Changes in UK gilt-edged and money markets in recent years

Central banks have been obliged in the recent past to pursue their objectives of monetary and financial stability within an environment of rapid and continuous change. Ian Plenderleith, an Executive Director, Monetary Stability at the Bank, illustrates[1] *the Bank's involvement in continuing change by looking at how the UK government bond and money markets have developed in recent years.*

Involvement in change is nothing new to us, as I would like to illustrate by touching on an area where we are in the midst of a significant process of continuing change—the UK government bond and money markets.

These markets are operationally important to us because it is through our operations in them that we conduct monetary policy. In our daily operations in the sterling money markets, we are able to influence the level of short-term rates; and it is, of course, through changes in short-term rates that we implement changes in the monetary stance. In the government bond market—the gilt-edged market—we seek to sell government debt in order to fund the government's borrowing requirement in a non-inflationary fashion and at least cost.

It is therefore vital that we should have a close interest in the structural health of these markets. The more efficient and liquid these markets are, and the broader the range of participants in them, the more effectively we can carry out our monetary operations in them. For this reason, we have in recent years been in the forefront, working with market participants, in encouraging the markets to evolve and adapt and modernise their structures. And this is a continuing process.

In the gilt-edged market, the track record of change is considerable. The major change just eight years ago to an open and competitive structure of committed market-makers has been followed by a range of further changes in trading strategies and instruments. Soon after the new structure had bedded down, we introduced auctions. And in the subsequent period of budget surpluses, we initiated a successful series of reverse auctions, in order to reduce the National Debt. More recently, as the need for borrowing reappeared, we have established a regular pattern of monthly auctions, combined with 'tap' sales of small, additional tranchettes of existing issues as and when demand for them emerges. In this way, in a market which is marked by a wide diversity of investors interested in a range of different coupons and maturities, we have been able to maintain liquidity across the range of existing issues, while establishing major benchmarks at key points in the maturity spectrum. All of this has, we believe, enabled the government to fund its deficit in a non-inflationary fashion and to minimise its cost of debt service, which have to be our overriding long-term aims.

We have also sought actively to develop a range of instruments, establishing floating-rate gilts earlier this year, and reintroducing convertible issues which give investors options to extend the maturity on pre-set terms. We have also, over the years, built up the largest index-linked government bond market in the world.

To support the liquidity of this range of different instruments, we have worked with the market-makers to enable them to manage their books effectively by utilising the actively traded futures contracts on LIFFE and a range of swap and derivative products. And we have provided for them to be able to extend their activity into Ecu products, where we have ourselves issued a ten-year bond and have an on-going programme of issuing short-dated Treasury bills and three-year Treasury notes.

Nor have we ignored the evidence, as inflation has declined, of reviving interest for investment in gilts on the part of personal investors. Our booklet for personal investors, describing the workings of the gilt-edged market in plain English, issued in March 1993, generated demand for over a third of a million copies; and we have attached importance to ensuring that there are proper market-making facilities available for small-sized deals in gilts—including a market-maker operating in Scotland.

It is our expectation—and firm intention—that this process of change will continue in the future, particularly as international participation in the market increases. As is known, we have consulted widely about the possible development of a gilt repo market and have the issues that need to be addressed in that area under active consideration. In parallel, we continue to seek views from market participants on the scale of possible interest in zero-coupon instruments and in coupon-stripping facilities. Changes in the pension industry may generate demand for new forms of government security. And we are addressing the best means to achieve linkage of the Central Gilts Office, which provides electronic settlement for gilts, with international systems such as Euroclear and Cedel. There are technical features of tax and dividend payment also to be addressed.

(1) In part of his speech on recent developments in practical central banking at the third City of London central banking conference on 22 November 1994.

And there are of course major changes in train in the regulatory framework as the EC Directives are implemented.

Similarly in the sterling money markets, we have encouraged diversification of instruments with, for example, the establishment of a sound structure for sterling commercial paper and medium-term notes; and we have recently developed a fortnightly repo facility, in parallel with our daily operations, in order to diversify our range of operating methods. Experience so far with this facility has been encouraging and there has, as a result, been a notable lessening of volatility in the very short-dated rates. In the money markets, as in the gilt-edged market, there has been a notable intensification of competition and of international participation in recent years, with results that have increased both the efficiency of the markets and their integration with the international financial markets.

In parallel, our regular programme of issuing Ecu money-market instruments at monthly and quarterly auctions, alongside LIFFE's futures contract on three-month Ecu interest rates, are practical steps which lay the foundations for an integrated Ecu money market here in London; this is of immediate benefit in further extending the range of London's facilities as an international financial centre, and could be of more fundamental significance in the long run.

In pursuing this process of continuing change, we have always to keep thinking about where we are going, step carefully as we proceed and listen intently to the feedback we receive, because change has to be achieved, so to speak, during normal business hours. Markets cannot be closed for renovation. They need to continue to function effectively and we need to continue to be able to conduct our monetary operations in them. This argues strongly for an evolutionary process of change and for recognising that it is the firms participating in markets who are best able to develop them effectively.

But it does not mean that changes to improve the structure of markets are not both natural and desirable. What I have described here is a considerable programme of on-going change, in which we have felt it right to take a leading part because of the importance of these markets to our pursuit of monetary stability.