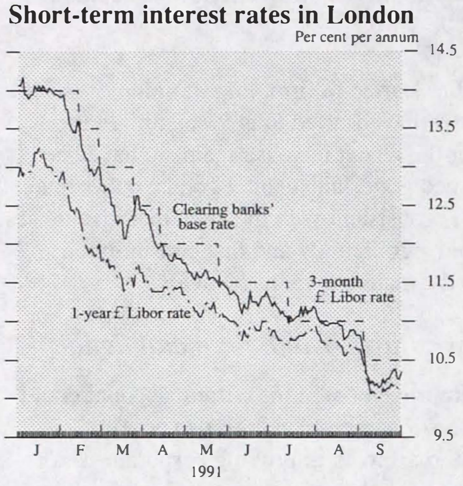
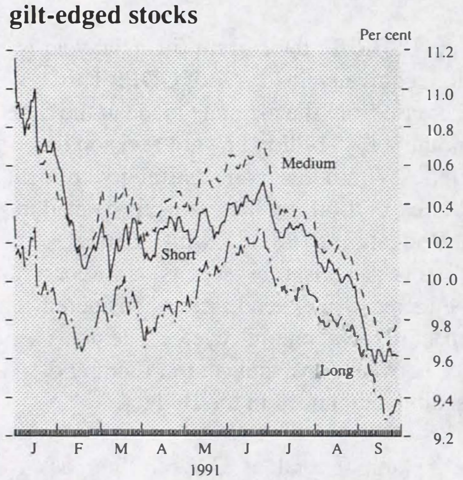
Operation of monetary policy

This article covers the period from July to September.

Short-term interest rates in London

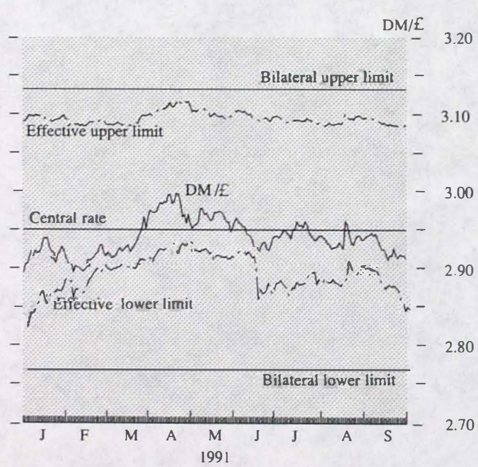


Yields on representative conventional gilt-edged stocks



Representative stocks: short - 12% Treasury 1995; medium - 12% Exchequer 1998; long - 9% Treasury 2008.

Effective and bilateral wide-band limits of sterling against the deutschemark



Introduction

During the third quarter the rate at which inflation was declining became evident. This was seen in the slower growth of retail prices, as well as in underlying earnings and pay settlements, and was reflected in falling inflation expectations among producers and consumers and in financial markets. In addition, sterling remained firm, well within its ERM bands, and rose modestly in effective terms over the quarter. Against this background, a further moderate easing of policy was possible, with two ½% cuts in base rates effected in July and September. As sterling's overall steadiness in the ERM indicated, these moves were accepted by the markets as being fully consistent with the continuing stance of easing policy only as inflationary pressures abate.

A fall in inflation expectations was evident in gilt yields, which fell at all maturities, with long yields down from above 10% at the beginning of July to below 9.5% by the end of the quarter. Moreover, the differential between conventional and index-linked yields narrowed over the quarter, possibly further indicating an improvement in inflation expectations. The rally in the gilt-edged market also enabled substantial official sales of stock to be made, worth some £4.7 billion over the quarter.

As the German-US short-term interest rate differential widened during the quarter, the dollar reversed some of the gains it had made since February and, although sterling also gained against the dollar, it lost ground to the deutschemark, because of the effect of the dollar's depreciation. Partly as a consequence, sterling moved within the ERM from a position which would have put it within the upper half of the narrow band, to one only ¼% above the French franc, which was at the bottom of the band, by the end of September. In the wide band, sterling nevertheless remained well above its lower limits (see the chart opposite). The reduction in UK interest rates in July was widely expected when it occurred and had little effect on sterling. The further reduction in September was similarly expected to occur at some stage, but its precise timing was not fully anticipated by markets and was initially taken to indicate that the General Election would be held in November, and would be preceded by a further interest rate cut. As a result, both money-market rates and sterling softened and, although money-market rates rose again as it became clear that an election would not be held in November, sterling remained subdued, ending the quarter a little above DM 2.91.

The narrowing of the interest differential against German rates during the quarter reduced the scope for a further fall in domestic interest rates. However, the substantial reduction in interest rates which had occurred since sterling joined the ERM had already provided a significant stimulus to demand. Signs emerged during the quarter that this had begun to stem the decline in activity, but the full effects had yet to be seen. Domestic policy objectives thus remained fully consistent with maintaining sterling's position in the ERM.

Monetary aggregates and credit

The figures in this section are seasonally adjusted unless otherwise stated.(1)

M0 grew modestly in the third quarter while the growth in M4 fell sharply. However, the recent movements in broad money probably overstate the extent of continuing adjustment in private sector spending. Indicators of the private sector's financial balance suggest some slackening in the scale of retrenchment.

Components of money

The twelve-month growth of M0 rose from 1.9% to 2.3% between June and September, and remained firmly within its target range (0%–4%). During the quarter M0 rose 0.7%, a similar increase to the previous quarter.

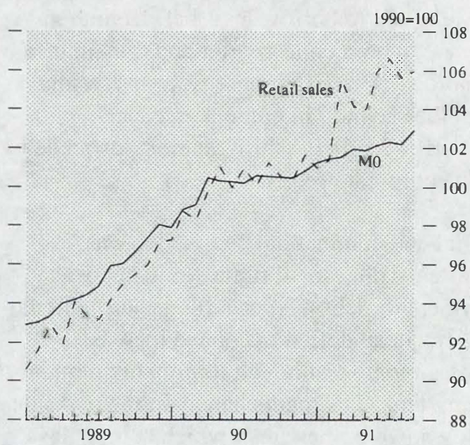
Table A
Growth rates of the monetary and credit aggregates(a)

Percentages; *seasonally adjusted (financial year constrained)*

	12 months to end-June 91	12 months to end-Sept. 91	1991 Q2	Q3
M0(b)	1.9	2.3	0.6	0.7
M2	12.0	10.7	2.9	0.6
M4	7.9	6.4	1.8	0.6
M4 lending	8.7	7.2	1.1	1.3

(a) See the statistical annex to the February 1991 *Bulletin* for definitions.
(b) Data are based on end-month figures,except M0,which is an average of Wednesdays in each month.

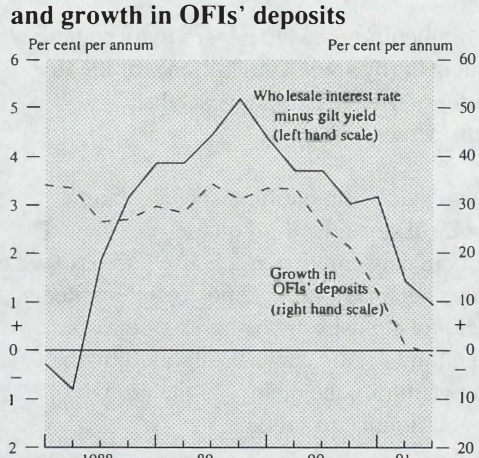
M0 and the value of retail sales



Nevertheless, narrow money has increased less rapidly than the value of retail sales since the spring (see the chart opposite). The rise in non-cash-financed spending and total spending in the spring and early summer may reflect a faster rise in expenditure on larger, non-essential and luxury goods than in spending on more essential items.

The twelve-month growth rate of M4 slowed further in the third quarter to 6.4%, the lowest annual growth rate since the first quarter of 1970. This compares with the recent peak of 18.2% in the fourth quarter of 1989. During the twelve months to September, the decline in broad money growth has been concentrated in its wholesale component. The twelve-month growth rate of wholesale M4 in September was only 0.4%, compared with a peak of just over 33% in January 1990. In contrast, the twelve-month growth rate of retail deposits had remained little changed for over a year; it has, however, also fallen back in the latest quarter.

Wholesale interest rate minus gilt yield(a) **and growth in OFIs' deposits**



(a) Wholesale interest rate is 3-month Libor, gilt yield is gross redemption yield on representative 20-year gilt.

Most of the fall in wholesale deposit growth has stemmed from an asset portfolio switch by other financial institutions (OFIs) out of bank deposits into longer-term assets. Resumed gilt issues by the government in recent quarters, and capital issues by industrial and commercial companies (ICCs) over the last year, have offered alternative assets to institutional investors, while the banks and building societies have lent less to the private sector. Since there has been less requirement for them to raise as many deposits to finance their lending operations—partly because ICCs have used some of the proceeds of capital issues to repay outstanding bank lending—banks and building societies may also have competed less aggressively for wholesle deposits.

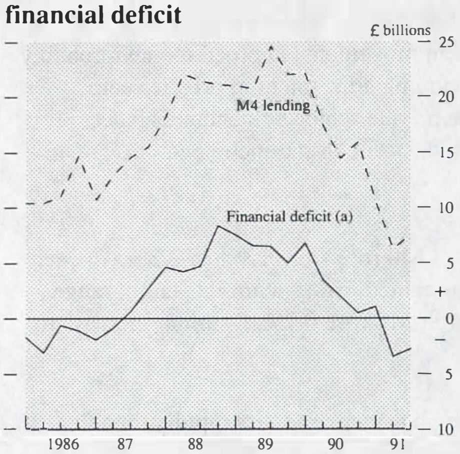
Sectoral lending and deposits

The public sector's financial balance probably moved deeper into deficit during the third quarter, judging by the movement in the PSBR (seasonally adjusted and excluding asset sales). The UK

(1) The adjustments used for M0 are those derived from the most recent update (published in November 1991). The other aggregates are adjusted using seasonals derived from the previous update (published in the August 1991 *Bulletin*).

current account deficit also widened during the last three months in comparison with the previous quarter, meaning that the financial surplus of the overseas sector increased. In an accounting sense, these factors are offsetting in their impact on the financial balance of the M4 private sector, which thus appears to have been little changed in the third quarter, perhaps deteriorating slightly, after the sharp improvement in the second quarter.

Private sector M4 lending and financial deficit



(a) Proxied by current account deficit minus estimated public deficit.

Some confirmation of a slackening in the pace of private sector adjustment may be seen in the faster rate at which the private sector borrowed from the M4 institutions (banks and building societies) in the third quarter (see chart). However, such borrowing will also have been affected by the scale of capital issues, which was less in the third quarter than it had been in the second.

In the third quarter, *net* sterling borrowing (that is, borrowing less the placing of deposits) from the banks and building societies by the whole of the M4 private sector was £4.4 billion. This compares with net *deposits* of £2.4 billion in the second quarter, but is of a similar magnitude to the preceding three quarters. A possible interpretation of these movements (for which the evidence is as yet incomplete) is that the particularly large capital issues of the second quarter attracted inflows from abroad to the private sector. The private sector as a whole thus had to borrow less (net) from the banks and building societies in the second quarter and they in turn had to borrow less from abroad. But all of these flows were smaller in the third quarter than in the second. In contrast to earlier quarters, most of the net borrowing in the third quarter was made by the personal rather than the corporate sector.

Table B
Sectoral analysis of sterling deposits with, and borrowing from, banks and building societies

£ billions; *seasonally adjusted (calendar year constrained)*

	1990		1991		
	Year	Q4	Q1	Q2	Q3
Personal sector					
1 Deposits	34.0	9.0	8.5	7.5	3.0
of which:					
Banks	15.8	3.8	3.0	2.2	-0.6
Building societies	18.2	5.2	5.5	5.3	3.6
2 Borrowing	39.6	8.9	6.8	7.3	6.2
of which:					
Mortgage	30.4	6.8	6.2	6.2	6.8
Non-mortgage	3.4	1.0	0.3	0.1	0.2
Unincorporated businesses, etc	5.8	1.2	0.2	0.9	-0.8
3 Net recourse (=2-1)(a)	**5.6**	**-0.1**	**-1.8**	**-0.2**	**3.2**
ICCs					
4 Deposits	4.0	0.8	-2.4	5.0	-0.9
5 Borrowing(b)	16.8	4.4	2.4	-3.4	-0.8
6 Net recourse (=5-4)(a)	**12.8**	**3.7**	**4.8**	**-8.3**	**0.1**
OFIs					
7 Deposits	13.6	1.4	0.6	-3.5	0.6
8 Borrowing(b)	13.1	2.4	1.5	2.5	1.7
9 Net recourse (=8-7)(a)	**-0.5**	**1.1**	**0.9**	**6.1**	**1.1**

(a) Excludes notes and coin.
(b) Includes Issue Department take-up of commercial bills.

Net borrowing by industrial and commercial companies was negligible in the third quarter, with a small rundown in deposits matched by a small repayment of debt. After falling sharply in the second quarter, the ICCs' financial deficit may have increased somewhat over the last three months, although it probably remains far lower than in earlier quarters. The main change on the real side appears to have been a slowdown in the rate at which companies have been destocking. The rundown of deposits may reflect large companies, which have access to the capital markets, spending some of the proceeds from the spate of capital issues in the second quarter.

During the third quarter, unincorporated businesses reduced their stock of outstanding bank debt (by some £0.8 billion) for the first time since the third quarter of 1975. This suggests that retrenchment by small businesses continued.

Individuals' net recourse to banks and building societies in the quarter was at its highest level since the third quarter of 1986. The flows of M4 lending for both consumption and house purchase were similar to last quarter, whereas inflows into deposits fell markedly. This could indicate that liquid deposits are being used, in part, to finance consumers' expenditure. This view is supported by the particularly sharp slowdown during the quarter in the growth of M2 (which comprises small and liquid deposits).[1]

Despite the reductions in interest rates over the last year, the quarterly growth of bank and building society lending for house

(1) The reduction of inflows into TESSAs, included within the M2 definition, only accounts for a modest part of the decline in M2 growth.

purchase was unchanged in the first nine months of 1991, confirming the impression given by house price and activity data that the housing market remained depressed.

As noted above, the largest component in the fall of aggregate M4 growth during the last twelve months has been a decline in OFIs' deposits. OFIs have switched into alternative assets as the return on bank deposits has become less competitive, a reflection, in part, of the M4 institutions' reduced requirement for funds to finance lending. However, over the last quarter OFIs have built up their bank deposits, albeit modestly, and reduced their M4 borrowing. In part this may be a counterpart in the monetary data to lower capital issues by industrial and commercial companies. It may also reflect disintermediation, as capital issues by OFIs themselves remained reasonably strong in the third quarter.

Public sector counterparts to money

The public sector remained in large deficit in the third quarter with a PSBR (not seasonally adjusted) of £3.7 billion, or £5.1 billion excluding privatisation proceeds. This was lower than the second quarter, which was distorted by the Budget changes to the community charge as well as reflecting the normal seasonal pattern, but compares with a £0.5 billion debt repayment in the same period of last year (a borrowing requirement of £1.2 billion excluding asset sales). Large net borrowing by the government continued to result from the effect of the Budget's changes to the tax system as well as the continued impact of the recession, which has depressed tax revenues and increased some expenditures.

In contrast to the second quarter, borrowing was more than fully funded in the third (£0.5 billion not seasonally adjusted) with the M4 private sector purchasing a sizable amount of government debt, particularly gilt-edged securities. These purchases may have been financed out of deposits at banks and building societies.

In seasonally adjusted terms, and unlike in the second quarter, banks and building societies made no net lending to the public sector. In an accounting sense, this partly explains why lending to the private sector was significantly higher than deposit inflows during the third quarter. In addition, an exceptionally large part of bank and building society lending to the UK public and private sectors was financed by net deposits from overseas. As noted above, this may reflect the overseas sector making fewer purchases of company securities in the United Kingdom and placing more in net deposits here. The deterioration in the current account during the quarter, albeit modest, also implies greater total net financial inflows from abroad.

Table C
Counterparts to changes in M4[(a)]

£ billions; *seasonally adjusted figures (financial year constrained)*

		Counterparts to M4 1991 Q2	Q3	12 months to end-Sept. 91
1	PSBR (+)	2.0	2.8	4.1
2	Net purchases (-) of public sector debt by the M4 private sector	0.6	-3.0	-3.8
	of which, central government debt	*0.5*	*-2.9*	*-3.5*
3	External and foreign currency finance (-) of the public sector	-0.2	0.1	1.1
4	Public sector contribution (=1+2+3)	2.3	—	1.4
5	Sterling lending to the M4 private sector (b)	6.2	7.6	40.3
6	Other external and foreign currency flows	0.8	-3.7	-8.8
7	Net non-deposit sterling liabilities of banks and building societies(-)	-0.8	-1.0	-3.2
8	**Total (=4+5+6+7) =change in M4**	**8.6**	**2.9**	**29.7**

(a) See the statistical annex to the February 1991 *Bulletin* for definitions.
(b) Including changes in Issue Department's holdings of private sector commercial bills and promissory notes relating to shipbuilding paper guaranteed by the Department of Trade and Industry.

Table D
Average daily money-market statistics

£ millions; *not seasonally adjusted*
Increases in the market's cash (+)

	1991 June	July	Aug.	Sept.
Average daily figures				
Influences (excluding maturing assistance)	+40	-120	- 7	+ 101
Maturing assistance(a)	-1,080	-1,080	-1,373	-1,071
Surplus (+)/shortage (-) before daily operations	-1,040	-1,200	-1,380	- 970
End-period levels				
Stock of assistance	6,890	9,760	8,200	4,670
Sterling Treasury bills outstanding(b)	13,620	13,880	12,230	10,710

(a) Including net issuance of sterling Treasury bills and the level of bankers' balances above or below target from the previous day.
(b) Other than those held outright by the Bank and government accounts but including those purchased by the Bank on a repurchase basis.

Official operations in financial markets

Sterling started the quarter on a firm note, at around DM 2.94, encouraged by the Government's showing in opinion polls. This strength fostered hopes of an early reduction of interest rates, but the Bank resisted downward pressure by lending on 5 July at 2.30 pm for 7 days. With sterling remaining steady, a $^1/_2$% cut to 11% was signalled on 12 July, as was widely expected following the Bundesbank's decision the previous day to leave German rates unchanged. New stop rates (the lowest rate at which the Bank buys bills) were established at $10^7/_8$% for both Band 1 and Band 2 bills,

The cash position in the money market

There was a net outflow of £0.7 billion from the market in the third quarter as the CGBR of £3.5 billion was more than offset by net sales of debt, especially gilts. The heavy front-loading of expenditure this year, caused by the delayed collection of the community charge and compensating early payment of grants to local authorities, was partly offset during the quarter as VAT receipts at the new higher rate began to be collected. There were also privatisation proceeds amounting to £1.4 billion, mainly from the third instalment of the sale of the water companies.

Table 1
Influences on the cash position of the money market

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

	1990	1991		12 months to end-
	Q3	Q2	Q3	Sept. 91
Factors affecting the market's cash position				
CGBR (+)	-0.6	+6.7	+3.5	+4.0
of which, on-lending to local authorities and public corporations	*-0.6*	*+0.2*	*-0.1*	*+1.1*
Net sales (-) of central government debt (a)	+0.5	-3.1	-5.0	-7.7
of which: Gilt-edged	*+0.9*	*-2.5*	*-4.2*	*-5.6*
National savings	*-0.4*	*-0.6*	*-0.7*	*-2.0*
CTDs	—	—	*-0.1*	*-0.1*
Currency circulation (increase -)	—	+0.1	+0.6	+0.2
Reserves etc	+0.2	+0.9	-0.1	+0.9
Other	+0.5	-0.5	+0.3	+0.3
Total (A)	+0.6	+4.1	-0.7	-2.3
Offsetting official operations				
Net increase (+) in Bank's commercial bills (b)	+0.8	-2.3	-0.8	-0.6
Net increase (-) in sterling Treasury bills in market (c)	-0.9	-3.3	+2.9	+2.3
Other	-0.2	+1.5	-1.4	+0.4
Total (B)	-0.3	-4.1	+0.7	+2.1
Changes in bankers' operational balances at the Bank (=A+B)	+0.3	—	—	-0.2

(a) Other than sterling Treasury bills.
(b) By the Issue and Banking Departments of the Bank of England.
(c) Excluding repurchase transactions with the Bank.

The alternative presentation of the market's position (Table 2) shows that the excess of net debt sales over the government borrowing requirement, which resulted in £0.5 billion of overfunding, was accompanied by a further £1.1 billion outflow arising from net public sector borrowing from banks and building societies. This included a further run-down of local authorities' deposits with banks and building societies, of some £0.5 billion, which was only partly offset by a £0.3 billion rise in public corporations' bank deposits.

Table 2
Alternative presentation of factors affecting the market's cash position

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

	1990	1991		12 months to
	Q3	Q2	Q3	end-Sept. 91
Factors affecting the market's cash position				
Under/overfunding (+/-)	-0.2	+4.7	-0.5	-1.7
Central government net debt sales to banks and building societies(a) (-)	+0.5	+0.1	-0.8	-0.1
Other public sector net borrowing from banks and building societies (-)	—	-0.8	-0.3	-0.7
of which, local authorities' deposits with banks and building societies (+)	*+0.1*	*-0.6*	*-0.5*	*-1.2*
Currency circulation (-)	—	+0.1	+0.6	+0.2
Other	+0.3	—	+0.3	—
Total	**+0.6**	**+4.1**	**-0.7**	**-2.3**

(a) Other than sterling Treasury bills.

During the quarter the Treasury bill tender was reduced on three occasions from £900 million to £400 million by 6 September (see Table 3). The first reduction was in July, when 63-day bills ceased to be issued, having been introduced to offset the effect of the earlier than usual payment of grants to local authorities. The money-market position was such as to enable a further £200 million reduction in August, and £100 million in September in anticipation of the increased drainage of liquidity from the money market caused by large net government receipts during the main revenue-paying season.

Table 3
Size of the Treasury bill tender, from 1988

£ millions

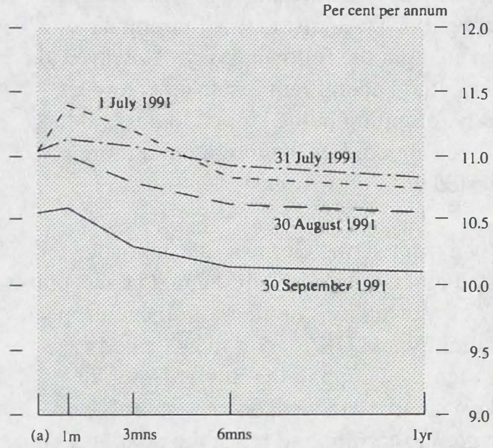
Period beginning	63 days	91 days	182 days	Total
End-1987	—	**100**	—	**100**
1988				
23 September	—	400	—	400
28 October	400	100	—	500
25 November	—	100	—	100
1989				
12 May	—	300	—	300
19 May	—	500	100	600
29 September	200	500	100	800
17 November	—	500	100	600
24 November	—	300	100	400
1990				
2 February	—	500	200	700
28 September	200	250	200	650
30 November	—	250	200	450
1991				
15 February	—	350	200	550
19 April	—	500	200	700
10 May	200	500	200	900
12 July	—	500	200	700
2 August	—	300	200	500
6 September	—	300	100	400

Table E
Sterling interest rates, gilt yields and exchange rates; end-month and selected dates (a)

Date (1991)	Interbank interest rates (per cent per annum)				Yields on gilt stocks (b) (per cent per annum)				Exchange rates		
					Conventionals			Index-linked			
	1 month	3 months	6 months	12 months	Short	Medium	Long	Long	ERI	£/$	£/DM
1 July	11 13/32	11 7/32	10 27/32	10 3/4	10.42	10.65	10.17	4.24	89.5	1.6195	2.9378
12 July	11 1/8	11 1/16	10 7/8	10 3/4	10.28	10.38	9.97	4.25	90.4	1.6460	2.9529
31 July	11 1/8	11 3/32	10 29/32	10 27/32	10.24	10.33	9.92	4.26	90.9	1.6840	2.9403
15 August	11 1/32	10 29/32	10 3/4	10 21/32	10.05	10.15	9.77	4.30	90.6	1.6880	2.9245
20 August	10 31/32	10 25/32	10 5/8	10 17/32	10.00	10.17	9.80	4.28	90.2	1.6405	2.9537
30 August	11	10 13/16	10 5/8	10 9/16	9.98	10.09	9.72	4.26	90.5	1.6760	2.9355
4 September	10 17/32	10 3/8	10 9/32	10 5/16	9.83	9.96	9.65	4.18	91.0	1.6945	2.9433
17 September	10 15/32	10 3/16	10 3/32	10 3/32	9.65	9.73	9.40	4.19	91.0	1.7405	2.9136
30 September	10 19/32	10 5/16	10 5/32	10 1/8	9.62	9.77	9.36	4.18	91.1	1.7505	2.9120

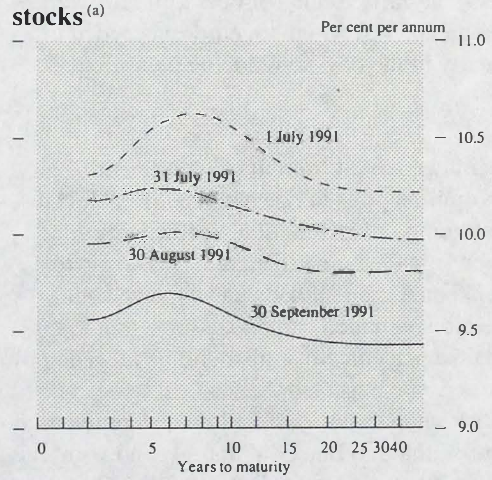
(a) Close of business rates.
(b) For representative stocks: short—12% Treasury 1995, medium—12% Exchequer 1998; long—9% Treasury 2008; index-Linked—2 1/2% Treasury Index-linked 2024 (5% inflation assumed).

Sterling interbank rates



(a) For one week.

Time/yield curves of British government stocks (a)



(a) Calculated par gross redemption yields on British government stocks.

representing a fall of 1/2% and 7/16% respectively from previous rates. The equality of stop rates was widely interpreted by the market as a signal that a further cut in rates was some way off.

This view was further encouraged by disappointing RPI data, and the absence of downward pressure on rates enabled the Bank to return to a neutral operating stance. Indeed, it was fully accommodating in early rounds of operations in response to the firmness of very short rates arising from large market shortages. Sterling firmed as exchange markets also did not expect interest rates to be cut again for some time and, supported by better than expected trade and retail sales data, traded narrowly around DM 2.9550 in mid-July.

The Bundesbank's decision on 11 July not to raise official interest rates encouraged a strong rise in the dollar which met with concerted intervention. As the dollar then weakened against the continental European currencies in the second half of July so also did sterling, which weakened further against the deutschemark as poor German inflation data made a rise in German interest rates appear more likely. Sterling ended July at DM 2.94 and $1.68.

Sterling's performance in the ERM supported a strong rally in the gilt-edged market in July, enabling gross official sales of some £2 billion to be made. The market was further encouraged at the beginning of July by the absence of funding announcements (see Table F) as well as by strong overseas buying, and the remaining £125 million of the 10% Treasury 1994 tranchette sold out on 4 July at a premium on the issue price, as did the 12% Exchequer 1998 and 9 1/2% Conversion 2005 tranchettes on 18 July. The 1/2% cut in base rates on 12 July had little effect on the market, but the placing with Issue Department of £1 billion of 9% Conversion 2011 on 19 July, on the back of a rally in long gilts, temporarily set the market back. The rally, however, resumed towards the end of the month, and the 9% Conversion 2011 tap was exhausted by 2 August following a rise of over a point in the US bond market after weaker than expected US employment figures.

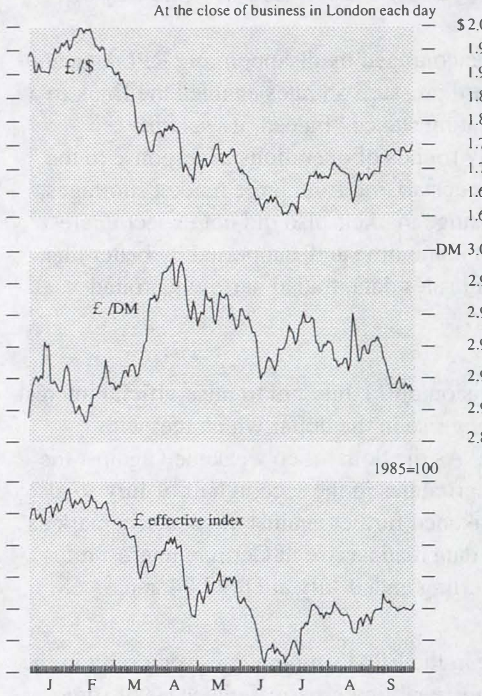
At the beginning of August, money-market rates eased as the prospect of a further fall in US official rates reduced expectations that the Bundesbank would raise rates, and on 2 August the three-month interbank rate closed at 10 15/16%, below the level of base rates for the first time since the move to 11%. The yield on three-month Treasury bills also fell, to 10.58%, reflecting softer interbank rates.

Table F
Issues of gilt-edged stock, 1991 Q3

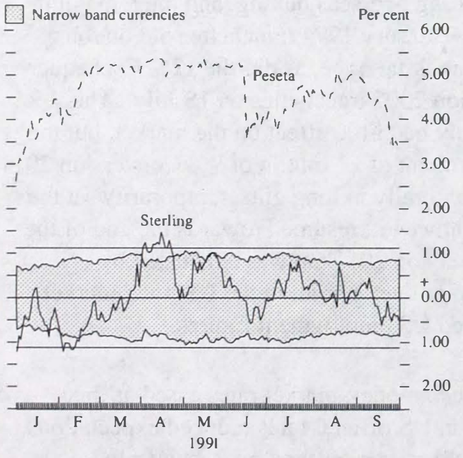
Stock	Amount issued (£ million)	Date announced	Date issued	Method of issue	Price at issue (per £100 stock)	Details of payment	Yield(a) at issue	Yield(a) when exhausted	Date exhausted
9½% Conversion 2005	250	12/7/91	12/7/91	To Bank	94.4375	In full	10.11	10.10	18/7/91
12% Exchequer 1998	250	12/7/91	12/7/91	To Bank	108.1875	In full	10.36	10.34	18/7/91
9% Conversion 2011	1,000	19/7/91	19/7/91	To Bank	92.5	Part paid (b)	9.87	9.82	2/8/91
8½% Treasury 2007	150	5/8/91	5/8/91	To Bank	89.5	In full	9.81	9.81	6/8/91
10¼% Conversion 1999	150	5/8/91	5/8/91	To Bank	100.8125	In full	10.09	10.05	20/8/91
10¼% Exchequer 1995	150	5/8/91	5/8/91	To Bank	100.5	In full	10.08	10.08	6/8/91
9½% Treasury 1999	200	9/9/91	9/9/91	To Bank	99.6875	In full	9.54	9.47	13/9/91
10½% Exchequer 1997	200	9/9/91	9/9/91	To Bank	103.3438	In full	9.68	9.62	12/9/91
9% Treasury 1994	200	9/9/91	9/9/91	To Bank	98.2813	In full	9.61	—	On tap (d)
9½% Conversion 2004	1,500	17/9/91	25/9/91	Auction	99.5625	Part paid (c)	9.56	9.56	25/9/91
2½% Index Linked 2013	100	30/9/91	30/9/91	To Bank	110.6250	In full	4.22	4.22	11/10/91
2% Index Linked 1996	100	30/9/91	30/9/91	To Bank	176.6250	In full	3.82	3.90	29/10/91

(a) Gross redemption yield, per cent.
(b) With 30 payable at issue, 30 on 19/8 and remainder on 9/9.
(c) With 24.5625 payable at issue, 35 on 28/10 and remainder on 18/11.
(d) At 31/10/91.

Sterling exchange rates



ERM positions



The zero line represents the middle of the narrow band.

The rally in the gilts market was sustained through early August. The three tranchettes brought on 5 August met with immediate demand and two of them sold out the following day. However, the 25 basis points reduction in the Federal Funds rate on 6 August, together with the quarterly refunding in the United States and large sterling non-gilt bond issues, marked the beginning of a more subdued period which lasted until mid-August.

As had become generally expected, the German discount and Lombard rates were raised on 16 August, by 100 and 25 basis points respectively, and this was followed by a number of other European countries. Sterling fell slightly and UK market rates firmed modestly. News of the attempted coup in the Soviet Union on 19 August caused the deutschemark to weaken very sharply and sterling more than recovered lost ground to reach the quarter's high of DM 2.9660 during 20 August, although it fell back along with other currencies against the dollar. Short-dated gilts also benefited from a 'flight to quality' and the third tranchette which had been brought on 5 August was sold out the following day. Money-market rates also rose temporarily on news of the coup but fell back, along with sterling, as the failure of the coup became apparent. Towards the end of the month, the money markets were seasonally quiet, but large end-month shortages led the Bank to make outright purchases in its early rounds of operations, as well as undertaking repurchase agreements, which together succeeded in relieving the shortages early in the day, so reducing pressure on short rates.

In early September, sterling benefited from the Government's stronger performance in opinion polls to rise above DM 2.94. This, accompanied by the continuing fall in inflation, enabled a further ½% cut in base rates to be signalled on 4 September. The move nevertheless came rather sooner than markets had expected, and, seeking explanation, the money market came to assume that a General Election would take place in November and be preceded by a further cut in base rates. Some expected the next cut to be signalled on 12 September when the August RPI data were released and there was some surprise that the Bank did not respond with 2.30 pm lending on 6 September, when the three-month yield fell to 9.96% at the Treasury bill tender. Three-month interbank rates fell to a low of $10\frac{3}{32}$% on 13 September but firmed as sterling weakened against the deutschemark because of the further prospective narrowing of the differential between UK and German rates. Thereafter the yield on three-month Treasury bills rose and, when a

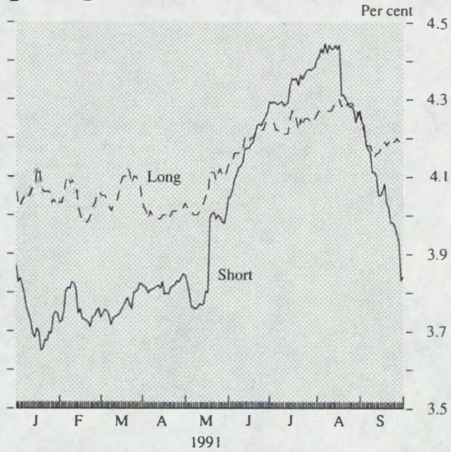
Table G
Official transactions in gilt-edged stocks

£ billions: *not seasonally adjusted*

	1990 Q3	Q4	1991 Q1	Q2	Q3
Gross official sales (+) (a)	+0.1	+0.5	+2.0	+3.3	+4.7
less					
Redemptions and net official purchases of stock within a year of maturity	-1.0	-2.0	-1.7	-0.8	-0.5
Equals net official sales (b)	-0.9	-1.4	+0.3	+2.5	+4.2
of which, net purchases by:					
Banks (b)	*-0.3*	*+0.7*	*-0.8*	*+0.2*	*+0.6*
Building societies	*-0.2*	*+0.3*	*-0.9*	*-0.2*	*+0.1*
Overseas sector	*-0.5*	*-1.5*	*+1.5*	*+2.1*	*+0.5*
M4 private sector	*+0.1*	*-0.9*	*+0.5*	*+0.5*	*+2.8*

(a) Gross official sales of gilt-edged stocks are defined as net official sales of stock with over one year to maturity apart from transactions under purchase and resale agreements.
(b) Apart from transactions under purchase and resale agreements.

Yields on representative index-linked gilt-edged stocks



Representative stocks: short - 2% Treasury Index-linked 1996; long - 21/2% Treasury Index-linked 2024.

Table H
Changes in UK official reserves

$ millions

	1991 June	July	Aug.	Sept.
Changes in reserves	+553	+367	+60	-98
of which:				
Net borrowing(+)/payment(-) of public debt	-40	-65	-11	-108
Valuation change on rollover of EMCF swap	-	+397	-	-
Underlying changes in reserves	+593	+35	+71	+10
Level of reserves (end of period)	**44,264**	**44,631**	**44,691**	**44,593**

November election appeared less likely and opinion polls were less favourable to the Government, market expectations of a cut were pushed further back. The three-month interbank rate rose to end the quarter at $10^5/_{16}$%. Sterling continued to weaken against the deutschemark, however, and closed on 30 September at DM 2.9120.

The gilt-edged market followed a similar path in September, continuing its rally in the first half on the improving outlook for domestic inflation, and enabling a package of three tranchettes to be brought on 9 September. Long-dated gilts rallied when the auction of £1.5 billion of $9^1/_2$% Converson 2004 was announced on 17 September because of demand from those who had expected the auction to be of longer-dated stock, because the amount was less than expected and because there were to be three, well-spread calls. The market then peaked on 20 September with yields at their lowest levels since 1989, but thereafter fell back in the run-up to the auction on 25 September. The auction stock was actively traded on a when-issued basis in the week before the auction, with demand greater than before the previous two auctions. Despite this apparent switch away from bidding directly for the stock, the auction was 1.93 times covered with a tail (the difference between the average and the lowest yield) of only two basis points. There was further good demand in the after market and, overall, gilts were supported by the strength of the US bond market. Demand for index-linked stocks, partly resulting from a switching out of equities, enabled two tranchettes to be brought on 30 September. The market for conventional stocks, however, fell back towards the end of the month as sterling weakened and the prospect of a November election and an accompanying fall in interest rates receded.

Official reserves

The level of reserves rose by $330 million over the third quarter, to $44.6 billion (see Table H). Foreign currency contributions to Gulf operations from countries not involved in hostilities were $2 million in July and $100 million in September, and are included in the underlying changes.

Ecu bond and Ecu Treasury bills

The UK Government's first 'Ecu bond' (ECU 2.75 billion at 10 years, issued on 13 February) maintained its position as the lowest yielding 10-year issue and principal benchmark during the quarter. It was the most actively traded Ecu issue in the international settlement systems, accounting for 18% of total turnover in Ecu bonds.

There were ECU 3.6 billion of Treasury bills outstanding at the end of the third quarter, unchanged from the previous quarter. The Bank allotted ECU 300 million of one and three-month bills, and ECU 400 million of six-month bills, at each of the tenders held on 9 July, 13 August and 10 September; tenders continued to be around 2 to 3 times covered at each maturity. The margin of the average yield accepted at tender below the bid-rate for Ecu-denominated bank deposits narrowed slightly for all maturities during the quarter to around 20 basis points for one-month bills and 30–40 basis points for three-month and six-month bills. Total turnover rose to ECU 15.9 billion in the third quarter of 1991, from ECU 13.8 billion in the previous quarter.

Building on the success of the ECU Treasury bill programme, the Chancellor of the Exchequer announced on 31 October that a new programme of UK Government 3-year Ecu Treasury notes would be launched next year.

Bill turnover

Discount houses' transactions in eligible bills[1][2] (including sales to the Bank) averaged a record £2.3 billion per day in the third quarter, some £300 million more than the previous record in the first quarter. Within the total, transactions in Treasury bills rose to average £460 million per day, from £240 million per day in the second quarter, despite a reduction in the size of the tender, as both sales to the Bank rose in July and August, and turnover in the secondary market rose. Discount houses' transactions in certificates of deposit fell again, to a daily average of £630 million.

(1) Figures for discount houses cover only those money-market dealing counterparties which are authorised under the Banking Act 1987.
(2) See the Bank's monthly press notice, *Bill Turnover Statistics*.