	31.12.93
4⅜% Index-Linked 2004	250	30.12.93	30.12.93	Tap	118.3125	In full	2.62 (e)	2.61 (e)	31.12.93
2½% Index-Linked 2013	150	30.12.93	30.12.93	Tap	146.0625	In full	2.87 (e)		
4⅛% Index-Linked 2030	200	30.12.93	30.12.93	Tap	128.6250	In full	2.95 (e)		

(a) Gross redemption yield, per cent.
(b) Of which £200 million reserved for CRND.
(c) With £50% payable on issue and balance on 10 November.
(d) With £61.9375% payable on issue and balance on 11 October.
(e) Real rate of return, assuming 5% inflation.
(f) Lowest accepted price for competitive bids. The non-competitive allotment price was £98.875.
(g) With £48.84375% payable on issue and balance on 2 December.
(h) Yield at lowest accepted price for competitive bids.
(i) Lowest accepted price for competitive bids, which was also the non-competitive allotment price.
(j) With £51.8125% payable on issue and balance on 14 February.

Gross official sales of gilt-edged stock

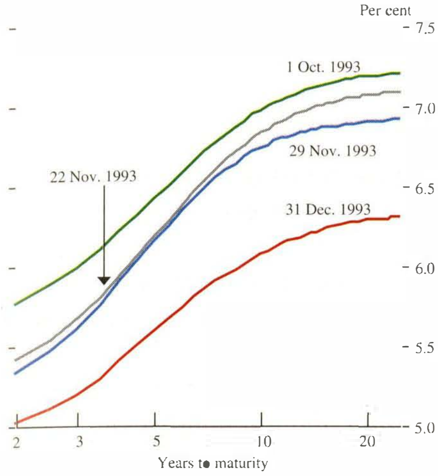


This rally was to a large extent driven by substantial downward revisions in expectations of future funding requirements and nominal interest rates. Before the Budget, this reflected renewed confidence in the recovery and an expectation of some fiscal tightening in the Budget, accompanied by a cut in interest rates. In the event, the medium-term fiscal tightening announced in the Budget exceeded market expectations, and encouraged expectations of more rapid falls in the PSBR and a longer period with low interest rates. The prospective future supply of gilts was reduced further by the clarification in the Budget speech that the sales of gilts to banks and building societies made in 1992/93 would be taken into account in funding to the end of 1994/95.

Given the progress on funding that had already been made at the beginning of the quarter, and given the uncertainties surrounding the end-November Budget and the lack of market activity over the Christmas season in late December, it was decided to deviate slightly from the established pattern of auctions at the end of each month. The announcement of the end-October auction stated that no auction would be held in November, and the last auction of the calendar year was held on 8 December, rather than at the end of the month.

In view of the market appetite for more liquidity in key benchmark stocks and the absence of a November auction, the end-October auction of 1994's current-coupon five-year benchmark stock (6% Treasury 1999) was increased in size to £3½ billion—the largest to date. It was a healthy 1.56 times covered, with a tail of just one basis point. Keen investor interest led to the issue of an additional £400 million as part of the 8 December tap stock package.
The 8 December auction of £3 billion of 6¾% Treasury 2004 'A' was also aimed at increasing the liquidity of a new, ten-year, benchmark stock. Benefiting from the further rally in the gilt market after the Budget and strong investor interest, the issue was

Par yield curves for British government stocks



2.19 times covered with no tail, at a price which compared well with issues of neighbouring maturities.

These two auctions, along with five packages of tap issues, took advantage of the cheaper funding opportunities provided by the buoyant demand for gilts, added to the liquidity of next year's ten-year benchmark stock (up from £3¼ billion to £6¼ billion), and created £3.9 billion of a new five-year benchmark stock. The market for index-linked gilts was also enhanced, with new issues totalling £1.8 billion nominal.