Operation of monetary policy

- *During the second quarter, the Chancellor extended the Government's inflation objective beyond the end of the current parliament: the aim is a rate of inflation—measured by the twelve-month change in the retail prices index excluding mortgage interest payments—of 2½% or less.*

- *There were indications of significant cost pressures in the quarter, and there continued to be a marked contrast between domestic demand and the traded sector.*

- *Official interest rates remained unchanged during the quarter. The decision not to increase rates in May surprised the markets; initially, sterling fell to a new low on a trade-weighted basis and long-gilt yields rose, but market reaction subsequently steadied.*

- *The Government announced proposals for a new tax regime for gilts and other bonds, which are likely to facilitate the development of an official gilt strips market.*

Overview

Decisions on monetary policy are based on the analysis of a wide range of indicators. The Bank's current assessment is given in the August *Inflation Report*; this article reviews the operation of monetary policy in the second quarter of 1995.

In his Mansion House speech on 14 June, the Chancellor restated the Government's aim of achieving a rate of inflation of 2½% or less—measured as the twelve-month change in the retail prices index excluding mortgage interest payments. The aim is now to achieve this inflation target not just by the end of the current parliament but also in the longer run.

Statistics published during the quarter showed inflation on this measure running at just above 2½% (2.7% in the year to May); with indirect tax changes also excluded, inflation was lower but rising (to 2.2% in the year to May). There was also evidence of significant pressure on costs. Import prices rose by over 7% (not annualised) in the three months to March, more than could be attributed to the fall in the exchange rate over the period. But some of these pressures abated over the course of the quarter, as oil and other commodity prices eased. Manufacturers' input prices continued to rise (at an annualised rate of 6½% in the three months to May), but less rapidly than earlier. There was little evidence of any upward movement in pay settlements or average earnings, but with manufacturing output and productivity growth slowing, manufacturers' unit labour costs were no longer falling. Short-run measures of the change in manufacturers' output prices also fell, and the relative movements of input and output prices suggested a continuing narrowing of margins on domestic sales.

It became clear that output growth had slackened a little in the first quarter and very partial evidence suggested that this trend might have continued into the second quarter. There was a marked contrast between domestic demand, which fell in the first quarter, and a strong trade performance. A slight fall in consumption was

accompanied by a rise in the personal saving ratio, and the housing market continued to be weak. Business investment also fell in Q1 despite reportedly strong investment intentions.

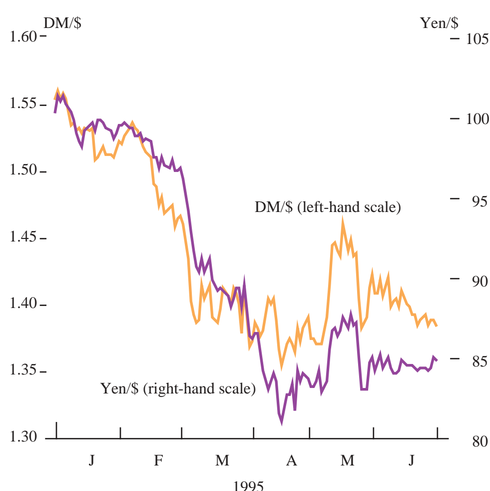
Data indicated a slowdown in activity in the United States, which raised concerns that the 'soft landing' there might turn into a recession. However, there was less evidence of a slowdown in Europe (where strong industrial growth continued in France and Italy, but surveys suggested some slowing in Germany) and some increase in inflationary pressures—most noticeably in countries whose exchange rates had fallen.

Against this background, official interest rates remained unchanged throughout the quarter. The decision not to increase rates in May took the markets by surprise, and there was some concern that this might impair achievement of the Government's inflation target. Initially sterling fell to a new trade-weighted low of 82.7 and long-gilt yields rose. These first reactions were quickly reversed in the wake of a rally by the US dollar and a strong rise in bond markets internationally. Subsequently, somewhat weaker UK activity data led the markets to judge an early change in rates less necessary and to expect no change in the remainder of the quarter.

Foreign exchange markets

Some stability returned to the foreign exchange markets in the second quarter, with the major currencies trading in narrow ranges. The dollar exchange rate index fell by less than 1% in the quarter, in contrast to its fall of 7.5% in the first. Sterling moved sideways with the dollar, trading in a range between 84 and 85 on its effective rate index (ERI) for much of the period, before weakening late in June at the start of the election for the leadership of the Conservative Party.

Dollar exchange rates[(a)]



(a) Close-of-business London prices.

The dollar's fall against the Deutsche Mark came to a halt at the start of April and it steadied at around DM 1.40, a level around which it traded for much of the quarter. Investors were attracted by the widening of interest rate differentials in the dollar's favour, as German money-market rates fell prior to the Bundesbank's decision to cut interest rates on 31 March.

With uncertainty surrounding the contents of the Japanese fiscal and monetary support package announced on Good Friday, the dollar was initially more vulnerable against the yen, despite a similar move in money-market interest rate differentials in its favour; it received support from concerted intervention on 5 April. The package, when announced, was widely regarded as disappointing; the $^{3}/_{4}$% cut in the Official Discount Rate had been widely discounted and the front-loading of already planned expenditure was thought to be insufficient to stimulate domestic demand from a very subdued level. The dollar fell back sharply, with concerns that the US-Japanese trade talks were reaching an impasse adding to the downward momentum. In illiquid markets on 19 April, it briefly touched an all-time low of ¥79.90 (after the close in London), before recovering to stabilise at around ¥84 before the meeting on 25 April of the Group of Seven (G7) countries. Despite the lack of action on exchange rates at that meeting, the general agreement on the need for an orderly reversal of the dollar's decline helped it to establish a base at these levels, where it traded for much of the rest of the quarter.

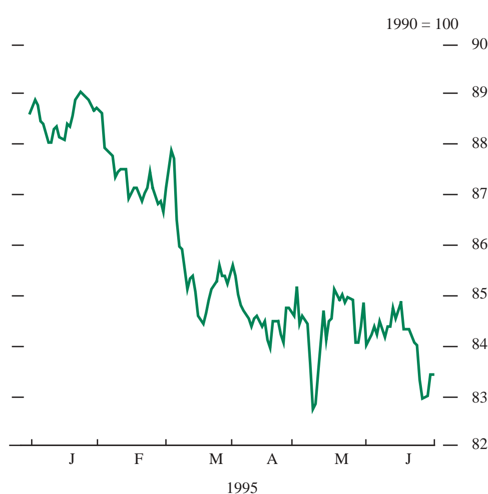
Table A
Interest rates, gilt yields and exchange rates; selected dates(a)

	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			
1995	1 month	3 months	6 months	12 months	3 months	Short	Medium	Long	Long	ERI	$/£	DM/£
3 April	6 5/16	6 23/32	7 1/32	7 5/8	7.64	8.32	8.42	8.35	3.86	85.0	1.6170	2.2190
4 May	6 25/32	7	7 7/32	7 11/16	7.60	8.14	8.27	8.19	3.72	84.4	1.6178	2.2164
6 June	6 13/32	6 9/16	6 23/32	6 31/32	6.85	7.38	7.69	7.75	3.55	84.3	1.5882	2.2517
22 June	6 11/32	6 19/32	6 25/32	7 3/32	6.86	7.69	7.98	8.02	3.64	84.1	1.6067	2.2248
30 June	6 5/8	6 29/32	7 5/32	7 1/2	7.17	8.19	8.46	8.44	3.80	83.4	1.5908	2.2021

(a) Close-of-business rates in London.
(b) Gross redemption yield. Representative stocks: short—8% Treasury 2000; medium—8½% Treasury 2005; long—8% Treasury 2015; index-linked—2½% Index-Linked Treasury 2016 (real yield assuming 5% inflation).
(c) Middle-market rates.
(d) Implied future rate: September 1995 contract.

Sterling was on the sidelines for much of April. It made some progress against the weakening dollar, but failed to push through the $1.60–$1.61 area. As a result, it fell sharply with the dollar against the Deutsche Mark, from around DM 2.22 in the early part of April, and touched an all-time low of DM 2.1795 on 19 April. It then rebounded with the stronger dollar; and following the publication of data on UK activity that were stronger than market expectations (in particular, the initial Q1 GDP data released on 25 April), it was supported by widespread expectations of an interest rate rise following the Chancellor/Governor meeting on 5 May.

Sterling's effective exchange rate index



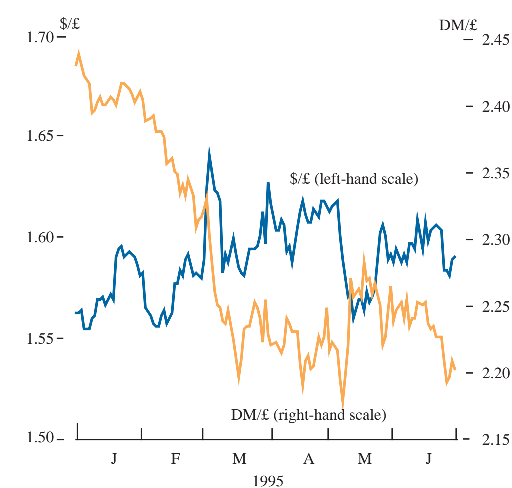
The decision not to raise interest rates at this meeting confounded market expectations and led initially to a sharp sell-off in sterling, on concerns over its implications for the inflation outlook and for the credibility of the monetary policy framework. Sterling hit new all-time lows of DM 2.1765 and 82.7 in effective terms on 9 May. This initial reaction was, however, quickly reversed as the dollar strengthened. Sterling was also helped by comments by the Chancellor and the Governor that made it clear that there was no disagreement between them on the ultimate policy objective of permanently low inflation. Sterling moved back into the 84–85 range on the ERI, where it stayed until it was unsettled by political events at the end of June.

The dollar traded in narrow ranges of ¥83.5–¥85 and DM 1.38–DM 1.41 for much of May and June. Interest rate differentials remained more or less unchanged as the news of a marked slowdown in the US recovery was matched by serious concerns over recession in Japan and indications of slower monetary growth in Germany; all of these led to a worldwide easing of interest rates across the yield curve. In the absence of changes in underlying economic fundamentals, technical factors and market liquidity were very important in determining exchange rate movements. This was particularly true during mid-May when the dollar briefly moved out of its trading ranges. In illiquid Ascension day markets, it rose sharply on 9 May after breaking through a key resistance level at DM 1.395 and taking momentum from a strong bond-market rally. In a short squeeze it moved up to DM 1.44 and ¥85, where it traded until 25 May. However, the combination of indications of weakening US activity (particularly in the employment data) and frustration over the lack of further progress by the dollar led investors to reduce their long dollar positions. In thin markets aggravated by a bunching of international holidays, the dollar fell back sharply to hit the floor of its recent trading range at DM 1.38.

It was moved off this level by the concerted intervention on 31 May. In contrast to some of the other recent episodes of intervention, this was perceived by the market to have been successful and initially pushed the dollar up to DM 1.41. The main reasons for the success of the operation included its timing (the market seemed to be short of dollars relative to desired neutral holdings following the end-May sell-off, and there was already strong demand for the dollar), its unexpectedness and the link with the G7 communiqué issued on 25 April which, as well as establishing a clear motivation for the intervention, also raised the possibility of further intervention around the time of the G7 summit on 15/16 June.

However, the lack of policy action and further weak US data soon reduced the effect of the intervention. The dollar moved back to the bottom of its trading range, weakened by concerns over the continued lack of progress on the US/Japanese trade talks and the threatened implementation of sanctions on 29 June. It finished the month slightly more strongly, following the last-minute agreement between the US and Japanese trade negotiators.

Sterling exchange rates

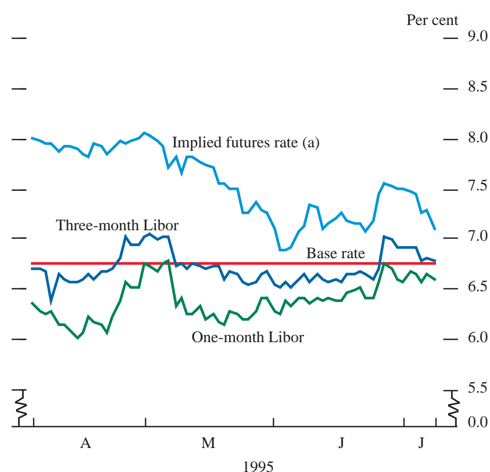


Sterling tracked the dollar throughout May and June. Evidence of some moderation in the pace of UK activity (from continued weakness in the housing market and downward revisions to Q1 GDP growth) reduced market expectations of a near-term interest rate rise. Sterling was little affected by this, as the UK situation was seen to be in line with the general fall in worldwide interest rate expectations. However, towards the end of June, heightened political uncertainty weighed on sterling (although initially not as heavily as in the UK domestic markets).

The announcement of the election contest for the leadership of the Conservative Party had little immediate effect. The market consensus at the time was that there was little prospect of the contest going to a second round and that the incumbent would probably emerge with his position strengthened. However, as it became less clear that a second round could be ruled out, uncertainty over the outcome, and its implications for the future conduct of monetary and fiscal policy, led sterling to move lower: it equalled its all-time low of 82.7 on its effective rate index on 27 June. After the election result, sterling strengthened but did not immediately return to its pre-election levels.

In Europe, tensions in the ERM eased after the turmoil of March, helped by the decline in German interest rates. The Deutsche Mark fell back against most European currencies following comments by Bundesbank Council members that a permanently overvalued currency was not in Germany's interests. The French franc fell a little around the time of the presidential election in May, with the market unsure of the commitment of either of the second-round candidates to the established strong exchange rate policy. The French franc reached FFr 3.5791 against the Deutsche Mark on 5 May, just 1.5 centimes away from the all-time low it reached in the ERM turmoil in March. It regained most of the lost ground in the weeks after the election, but because of its volatility France, unlike the Netherlands and Belgium, was unable immediately to follow Germany's lead on 31 May and cut its interest rates. But rates in France were cut when the government introduced its budget package on 27 June.

Short-term interest rates



(a) Three-month Libor implied by December 1995 futures contract.

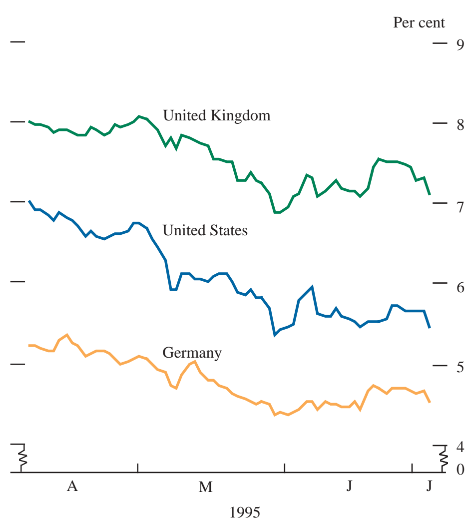
Table B
Influences on the cash position of the money market

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

	1994/95	1995/96		
	Apr.–Mar.	Apr.	May	June
Factors affecting the market's cash position				
Under/overfunding (+/-) (a)	11.0	0.8	4.2	0.3
Other public sector net borrowing from banks and building societies (-) (b)	2.0	-0.6	0.6	0.4
of which, local authorities' deposits with banks and building societies (+)	*0.6*	*-0.4*	*0.3*	*0.2*
Currency circulation (-)	-0.4	-0.4	0.6	-1.0
Other	0.7	2.8	-3.2	4.3
Total	**13.3**	**2.6**	**2.2**	**4.1**
Increase (+) in the stock of assistance	-8.5	-1.6	-0.3	-0.6
Increase (-) in £ Treasury bills outstanding (c)	4.8	1.0	1.8	3.2
Increase in bankers' balances at the Bank	—	—	—	0.2

(a) From 1993/94, net purchases of central government debt by banks and building societies are included in funding. Purchases by banks and building societies in 1992/93 are counted as funding in 1994/95.
(b) From 1993/94, banks' and building societies' purchases of 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.

Three-month interest rates implied by December 1995 futures contracts



Official money-market operations

Official interest rates remained unchanged throughout the quarter. Markets continued to expect some further increase, especially in the run-up to the May meeting between the Chancellor and the Governor. But when none resulted on that occasion, the market revised its expectations to later—and smaller—increases. Period rates rose at the end of the quarter, as a reaction to the heightened political uncertainty caused by the Conservative Party leadership election.

Short-term rates were below official dealing rates and base rates for much of the quarter; daily market shortages remained low in April and May, and larger banks continued to benefit from inflows of funds following the collapse of Barings. Some deviation between official and market rates is normal, and indeed gives useful information to the Bank in its implementation of policy. But a prolonged divergence may put the stance of policy in doubt, and the Bank gradually became less accommodating in its operations. This—together with an increase in the size of daily shortages in June—tightened conditions in the market and brought market rates back up towards official rates.

International monetary conditions continued to have an important influence on UK markets. Evidence of slower growth in the United States and the possibility of an easing in US monetary policy led to easier money-market conditions there and elsewhere. The three-month rates implied by December 1995 dollar and Deutsche Mark futures contracts declined during April and May, and steadied or rose slightly in June. The rates implied by sterling contracts moved in a similar pattern during the quarter.

At the beginning of the quarter, market expectations were not firmly held. Market rates reacted to each piece of economic news, and the volatility implied by options on the short-sterling contract was high. But as the monthly Monetary Meeting in May approached, the markets—influenced by GDP data showing faster growth than the monthly indicators had suggested, and by publication of the March minutes, which drew attention to concern over the fall in the exchange rate—became more convinced that a tightening was imminent. The decision to leave rates unchanged came as a surprise. In an immediate technical adjustment to the news short-sterling contracts rallied, though much of this was reversed shortly afterwards when the Bank's *Inflation Report* projected that RPIX inflation would rise to close to the top of its 1%–4% target range in 1996 and, despite declining thereafter, would still be in the top half of that range in the first quarter of 1997.

In the rest of May, expectations of a rate rise in June were briefly kindled by the increase in input and RPIY inflation, but subsequent data—particularly weak retail sales figures and a downward revision to GDP—led the market virtually to rule out a rise by the time of the June meeting. The market was also influenced by a global bond-market rally, which pushed down money-market rates in most major centres abroad.

The announcement of an election for the leadership of the Conservative Party had little initial impact on the money markets but as the possibility of a second round was seen to increase and as sterling slipped, money-market rates rose—although without any

Debt Management Review

On 19 July, H M Treasury and the Bank of England issued the Report of the Debt Management Review. This box reproduces the executive summary of the Report.[1]

The Debt Management Review, which was announced by the then Minister of State to the Treasury on 10 November 1994, had the following terms of reference:

> 'To review the existing arrangements for the setting of debt management policy, the selling of government debt and the management of outstanding debt.'

The Review covers gilt issuance only. It does not cover National Savings. It was conducted by the Treasury's Debt and Reserves Management Team and involved an extensive process of consultation. The Review was conducted in close coordination with the Bank of England.

This joint Report by the Treasury and the Bank of England contains the conclusions of the Review, and also discusses a number of other current developments in the gilts market. It covers the following principal issues:

(i) **Objectives**: The Government has decided to change the stated objectives of debt management policy to reflect current practice more accurately. The primary objective of debt management policy is to minimise over the long term the cost of meeting the Government's financing needs, taking account of risk, whilst ensuring that debt management policy is consistent with monetary policy.

(ii) **Funding rule**: Beginning in 1996/97, the Government has decided to introduce a new framework for financing, which will continue to ensure a prudent maturity structure for debt issuance. The Government will aim to sell sufficient gilts of any maturity, Treasury bills and National Savings products to finance the Central Government Borrowing Requirement (CGBR) (plus maturing debt and any net increase in the official foreign exchange reserves). All such debt issuance will take place within a set maturity structure, to be determined and published each year. The Government has no current plans to make significantly greater use than at present of short-term debt issuance. This change will not affect the amount the Government needs to borrow, or change the PSBR's role as a fiscal control aggregate.

(iii) **Debt Management Report:** The Government will publish an annual Debt Management Report and Remit to the Bank of England, setting out advance details of the annual issuance programme, including an auction timetable and the maturity structure of issuance for the forthcoming financial year. The first such Report was published in March 1995.

(iv) **Auctions**: Auctions will constitute the primary means of conventional gilt issuance. The authorities will consider the possibility of using uniform-price auctions, on an experimental basis.

(v) **Tap sales**: In order to improve predictability and transparency, the authorities will make a number of changes to the process by which tap and 'unofficial' sales are made. In future, conventional tap sales will function primarily as a market management mechanism, and will not normally constitute more than 10% of total issuance.

(vi) **Index-linked**: The authorities will seek views on the development of the market in index-linked gilts. The Bank of England has arranged a conference for September on index-linked government debt.

(vii) **Tax**: Next year's Finance Bill will provide that from April 1996 all returns on gilts should be taxed as income for corporate holders. This will increase market efficiency, and facilitate the introduction of a strips market.

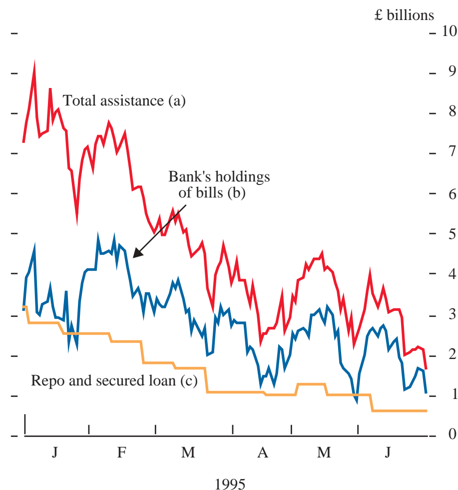
(viii) **Market structure**: An open gilt repo market will be introduced in January 1996; an official gilt strips facility will be introduced subsequently, but not before the second half of 1996.

(ix) **Consultation**: The authorities will introduce a formal consultation process to enable them to ascertain the views of market participants on strategic debt management policy issues.

Some of these proposals have already been implemented; others are not firm decisions, but are subject to consultation and further consideration. The Government and the Bank of England believe that these changes, taken together, will increase the liquidity and efficiency of the gilts market, and should reduce funding costs, to the ultimate benefit of taxpayers.

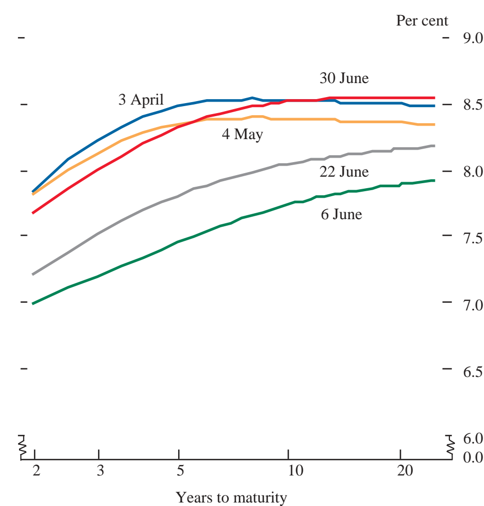
(1) The Bank is publishing research that it undertook in connection with the Debt Management Review. The papers can be obtained by contacting the Publications Group, Bank of England (on 0171–601–4030).

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 bills outright and on a repurchase basis and 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 under repo and secured loan facilities.

Par yield curves for British government stocks



UK implied bond market volatility(a)

(a) The expected standard deviation of annualised price movements in LIFFE's long-gilt future.

serious expectation of a rise in official rates. The rise in market rates essentially reflected greater uncertainty: the implied volatility on the September short-sterling contract rose sharply to over 19%. After the end of the quarter, when the result of the leadership election was known, money-market rates fell back, though not to the levels seen before the election had been announced.

Gilt-edged funding

Gilts had a mixed quarter, gaining substantial ground in May before falling back to close very little changed over the period as a whole. Ten-year yields traded in a range of 109 basis points. After opening the quarter at 8.40%, they fell to a 15-month low of 7.68% in early June before rising again to close at 8.43%. The rally resulted primarily from the influence of international sentiment, but was also helped by weaker domestic data releases in May. The reversal was brought about mainly by the political uncertainties which weighed on the market prior to the Conservative Party leadership contest.

Sentiment in international bond markets was influenced by US data releases, which showed a slowdown in activity and which increased expectations that the Federal Reserve might ease its policy. Sentiment towards the possibility of a rate cut in Germany was mixed: although there had been some expectation, helped by subdued data and a slight fall—to 4.50%—in the lowest accepted rate on the variable repo, it had largely dissipated by the end of the quarter, when the figure for inflation was higher than forecast following higher-than-expected wage settlements.

Spreads between gilts and US government bonds had risen from around 100 basis points at the start of the year to 140 basis points by the end of the first quarter; they rose further to 230 basis points by end-June. Against German government bonds, there was less of a rise, from a similar starting-point of 100 basis points to 130 by end-March and 140 by end-June. As the chart of implied bond-market volatility suggests, the particularly large spreads at the end of June in part reflected uncertainty—both political, related to the Conservative leadership election, and technical, related to the fundamental reform proposed for the taxation of gilts consultation on which straddled the end of the quarter.

Real yields, like conventional yields, were little changed over the quarter; the simple comparison would suggest little change in the market's inflation expectations over the quarter as a whole. If UK real yields are a measure of real yields worldwide, the implication of widening spreads between conventional gilts and other major government bonds would be that there was a fall in the market's expectations of inflation in other countries.

There were some movements in the differential between UK index-linked and conventional yields during the quarter, but as these often coincided with movements in implied volatility, they should be treated with some caution. The spread between conventional and index-linked yields also narrowed in late May to around 4.4%, as the proposals for the reform of the taxation of gilts caused some concern; there was initially some misunderstanding that the whole of the nominal return on index-linked gilts might be taxed. Once this was clarified, there remained some concern that the method for ensuring that only the real return was taxed had not been decided. Towards the end of the quarter, index-linked stocks outperformed

Changes to the taxation of gilts and the development of an official strips market

On 25 May, the Inland Revenue published a consultative document on proposed changes to the taxation of gilts and bonds. The Bank of England simultaneously published a consultative paper on the development of an official gilt strips facility,(1) which would be made possible by changes in the tax arrangements. Both consultation periods ended on 30 June.

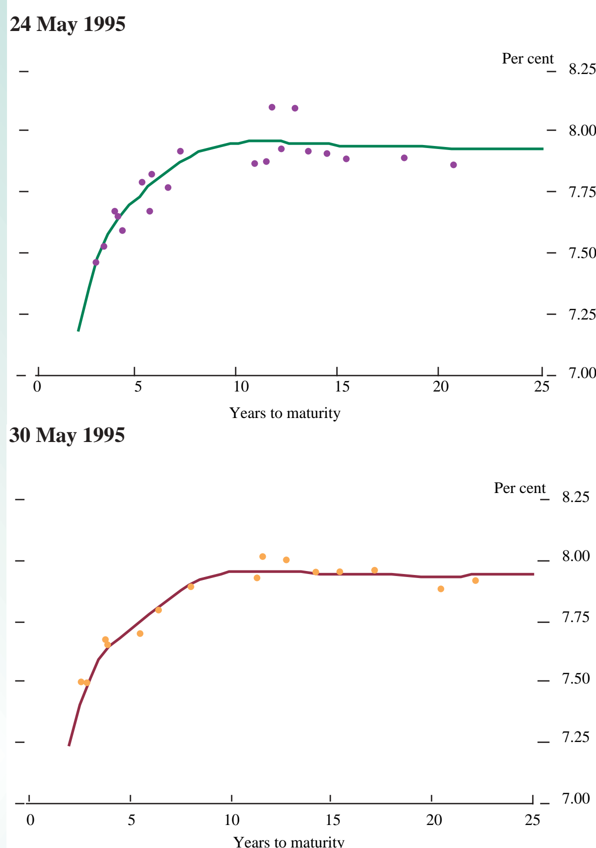
The Inland Revenue proposed a regime in which the distinction between capital gains and income would be removed; a bond would be taxed on its total return, with relief given against capital losses.

The Bank's paper suggested that there might be demand for strips from a wide range of investors: those seeking a specific set of cash flows or wanting to avoid reinvestment risk; those familiar with strips in other markets; retail investors saving for outlays due to start a number of years ahead; and institutions wishing to match their long-term liabilities more accurately with the more distant coupon and principal repayment components of a coupon bond. Overseas investors might be attracted to an investment on which it was easier to effect a currency hedge. The paper pointed out that under the current tax arrangements, strips would add to tax distortions and increase the scope for tax-avoiding strategies. Tax reform was therefore a necessary precondition for the introduction of strips.

The immediate impact of the announcement on gilt prices was as expected:(2) high-coupon stocks outperformed low-coupon stocks and so the yield spread between high and low-coupon stocks narrowed, as stocks moved closer to the par yield curve (see the chart); implied volatility increased as the market assessed the proposals; and the premium on high duration/convexity stocks was marginally reduced.

The Chancellor announced on 10 July that the tax proposals would go ahead, with some modifications. During the consultation period, concerns had been expressed about the impact that the changes would have on personal investors and about the proposal that the start date for the new regime would be the date on which the decision to go ahead was announced. The Chancellor announced that for personal investors the threshold below which the new arrangements would not apply would be set at nominal holdings of £200,000; that the new arrangements would not apply to two stocks that are widely held by private investors ($3^{1}/_{2}$% Funding

Position of stocks relative to the par yield curve(a)



(a) The yield curve model used to produce the charts employ a cubic spline function to provide accurate fit to the data.

1999/2004 and $5^{1}/_{2}$% Treasury Loan 2008/12); and that the start of the new arrangements would be delayed until 1 April 1996 for corporate investors and 6 April 1996 for personal investors. It was also announced that there would be special rules to ensure that gilt and bond unit trusts are not disadvantaged and that there is tax exemption for corporate bond PEPs. All non-equity shares—including zero-coupon preference shares—would be outside the new regime.

The Bank announced on the same day that an official strips market would go ahead. The proposals in the Bank's consultative paper had received widespread support from traders and institutional investors, indicating that there was clearly demand for a strips facility. The Bank will announce details after further discussion with the market. The facility will not be introduced before the second half of 1996, allowing the new gilt repo market six months to settle down.

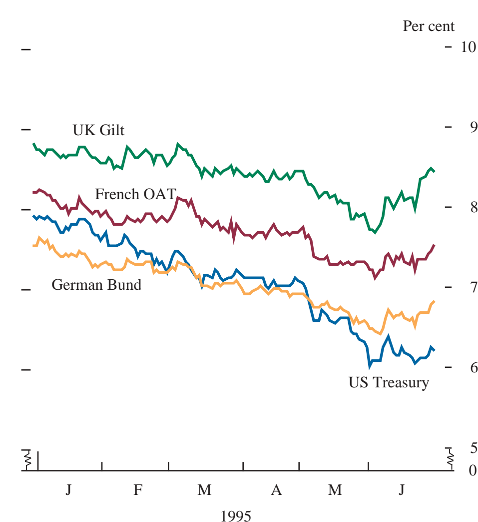
(1) *Stripping* a bond is the process of separating a standard coupon bond into its constituent interest and principal payments, so that they can be held separately or traded as zero-coupon instruments. It allows investors to choose their own cash flows more precisely. An official strips facility will enable investors to exchange a coupon gilt for a series of zero-coupon strips exactly matching the cash flows of the parent bond and each of which is an obligation of the UK government. Investors will also be able to reconstitute a gilt, ie to exchange a series of strips for a coupon gilt.
(2) The tax reform would benefit high-coupon stocks trading above par, since tax relief would be available for the capital losses that would result if any of these bonds were held to redemption. Yields on low-coupon stocks trading below par would increase, because the capital gains that accrue as redemption is approached would be taxed.

Table C
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
21/2% Index-Linked 2013	150	5.4.95	5.4.95	Tap	132.8125	Fully paid	3.81 (b)	3.81	6.4.95
21/2% Index-Linked 2003	150	5.4.95	5.4.95	Tap	165.1875	Fully paid	3.81 (b)	3.81	6.4.95
21/2% Index-Linked 2020	150	7.4.95	7.4.95	Tap	136.6875	Fully paid	3.80 (b)	3.80	26.4.95
21/2% Index-Linked 2009	150	7.4.95	7.4.95	Tap	156.8750	Fully paid	3.76 (b)	3.77	26.4.95
8% Treasury 2000 'A'	2,000	18.4.95	27.4.95	Auction	98.6563 (c)	Fully paid	8.30	8.30	5.7.95
21/2% Index-Linked 2024	100	2.6.95	2.6.95	Tap	120.6875	Fully paid	3.54 (b)	3.74	5.7.95
21/2% Index-Linked 2011	100	2.6.95	2.6.95	Tap	170.4375	Fully paid	3.51 (b)	3.73	26.4.95
8% Treasury 2013	200	2.6.95	2.6.95	Tap	102.1875	Fully paid	7.77	7.75	5.6.95
8% Treasury 2013	100	2.6.95	2.6.95	To CRND	102.1875	Fully paid	7.77		
7% Treasury 2001	200	2.6.95	2.6.95	Tap	97.1250	Fully paid	7.56	7.55	5.6.95
7% Treasury 2001	100	2.6.95	2.6.95	To CRND	97.1250	Fully paid	7.56		
81/2% Treasury 2005	2,500	20.6.95	30.6.95	Auction	100.4688 (d)	Fully paid	8.42	8.42	30.6.95

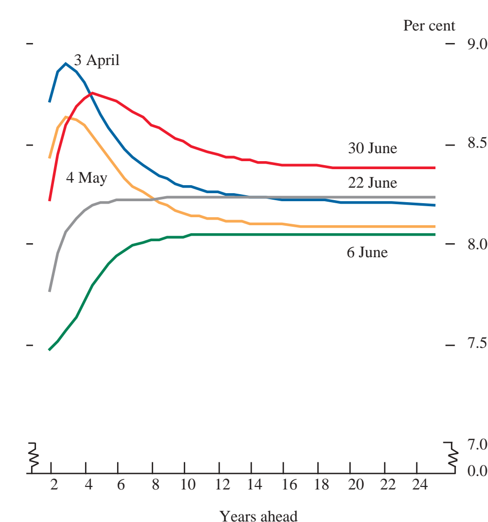
(a) Gross redemption yield, per cent.
(b) Real rate of return, assuming 5% inflation.
(c) Lowest-accepted price for competitive bids, and the non-competitive allotment price.
(d) Lowest-accepted price for competitive bids. The non-competitive allotment price was £100.50.

Ten-year government bond yields(a)



(a) Gross redemption yield on a semi-annual basis.

Implied forward rates(a)



(a) Annualised six-month interest rates derived from zero-coupon yield curve.

conventional gilts as political uncertainties set in. The yield on the eleven-year Treasury 2% 2006 fell to 3.38% before climbing again to close the quarter at 3.72%. The yield spread between the 2013 index-linked and conventional stocks reached a low of 422 basis points early in June (toward the end of the rally), but widened before the leadership contest to a high of 4.73 basis points. The restatement of the inflation target had little impact.

The Chancellor's decision to leave interest rates unchanged in May took the market by surprise; there was some concern that this might impair achievement of the Government's inflation target. The long-gilt future fell immediately by ten ticks and seemed liable to fall further. However, it was then helped by a sharp improvement in US sentiment following a weaker-than-expected employment report, and the future rose to close at a new high of 105–00 in high volumes of over 96,000 contracts. The gilt market largely ignored sterling's fall to below DM 2.19. Subsequent domestic data were seen as generally soft and removed any expectation of an interest rate move in the remainder of the quarter.

The proposals for a new tax regime for gilts and bonds, announced by the Inland Revenue on 25 May (see the box on page 228), influenced activity in the gilt market. Widespread 'bed-and-breakfasting' of gilts was reported (which added artificially to turnover), in response to uncertainty as to whether the arrangements would include a 'kink test' (this would ensure that investors were not taxed on more returns than they actually made or relieved on more losses than they suffered). The Bank's proposals for the development of an official strips facility (published on the same day) were broadly welcomed in the market. The market appeared fully to expect the proposals to come into force, and distortions in the yield curve were greatly reduced as the *coupon effect*—the incentive for high taxpayers to hold low-coupon gilts—largely disappeared. The rally in May was not marked by any issues of tap stocks, because of the imminence of the publication of the Revenue's proposals for the reform of the taxation of gilts and other bonds.

The annual funding remit for 1995/96 was issued to the Bank by the Treasury at the end of March. It included an auction calendar, giving dates of the eight auctions in the coming year; maturity ranges are to be announced shortly before the beginning of each quarter. The two auctions held in the first quarter of the new financial year were both successful. The April auction of £2 billion

Table D
Official transactions in gilt-edged stocks

£ billions: *not seasonally adjusted*

	1994/95 (a)	1995/96		
	Apr.–Mar.	Apr.	May	June
Gross official sales (+) (b)	29.8	2.9	-0.1	2.9
Redemptions and net official purchases of stock within a year of maturity(-)	8.3	—	0.2	—
Net official sales (c)	21.5	2.9	-0.3	2.9
of which net purchases by:				
Banks (c)	0.7	-0.1	0.1	0.3
Building societies (c)	-0.5	0.2	-0.5	0.3
Overseas sector	-5.6	0.9	0.3	1.0
M4 private sector (c)	26.5	1.9	-0.2	1.2

(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.

of 8% Treasury 2000 'A' tranche was covered 2.17 times with no tail—the yields corresponding to the average and lowest-accepted bids were the same. The reason for issuing an 'A' tranche was that the parent stock was due to go ex-dividend a few days after the auction and might have been unattractive to those not wanting to receive coupon. The 'A' stock was fungible with the parent on the ex-dividend date (1 May) but bore a lower first coupon.

The June auction was delayed by a day in order to give the market time to digest the Government's summer forecast published on 28 June. Despite upward revisions to the borrowing requirement and inflation forecasts, there was little market reaction. The auction of £2.5 billion of 8½% Treasury 2005 took place against a background of political nervousness during the Conservative leadership election. However, its benchmark status and its inclusion in the basket of stocks deliverable into LIFFE's long-gilt futures contract made the stock attractive to a wide range of investors. The auction was twice covered and there was no tail.

The results of a new survey of gilt holdings have now been published in the Bank's Review of Gilts and the Gilts Market 1994–95.[1] They show an estimated decline between March and December 1994 in the gilts held directly by individuals. Banks and other financial institutions increased their holdings, while overseas investors were small net sellers. Overseas holders continued to make net sales of gilts in the first quarter of 1995, but were net buyers in the second quarter.

Total gilt sales in the second quarter of 1995 amounted to £5.7 billion. In addition to the £4.5 billion raised through auctions, the Bank also made tap issues of both conventionals and index-linked stocks.

At the end of the quarter, the Bank announced that the auctions in the third quarter would be in the maturity ranges 2014 to 2016 for the auction on 26 July, and 2005 to 2007 for that on 27 September.

(1) The Review may be obtained from the Bank of England, PO Box 96, Gloucester GL1 1YB.