The operation of monetary policy

Decisions on monetary policy are based on a wide range of evidence. The Bank's current assessment is given in the February Inflation Report. *This article reviews the operation of monetary policy in the final quarter of 1995.*

Overview

In the November *Inflation Report*, the Bank's medium-term projection was that the RPIX inflation rate in two years' time was likely to remain just above 2½%. The *Inflation Report* added that the uncertainties surrounding the central projection had increased since the August issue and that the range of possible outcomes had become wider. Developments since the November *Report* suggest that the chances of inflation being below 2½% in two years' time have improved, and this made possible a modest easing in official interest rates, consistent with meeting the Government's inflation target of 2½% or less.

Among the data released during the quarter, current retail price inflation on the targeted RPIX measure fell to 2.9% in October and remained at this level in November. Seasonal food prices fell after the drought-induced increases in the summer. But more long-lasting factors were at work as well, particularly increased competition, while cost pressures were much less than earlier in the year. The producers' input price index fell in both October and November, bringing the twelve-month rate of increase down to 6½% from a peak of 12% earlier in the year. And surveys continued to confirm the reduction in input price pressures. There were few signs of increased wage pressure in the quarter. Underlying earnings growth remained at 3¼% and settlements (employment-weighted median), remained at 3% in the three months to November despite the fall of nearly 50,000 in unemployment over the same period. The figures showed GDP growth tending to slow (to 0.4% in the third quarter, or 0.3% excluding oil and gas). Growth in Q3 was driven by consumption and stock-building; fixed investment and external trade made negative contributions. The build-up in stocks in Q3 was spread evenly between finished goods, materials and work-in-progress, but some adjustment of stocks still seemed likely, adding to the possibility of a pause in output growth. The fall in investment mainly reflected weakness in construction (particularly housing), but investment in plant and machinery was also less buoyant than in previous recoveries. Both M0 and M4 were growing above their monitoring ranges by the end of the quarter. There are reasons why the relationship between nominal demand and money (both narrow and broad) might have changed. But a continuation of strong monetary growth might lead to higher inflation in the future.

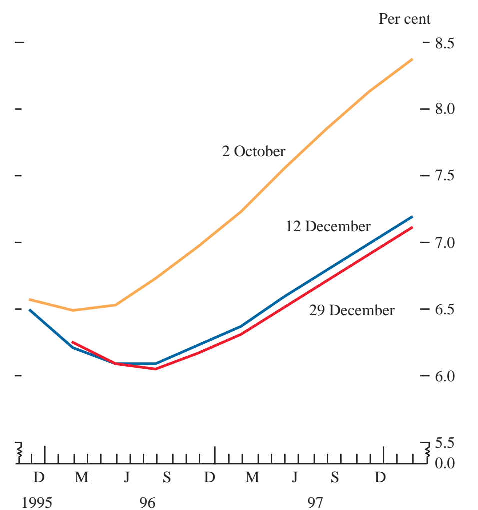
Money markets

Official interest rates were reduced by 25 basis points late in the quarter (13 December), the first reduction since February 1994.

UK interest rates

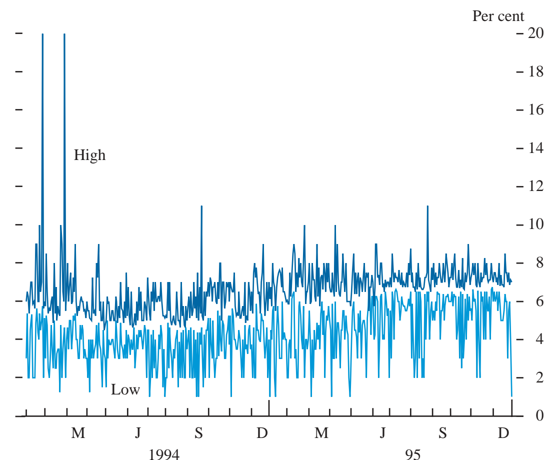
(a) Three-month Libor in March 1996 implied by short-sterling futures contract.

Short-sterling futures curves(a)



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

High and low overnight interest rates



The move followed increases of 50 basis points in September and December 1994 and February 1995. In the third quarter the market expected a possible reduction in official rates towards the end of the year and this view strengthened as the fourth quarter progressed. There was no expectation of a change in rates arising from the Monetary Meetings held on 29 September and 1 November; expectations were focused on the 28 November Budget and the subsequent Monetary Meeting (13 December).

Early in the period money-market rates tightened sharply. Confidence that a slowing economy and moderating price pressures would result in a reduction in interest rates was shaken by the data releases for September. These showed some recovery in industrial output (6 October) and stronger producer price pressures (9 October). But significantly worse-than-expected RPI figures on 12 October did most to dent confidence; and money-market rates reached their highest levels since late August when sterling fell to a low (DM 2.1855) during 23 October, as a strengthening DM revived tensions in the ERM. From early October to 23 October, the three-month rate implied by the December short-sterling futures contract rose by 25 basis points, from 6.53% to 6.78%, and similar or slightly greater changes were seen along the futures curve as far as March 1997.

Aided initially by a strengthening exchange rate and statistical releases covering October, the money market recovered in November. The RPI figures for October, released on 16 November, took the December short-sterling contract to record highs and, although a recurrence of exchange rate weakness towards the end of the month slowed the market's progress, growing expectations that the Bundesbank and Federal Reserve might soon lower their key rates helped to push the market on. The publication of the Bank's *Inflation Report* on 8 November (its contents being broadly interpreted as moving cautiously towards the market's improved view of the inflationary outlook) also played a part in sustaining the market's expectations. By the time of the Budget on 28 November, a 25 basis-point reduction in three-month rates by the expiry of the December short-sterling contract on 20 December (one week after the Monetary Meeting) had been fully priced in.

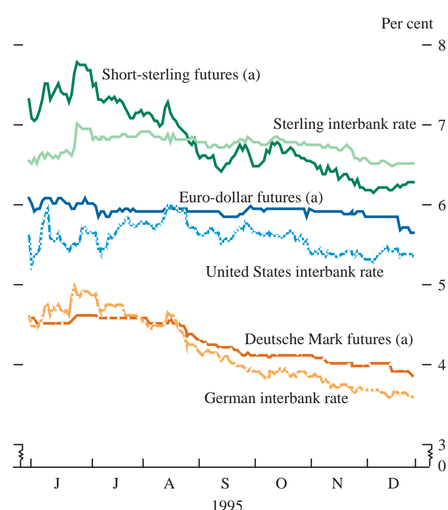
The market saw the approaching Budget as a significant determinant of the likelihood of interest rate reductions, and occasional speculation during November of a substantial fiscal stimulus unsettled the market at times. As the Budget was

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/£
2 October	$6\tfrac{23}{32}$	$6\tfrac{23}{32}$	$6\tfrac{23}{32}$	$6\tfrac{23}{32}$	6.47	7.50	8.04	8.24	3.71	85.2	1.5885	2.2696
23 October	$6\tfrac{21}{32}$	$6\tfrac{3}{4}$	$6\tfrac{13}{16}$	$6\tfrac{7}{8}$	6.70	7.65	8.21	8.36	3.77	83.5	1.5808	2.1899
20 November	$6\tfrac{13}{16}$	$6\tfrac{21}{32}$	$6\tfrac{9}{16}$	$6\tfrac{17}{32}$	6.37	7.16	7.76	7.93	3.59	82.2	1.5460	2.1834
12 December	$6\tfrac{19}{32}$	$6\tfrac{1}{2}$	$6\tfrac{3}{8}$	$6\tfrac{5}{16}$	6.20	6.86	7.44	7.67	3.55	82.8	1.5315	2.2184
13 December	$6\tfrac{1}{2}$	$6\tfrac{15}{32}$	$6\tfrac{11}{32}$	$6\tfrac{1}{4}$	6.19	6.83	7.42	7.66	3.55	83.0	1.5327	2.2221
29 December	$6\tfrac{1}{2}$	$6\tfrac{1}{2}$	$6\tfrac{11}{32}$	$6\tfrac{5}{16}$	6.25	6.79	7.41	7.66	3.56	83.1	1.5492	2.2200

(a) Close-of-business rates in London.
(b) Gross redemption yield. Representative stocks: short—8% Treasury 2000; medium—81/2% Treasury 2005; long—8% Treasury 2015; index-linked—$2\tfrac{1}{2}$% Index-Linked Treasury 2016 (real yield assuming 5% inflation).
(c) Middle-market rates.
(d) Implied future rate: March 1996 contract.

UK, US and German three-month cash rates and rates implied for March 96



(a) Three-month rates implied by March 1996 futures contracts.

interpreted as broadly neutral and the Chancellor's forecast for GDP growth in 1996 was considered ambitious, an early interest rate reduction was regarded by the market as both likely and appropriate—although expectations of a 50 basis-point reduction quickly faded. On the morning of 13 December, when the Monetary Meeting was held, the December short-sterling contract implied a rate of 6½% and the three-month interbank rate also traded at that level. With a 25 basis-point reduction in rates fully discounted and the Chancellor and Governor in agreement about the conditions which warranted a cut, there was little immediate movement in rates at the front of either the short-sterling or cash market curves. But the robust performance of the exchange rate in the wake of the UK cut, and the reduction in German rates the following day, helped make the curve still steeper. From the day before the Budget to the middle of December, the mid-1996 area of the short-sterling curve eased by around 25 basis points, to just under 6%. The rate implied by the December 1996 contract eased by around 40 basis points to a little above 6% over the same period. However, after mid-December the market weakened against the background of considerable uncertainty about the outcome of the US budget issue and, after the turn of the year, the re-emergence of concerns about the Conservative Party's slender Parliamentary majority. Over the quarter as a whole, market expectations of future short-term rates fell—the falls increased with the maturity of the period to which they related.

The Bank's daily money-market operations during the quarter were consistently directed towards maintaining the general level of short-term interest rates around the prevailing level of the base rate. To this end, the Bank continued to scale back bill offers and to require the market to meet part of each day's shortage via its late lending operations, although there was less need to do so as December progressed on account of seasonal pressures. For much of the quarter, interbank rates as far as the three-month maturity traded relatively close to base rate. As the market grew more bullish in November, however, the negative slope to the yield curve steepened. By the time of the Budget, three-month rates had slipped to 6½% against 6¾% at the start of the quarter, and one-year rates had fallen to 6 11/32%.

Table B
Influences on the cash position of the money market

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

	1995/96 Apr.–Sept.	1995 Oct.	Nov.	Dec.
Factors affecting the market's cash position				
Under/overfunding (+/-) (a)	9.0	-5.5	2.9	-2.6
Other public sector net borrowing from banks and building societies (-) (b)	0.8	-0.3	0.7	-0.5
of which, local authorities' deposits with banks and building societies (+)	*0.5*	*-0.3*	*0.5*	*0.1*
Currency circulation (-)	-1.0	1.3	-0.8	-2.6
Other	4.1	1.3	-4.2	4.1
Total	**13.0**	**-3.2**	**-1.3**	**-1.6**
Increase (+) in the stock of assistance	-1.2	2.9	-1.1	1.6
Increase (-) in £ Treasury bills outstanding (c)	11.5	-0.3	-2.2	—
Increase in bankers' balances at the Bank	0.2	—	-0.1	—

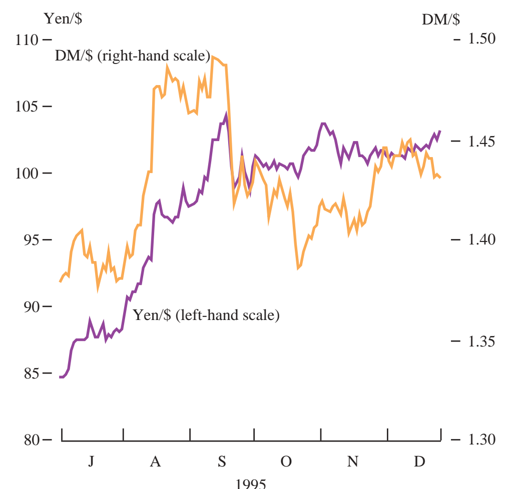
(a) Central government net debt sales to banks and building societies are included in funding.
(b) Banks' and building societies' transactions in local authorities' and public corporations' listed sterling stocks and bonds are included in funding.
(c) Other than those held outright by the Bank and government accounts but including those purchased by the Bank on a repurchase basis.

With short-dated interest rates generally trading a little above the Bank's money-market intervention levels, interest in the twice-monthly gilt repo facility continued to increase. On only one occasion during the quarter (on 24 October) were applications allotted in full. By the first week of January total participation had risen to £4.9 billion, compared with only £0.5 billion at the end of the second quarter and £1.1 billion at the end of the third. Early in the quarter, bids were mainly for longer maturity (four-week) money, but as the market's interest-rate expectations developed during the quarter, the two week option was increasingly favoured. On 6 December, one week before interest rates were cut, 99% of bids were for the shorter maturity. Allotments of money in the gilt repo facility during the period were aimed at a steady increase in its use, while maintaining appropriate money-market conditions.

Foreign exchange markets

The Deutsche Mark was at the centre of foreign exchange market developments during the fourth quarter. The combination of dollar weakness and Deutsche Mark appreciation against other European currencies was again apparent during much of October. Similarly,

Dollar exchange rates



an easing of tensions within the Exchange Rate Mechanism was associated with the dollar's recovery against the Deutsche Mark during November.

The tensions which had developed within the ERM in the second half of September continued for much of October. Market attention was focused on the prospects for EMU and the ability of EU members to meet the convergence criteria. The Bank of France responded on 9 October by replacing its 5–10 day repo facility with an overnight repo facility at a rate 110 basis points higher at 7.25%. The French franc rallied subsequently, but then fell back after the cut in French overnight rates on 16 October. It fell as low as FFr 3.54 on 23 October, before stabilising ahead of the Franco-German summit. Official statements reaffirming commitment to meeting the fiscal criteria of the Maastricht Treaty also reassured the market. The lira, which had also fallen sharply against the Deutsche Mark, gained 17 points to Lit 1,143 on 26 October on the news that the Italian opposition's no-confidence motion had failed.

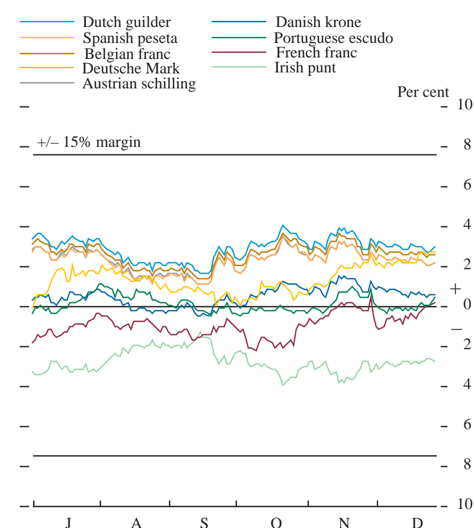
The dollar drifted lower against the strong Deutsche Mark during October, as tensions within the ERM mounted. It fell as low as DM 1.3830 on 23 October as those tensions reached their peak. Other developments which coincided with the dollar's fall were Canadian dollar weakness ahead of Quebec's referendum on sovereignty, and sharp falls in the value of the Mexican peso. But the dollar recovered and rose above DM 1.40 on 25 October as ERM tensions eased, helped by a statement by a German official that the Bundesbank was preparing to co-operate on exchange rates. The subsequent release of stronger-than-expected figures for US GDP growth in Q3 and the 'no' vote in the Quebec referendum underpinned the dollar's recovery. The dollar ended October at DM 1.4068, compared with September's closing level of DM 1.4248.

The Deutsche Mark's appreciation against the yen continued until the German currency encountered strong technical resistance at the ¥73 level at the beginning of November. The dollar traded in a narrow range against the yen ahead of the G7 summit, which was held on 7–8 October. The G7 communiqué welcomed the orderly reversal in the movements of the major currencies which had begun in April, and stated that a continuation of these trends would be consistent with economic fundamentals. After the communiqué was released the dollar continued to trade above ¥100 level in thin markets.

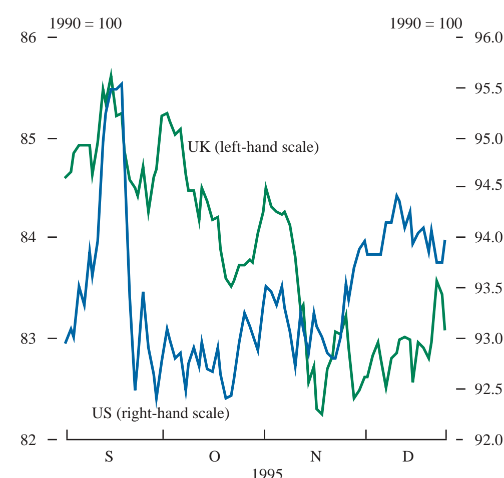
Sterling's close link with the dollar, evident for much of the year, was maintained during October. Indeed the link appeared to strengthen: implied volatilities on options fell to low levels, and sterling traded in a narrow range against the dollar—around $1.58. Consequently, with UK monetary policy considered to be on hold until the Budget, sterling's performance against the Deutsche Mark in October mirrored that of the dollar. Sterling fell to DM 2.1855 on 23 October, within a pfennig of its historic low. But it subsequently recovered with the dollar and ended October at DM 2.2240, compared with September's closing figure of DM 2.2547.

During the first half of November, the French franc's recovery continued: it appreciated by 2% against the Deutsche Mark ahead

Movements in the exchange rate mechanism, July–December 1995



UK and US effective exchange rates



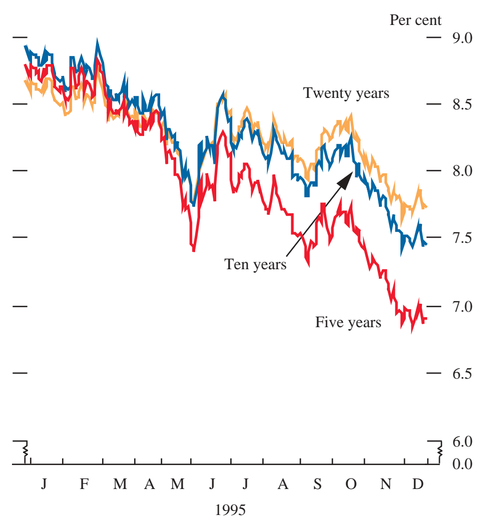
of the French mini-budget, which was delivered on 16 November. Although the Deutsche Mark was also weaker against other European currencies, it held up against the dollar, which was weighed down by concerns about the US budget impasse. These concerns diminished after agreement was reached on the framework for further talks on 18–19 November. The dollar strengthened above DM 1.44 ahead of the Bundesbank Council meeting on 30 November. Even though the Council decided to leave its Discount and Lombard rates unchanged, the market expected cuts in due course. As a result the dollar continued to trade in a firm manner against the Deutsche Mark; it reached DM 1.4497 on 30 November (a ten-week high).

Sterling experienced a period of independent weakness in November as the market focused on the prospects for fiscal and monetary policy. In particular, speculation that tax cuts in the Budget could be substantial began to mount after 9 November. The subsequent release of better-than-expected RPI figures for October switched market attention to the prospects of an interest rate cut; the currency weakened further to historic lows. (Sterling fell as low as DM 2.1740 in London trading on 17 November and 82.2 on the effective exchange rate index on 20 November.) In the week before the Budget, sterling recovered against the Deutsche Mark, reaching DM 2.2376 on 27 November; this stemmed, in part, from an expectation that the Bundesbank would soon lower its key interest rates. But an episode of renewed weakness began on Budget day itself. Although the Budget was broadly neutral, it confirmed the market in its belief that UK interest rates would be reduced in December and sterling fell back to 82.2 on an effective basis on 29 November. The combination of the dollar's rally against the Deutsche Mark on 30 November, and strong technical support around the $1.53 level then helped to underpin sterling. It finished November at DM 2.2094.

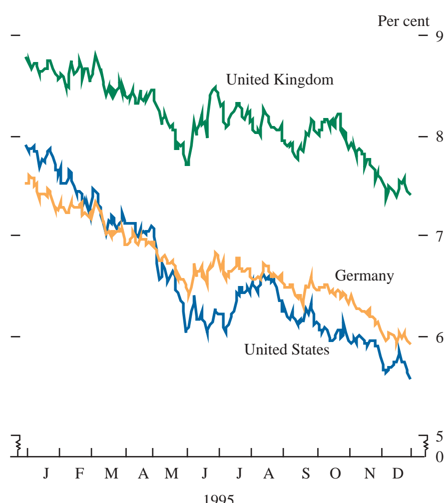
Trading over the next two weeks was dominated by market expectations of policy action by the Bundesbank and the Federal Reserve—with sterling moving back towards the sidelines. The Bundesbank's long-awaited decision to lower its Lombard and Discount rates on 14 December was received positively by the market: the dollar fell back against the Deutsche Mark towards DM 1.44. On 18 December, renewed fears about the implications of the US budget impasse for monetary policy (the funding resolution expired on 15 December) caused both US bond prices and the dollar to fall sharply. In the event, the Federal Reserve lowered its target federal funds rate from 5.75% to 5.50% the following day and the dollar rose above DM 1.44 on 20 December. Although adverse interest differentials moved in the yen's favour during December the yen failed to benefit, partly as a result of renewed concern about financial fragility in Japan. The dollar finished December at ¥103.08.

Sterling traded in a narrow range against both the dollar and Deutsche Mark in the first half of December, ahead of the monthly Monetary Meeting between the Chancellor and the Governor. Sterling wavered momentarily following the $^1/_4$ percentage point reduction in UK official rates. But it gained 0.2 points on the index by the end of the day, as the market quickly took heart from the clear evidence that there was full agreement between the Chancellor and Governor. In the final few days of December,

Par yields on British government stocks

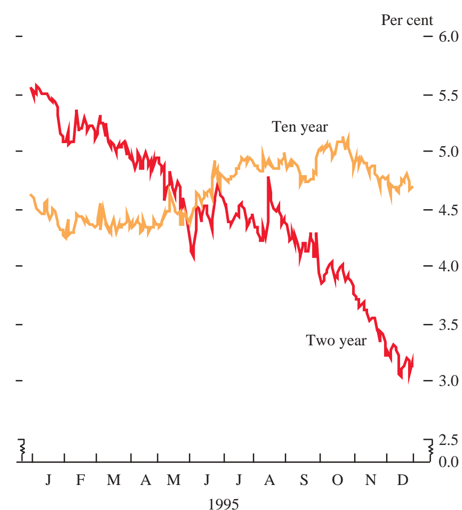


Ten-year government bond yields(a)



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

Implied forward inflation rates two and ten years ahead



sterling moved higher against the dollar in thin markets helped by corporate buying. As a result, sterling finished December at 83.1 in effective terms, a rise of 0.6 points over the month. But it was down by 1.6 points over the fourth quarter as a whole.

Gilt-edged market

Gilt yields continued their downward trend in the fourth quarter, reaching their lowest levels since spring 1994. All benchmark gilts finished the quarter with yields comfortably below 8%. Five-year yields closed under 7%: they dipped to 6.74% following the interest rate cuts in mid December. International spreads narrowed at ten years and the yield curve continued to steepen, with the spread between the five and 20-year benchmarks increasing by 13 basis points to 87 basis points. Inflation expectations implied by the gilt-yield curve reduced across the curve, but particularly so at the short end. Marginal (six-month) rates at the two-year maturity came down by more than 80 basis points over the quarter, to just over 3%, while the fall at ten years was just over 30 basis points to 4.7%. Real yields came down only slightly but this may, in part, have reflected the supply of index-linked gilts over the quarter; £1 billion was brought in taps. Volatility implied by options on gilt futures contracts rose slightly at the beginning of October, but declined thereafter.

Gilts had been hit at the end of the third quarter by the first uncovered auction and by the currency turbulence surrounding the Majorca summit. The fourth quarter started on a more optimistic note. The UK purchasing managers' index fell slightly, the US equivalent was weaker than expected and the German repo rate was cut from 4.08% to 4.05%. These combined to push ten-year gilt yields back under 8%. The US long bond yield fell to 6.043%, the lowest since February 1994.

However, further domestic data releases in October—in particular, the manufacturing component in September's industrial production and the September price data—were stronger than expected, and served to dampen the market. There were also further political concerns as the Government's majority was reduced. Ten-year gilt yields reached the quarter's high of 8.18% on 24 October. International spreads widened to hit a high of 219 basis points against the United States on 17 October and 178 basis points against bunds on 24 October. This was reversed towards the end of the month, however. Spreads were dramatically reduced, particularly against the United States on concerns about the stalled Budget talks. Spreads narrowed by twelve basis points against both the United States and Germany on 25 October, when an auction of £3 billion of the strippable 8% 2015 gilt was all but twice covered. Sentiment had also been helped the previous day by a CBI Survey which indicated slower manufacturing growth. Ten-year yields were back under 8% by the end of October.

Data releases at the beginning of November encouraged the market; the October Purchasing Managers' Index was the lowest since November 1993; and the October industrial production figures, although slightly higher than expected, had a significantly weaker manufacturing component. The market reaction to the *Inflation Report* on 8 November focused on the slight shading down of the Bank's inflation forecast. Other factors also encouraged the market. The Bundesbank's repo rate had been gradually shaved to 3.98%;

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 (b)	Date exhausted (b)
8% Treasury 2015 'A'	3,000	17.10.95	26.10.95	Auction	£96.78125 (c)	Fully paid	8.33		
Floating Rate Treasury 1999	500	26.10.95	26.10.95	Tap	£100.33000	Fully paid	. .	. .	27.10.95
Floating Rate Treasury 1999	100	26.10.95	26.10.95	To CRND					
2½% Index-Linked 2003	100	26.10.95	26.10.95	Tap	£172.00000	Fully paid	3.65 (d)	3.64 (d)	26.10.95
2½% Index-Linked 2011	150	26.10.95	26.10.95	Tap	£168.68750	Fully paid	3.68 (d)	3.68 (d)	26.10.95
7% Treasury 2001	250	30.10.95	30.10.95	Tap	£97.06250	Fully paid	7.61	7.60	31.10.95
2% Index-Linked 2006	100	30.10.95	30.10.95	Tap	£180.68750	Fully paid	3.63 (d)	3.63 (d)	2.11.95
2½% Index-Linked 2024	150	30.10.95	30.10.95	Tap	£118.37500	Fully paid	3.70 (d)	3.70 (d)	1.11.95
8% Treasury 2003	250	9.11.95	9.11.95	Tap	£102.12500	Fully paid	7.62	7.61	14.11.95
2½% Index-Linked 2009	150	9.11.95	9.11.95	Tap	£165.12500	Fully paid	3.57 (d)	3.50 (d)	24.11.95
2½% Index-Linked 2016	100	9.11.95	9.11.95	Tap	£150.37500	Fully paid	3.62 (d)	3.58 (d)	24.11.95
7½% Treasury 2006	3,000	29.11.95	7.12.95	Auction	£99.50000 (e)	Fully paid	7.56		
2½% Index-Linked 2011	150	11.12.95	11.12.95	Tap	£172.68750	Fully paid	3.48 (d)	3.50 (d)	18.1.96
2½% Index-Linked 2020	100	11.12.95	11.12.95	Tap	£145.81250	Fully paid	3.56 (d)	3.58 (d)	18.1.96

. . not applicable.

(a) Gross redemption yield, per cent.
(b) Taps are exhausted when the issue is no longer operating as a tranchette; the equivalent date for stocks sold at auction is the issue date.
(c) Lowest-accepted price for competitive bids, and non-competitive allotment price.
(d) Real rate of return, assuming 5% inflation.
(e) Lowest-accepted price for competitive bids, the non-competitive allotment price was £100.3125.

UK retail sales in October fell marginally, against market expectations; and the October RPI change of -0.5% and a PSBR surplus also surprised the market. Yields fell and international spreads continued to narrow. The rally was little affected by the fall in the currency, which hit an all time low of DM 2.1740 on 17 November.

Towards the end of November, gilts were helped by pre-Budget optimism. Most market participants expected to see any tax cuts fully offset by public spending cuts. The day before the Budget, the December gilt contract closed above 110, the highest level since March 1994. The yield on the five-year benchmark closed below 7%. Although initial market reaction to the Budget focused on the upward revisions to the PSBR, the adverse reaction was largely reversed the next day, helped by cuts in mortgage rates from three large mortgage lenders.

The December auction of the strippable 7½% 2006 stock was covered 1.12 times, with an eleven-basis point tail (the longest ever). Despite the long tail, the market moved up in high trading volumes: the future was up a point on the day with over 102,000 contracts traded. Sentiment continued to be positive, as expectations of an interest rate cut gathered. The yield curve steepened. The 25 basis point reduction in official rates on 13 December was followed by cuts in clearing bank base rates and further cuts in mortgage rates. An announcement on the following day that the electricity rebate would not be included in the RPI caused short index-linked prices to rise—up to ten ticks at best at the very short end.

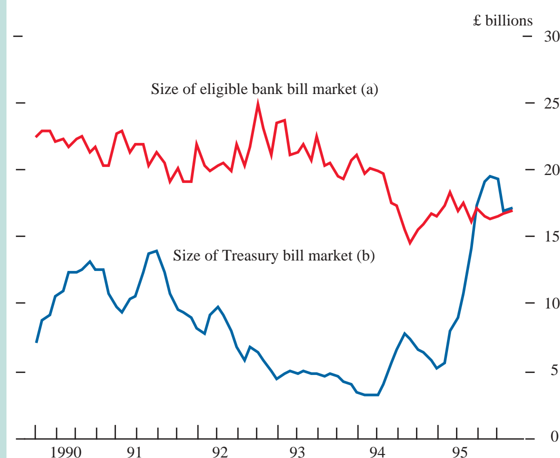
The market rallied on the Bundesbank decision (14 December) to cut both the Lombard and Discount rates by 50 basis points; Austria, Denmark, Belgium and the Netherlands followed suit. The market was given a further boost in the afternoon by the flat US CPI; gilts closed ten ticks up on the day at 110–28. The rally continued and the March contract reached a new high of 111–14 on 15 December. Although concerns over US budget talks in mid-December caused a slip in US bonds, which also affected European markets, the 25 basis point cut by the FOMC to 5½% on 19 December helped to reverse the fall, particularly at the short end.

The eligible bill market

Eligible bank bills and Treasury bills are the assets accepted by the Bank in the open market operations which it conducts to implement monetary policy. The Bank normally invites offers of eligible bank bills and Treasury bills for outright sale. If the daily shortage in the money market is large, the Bank may also invite repos of eligible bank bills or Treasury bills (in which bills are sold to the Bank with an agreement for their subsequent repurchase).

Eligible bank bills are issued ('drawn') by an industrial or commercial borrower and are accepted by an eligible bank. They meet a number of criteria which relate to the purpose for which the bill is drawn and the clausing and maturity of the bill. Sterling Treasury bills are government paper, payable on or after a certain date.

Chart 1
Eligible bank bills and Treasury bills



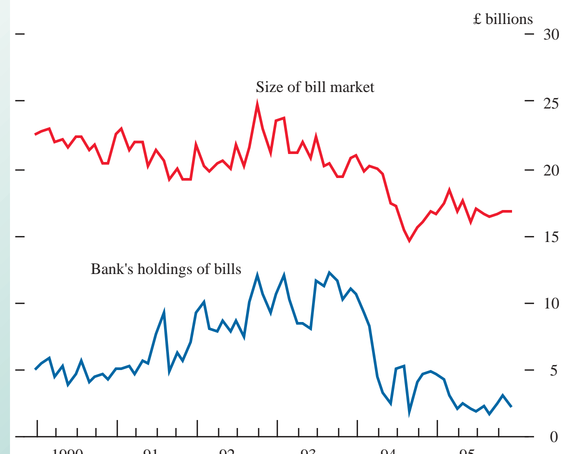
(a) Includes bills held by the Bank of England.
(b) Excludes all official outright holdings.

Both eligible bank bills and Treasury bills are issued and traded at a discount to face value.

The size of the market in eligible bank bills depends on the activities of the accepting banks and the attractiveness of the instrument to drawers: in recent years corporates have been offered a wider range of financing instruments. The market in eligible bank bills fell from an outstanding stock of £21.8 billion in 1993 (average of end-months) to £16.8 billion in 1995.

The Bank does not impose any direct limit for monetary control purposes on the volume of acceptance business undertaken by eligible institutions. However, since the current money market system was introduced in 1981, for reasons of equity and prudence it has set limits on the proportion of the market which any individual bank's acceptances may represent.

Chart 2
Eligible bank bills: size of market and Bank's holdings

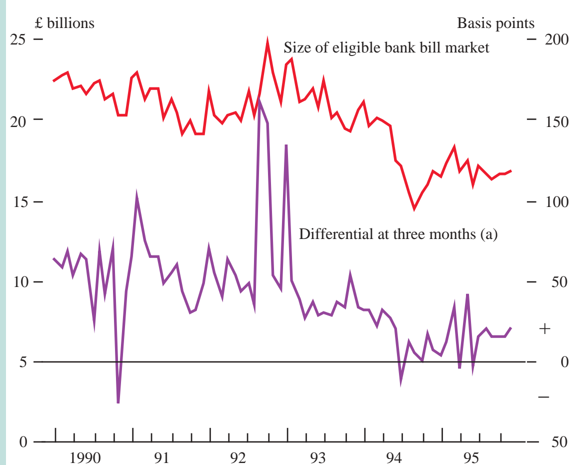


Gilt-market volumes in the final two weeks of the year were relatively low. The US long bond dipped below 6% after Christmas and closed the year at 5.94%, but this had little effect on the gilt market.

Index-linked gilts

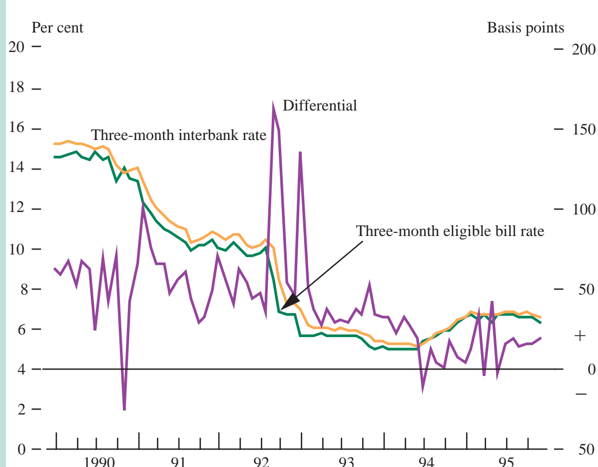
The Bank announced on 14 December that, following the September conference on developing the index-linked market, it was consulting the market in detail on the merits and practicalities of establishing a separate list of index-linked market-makers and of holding a pilot series of auctions of index-linked gilts in the coming financial year. The Bank also announced that there were no immediate plans to introduce limited price indexed (LPI) gilts or earnings-related gilts; the scale of demand was very uncertain and there would be a risk of fragmenting the liquidity of the index-linked market. The Bank also announced that there were no plans to amend the eight-month indexation lag; the market had indicated that it was not seeking a change and that the level of demand was not affected by the lag.

Chart 3
Size of eligible bank bill market and differential between bills and cash



(a) Differential between eligible bank bill and interbank rates.

Chart 4
Three-month interbank vs three-month eligible bill rates



Decisions on the size of Treasury bill issues are part of the process of money-market management. If the cash position of the market is forecast to become easier—for example, because of seasonal disbursements by Government—more Treasury bills can be issued to drain liquidity from the market, and so keep it dependent on the Bank's operations.

The weekly tender, having been increased in mid-1995 to £1,500 million, has since been reduced to £800 million over the tax season (which drains cash from the market). The total stock of bills in market hands (eligible bank bills plus Treasury bills) rose from £17.8 billion in December 1994 to £32.7 billion in December 1995.

Past experience suggested that when the Bank's holdings were relatively high, the scarcity of eligible bank bills in market hands made them a relatively attractive source of finance for drawers, and the bill market expanded. (Chart 2 shows the size of the eligible bank bill market compared with the level of the Bank's holding.) But over the past year the outstanding stock of eligible bank bills has risen, despite continued low holdings by the Bank.

Chart 3 shows the differential between eligible bill and interbank rates. As the differential becomes more positive (bills become cheaper), the bill market is seen to expand.

Chart 4 plots interbank rates against eligible bank bill rates. The differential line is also plotted. From the peaks in the differential there is some evidence that interbank rates 'follow' eligible bill rates. To the extent that this is so, drawings of eligible bills may be relatively unattractive when interest rates generally are tending to rise.

Funding

Total gilt sales of £8.0 billion were made during the quarter, bringing the total for the financial year to £20.3 billion. This left £10.8 billion to be sold in the final quarter of the financial year, on the basis of the Budget forecast for the full-year gilt sales requirement. The M4 private sector (which excludes banks and building societies but includes large institutional investors) continued to make large net purchases during the fourth quarter of 1996, at rate similar to that of the previous six months. Banks, which had made only modest net purchases of gilts earlier in the financial year, also made substantial net purchases in the fourth quarter.

On the day after the Budget, a revised remit for funding in 1995/96 was announced in the light of the Government's higher forecast of the PSBR and funding requirement: an extra auction would be held on 28 February 1996, bringing the total for the year to nine. It was announced on 28 December that the January and March auctions would each be for stock in the maturity range 2000–2002 and that

Table D
Official transactions in gilt-edged stocks

£ billions: *not seasonally adjusted*

	1995/96 (a) Apr.–Sept.	1995 Oct.	Nov.	Dec.
Gross official sales (+) (a)	12.3	3.8	1.1	3.0
Redemptions and net official purchases of stock within a year of maturity(-)	2.6	—	0.8	—
Net official sales (b)	9.8	3.8	0.2	3.0
of which net purchases by:				
Banks (b)	0.2	0.2	1.3	1.9
Building societies (b)	-0.3	-0.1	-0.4	0.1
Overseas sector	3.7	0.9	-0.7	0.2
M4 private sector (b)	6.1	2.9	0.1	0.8

(a) 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.
(b) Excluding transactions under purchase and resale agreements.

the February auction would be for stock with a maturity of 2020 or longer.