DEBT & RESERVES MANAGEMENT REPORT 2002-03

March 2002

HM TREASURY

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FOREWORD BY THE ECONOMIC SECRETARY TO THE TREASURY

This is the eighth annual report on the Government's debt management activities. It also includes details of the management of the official reserves by the Bank of England.

The report is being published ahead of the Budget in order to comply with the Code for Fiscal Stability which requires the publication of a debt management report every financial year. This allows us to provide market participants with a preliminary indication of the Government's financing plans for 2002-03. A full update will be published with this year's Budget papers on 17 April.

2001-02 saw the return of issuance to medium sector of the curve with the issuing of a new 10-year benchmark gilt on 25 May 2001. Within two months of first being issued, this bond had been built up to £11 billion outstanding by use of our first conversion offer since July 1999. A further innovation in the Debt Management Office's (DMO) secondary market operations was their first ever index-linked switch auction held on 19 July 2001. Over the course of the year, the DMO also consulted on the re-design of index-linked gilts. This was a difficult exercise as views were finely balanced across the market. Since there was no clear mandate to undertake a full re-design, the existing design will be maintained albeit with some minor changes. On the reserves side, the Government completed its programme of gold auctions while National Savings under-went a name change (it is now known as National Savings and Investments), and launched its first equity-linked product.

On our preliminary financing plans, 2002-03 will be the first year of positive net gilt issuance since 1997-98. The plans reflect our continued commitment to preserving a well-ordered and efficient gilts market and responding to the needs of the market while balancing the risks to our portfolio.

Ruth Kelly

14 March 2002

RUTH KELLY
Economic Secretary to the Treasury

INTRODUCTION

This is the eighth annual report outlining the Government's debt management activities. It again includes details of the management of the official reserves by the Bank of England.

The *Debt and Reserves Management Report* is usually published on the day that the Chancellor of the Exchequer announces the Budget. However, the Code for Fiscal Stability requires that a debt management report be published every financial year. Therefore, the Government has taken the unusual step of publishing the *Debt and Reserves Management Report* before the Budget. This fulfils the requirement of the Code and provides an indicative financing remit for 2002-03.

The *Debt and Reserves Management Report* is designed to review developments in debt and reserves management over the past financial year and sets out some indicative details of the Government's borrowing programme for the forthcoming financial year.

The report complements the Debt Management Office's (DMO) Annual Review and covers the following areas:

- the size and structure of UK Government's debt;
- UK debt and cash management policy;
- a review of the Government's financing programme in 2001-02;
- developments in the structure of the gilts market and National Savings and Investments in 2001-02;
- the management of the official foreign currency reserves by the Bank of England;
- a preliminary Government financing programme for 2002-03; and
- the preliminary Remits set by HM Treasury to the DMO, National Savings and Investments and the Bank of England.

SIZE AND STRUCTURE OF UK GOVERNMENT'S DEBT IN 2001-2002

Debt stock

The total outstanding stock of United Kingdom central government marketable sterling debt (including official holdings by central government) was £286.1 billion at end-December 2001. This was comprised of £204.4 billion of conventional gilt-edged stock, £70.5 billion of index-linked gilts (including accrued inflation uplift) and £11.2 billion of Treasury bills (Table 1). An additional £62.4 billion (including accrued interest) was invested in National Savings and Investments instruments.

Table 1: Composition of UK central government sterling debt

(£ bn, nominal value, including official holdings)

	End-March 2001	End-Dec 2001
Conventional gilts[1]	210.4	204.4
Index-linked gilts[2]	71.4	70.5
Treasury bills[3]	3.3	11.2
Total	285.1	286.1
National Savings and Investments	62.6	62.4

[1] *Includes floating rate gilt and undated stocks.*

[2] *Includes accrued indexation uplift.*

[3] *Includes Treasury bill stock in market hands.*

Chart 1: Changes in the percentage composition of UK total government marketable debt (including official holdings)

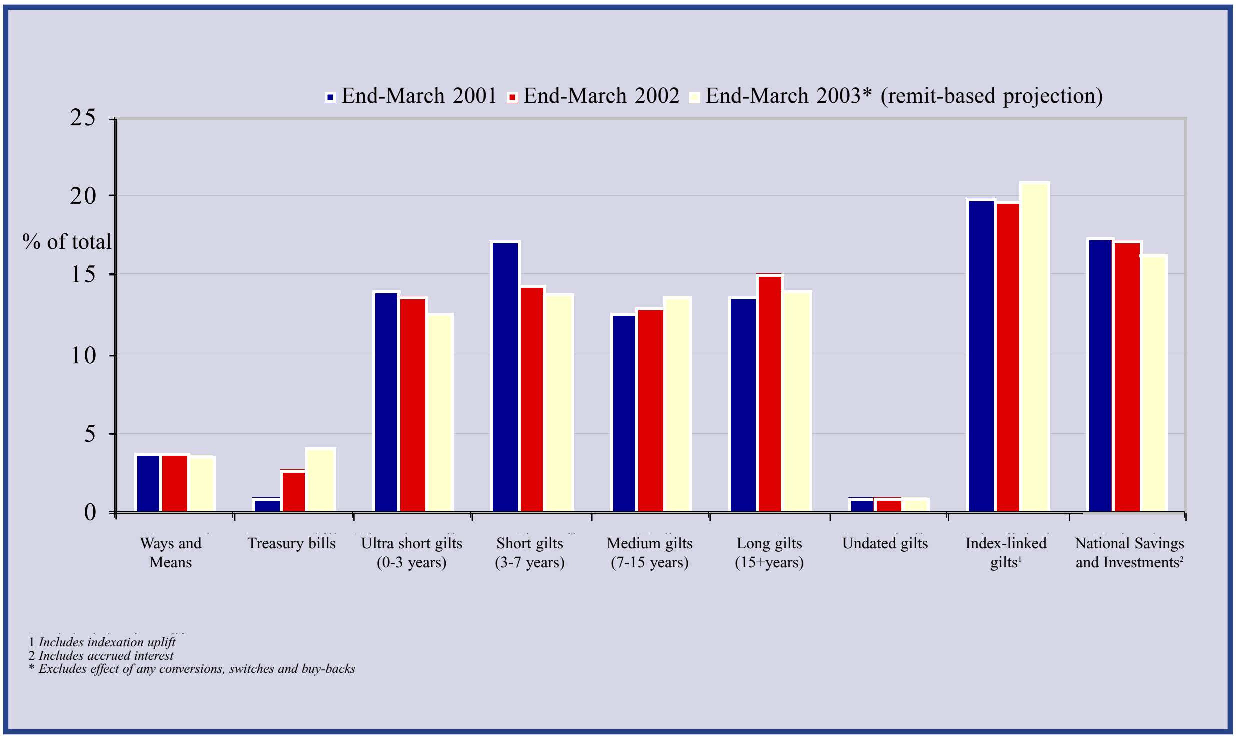


Chart 1 shows a comparison of the Government's debt portfolio at end-March 2001 through to the projected composition at end-March 2003. It assumes that new debt is issued in accordance with the forecast financing requirement and preliminary issuance remit and takes account of the ageing of existing debt. It does not, however, make assumptions about possible conversion offers, switch and reverse auctions or buy-backs.

Maturity and duration

The average maturity of the stock of all dated gilts rose from 10.98 years to 11.28 years between end-March 2001 and end-December 2001. The average maturity of conventional gilts alone rose from 10.26 years to 10.59 years. Over the same period, the modified duration of the gilt portfolio as a whole rose from 7.54 years to 7.79 years. The modified duration of conventional gilts alone rose from 6.51 years to 6.76 years.

Compared to other European countries, the maturity and duration of the UK Government's marketable domestic debt are among the longest.

Distribution of gilt holdings

Table 2 shows the distribution of the market value of gilt holdings by sector at end-March 2000 and end-March 2001. Insurance companies and pension funds still own the majority of gilts in issue whilst overseas holdings have remained stable.

Interest payments

Gross central government debt interest payments in 2001-02 are forecast to be £22.2 billion (2.2% of GDP). This figure is expected to fall in 2002-03 to £21.4 billion (2% of GDP) and rise to £23.2 billion (2.1% of GDP) in 2003-04.

Table 2: Distribution of gilt holdings at end-March 2000 and March 2001 (market values)

	End-March 2000		End-March 2001	
	£ bn	%	£ bn	%
Insurance companies and pension funds	203.3	63.5	188.2	61.4
Banks and building societies	9.1	2.9	7.4	2.4
Other financial institutions	20.2	6.3	29.1	9.5
Households	26.5	8.3	22.5	7.3
Public sector holdings*	4.3	1.4	3.8	1.2
Overseas sector	56.7	17.7	55.7	18.2
Total	**320.1**	**100**	**306.7**	**100**

NB. These figures are expressed at market values, whilst the figures in Table 1 are nominal values.

**Local authorities and public corporations* *Source: ONS*

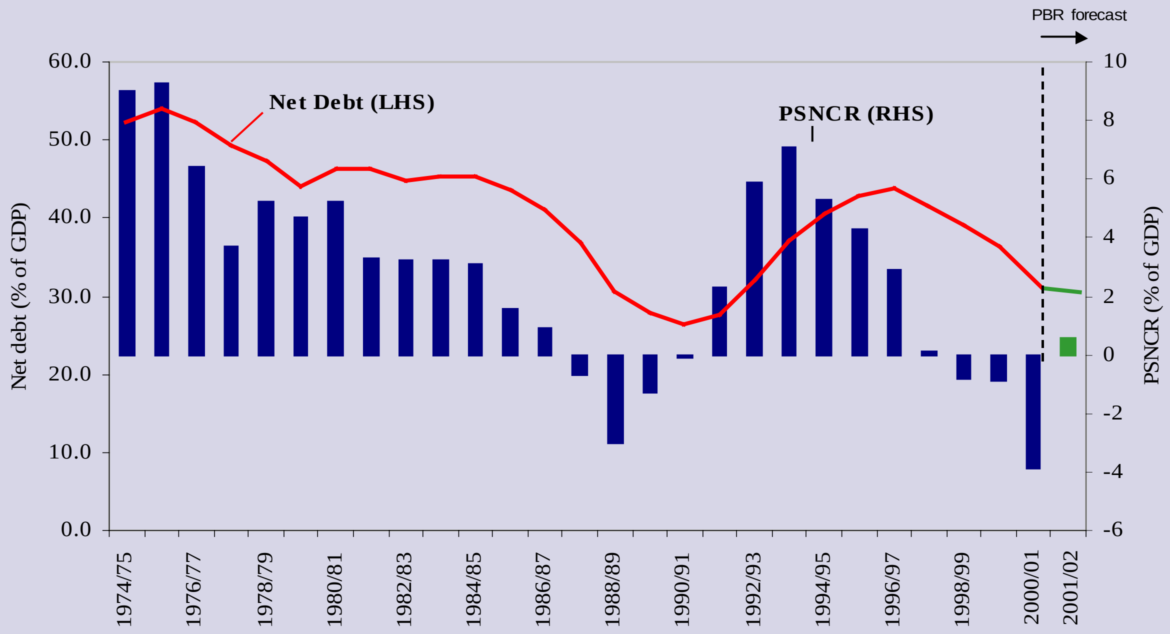
Creditworthiness of the United Kingdom Government

The UK's sovereign credit rating is an assessment of how robust the government's ability is to service its current level of debt, but also how sustainable future levels of debt are under current economic and political policies. Credit ratings agencies consistently rate the UK government as having the highest possible rating available. This is underpinned by a number of key factors:

Sound public finances. The current UK Government's fiscal policy framework is underpinned by two fiscal rules - the golden rule and the sustainable investment rule. These rules are designed to promote economic stability by ensuring sound and sustainable public finances. Within this framework, the benefits of greater economic stability have helped to restore the public finances to a sustainable path. The Public Sector Net Cash Requirement (PSNCR) measures the amount the government has to borrow to meet all its expenditure commitments. The PSNCR was equal to 2.9% of GDP in 1996-97, whereas in 2000-01 there was a surplus equivalent to 3.9% of GDP. Net debt as a proportion of GDP has fallen from 43.7% in 1996-97 to a more modest 31.2% of GDP by 2000-01 – the lowest level out of all the G7 countries. In the Pre-Budget Report 2001, public sector net debt is projected to be at 30.7% of GDP in 2001-02 and 30.6% in 2002-03 before rising slightly to 31.0% by 2003-04, comfortably below 40 per cent and therefore fully consistent with the sustainable investment rule. General government gross debt is projected to remain well below the 60 per cent reference level in the EU Treaty.

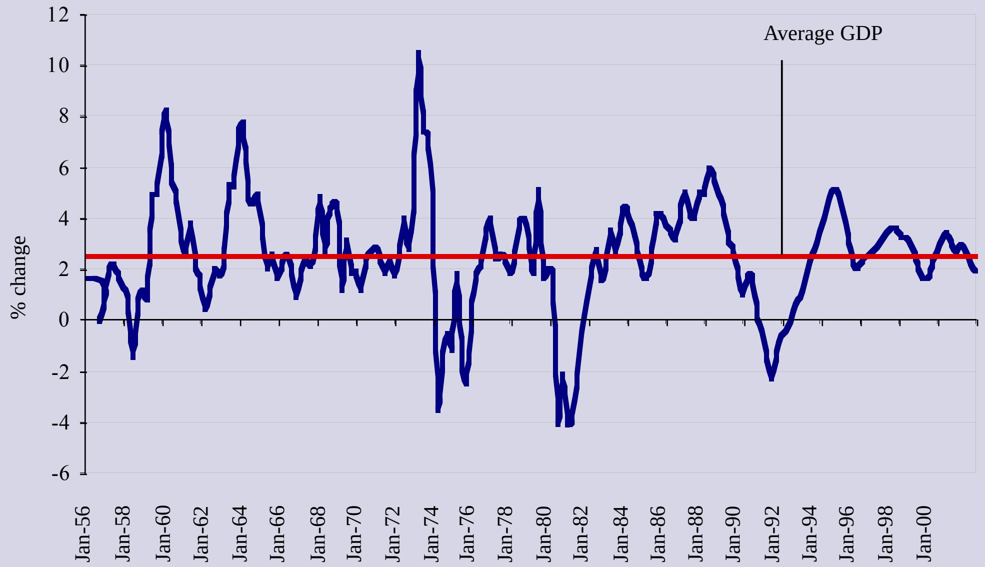
Diversified debt structure. The Government primarily borrows from the UK's domestic wholesale capital markets, though 18% of sterling debt is borrowed from the retail debt market mainly through investment products issued by National Savings and Investments. The UK's very low level of foreign currency debt is hedged by matching the foreign currency reserves. A variety of borrowing instruments are used ranging from conventional gilts (which account for 59% of all sterling debt); index-linked gilts (20%); and Treasury bills (3%). The latter are issued for the Exchequer's cash management purposes. Moreover, the long average maturity of the UK Government's debt portfolio reduces the need to refinance large proportions of the debt portfolio at any one time.

Public sector net debt and PSNCR as a percentage of GDP



Stable economy. Under the current monetary policy framework, the Bank of England's Monetary Policy Committee has maintained inflation close to target; RPIX inflation has averaged 2.4% since May 1997, just slightly below the Government's target of 2.5%, and market-derived expectations are for it to remain close to target. In recent years, the UK has experienced a period of stability and steady growth. Growth since the second quarter of 1997 has averaged slightly over 2.5% on an annualised basis.

Real GDP Growth (q-o-q, annualised)



UK GOVERNMENT'S DEBT AND CASH MANAGEMENT POLICY

Objectives of debt management

The Government's debt management policy objective remains:

"To minimise over the long-term the costs of meeting the Government's financing needs, taking into account risk, whilst ensuring that debt management policy is consistent with the aims of monetary policy."

The debt management policy objective is achieved by:

- pursuing an issuance policy that is open, predictable and transparent;
- issuing conventional gilts that achieve a benchmark premium;
- adjusting the maturity and nature of the Government's debt portfolio, by means of the maturity and composition of debt issuance and other market operations including switch auctions, conversions offers and buy-backs;
- developing a liquid and efficient gilts market; and
- offering cost-effective savings instruments through National Savings and Investments.

Central Government's Asset and Liability Risk Monitor

The following two tables are a preliminary version of the central government's asset and liability risk monitor. The figures presented are approximations. It highlights new data on the riskiness of National Savings and Investments' liabilities as well as for the National Debt Office and Public Works Loans Board's assets. However, it is not a comprehensive assessment of all the central government's assets and liabilities, and excludes, for example, the central government's contingent liabilities, and departmental voted loans. Therefore, it cannot be reconciled with other central government accounting publications.

The monitor has been produced in order to aid the quantification of the risks faced by the central government on its balance sheet, and forms part of an on-going HM Treasury work programme. This risk monitor is a precursor to the publication of the "Whole of Government Accounts" in 2005-06 and is in accordance with the transparency and accountability recommendations contained within the IMF's Guidelines for Public Debt Management (2001).

Central Government Asset and Liability Risk Monitor at 31 December 2001[a]

ASSETS

Managing Organisation or HM Treasury Agent	Nominal value (£ bn)	Market value (£ bn)	Maturities of less than 1 yr[b] (£ bn)	Average modified duration (yrs)	Average maturity (yrs)	Floating rate composition[c] (£ bn)
Public Works Loan Board[d]	47.6	58.2	1.9	10.5	20.6	1.2
Debt Management Office						
Marketable gilts held by the DMO and National Debt Office						
Conventional:	5.6	6.2				
Index-linked:	0.7	0.7				
Total:	6.3	6.9	0.6	4.6[e]	6.3[e]	-
Other short-term assets[f]						
Rev Repo:	7.1	7.1	7.1	0.1	0.1	-
Deposits g:	0.6	0.6	0.6	0.0	0.0	-
Forward Starting Repos[h]:	0.8	0.8	0.8	-	-	-
Bank of England						
Foreign currency assets						
Bonds:	13.6	14.4	2.6[i]	1.9	2.0	0.0
Money Market Instruments:	2.9	2.8	2.9	0.1	0.1	-
Short-term Assets[j]:	4.0	4.0	3.8	0.1	0.1	-
Gold:	2.2	2.2	-	14.7[k]	-	-
IMF Special Drawing Rights:	0.2	0.2	-	0.0	-	0.2
HM Treasury						
Sterling assets						
National Loans Fund Loans[l]:	3.2	3.2	0.0	5.1	17.2	-
Reserve Tranche Position:	3.5	3.5	-	0.0	-	3.5
Total:[m]	**92.0**	**103.9**	**20.3**	**2.3**	**6.8**	**4.9**

LIABILITIES							
Managing Organisation or HM Treasury Agent		**Nominal value (£ bn)**	**Market value (£ bn)**	**Maturities of less than 1 yr[b] (£ bn)**	**Average modified duration (yrs)**	**Average maturity (yrs)**	**Floating rate composition[c] (£ bn)**
National Savings and Investments		62.4	62.4	11.2	5.6	5.9	36.4
Debt Management Office							
Gilts in issue:	Conventionals:	204.4	230.7				
	Index-linked:	70.5	72.1				
	Total:	274.9	302.8	17.7	7.8[e]	11.3[e]	-
Treasury bills:		11.2	11.2	11.2	0.1	0.1	-
Other short-term liabilities[f]:		5.2	5.2	5.2	0.1	0.1	-
Bank of England							
Sterling liabilities							
Ways and Means Advance[n]:		13.4	13.4	-	0.0	-	13.4
Foreign currency liabilities							
HMG Bonds:		4.5	4.7	3.3	0.7	0.7	-
Loans o:		0.6	0.5	0.0	4.4	4.9	-
Repo:		0.1	0.1	0.1	-	-	-
Swaps & FX liabilities (excluding £ leg):		10.3	10.8	1.8	2.0	2.1	10.3
IMF Special Drawing Rights allocation:		1.7	1.7	-	0.0	-	1.7
HM Treasury							
Sterling liabilities							
IMF Non-Interest Bearing Securities:		5.9	5.9	-	0.0	-	5.9
Total:[m]		**390.2**	**418.7**	**50.5**	**6.5**	**9.6**	**67.7**

Notes: [**a**] The figures presented in this table are **preliminary** estimates, and are by no means comprehensive. They form part of an ongoing HM Treasury work programme and may be revised accordingly. This balance sheet is not a comprehensive representation of all the central government's assets and liabilities. As of 31 March 2001, Public Dividend Capital stood at £23.2 billion, advances and revenue to be accrued in the future stood at £1.6 billion, and £5.1 billion of voted loans were outstanding to government departments. In the current financial year, there have been no substantial developments apart from an additional voted loan made by DTLR of £1.5 billion (net) as of 31 January 2002. [**b**] Expressed in nominal terms. [**c**] Expressed in nominal terms and includes instruments which refix interest rates paid periodically but not short-term instruments (e.g. T-bills, repo, contracts etc). [**d**] Composed of local authority loans. [**e**] Weighted average using the market value of marketable gilts outstanding at 31 December 2001. [**f**] Expressed at cash settlement or nominal terms with the average maturity and duration weighted by nominal or cash value settled. [**g**] Includes deposit held at the Bank of England and remunerated at its repo rate. [**h**] At cash to be settled terms. [**i**] Using US$:£ exchange rate of 1.45:1 on 31 December 2001. Source: Bloomberg. [**j**] Composed of deposits and reverse repos at nominal terms. [**k**] 30-day moving average volatility of spot gold prices as of 31 December 2001. Source: Bloomberg. [**l**] Composed of loans to nationalised industries and public corporations. [**m**] Average modified duration and maturity weighted by market values, excluding gold volatility measure. [**n**] Interest rate charged at the Bank of England's official repo rate. [**o**] Composed of Canadian and US War debt, Exchange Cover Scheme for local authorities and novated loans.

Maturity and composition of debt issuance

In order to determine the maturity and composition of debt issuance, the Government takes account of a number of considerations including:

- investors' demand for gilts;
- the Government's attitude to risk, both real and nominal;
- the shape of both the conventional and real yield curves and the expected effects of issuance policy; and
- changes to the stock of Treasury bills and other short-term instruments required for cash management in 2002-03.

The Government keeps its optimal issuance framework under review. When deciding on the volume and composition and maturity of gross issuance, the Government must not only be aware of the needs of the market (as was the case in 2001-02 with the provision of a new 10-year benchmark gilt) but also its own risk appetite and preferences.

As previously noted, the UK gilts portfolio's average maturity and modified duration are markedly higher than the equivalent measure for comparable economies. Historically, the pension funds and life assurance companies have been ready buyers of long maturity conventional and index-linked gilts in order to meet their own needs. Additionally, the very high levels of Government indebtedness following the Second World War meant that there was a very real need to minimise refinancing risk (the risk that the Government will not be able to rollover its maturing debt) by reducing the proportion of short-dated debt in the portfolio.

In 2001-02 issuance was again biased slightly towards long conventional and index-linked stock (these two categories combined made up just under two-thirds of the total amount of cash raised by gilt sales).

High duration of a debt portfolio indicates that the debt servicing costs is less sensitive to future changes in interest rates. If issuance continued to be biased towards long maturity stocks, the Government would not be able to benefit from a general fall in interest rates as it would have locked itself into previously borrowing at higher interest rates. Conversely, if interest rates rose and the Government had financed itself by issuing long maturity stocks, it would benefit from not having to refinance itself at higher interest rates. The box on pages 10-11 looks at issuance strategy in greater detail.

Similar considerations need to be made when deciding on the appropriate level of index-linked issuance. Index-linked gilts provide a hedge against inflation for investors and real rate shocks for the issuer. However, inferring inflation expectations from real and nominal yield curves, long-term expectations of inflation (as measured by the Retail Price Index (RPI)) have settled around 2.5% p.a. which is broadly consistent with the current target given to the Bank of England's Monetary Policy Committee by the Government. Consequently, it would seem that there is no longer a significant inflation risk premium built into the prices of conventional gilts compared to index-linked gilts. To an extent, this reduces the expected cost advantages to the Government of issuing index-linked debt. However, there remains strong demand from the market for these securities with limited substitutes available from corporate issuers.

Additionally, index-linked debt offers the Government an opportunity to hedge against inflation (as measured by the RPI) averaging more or less than 2.5%. If inflation is higher than expected, the cost of servicing index-linked debt will rise, while the real cost of servicing nominal debt will fall. Thus index-linked debt can fulfil a useful issuance diversification role and can help provide more certainty over the cost and real value of debt.

Index-linked debt can also provide "fiscal insurance" in the event of demand shocks i.e. where fiscal deficits are negatively correlated with inflation. In this eventuality, index-linked debt acts as a fiscal stabiliser. For example, given a negative demand shock, the fall in inflation would mean that the nominal costs of servicing index-linked debt would fall as the deficit and debt level rose. Conversely, given a positive demand shock, the falling borrowing requirement would be offset by the rising nominal costs of servicing index-linked debt as debt inflation rose.

Debt Portfolio Stock-Flow Dynamics

The Government keeps its optimal issuance strategy under constant review. Part of this review involves analysis of the effects on the gilts portfolio of a change in issuance strategy. There is an active research programme looking into optimal issuance strategy and the optimal portfolio. This section outlines the relationship between different issuance strategies and the resultant portfolios generated by these strategies over the long-term.

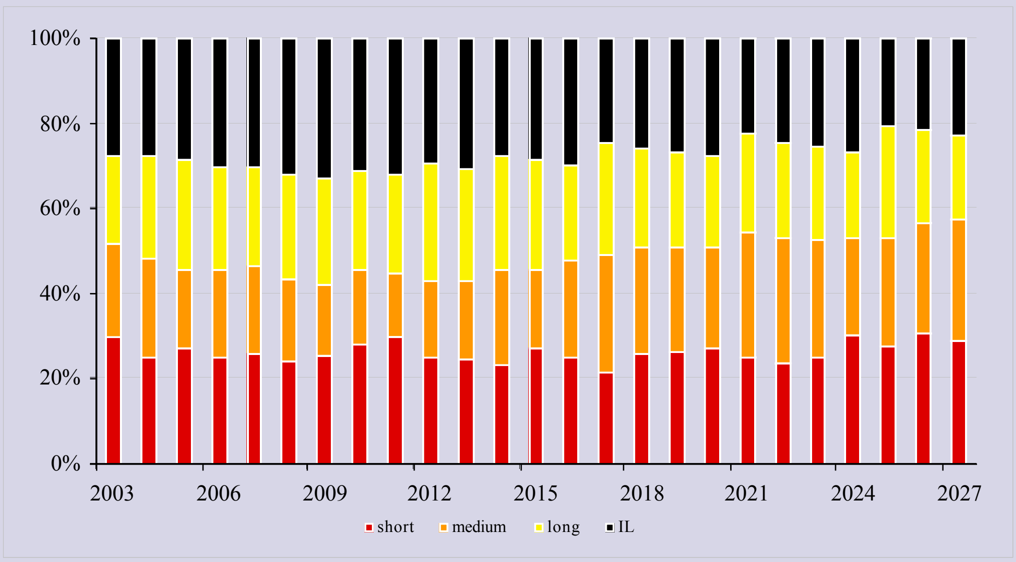
The table below compares the Government's issuance strategy over the last financial year with a strategy that involves the issuance of only long maturity conventional gilts and an issuance rule assumes that future issuance reverts back to the proportions of the 1997-98 Debt Management Report. As in last year's report, for illustrative purposes the calculations assume a CGNCR of £5 billion annually and index-linked issuance distributed evenly across the curve. Figures include indexation uplift on index-linked gilts. Future prices and inflation are derived from the forward curves and breakeven inflation, respectively, calculated on 5 February. The table shows the relationship between different issuance strategies and their resultant portfolios under these assumptions.

Illustrative Issuance Strategies and the Resulting Debt Portfolio (%share of portfolio)

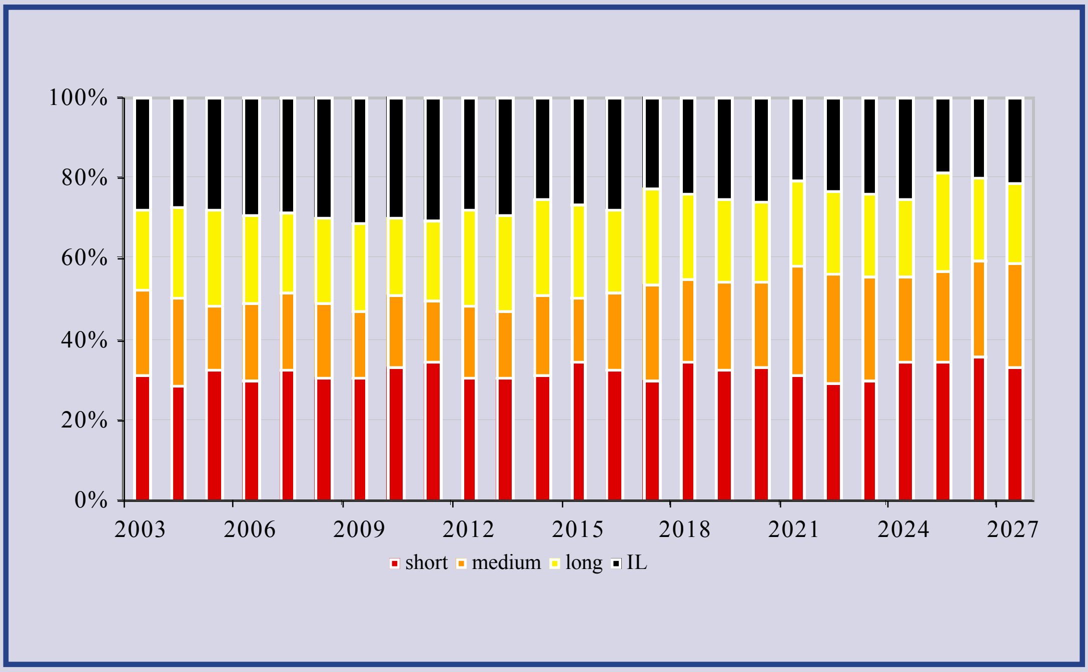
Issuance Strategy					Resulting Debt Portfolios (2027)					
Remit	Index -linked	Conventional			Index -linked	Conventional			Ave. Maturity (yrs)	Duration (yrs)
		Short (0-7yrs)	Medium (7-15 yrs)	Long (15 yrs+)		Short (0-7yrs)	Medium (7-15 yrs)	Long (15 yrs+)		
2001-02	26	0	35	39	22.8	28.9	28.4	19.9	13.1	9.5
All long	0	0	0	100	1.7	39.4	32.4	26.5	10.6	8.1
1997-98	20	36	20	24	21.5	33.3	25.9	19.3	10.7	7.7

The following charts illustrate the development of the current portfolio under the above issuance strategies

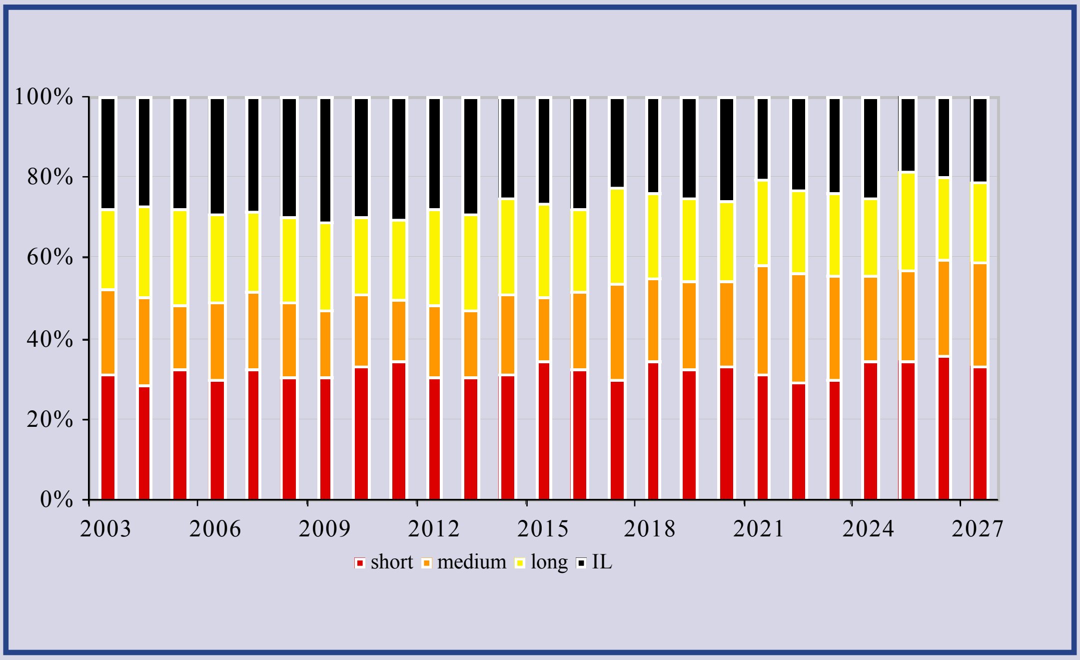
Portfolio composition if 2001-02 is repeated:



Portfolio composition if only long conventional issuance



Portfolio composition if 1997-98 remit issuance pattern is repeated



Objectives of cash management

The Debt Management Office took over full responsibility from the Bank of England for the Exchequer's cash management on 3 April 2000. This completed the restructuring of the Government's debt and cash management arrangements that were announced by the Chancellor of the Exchequer in his statement of 6 May 1997. The DMO's primary objective in carrying out its cash management role is to:

"offset, through its market operations, the expected cash flow into or out of the National Loans Fund (NLF). It aims to do so in a cost effective manner, taking account of risk."

Structure of cash management

The DMO's operations are part of a wider Government structure for managing the Exchequer cash flows. All Government cash flows are based around two central funds, the Consolidated Fund and the NLF. Revenues from taxation and other sources are collected daily in the Consolidated Fund. Payments out of the Consolidated Fund made to finance Government spending are authorised by Parliament and almost all of the spending is channelled through Government departments' accounts held at the Office of Her Majesty's Paymaster General, which in turn banks at the Bank of England. The NLF formally borrows for the Government and funds, for example, lending to Local Authorities by the Public Works Loan Board. Gilts are liabilities of the NLF.

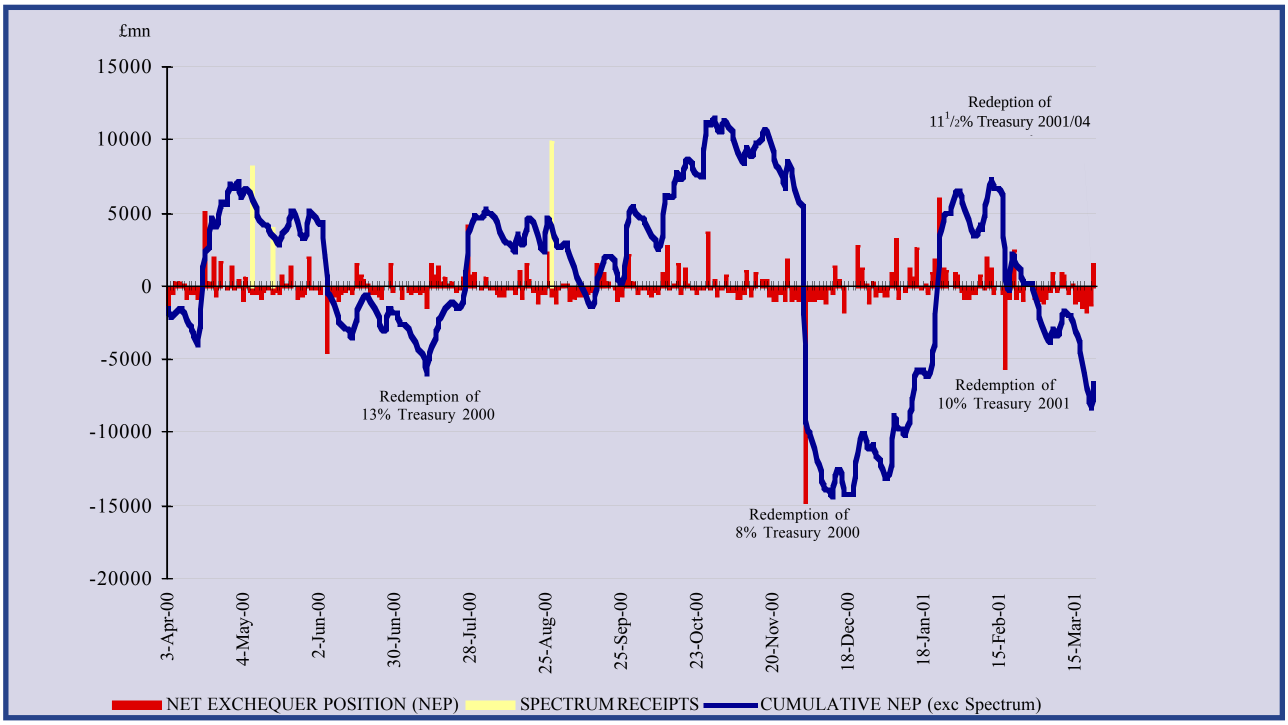
In order to minimise the Government's cash needs, a system of accounts known as the "Exchequer Pyramid" makes sure that any cash balances left in the Government accounts at the Bank of England are channelled into the main Government accounts. If the Consolidated Fund has a surplus, this is automatically transferred to the NLF in order to reduce its net borrowing requirement. Equally, a deficit in the Consolidated Fund is automatically financed by a transfer from the NLF.

Cash management task

The DMO's money market dealers borrow from, or lend to, the market on each business day to balance the resultant NLF position after the working of the Exchequer Pyramid. In order to do this, the DMO requires reliable forecasts for each day's significant cash flow into and out of central government. Additionally, they require up-to-date monitoring of cash flows as they actually occur. Responsibility for the monitoring and forecast of central government's cash flows lies with HM Treasury.

Over the course of the year, the Exchequer's cash flow has a fairly regular pattern associated with the tax receipt and expenditure cycles but the major flows are associated with gilt redemptions. Chart 2 below shows the scale of the daily cash flows in 2000-01, including receipts from the spectrum auctions and gilt redemptions. Full details of the DMO's activities can be found in the "Cash Market Review" on pages 39-41 and in the DMO publication "Exchequer Cash Management in the United Kingdom: A DMO Handbook" published on 20 February 2002.

Chart 2: Daily and Cumulative Exchequer Cash flows 2000-01

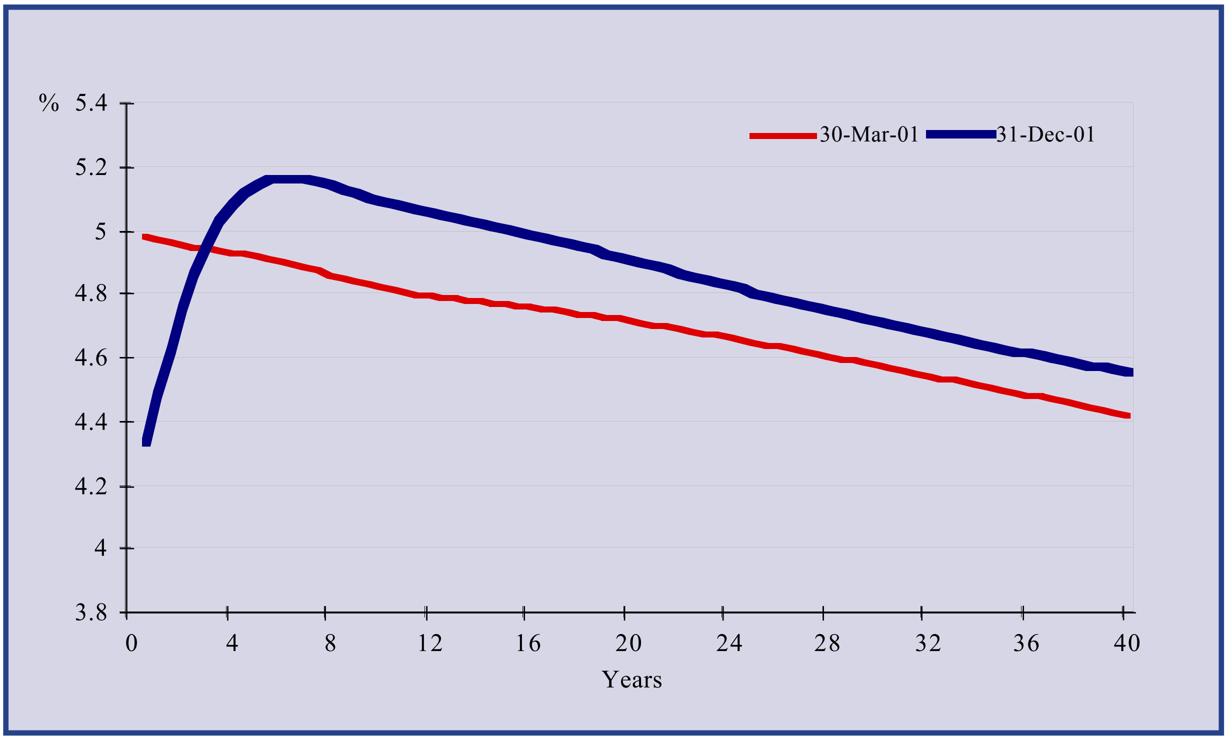


THE GOVERNMENT'S BORROWING PROGRAMME 2001-02

Gilt market review 2001-02

Between the start of the financial year and end-December 2001, yields on conventional gilts fell sharply at the ultra-short end (maturities of three years or less) of the curve, while yields increased over the remainder of maturities (see Chart 3). Over this period the yield curve disinverted at the short end, with the spread between the 2–year and 10–year yields widening by 47 basis points (bps) to 34 bps. Over the same period, the spread between 10– and 30–year yields also widened from –25 bps at the start of April to –38 bps by end-December 2001, as the long end of the curve became more inverted.

Chart 3: Par gilt yield curves

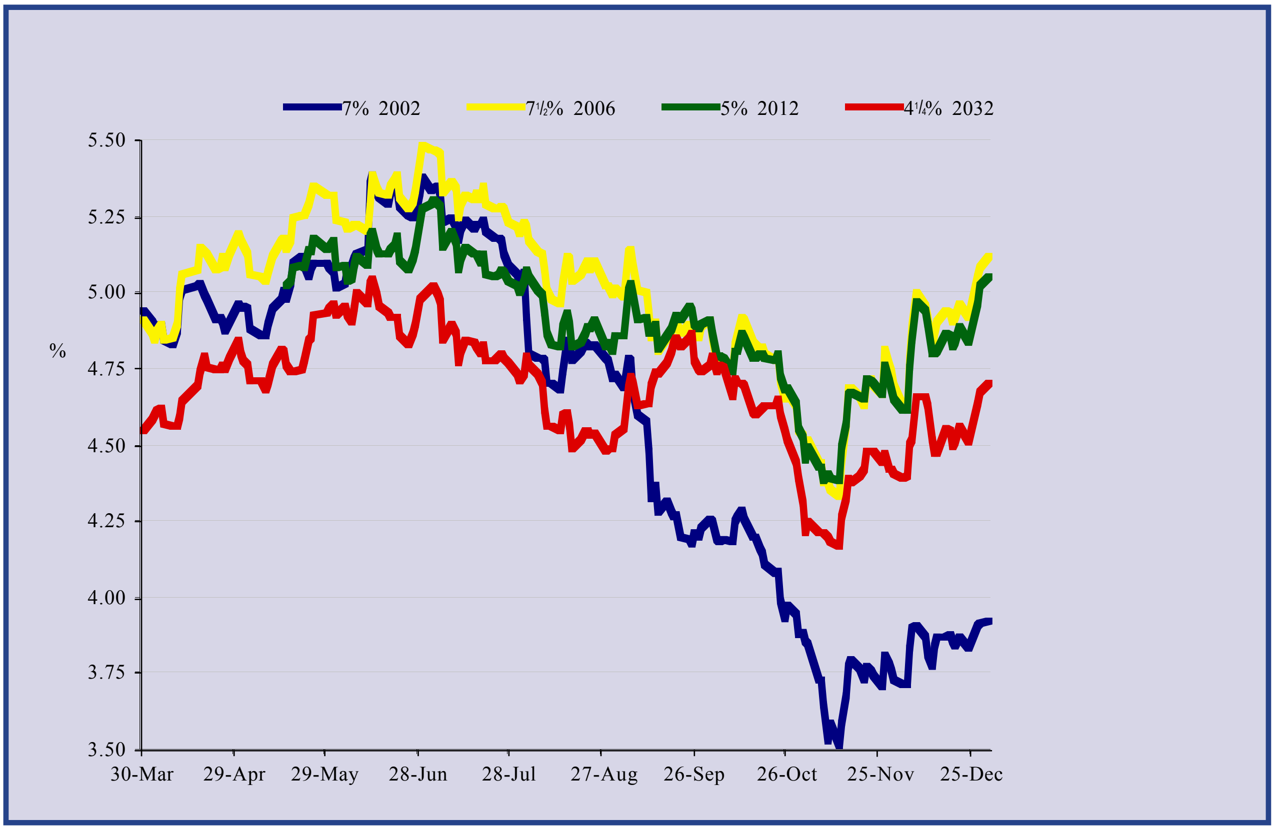


Yields rose across the curve during the first four months of the financial year. The financial year began with the Bank of England's Monetary Policy Committee (MPC) cutting the Bank's repo rate at its April and May meetings. This altered interest rate expectations in the latter part of the quarter as many in the financial markets considered the UK interest rates had reached the trough of their cycle. The yields on the 5-year benchmark stock (7 ½% Treasury 2006) and 30-year benchmark stock (4¼% Treasury 2032) peaked in June at 5.48% and 5.05% respectively, a rise of 57 and 50 bps respectively over the end-March 2001 levels (see chart 4 on page 14).

Yields over all maturities decreased during the second quarter of the financial year, as most major economies showed signs of weakening. The MPC lowered the Bank's repo rate again in August and September. The terrorist attacks on the United States on 11 September also lowered prospects for world growth and increased expectations that interest rates would need to be lowered to be cut further in order to sustain economic activity. As a result, the short-end of the yield curve steepened sharply in late September and during the quarter the spread between 7% Treasury 2002 and 7½% Treasury 2006 increased from 13 bps to 66 bps. The spread of 2-year yields over the Bank's repo rate fell from +21 bps to –21 bps over the same period. The spread of 30-year yields over 10-year yields increased by 14 bps to reach –16 bps over the quarter. This was the least disinverted the 10- to 30-year part of the curve had been since June 1999.

All yields fell significantly during October and the first half of November as the MPC continued to cut rates in both months. The November cut was a full 50 bps in the face of increasingly weak economic indicators. The yield on 7% Treasury 2002 fell to 3.52%, its lowest point of the year in mid-November — this was the first time gilt yields had fallen below 4% since the mid-1950s. At the same time the yields on the 10-year benchmark (5% Treasury 2012) and the 30-year benchmark fell to year-to-date lows of 4.38% and 4.17% respectively. The decline in long yields was exacerbated late in October, by the US Treasury's announcement that it would cease to issue 30-year bonds.

Chart 4: Conventional yields (April - December 2001)



Yields increased across the curve towards the end of the last quarter of 2001 on the back of improving indicators of consumer demand in the UK and less negative data from the United States. This created the expectation that interest rates may be at, or near, their trough in the current business cycle. As a result, the short end of the yield curve steepened, with the spread between 7% Treasury 2002 and 7½% Treasury 2006 increasing from 66 bps at the end-September to 119 bps at the end-December 2001.

Fluctuations in real yields were broadly in line with conventional gilt yields. The real yield[1] on the 2½% Index-Linked Treasury 2011 and the 4⅛% Index-Linked Treasury 2030 both hit lows of 2.19% and 1.88% respectively in mid-November. Over the first three months of the financial year, medium-term conventional bond yields rose faster than real index-linked yields. Breakeven inflation rates rose by 22 bps in the 2011 maturity sector, over the period, but were relatively unchanged in the thirty-year area of the curve (see chart 5).

[1] On a 3% inflation assumption.

Chart 5: Real Yield on 10- and 30-year index-linked gilt yields (April-Dec 2001)

Chart 6: Breakeven inflation rates

The spread between nominal yields on gilts and other major government bond markets was little changed between the start and end of the financial year. The ten-year spread between gilts and German government bonds (bunds) ranged from a minimum of 3 bps to a maximum of 31 bps, with an average of 14 bps (i.e. on average, gilt yields were 14 bps higher than the equivalent bund yield). In contrast the spread of gilts over US Treasuries was much more volatile during the period. Spreads ranged between lows of –43 and –50 bps on 16 May and 17 December respectively, to a high of +35 bps on 1 November with an average of -5 bps.

Gilt sales and remit contingencies

Planned gilt sales of £13.5 billion (cash)[2] were published in the remit for 2001-02 on 7 March 2001. This was based on a forecast central government net cash requirement (CGNCR) of £0.3 billion. After taking account of gilt redemptions (£17.8 billion), pre-financing of foreign currency debt (£1.3 billion), debt buy-backs (£1 billion) and a forecast negative contribution to financing of £3 billion by National Savings and Investments, the net financing requirement was £23.4 billion. This was to be met by:

- gilt sales of £13.5 billion, split as follows –
  - £4.75 billion medium conventional issuance;
  - £5 billion long conventional issuance; and
  - £3.75 billion index-linked issuance, and
- short-term debt sales of £9.9 billion, split as follows –
  - an increase in the stock of Treasury bills of £5 billion; and
  - an unwinding of the DMO's net cash position of £4.9 billion.

As in previous years, the remit specified a number of contingencies which could be exercised in the event of substantial revisions to the forecast financing requirement.

In the event of a rising financing requirement, consideration was to be given to increasing planned gilt sales, increasing the planned stock of Treasury bills and running down further the DMO net cash position.

In the event of a falling financing requirement, consideration was to be given to increasing the size of debt buy-backs (including the re-introduction of reverse auctions) by £1.5 billion, reducing planned gilt sales, reducing the planned increase in Treasury bill sales and some repayment (up to £1 billion) of the Ways and Means facility at the Bank of England.

There was no change to the planned level of gilt or Treasury bill sales in 2001-02, following the publication of the outturn CGNCR for 2000-01 of -£35.2 billion on 23 April 2001. The outturn represented an increase of £1.9 billion in the surplus on the Budget 2001 forecast but the net financing requirement for 2000-01 fell by only £1.4 billion as a result of higher debt buy-backs (by £0.2 billion), a higher DMO cash deposit at the Bank of England (by £0.3 billion), an increase in the pre-financing of foreign exchange reserves (by £0.1 billion) and a lower negative financing contribution by National Savings and Investments (by £0.1 billion) than forecast in the Budget.

The impact of these changes was reflected in the level of short-term debt sales. At end-2000-01, Treasury bill stock was £0.2 billion lower than forecast in the Budget (at £3.3 billion) and the DMO's net cash position increased to £13.6 billion compared to in the Budget forecast.

In the Pre-Budget Report on 27 November 2001, the forecast of the CGNCR for 2001-02 was increased by £6 billion to £6.3 billion. Offsetting this, however, were a reduction of £0.5 billion (to £0.5 billion) in the planned level of debt buy-backs by the DMO and an increase of £3 billion in the forecast for National Savings and Investments' net contribution to financing. The forecast net financing requirement therefore increased by £2.5 billion from the forecast published on 23 April 2001 to £25.6 billion. Accordingly, in line with the contingencies outlined above further changes were made to the DMO remit:

- an increase of £0.5 billion in planned gilt sales to £14 billion, with the increase being reflected in long conventional issuance;
- an increase of £1.4 billion in planned Treasury bill sales (taking the planned end-March 2002 stock of Treasury bills to £9.7 billion); and
- a planned increase of £0.6 billion in the reduction of the DMO's net cash position, reducing its forecast level to £8.1 billion by end-March 2002.

[2]Unless indicated otherwise references to planned gilt sales are in cash terms.

Table 3: Financing Requirement 2001-02 (£ billion)

	Budget March 2001	23 April 2001 Revision	PBR 27 November 2001	14 March 2002 Revision
CGNR forecast	0.3	0.3	6.3	6.3
Pre-financing forex debt	1.3	1.3	1.3	1.2
Gilt redemptions	17.8	17.8	17.8	17.8
Buy-backs	1.0	1.0	0.5	0.5
Financing Requirement	**20.4**	**20.4**	**25.9**	**25.8**
less				
National Savings and Investments	-3.0	-3.0	0.0	-0.2
Change in DMO cash deposit at Bank of England	0.0	0.3	0.3	0.3
Net Financing Requirement	**23.4**	**23.1**	**25.6**	**25.7**
Financed by:				
Planned gilts sales	**13.5**	**13.5**	**14.0**	**13.7**
Planned net short term debt sales	**9.9**	**9.6**	**11.6**	**12.0**
Short term debt				
Change in Ways and Means	0.0	0.0	0.0	0.0
Change in T-bill stock	5.0	5.0	6.4	6.4
Change in DMO net cash position*	4.9	4.6	5.2	5.6
Total	**9.9**	**9.9**	**11.6**	**12.0**
End-year short term debt levels				
Ways & Means	13.4	13.4	13.4	13.4
Treasury bill stock	8.5	8.3	9.7	9.7
DMO net cash position **	6.8	8.7	8.1	7.7

**Excl deposit at Bank of England*
*** Inc deposit at Bank of England*

The financing arithmetic for 2001-02 has been updated to reflect an undershoot in the planned level of gilt sales and a revised forecast for the net contribution from National Savings and Investments. These changes correspond to an equivalent increase in the planned unwind of the DMO's net cash position.

Switch auctions and conversion offers

The DMO continued with its programme of switch auctions holding one conventional switch auction (the sixth in all) on 21 June 2001 and its first index-linked switch auction on 19 July 2001.

The conventional switch auction from 8½% Treasury 2007 into the newly issued 5% Treasury 2012 was designed to provide an early boost to the size of the new stock (which had been first auctioned on 24 May 2001) ahead of a conversion offer into it (see below).

The index-linked switch auction (from 2% Index-Linked 2006 into 2½% Index-Linked 2016) was held following a consultation exercise and responded to market demand for a facility to enable index-trackers to switch into longer stocks as a stock fell out of the relevant gilt index. 2% Index-Linked 2006 fell out of the index-linked "over 5-year" index on 19 July 2001.

Cash Market Review

Developments in the sterling money markets

Market developments between the start of the financial year and the end-December 2001 were characterised by considerable uncertainty over the extent and likely duration of the economic slowdown in all the major economies.

Official interest rates were reduced throughout the year in the United States, the UK and in the euro area (see chart 7) in order to boost aggregate demand in the face of a corporate-led slowdown. The Bank of England reduced its two-week repo rate from 5.5% at the end of March, to 4% by the end of December, the lowest nominal official rate since 1964.

Market developments between the start of August and September were heavily influenced by a reduction in global growth forecasts. These were lowered further following the terrorist attacks on the United States on 11 September. Between August and the end-October, official interest rates were reduced by 125 bps in the United States and by 75 bps in the UK and the euro area.

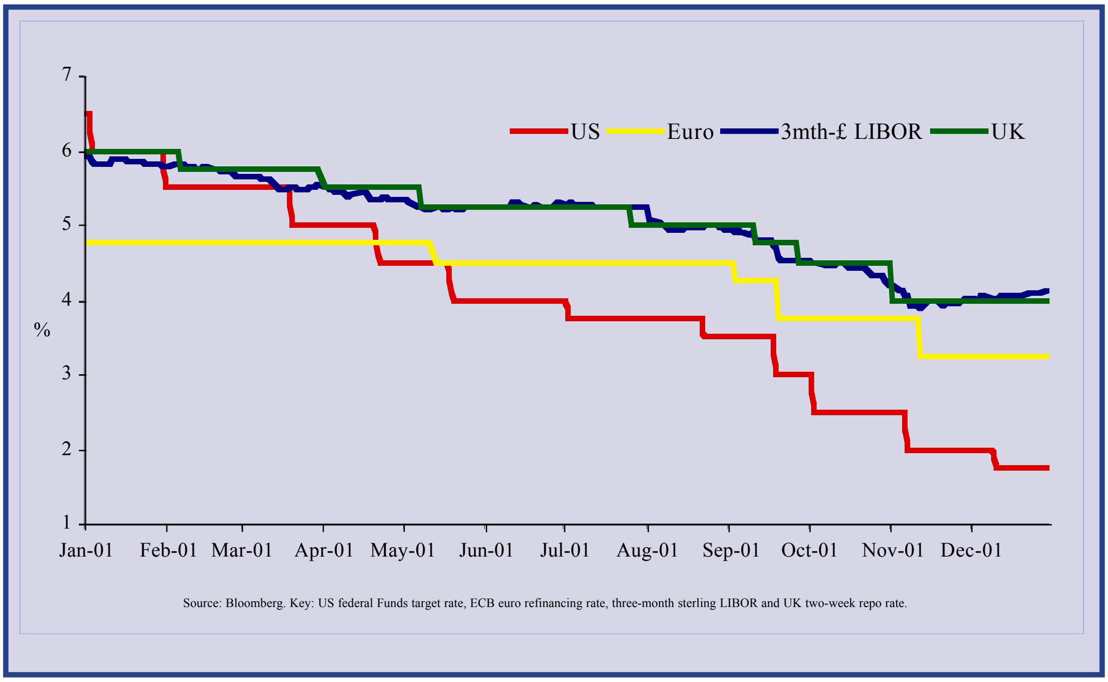
In November, the United States' Business-Cycle Dating Committee of the National Bureau of Economic Research (NBER) formally declared that a recession had begun in March 2001. This brought to an end a period of economic expansion that had begun in March 1991, the longest expansion in the NBER's history. Weak global growth forecasts and benign inflationary pressures, including global commodity prices, prompted the Bank of England's Monetary Policy Committee (MPC) to conclude, at its November meeting, that an additional 50bp cut in interest rates was needed in order to meet the 2½% inflation target. The size of the latter reduction surprised the money markets and the spread between the three-month sterling LIBOR[3] and Bank of England base rate went from -30bp to +19bp.

In order to boost aggregate demand in the United States, official interest rates were reduced for the eleventh time during the calendar year by 25 bps in December, to 1.75%, the lowest rate for 40 years. By the turn of the calendar year, there were tentative signs that the major European economies and the United States might be reaching a trough in the economic cycle and therefore market expectations of further rate cuts started to diminish. The spread between the three-month sterling LIBOR and Bank of England's base rate increased to +10bp by end-December 2001.

The ECB also reduced interest rates throughout the period with two 25 bps cuts in May and August 2001 and two 50 bps cuts in September and November 2001, taking the ECB rate to 3.25%. This was perceived by the market as a less aggressive monetary easing than that being undertaken in the United States.

[3] London Interbank Offer Rate - the rate at which AA-rated banks lend to each other. LIBOR is a key market rate.

Chart 7: Short-term interest rates in 2001



Supply conditions in the sterling money markets

The combined size of the sterling money market decreased by about £4 billion or 0.8%, between the start of the financial year and the end-December 2001. The end-December level represented a £31.3 billion increase (6.2%) on December 2000. Most of the decline over the first three quarters of the financial year was concentrated in Certificates of Deposit (CDs) and the stock lending markets, which more than offset significant growth in the interbank market and in UK Treasury bills. The nominal value of UK Treasury bills in issue rose from £3.3 billion at the start of the financial year to £11.2 billion by end-December 2001. The latter was consistent with the DMO's strategic aim, as set out in the annual remit, to build up the Treasury bill market in order to facilitate efficient cash management.

National Savings and Investments

The outstanding balance of National Savings and Investments' (NS&I) instruments at the start of the financial year was £62.6 billion. During 2001-02, NS&I are expected to make a net financing contribution of –£0.2 billion. Gross sales of NS&I's products for 2001-02 are expected to be £11.5 billion (including accrued interest).

NS&I's overall cost of financing remained lower than that of comparable gilts throughout the year after taking into account management costs and imputed tax forgone.

NS&I announced six packages of rate changes during the financial year. For variable rate products, the changes reflected movements by their competitors and short-term market interest rates following changes in rates announced by the MPC. New issues of fixed rate products were introduced during the financial year to reflect movements in medium-term rates. With relatively low nominal interest rates, demand for short-term variable rate products, particularly Premium Bonds, was stronger than for fixed rate and index-linked products.

Table 4: Change in NS&I products outstanding (2001-02)

	End-March 2001		End-March 2002*	
	£ bn	Per cent	£ bn	Per cent
Variable Rate	35.1	56	36.9	59.1
Fixed Rate	17.9	28.7	16.4	26.3
Index-linked	9.6	15.3	9.1	14.6
	62.6	**100**	**62.4**	**100**

**estimates*

National Savings and Investments - Brand Repositioning

As a result of the Public-Private Partnership with Siemens Business Systems, which was inaugurated in January 1999, National Savings and Investments (NS&I) has been working to bring new services, process and technology to improve customer service. On 11 February 2002, a new corporate name and logo was revealed with emphasis placed on NS&I's introduction of enhancements in its service to customers. As part of this process, on 7 March 2002 NS&I launched the Guaranteed Equity Bond. This is the first NS&I product whose return is linked to the performance of the FTSE-100 Index.

NS&I aims to deliver a customer focussed business that is based on the principles of high customer service, low cost, and greater flexibility. Some of the developments have included:

- a manned 24-hour, seven days a week telephone service;
- one telephone number for all enquiries;
- wider choice of payment method for customers;
- new customer focussed website - with the ability to apply to invest on-line under development;
- faster response times for customers; and
- new products and services.

DEVELOPMENTS IN THE GILTS AND TREASURY BILL MARKETS

Gilt market developments

Index-linked gilt switch auctions

On 12 March 2001, the DMO published a consultation document on the conduct of index-linked switch auctions. The primary rationale behind such auctions was to provide a mechanism for index-trackers to switch out of a stock as it fell out of the relevant maturity range in a key index. The DMO published its response on 10 May 2001. Reactions had been generally supportive of the proposed structure.

Accordingly, the first (and to-date only) index-linked switch auction was held on 19 July 2001 in which £500 million (nominal) of 2% Index-Linked Treasury 2006 was switched into £561 million of 2½% Index-Linked Treasury 2016.

Index-linked gilt mini-tender

On 19 June 2001 the DMO held a mini-tender for £95 million (nominal) of 4⅛% Index-Linked Treasury 2030. This was stock that had been acquired toward the end of 2000-01 under the facility through which the DMO was prepared to bid market makers for index-linked stock with a maturity of 2009 or longer. (This facility was subsequently withdrawn on 22 November 2001). The tender strike price was £180.05, equating to a real yield of 2.17%. The proceeds of £171 million did not however count toward the financing requirement in 2001-02. The acquisition of the stock in 2000-01 had added to the debt buy-back total for that year and similarly the proceeds from the tender reduced the buy-back total for 2001-02.

Gilt operations

Gilt sales for 2001-02 to date (with one medium conventional auction still to be held on 27 March 2002) relative to the remit are outlined in Table 5. The results for all the DMO's market operations in 2001-02 are shown in Table 6.

Table 5: Gilts sales vs remit: financial year to end-February 2002 (£ millions)

	Conventional Gilts			Index-linked	Total
	Short (0-7yrs)	Mediums (7-15yrs)	Longs (15+yrs)	Gilts	
Outright Auction sale	0	2,469	5,388	3,597	11,455
Remit plans	0	4,750	5,500	3,750	14,000
Net buy-backs	-321	-251	-5	44	-533
Target buy-backs					-500

Table 6: Results of DMO market operations 2001-02

**Index-linked gilts are issued through a uniform-price format*

Date	Stock	Amount auctioned (nom)	Cover	Average accepted price (AAP)	Yield at AAP	Tail (bp)*
25 April 2001	2½% IL 2011	£400mn	1.92	£225.30	2.54%	na
24 May 2001	5% 2012	£2,500mn	2.49	£98.81	5.15%	0
25 July 2001	2½% IL 2024	£500mn	1.48	£182.05	2.29%	na
26 September 2001	5% 2025	£2,500mn	2.01	£100.25	4.98%	1
24 October 2001	2½% IL 2026	£425mn	2.63	£213.00	2.39%	na
6 December 2001	5% 2025	£2,750mn	1.97	£104.93	4.65%	1
24 January 2002	4⅛% IL 2030	£500mn	1.98	£176.35	2.23%	na
27 March 2002	5% 2012					

Gilt switch auctions

Date	Source stock	Nominal switched	Destination stock	Nominal Created	Average DP ratio	Cover ratio
21 June 2001	8½% 2007	£1,400mn	5% 2012	£1694mn	1.2098	2.61
19 July 2001	2% IL 2006	£500mn	2½% IL 2016	£561mn	1.1228	1.27

Conversion offers

Date	Source stock	Nominal converted	Acceptances	Destination stock	Nominal created	Conversion Ratio per £100 nom
23 July 2001	9% 2012	£4,958mn	92%	5% 2012	£6,761mn	£136.35

Index-linked gilt mini tender

Date	Stock	Nominal amount sold (£mn (nom))	Strike price	Real yield at strike price
19 June 2001	4⅛% IL 2030	£95mn	£180.05	2.17%

Index-linked Gilt Re-Design Consultation

In last year's Debt and Reserves Management Report, it was announced that the DMO would consult market participants during 2001-02 on whether to adopt a new design for new issues of index-linked gilts. The main reason for deciding to consult on this issue was that over the past year some market participants had suggested that they would like the DMO to issue a new long maturity index-linked gilt, the last issue of a new index-linked gilt having been in September 1992. Although up to that point such interest had been fairly limited, the DMO thought it advisable to revisit the design issue ahead of wider market interest in issuing a new bond in order to allow sufficient time to consult. The main reason for considering a re-design of index-linked gilts was that the recent growth in the international markets for index-linked securities has led to an increasing convergence to the instrument design pioneered by the Canadian authorities. This design offers a much shorter indexation lag than is currently employed in the UK and as a result, provides investors with better inflation protection.

The DMO published its consultation paper on index-linked gilt re-design on 7 September 2001 and the consultation period ended on 31 October[4]. The responses were evenly split between those for and those against a complete re-design. This represented a much more positive response to the issue than when it was last aired in 1998. However, in most cases, those that were opposed to re-design had serious reservations over the introduction of a new design. Those in favour of change had different views on how the market should subsequently be developed. Having received no clear mandate from the market to proceed with the introduction of a new design of index-linked gilt, the DMO decided not to undertake a full re-design. Instead, the DMO intends to retain the current design for future new index-linked issues, albeit with some changes.

The first is a change to the prospectus indexation clause. The clauses in the current prospectuses allow for the possible early redemption of index-linked stock should there be a change in the RPI that is considered to be materially detrimental to bondholders. A trigger of the early redemption clause would clearly be disruptive to the index-linked gilts market, and other major markets operate perfectly well without such clauses. Given this, for any new issues the DMO intends to bring the UK into line with the approach used in other major markets. Instead of making provision for early redemption of stock affected by an index change, it places the onus on an independent institution to propose a satisfactory replacement index should the RPI cease to exist. The second change from the current bonds would be for the DMO to take over the role of fixing the coupon and redemption payments for new index-linked gilts - the Bank of England has this role for current bonds. Finally, the DMO intends to increase the precision of the coupon and redemption payments on any new index-linked gilts. Whereas the cash flows for current index-linked gilts are rounded down to either 2 or 4 decimal places, for new bonds these would be calculated by nearest rounding to 6 decimal places.

[4] Both the consultation paper and the response document are available on the DMO website at:
www.dmo.gov.uk/gilts/public/consdoc/cons070901.pdf
www.dmo.gov.uk/gilts/public/consdoc/cons150102.pdf respectively

DMO secondary market index-linked gilt bidding facility

On 22 November 2001, the DMO published an updated Gilts Market Operational Notice, the main feature of which was the withdrawal of the facility whereby the DMO had been prepared to bid market makers for index-linked stocks (2009 maturity and longer) on demand. This reflected a move by the DMO to bring its relationship with index-linked market participants more into line with that in conventional gilts. In place of the bidding facility a reverse tapping facility was introduced to mirror the existing tap facility- so that the DMO may now buy back and cancel stock for market management reasons generally only in conditions of extreme market dislocation.

Withdrawal of “debt buy-back” gilt bidding facility

On 13 December 2001, the DMO announced that it was withdrawing the facility whereby it had been prepared to bid GEMMs outright for specific stocks – index-linked gilts with 2003-06 maturities and non-rump double-dated gilts[5] . This facility had been introduced in 2000 as a means of increasing the net financing requirement at a time of reduced financing needs and supplemented debt buy-backs through reverse auctions. In the PBR 2001 the DMO’s debt buy-back target for 2001-02 was reduced from £1 billion to £500 million. The facility was withdrawn after the revised £500 million target was achieved.

New coupon dates

On 15 May 2001, DMO introduced a new set of coupon dates for 7 March/September. This was in order to provide investors with the option of a quarterly income pattern from strippable gilts and help reduce cash flow pressures on the existing June and December dates. The first gilt with the new cash flow dates - 5% Treasury 2012 - was auctioned on 24 May 2001. In order to reduce the chance of squeezes in the new strips it was decided that this bond would not be strippable immediately but would be built up in size before stripping would be permitted.

Since May, the DMO has used a conversion and a switch auction to increase the size of this bond to almost £11 billion and has also introduced a second bond - 5% Treasury 2025 - with the same coupon dates. With over £16 billion nominal outstanding in bonds with the 7 March/September coupon dates it was agreed - after consultation with the market - that it was an appropriate time to permit stripping of these bonds. In order to allow the market sufficient time to carry out any systems changes necessary, it was decided that the bonds would be strippable from 2 April 2002. Table 7 gives details of all strippable gilts as at end-December 2001.

Operation of the DMO’s standing repo facility

In June 2000 the DMO introduced a non-discretionary standing repo facility, whereby the DMO may temporarily create, upon request, a gilt for repo, for the purpose of managing actual or potential dislocations in the gilt repo market. The facility was used 14 times between the beginning of the financial year and end-February 2002, nine of which occurred between the end-September and 18 October 2001. The largest stock created under this facility was £850 million of 9% Treasury 2011 on 19 February 2002. The DMO charges an overnight penal rate and each issue of stock was cancelled on the following business day. These operations involve a simultaneous reverse repurchase, against general gilt collateral at the Bank of England’s repo rate and are therefore cash neutral.

[5] 8% Treasury 2002-06, 3½% Funding 1999-2004, 5½% Treasury 2008-12 and 7¾ % Treasury 2012-15.

Development of the Gilts Strips Market

The official gilts strips facility was launched on 8 December 1997. Experience from other strips markets had shown that the efficiency and liquidity of the market would be greater if the underlying strippable bonds were large liquid issues. Given this, for some time in advance of the introduction of the strips market the Bank of England (as debt manager at the time) concentrated conventional gilt issuance in strippable benchmark issues. As a result, by 8 December 1997 there were 7 strippable bonds in issue, with a total amount outstanding of just over £80 billion in nominal terms, representing almost 30% of the gilts market. These bonds all had aligned coupon dates of 7 June and 7 December in order to facilitate coupon strip liquidity.

After the transfer of debt management to the DMO, the pool of strippable bonds with 7 June/December dates continued to be built up and by the end-December 2001 there were 11 strippable bonds accounting for around 47% of the gilts market. The chart below illustrates the maximum potential size of each coupon and principal strip on this date. Despite the large pool of bonds eligible for stripping, the market in gilt strips has grown slowly and by December 2001 only 1.6% of strippable bonds were held in stripped form.

Strippable gilts (£ billions, nominal)

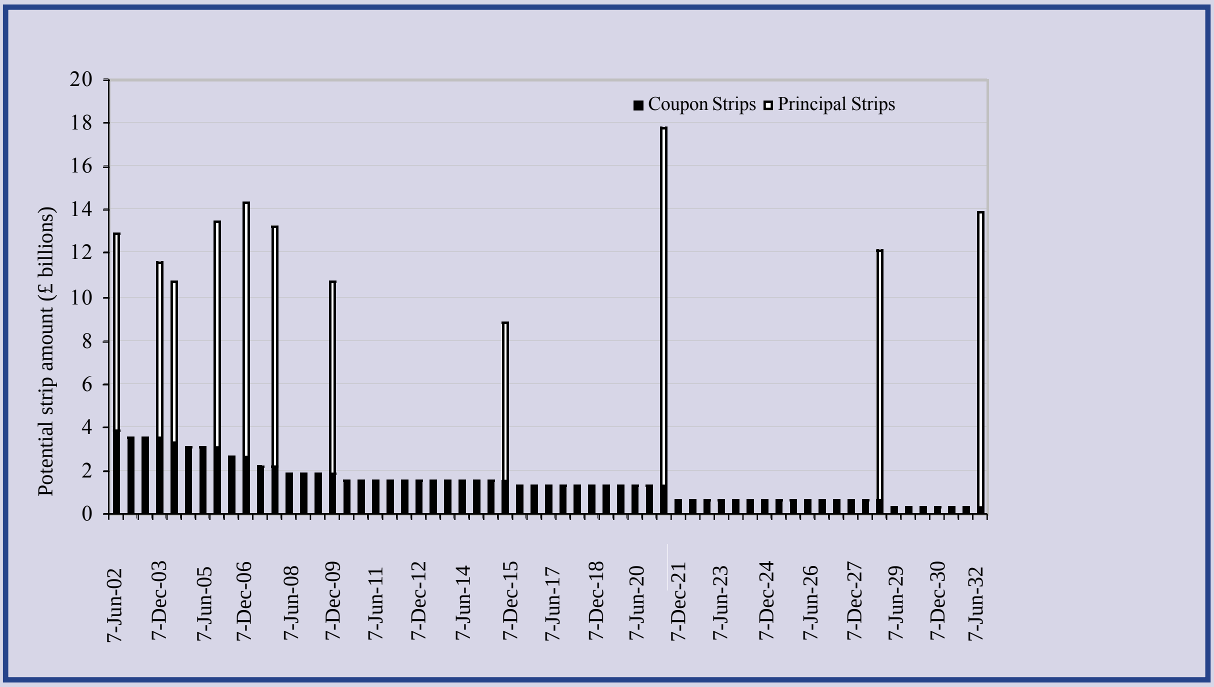


Table 7: Strippable stocks outstanding (end -December 2001)

	Nominal amount in issue (£mn)	Nominal amount held in stripped form (£mn)	Percentage held in stripped form
Gilt			
7% Treasury 2002	9,000	313	3.50%
6½% Treasury 2003	7,987	29	0.40%
5% Treasury 2004	7,408	36	0.50%
8½% Treasury 2005	10,373	110	1.10%
7½% Treasury 2006	11,700	215	1.80%
7¼% Treasury 2007	11,000	152	1.40%
5¾% Treasury 2009	8,827	23	0.30%
8% Treasury 2015	7,288	450	6.20%
8% Treasury 2021	16,500	300	1.80%
6% Treasury 2028	11,512	132	1.10%
4¼% Treasury 2032	13,580	40	0.30%
Total	**115,175**	**1,800**	**1.60%**

NB. As of 31 December 2001, the nominal amount of 5% Treasury 2012 outstanding was £10.979 billion whilst the amount of 5% Treasury 2025 was £5.25 billion.

Market turnover

Total turnover in the gilt market recorded on the London Stock Exchange reached £1,503 billion between April and end-December 2001. Figures reported to the DMO by the Gilt-edged Market Makers (GEMMs) show a similar picture. If turnover continues at the same rate as in the first three quarters of the year, the average daily turnover in the market will be around £7 billion for 2001-02, an increase of about 33% on the previous year.

As in the same period in the previous year, turnover was concentrated in the long (i.e. gilts with in excess of 15 years residual maturity) and medium (i.e. gilts with between 7 and 15 years residual maturity) sectors of the gilt market. These accounted for 21% and 36% of total turnover respectively. Turnover in index-linked stocks only accounted for 4.9% of total turnover.

Chart 8 shows the weekly turnover reported by the GEMMs, categorised as either professional or customer. Professional turnover captures all trades executed between GEMMs, either directly or indirectly through the inter-dealer brokers, plus transactions involving the DMO (including auction participation). Customer turnover captures everything else.

Unsurprisingly, the market was particularly active in weeks when the DMO held conventional auctions, and although auctions of index-linked stock had little impact on overall market turnover they do significantly increase index-linked market turnover. Whilst overall activity has increased, compared to the previous year, there was no discernable intra-year trend in turnover. Turnover rose from £463 billion in the first quarter of the financial year to £505 billion in the second quarter, before falling to £483 billion in the third quarter.

From April until end-December 2001, the average daily turnover in the long gilt futures contract traded on LIFFE was 26,748 contracts. This represents a 29% increase on the same period last year. Chart 9 shows the average daily turnover on a monthly basis with the level of open interest in the contract at the end of each month.

Chart 8: Gilt market turnover (weekly April-December 2001)

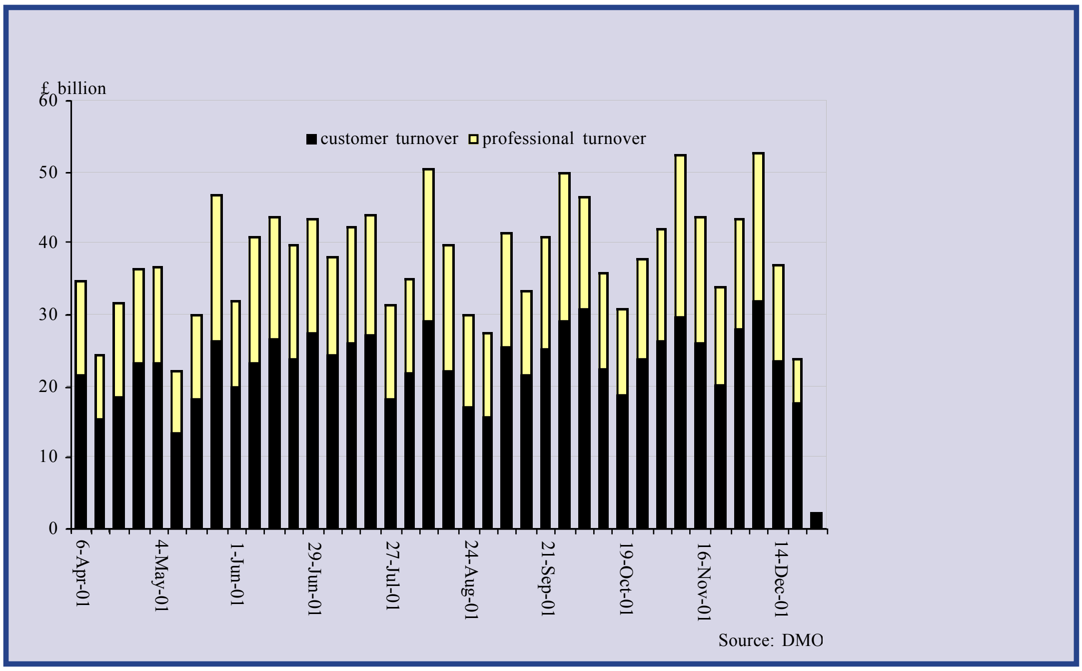
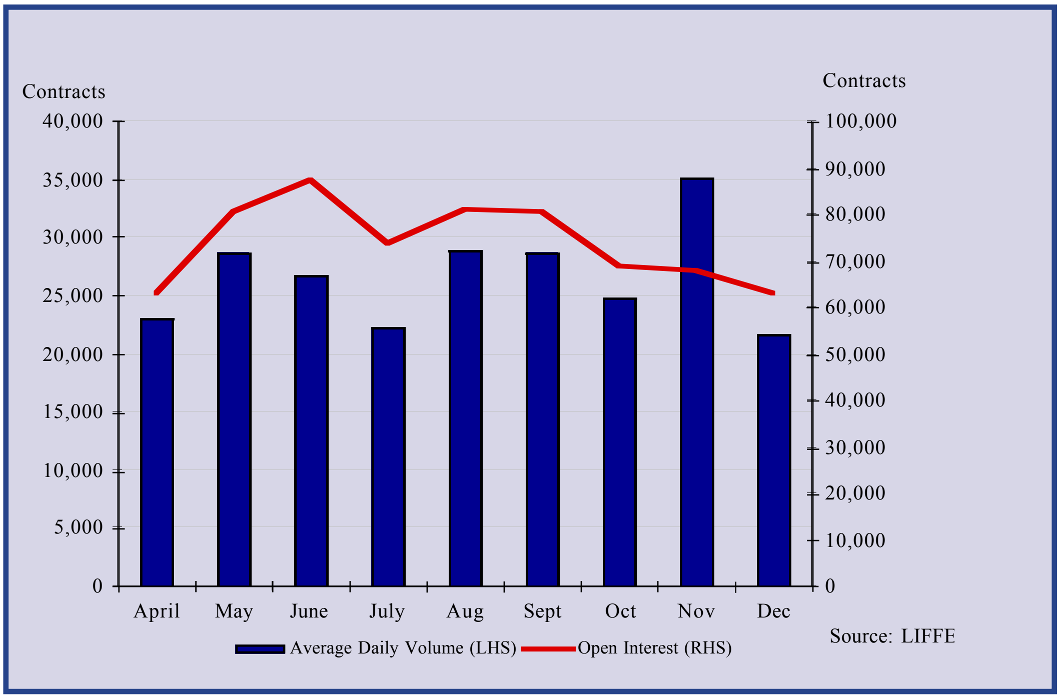


Chart 9: Average daily turnover of the long gilt futures contract and open interest (April - December 2001)



Tax issues

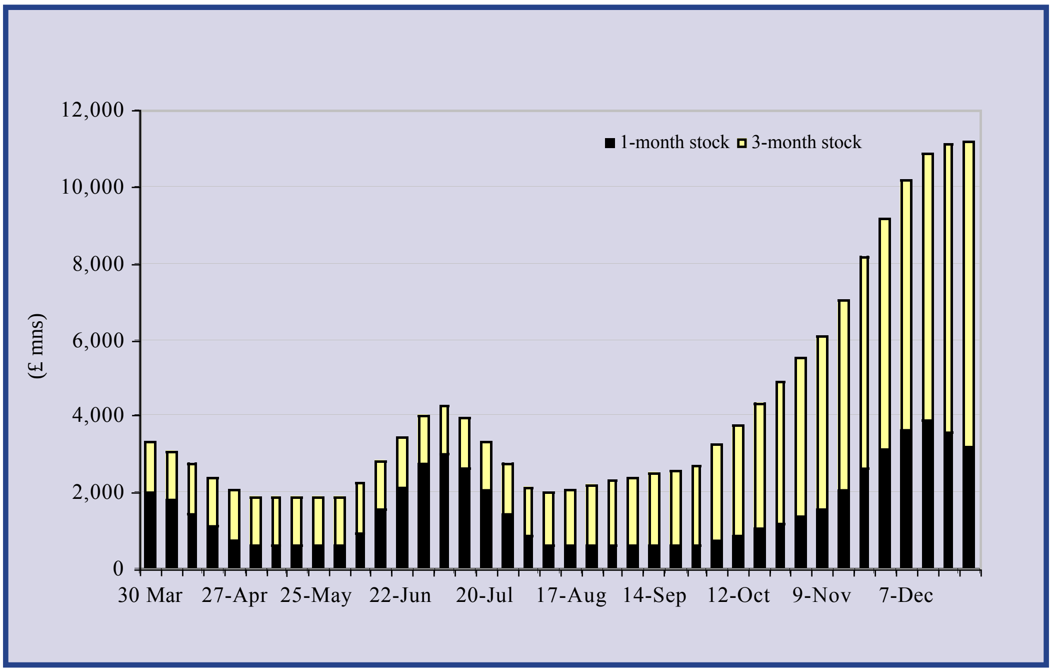
On 1 March 2002, in order for all gilts, irrespective of when they were originally issued to fall within the terms of the draft EU Savings Directive (as set out in Article 15), HM Treasury issued additional amounts of each gilt-edged stock to the DMO for use as collateral in its cash management operations. The total amount of new issues was £691 million (nominal), with increases in the size of individual gilts ranging from £0.25 to £30 million for conventionals, and from £5 to £15 million for index-linked gilts. For a period of six months, these new issues will be used only in Delivery by Value (DBV) transactions. To ensure the fungibility of STRIPS, the DMO stripped and then reconstituted a nominal amount of each the strippable bonds issues in this operation on 1 March 2002. Details on the amounts of these further issues and the amounts in issue after the re-openings can be found on the DMO's website (www.dmo.gov.uk).

Treasury bills and Exchequer Cash Management

Treasury bill stock April-December 2001

Treasury bill stock fell slightly over the first half of the financial year (from £3.3 billion to £2.7 billion) but began rising strongly from end-September onwards ahead of the projected cash outflow from the Exchequer in the final quarter of the calendar year and had reached £11.2 billion by the end-December 2001. The stock had earlier risen to £4.05 billion at the start of July to support smoothing operations to cover an Exchequer shortfall at the start of July and to reduce a surplus by end-July. The end-March 2002 target set out at the PBR in November 2001 is for a Treasury bill stock of £9.7 billion. Chart 10 shows the intra-year path of the stock of Treasury bills between April-December 2001.

Chart 10: Treasury Bill Stock (April-December 2001)



New arrangements for Treasury bill issuance

On 21 September 2001, as part of the preparations for significantly increasing the level of Treasury bill stocks from October onwards, the DMO announced new arrangements for Treasury bill issuance. The main operational changes which came into effect from tenders on 5 October 2001 onwards were:

- all bids to be received by 11.00 a.m. on the day of the tender (previously 12.30 p.m.);
- all bids can be made (on a money market yield basis) to three decimal places (previously two decimal places);
- bids at tenders to be for a minimum of £500,000 nominal of bills (previously £1 million); and
- the minimum issuance denomination of Treasury bills to be £25,000 (previously £5,000).

The DMO also announced that a group of nine banks had agreed to act as primary participants in connection with the issuance of Treasury bills. Primary participants will bid on behalf of other investors at tenders and have also agreed to provide indicative dealing prices for Treasury bills to their customers.

Cash management handbook

On 20 February 2002 the DMO published its cash management handbook describing its approach to cash management and its operations in the recent past. It also included all documentation (including the Cash Management Operational Notice) relevant to its Exchequer cash management activities. It was designed not only to be useful to practitioners for reference but also to a wider interested audience. It also fulfilled the undertaking the DMO gave to the Treasury Sub-Committee to produce such a document following a recommendation in the Treasury Sub-Committee's report into the Government's Cash and Debt Management published in 2000.

THE MANAGEMENT OF THE OFFICIAL RESERVES IN 2001-02

Introduction

The United Kingdom holds official reserves of gold, foreign currency assets and International Monetary Fund (IMF) Special Drawing Rights (SDRs). Apart from those SDR assets which constitute the UK's reserves tranche position at the IMF, these reserves are held in the Exchange Equalisation Account (EEA). The EEA is under the control of HM Treasury but the Bank of England, acting as HM Treasury's agent, manages the EEA by carrying out day-to-day tasks such as foreign exchange dealing and portfolio investment, within the framework of an annual remit set by HM Treasury (see the summary remit on pages 42-43).

Origin and purpose

The EEA was established in 1932 as a fund for stabilising the exchange value of sterling. Its uses were later extended to cover the financing of payments abroad (the EEA continues to provide extensive foreign currency dealing services to Government) and also aspects of the UK's membership of the IMF.

The EEA is closely linked to the National Loans Fund (NLF), which finances nearly all of the EEA's investments through a combination of sterling and foreign currency borrowing. Any NLF foreign currency exposures are managed alongside those of the EEA by the Bank of England, which also acts as HM Treasury's agent for foreign currency liability management.

Disclosure of financial data

In keeping with the Government's pledge to achieve greater openness and transparency in reserves data, the UK's international reserves have, since April 2000, been published in accordance with the IMF/G10's Special Data Dissemination Standard (SDDS). Data from July 1999 onwards can be found on the Bank of England website. This data discloses the value and composition of the UK's gold and foreign currency assets, liabilities and derivatives on a "marked-to-market" basis (that is, using current market valuations). The press release also reports the size(s) and date(s) of any intervention in the foreign exchange markets, either by HM Treasury or by the Bank of England, and gives an explanation of any intervention carried out.

In addition, HM Treasury now has a statutory obligation, as set out in the Finance Act 2000, to publish a full set of financial accounts for the EEA every year. The financial accounts for 2000-01 were prepared and laid before Parliament on 31 January 2002. Although this is the fourth year for which the accounts have been published, it is the first time they have been published under accruals accounting consistent with UK Generally Accepted Accounting Practice (UK GAAP).

Table 8: UK Official Holdings of International Reserves

Currency Breakdown as at 31 December 2001

	US$ mn: market value
Assets	
US$	8,344
Euro	15,818
Yen	6,698
Other currencies	10
SDR	5,330
Gold	3,158
Total	**39,359**
Liabilites	
US$	-5,379
Euro	-12,855
Yen	-5,229
Other currencies	-12
SDR	-2,403
Gold	-
Total	**-25,879**

Evaluation of the performance in reserves management

The Government has a Service Delivery Agreement (SDA) target to minimise the cost of holding the foreign currency reserves while reducing risk. Performance is reported on in detail in HM Treasury's annual report on the expenditure plans of the Chancellor of the Exchequer's Departments. The most recently reported figures, those for 1999-2000, show an overall cost of £315 million in that year, and was largely the result of exchange rate fluctuations.

Review of activities during 2001-02

Gold sales

The 2001-02 gold sales completed the programme announced in May 1999 as part of the restructuring of the reserves. During 2001-02 a total of 120 tonnes of gold were sold at six auctions of around 20 tonnes each.

The UK Gold Sales Programme

HM Treasury announced the restructuring of the UK's reserve holdings to achieve a better balance in the portfolio by increasing the proportion held in currency on 7 May 1999. This restructuring involved a programme of gold sales over the following three years, to reduce the UK's gold holding from over 700 tonnes to around 300 tonnes.

Prior to the announcement in 1999, with gold representing about 43% of the UK's net reserves, the Government judged that the net reserves were overexposed to a single asset. The programme was conducted as part of a medium-term plan to rebalance and diversify the reserves portfolio, thereby reducing risk by investing the proceeds from the gold sales into interest-bearing foreign currency assets. Upon completion of the programme, a permanent reduction in risk had been achieved[6] with gold accounting for only around 22% of the net reserves.

The objectives set by the Government were to sell gold in a transparent manner, over the medium-term, fairly and with a view to obtaining value-for-money for the taxpayer. Following consultations with the Bank of England on the various possible methods for selling gold, HM Treasury decided that a series of single-, or uniform-, price auctions would best fulfil these objectives. In such auctions, all successful bidders pay the same price, i.e. the lowest accepted price that clears the amount on offer.

The sales programme consisted of 17 bi-monthly auctions conducted by the Bank of England, on behalf of HM Treasury. The first auction took place in July 1999 and the programme of sales was completed in March 2002. Around 25 tonnes of gold were sold at each of the first 11 auctions with the size being reduced to around 20 tonnes for the last 6 auctions. Over the course of the programme around 395 tonnes of gold was sold, raising US$3.5 billion.

The proceeds from the gold sales programme have been reinvested in interest-bearing foreign currency assets in broadly the same proportions as are already held in the net currency reserves; 40% US dollars, 40% euros and 20% yen. These foreign currency assets have been retained in the reserves.

Towards the end of 2000, the National Audit Office (NAO) examined the way in which HM Treasury had handled the risks to the programme to secure a successful outcome. Their report, "The Sale of Part of the UK Gold Reserves" published in January 2001, concluded that the Treasury has so far "met successfully its objective to sell in a transparent and fair manner while achieving value-for-money". It also acknowledged the Bank of England's role in keeping the market well-informed and securing a technically successful gold sale programme.

Following the publication of the NAO report in February 2001, the Committee of Public Accounts of the House of Commons held a hearing in February 2001 addressing the conduct of the gold sales programme by HM Treasury and the Bank of England. They subsequently published a report on 19 December 2001 which concluded that "the Treasury are being rigorous in their approach to achieving a reduction in the riskiness of the portfolio in that they are carrying out the sales within a framework of risk assessment and management."

[6] The diversification of the net reserves resulting from the gold sales programme has led to a reduction in the value-at-risk on the net reserves of around 30%.

UK gold auction results

Date	Amount Allotted Ounces	Allotment Price US$/ounce	Cover Ratio
6 July 1999	804,000	261.20	5.2
21 September 1999	804,000	255.75	8.0
29 November 1999	804,000	293.50	2.1
25 January 2000	804,400	289.50	4.3
21 March 2000	804,400	285.25	3.0
23 May 2000	803,600	275.25	2.7
12 July 2000	804,000	279.75	1.3
19 September 2000	804,400	270.60	2.6
7 November 2000	804,000	264.30	3.3
23 January 2001	805,600	268.00	4.8
14 March 2001	804,800	266.00	2.2
15 May 2001	644,400	268.00	3.7
11 July 2001	643,600	267.25	4.1
12 September 2001	644,400	280.00	4.3
27 November 2001	644,400	273.50	2.6
16 January 2002	643,600	283.50	1.4
5 March 2002	644,400	296.50	3.7

Sterling swaps

The Bank continued its programme of swapping out of sterling aimed at obtaining better value-for-money in the financing of the reserves than the alternative of foreign currency borrowing, given the premium on gilts.

Some £1.2 billion of such swaps will have been completed by end-March 2002 bringing to an end the pre-financing programme.

Intervention

There has been no intervention in the foreign exchange markets in the financial year to date.

Size of UK reserves

Over the financial year to end-February 2002, the level of the UK's net reserves had changed very little in dollar terms and stood at US$13.6 billion compared to US$13.1 billion at end-March 2001. The fall in the level of the gross reserves from US$42.9 billion at the start of the financial year to US$38.5 billion at end-February 2002 was largely due to the redemption of pre-financed foreign currency debt (the €2 billion note which matured in January 2002, the US$2 billion bond which matured in July 2001 and the US$2 billion floating rate note which matured in October 2001). The gross reserves fell because, at maturity, assets funded by the foreign currency liabilities were used to redeem the debt. Redemption of foreign currency debt during 2002-03 (the US$3 billion bond maturing in December 2002 and €2 billion note maturing in January 2003) is expected to bring the level of the gross reserves down to around US$34 billion by the end-March 2003.

THE GOVERNMENT'S FINANCING PROGRAMME FOR 2002-03

Financing Framework

The Government intends to continue to finance the central government net cash requirement (CGNCR) using the framework which was established in the 1995 Debt Management Review. The Government aims to finance its net cash requirement plus maturing debt and any finance required for additional net foreign currency reserves through the issuance of debt. All such debt issuance will take place within a set maturity structure, which will be determined annually and published before the start of the financial year in the Debt and Reserves Management Report. In addition, the Government may hold conversion offers, switch and reverse auctions of non-benchmark stocks.

The financing requirement for 2002-03 is based on the forecast for the CGNCR published in the Pre-Budget Report (PBR) on 27 November 2001. The financing requirement and hence the structure and composition of financing may be revised depending on the public finance forecasts published when the Chancellor of the Exchequer publishes this year's Budget papers on 17 April. A full list of contingencies that HM Treasury may consider exercising is outlined on page 35. A full financing table taking in any revisions will be published with the Budget papers as well as separately on the DMO website.

Financing Arithmetic

Table 9 gives details of the preliminary financing arithmetic for 2002-03. It outlines the proposed structure and composition of debt instruments that the Government intend to use to finance the CGNCR in 2002-03.

PBR 2001 projected a CGNCR in 2002-03 of £13.6 billion. Gilt redemptions, excluding official holdings, are expected to be £17.2 billion (see table 10). In line with the assumption for 2002-03, the level of the net official foreign currency reserves is assumed to be unchanged between end-March 2002 and end-March 2003.

National Savings and Investments (NS&I)

NS&I's net contribution to financing (including accrued interest) in 2002-03 is forecast to be -£1.5 billion. This assumes gross sales (i.e. sales and deposits including accrued interest) of around £10.8 billion. This forecast is not a target but an estimate based on experience in previous years, trends in 2001-02 and NS&I's own forecasts and objectives.

Table 10: Stocks maturing in 2002-03 (£ million)

Redemption Date	Stock	Nominal amount outstanding	Official holdings (end-Dec 2001)	Nominal value of stocks outside Central Government (end-Dec 2001)
11 April 2002	10% Conversion 2002	21	12	9
07 June 2002	7% Treasury 2002	9,012	210	8,802
14 June 2002	9½% Conversion 2002	3	3	0
27 August 2002	9¾% Treasury 2002	6,538	119	6,419
05 October 2002	8% Treasury 2002-06*	2,064	228	1,836
19 November 2002	9% Exchequer 2002	83	67	16
22 January 2003	11¾% Treasury 2003-07*	234	77	158
Total		**17,955**	**716**	**17,240**

**Assuming redemption at the earliest date.*

Short-term net debt position

It is forecast that the short-term net debt position will change by £9.3 billion. This change is made up of:

- an increase in the planned end-year Treasury bill stock; and
- a further unwinding of the DMO's net cash position.

The level of the Ways and Means planned for 31 March 2002 is £13.4 billion and is assumed to remain at this level.

Table 9: Preliminary Financing Arithmetic 2002-03

Central government net cash requirement			13.6
Gilt redemptions			17.2
Gilt buy-backs			0.0
Financing for Official Reserves			0.0
Gross Financing Requirement			**30.8**
Less			
National Savings & Investments			-1.5
Net Financing Requirement			**32.3**
Financed by			
Gross Gilt Sales			**23.0**
	Conventional	Short	5.5
		Medium	5.5
		Long	7.5
	Index-Linked		4.5
Changes in net short-term debt			**9.3**
Changes in the Ways & Means Advance			0.0
Changes in Treasury bill stock			4.3
Change in DMO net cash position			5.0
Memo			
End-year short-term debt levels			
Ways & Means Advance			13.4
Treasury bill stock			14.0
DMO net cash position*			2.7

** Including the DMO's cash deposit at the Bank of England.*

The preliminary financing plans for 2002-03 assume a build up in the Treasury bill stock of £4.3 billion. The planned stock of Treasury bills held outside central government is targeted to rise to £14 billion by end-March 2003.

It is assumed that the DMO will further unwind their net cash position by £5 billion over 2002-03. A description of the nature and use of the DMO's net cash position is in the box on page 36.

Quantity of Gilt Sales

The DMO, under instruction from HM Treasury and on behalf of HM Government, will aim to meet the remainder of the financing requirement by selling gilts to the private sector. On the basis of the PBR 2001 forecast for the CGNCR in 2002-03, this means gross gilt sales of approximately £23 billion (cash).

Nature of stocks

The Government will continue to have available the full range of financing instruments and market operations, including conversion offers and switch auctions to maintain large, liquid issues across the maturity spectrum. Index-linked issuance will be concentrated in long and medium maturities. This is likely to include a new index-linked gilt. However, as stated in the DMO's response to the recent consultation exercise[7] , this will not be before July 2002 in order to allow the market time to make the appropriate systems adjustments.

Maturity structure of issuance

Based on the preliminary financing arithmetic, net gilts issuance in 2002-03 will be £5.8 billion. This is the first financial year of net positive issuance since 1997-98. Accordingly, this allows the first issuance of short maturity stock since 1999-2000.

The preliminary financing programme assumes seven outright auctions for conventional gilts, two each for short and medium maturities and three for long maturities.

It is assumed that just under one-fifth of total gross issuance (£4.5 billion cash) will be of index-linked gilts via five outright auctions. This reflects the Government's continued commitment to the index-linked market against a background of sustained low inflation.

[7]"Index-linked Gilt Re-design: Response to Consultation" published by the DMO on 15 January 2002.

DMO cash collateral

As described in the DMO's Exchequer Cash Management Remit (see pages 39-41), over the course of 2002-03, HM Treasury may issue gilts to the DMO for collateral purposes in order to aid the DMO in the efficient execution of their cash management operations. Any such issuance will be wholly transparent and fully reported to the market. It will be designed in such a way to minimise the effect on key market indices.

Contingencies

The preliminary financing arithmetic is based on the PBR 2001 forecast for the CGNCR in 2002-03. An updated forecast will be published on 17 April 2002 when the Chancellor of the Exchequer publishes the Budget.

Consequently, the following contingencies will be exercised depending on the CGNCR outturn for 2001-02 as well as the fiscal forecasts. If the forecast for the CGNCR is revised downwards (i.e. a smaller cash requirement or surplus), HM Treasury would consider accommodating such a revision by:

- adjusting the DMO's net cash position (by up to £3 billion);
- reducing planned long maturity conventional gilt sales (by up to £2.5 billion); or
- reducing planned index-linked gilt sales (by up to £0.75 billion).

If the CGNCR rises (i.e. a greater cash requirement) HM Treasury would consider meeting the increased financing requirement by:

- accommodating the increase in the DMO's net cash position (by up to £1 billion);
- increasing planned issuance of short maturity conventional gilts (by up to £2.5 billion); or
- increasing planned sales of medium maturity conventional gilts (by up to £2.5 billion).

Specific decisions on the exercising of contingencies would be made in light of circumstances.

DMO's Net Cash Position

Over the last two financial years, the DMO has run a sizeable "net cash position". This has been used to smooth the profile of gilt sales. For example, it was allowed to rise in order to maintain gilt supply during 2000-01 but is now in the process of being run down to reduce the level of gilt issuance through 2002-04. This section looks in more details at its origins and workings.

The origins of the cash position lie in the public finance surpluses of the late 1990s and the receipts from the 3G Spectrum auctions in Spring 2000. It was decided to use the receipts from the auctions to reduce net central government debt. In PBR 2000, HM Treasury announced a number of different market operations (debt buy-backs, reducing the balance of the Ways and Means facility and reducing the size of the stock of outstanding Treasury bills) all of which were designed to reduce gross debt. After some additional sterling to pre-finance outstanding foreign currency debt, the residual cash balance left after these operations was invested in short-term assets. Additionally, it was also announced that any further difference between the PBR 2000 forecast for the CGNCR in 2000-01 and outturn would be accommodated by changes in the short–term asset position. It was decided that the accumulated cash position would be unwound over the next three financial years (i.e. by end-March 2004) so as to minimise its impact on gilts issuance. The DMO was to be responsible for the management of these assets as an extension to their cash management responsibilities. The list of instruments available to the DMO for meeting these responsibilities are published in the Exchequer Cash Management Operational Notice of September 2001.

DMO's Net Cash Position 2000/01 – 2002/03

DMO's Net Cash Position						
(£ billion)	Forecast (for end-financial year)					
	PBR 2000	Budget 2001	PBR 2001	DRMR 2002-03	Outturn	Unwind
2000-01	6.3	11.9			13.6	
2001-02		**7.0**	**8.1**	**7.7**		**5.9**
2002-03				**2.7**		**5.0**

Note: Data in red is forecast; includes DMO cash deposit at the Bank of England.

The table above shows the path of the net cash position since its inception. As can be seen, the initial size of the cash position was underestimated. This was mainly due to the stronger than expected surplus on the public finances. Any difference between the forecast CGCNR and outturn has been absorbed in the cash position. The forecast rundown from the end-March 2001 to end-March 2003 is £10.9 billion. This leaves a further £2.7 billion to be unwound over 2003-04 in order to meet the policy commitment of unwinding the accumulated short-term cash position from end-March 2001 by end-March 2004.

Included in the net cash position is the DMO's cash deposit at the Bank of England. This is held to facilitate the DMO's cash management operations at the end of the business day. If there is an unanticipated adverse swing in the Exchequer's accounts with the Bank when cleared overnight, the deposit acts as a cushion that can be run down prior to the Exchequer having to borrow overnight from the Bank. In practice, this has rarely happened. The target balance for this deposit is £200 million. Ordinarily, this balance would not contribute to financing as the beginning and end of financial year levels would be expected to be the same. However, a late inflow on 30 March 2001 meant that the level of the balance rose to £500 million at end-March 2001. In order to return to the target level of £200 million, the deposit at the Bank of England has been reduced by £300 million and hence has made a contribution to financing in 2001-02.

DEBT MANAGEMENT OFFICE REMIT FOR 2002-03

A) Gilt Remit

Objectives

The Debt Management Office (DMO), an Executive Agency of HM Treasury, has been given the following objectives in respect of Government debt management:

- to meet the annual remit set by HM Treasury Ministers for the sale of gilts, with high regard to long-term cost minimisation taking account of risk;
- to advise Ministers on setting the remit to meet the Government's debt management objectives and to report to Ministers on the DMO's performance against its remit, objectives and targets;
- to develop policy on and promote advances in new instruments, issuance techniques and structural changes to the debt markets that will help to lower the cost of debt management, liaising as appropriate with the Bank of England, Financial Services Authority, London Stock Exchange, and other bodies; and to provide policy advice to Treasury Ministers and senior officials accordingly;
- to conduct its market operations, liaising as necessary with regulatory and other bodies, with a view to maintaining orderly and efficient markets and promoting a liquid market for gilts;
- to provide, including in liaison with the Bank of England and CRESTCo, a high quality efficient service to investors in government debt, and to deal fairly and professionally with market participants in the gilt and money markets, consistent with achieving low cost issuance;
- to contribute to HM Treasury's work on the development of the strategy for the debt portfolio; and
- to make information publicly available on the debt markets and DMO policies where that contributes through openness and predictability to efficient markets and lower costs of debt issuance.

Quantity of gilt sales

2. The DMO, on behalf of the Government, will aim for gilt sales of approximately £23 billion in 2002-03.

Pace of gilt sales

3. The DMO will aim to sell gilts at a broadly even pace through the year. Within-year seasonal fluctuations in the pattern of central government expenditure and revenue will be met by other financing means governed by the Exchequer Cash Management Remit.

Amount and maturity mix of index-linked gilt issuance

4. Over 2002-03, the DMO plans to sell £4.5 billion (cash), just under twenty per cent of its gilts sales, in index-linked stocks.

5. Five auctions of index-linked stocks are planned in 2002-03. Issuance will be directed at medium- and longer-dated maturities (i.e. stocks dated 2009 and longer).

6. To ensure the medium-term viability of the index-linked auction programme, the authorities remain committed to a minimum supply of £2.5 billion (cash) of index-linked stocks for the foreseeable future.

Amount and maturity mix of conventional gilt issuance

7. Seven auctions of conventional stocks are planned in 2002-03; three in the long (15 years and over) maturity area and two each in the medium (7-15 years) and short (1-7 years) maturity areas.

8. HM Treasury will consider accommodating reductions in the forecast 2002-03 financing requirement by: adjusting the DMO's net cash position (by up to £3 billion); reducing planned long maturity conventional gilt sales (by up £2.5 billion); or reducing planned index-linked gilt sales (by up to £0.75 billion).

9. Increases in the financing requirement will be accommodated by a combination of: accommodating the increase first in the DMO's net cash position (by up to £1 billion); increasing planned issuance of short maturity conventional gilts (by up to £2.5 billion); or increasing planned sales of medium maturity conventional gilts (by up to £2.5 billion).

10. Specific decisions would be made in the light of circumstances.

Buy-backs of debt

11. The DMO has no plans for a programme of reverse auctions.

Method of issuance of gilts

12. Auctions will constitute the primary means of issuance of all gilts (conventional and index-linked). The DMO plans to hold seven auctions of conventional gilts and five auctions of index-linked gilts. All auctions will be single auctions held on the day indicated.

13. Each outright auction of conventional gilts is planned to be for between £1½ billion and £3 billion (cash) of stock on a competitive bid-price basis. Each auction of index-linked gilts will be for between £½ billion and £1¼ billion (cash) on a uniform-price basis.

Gilt Auction Calendar 2002-03

Date		Type
24 April	2002	Index-linked
29 May	2002	Conventional
25 June	2002	Conventional
10 July	2002	Index-linked
24 July	2002	Conventional
25 September	2002	Index-linked
22 October*	2002	Conventional
24 October*	2002	Index-linked
27 November*	2002	Conventional
22 January	2003	Index-linked
26 February*	2003	Conventional
26 March*	2003	Conventional

**Subject to confirmation following the Chancellor's decisions on the Budgetary timetable.*

14. The programme of conventional and index-linked gilt auctions may be supplemented between auctions by official sales of stock by the DMO "on tap". Taps of stocks will be used only as a market management instrument in conditions of temporary excess demand in a particular stock or sector. The DMO would only contemplate taps of stocks in exceptional circumstances.

15. After an auction, the DMO will generally refrain from issuing stocks of a similar type or maturity to the auction stock for a reasonable period. Such stock will only be issued if there is a clear market management case.

16. For the purposes of market management, the DMO may create and repo out stock in accordance with the provisions of its Standing Repo Facility launched on 1 June 2000.

In-year consultation and announcements on auctions

17. Towards the end of each calendar quarter, the DMO will publish, with the agenda for the consultation meetings with gilt market participants, details of progress to date with the gilt issuance programme, including any changes to the Government's financing requirement and any changes to the gilts auction programme. The DMO will then consult Gilt-edged Market-Makers and representatives of major End Investors on the auction programme for the following quarter and any other issues that may arise. Following that consultation, at the end of the quarter, the DMO will announce plans for the auctions scheduled for the coming quarter. For each auction, this will indicate the stock to be auctioned or, where relevant, the approximate maturity of a new stock.

18. The auction plan for the first quarter of will be announced at 3:30 p.m. on 28 March 2002.

19. Full details of these, and subsequent, auctions will be announced at 3.30p.m. on the Tuesday of the week preceding the auction.

Coupons

20. As far as possible, coupons on new issues of gilts will be set to price the stock close to par at the time of issue.

Buy-ins of short maturity debt

21. The DMO will have responsibility for buying-in stocks close to maturity to manage Exchequer cash flows.

Conversions and switch auctions

22. In order to build up the pool of benchmark stocks further, the DMO may in future make offers for the conversion of unstrippable stocks into benchmarks of similar maturity during 2002-03. The DMO may consider converting out of stocks with up to £5.5 billion (nominal) in issue. Such offers may be supplemented by switch auctions into benchmark stocks during 2002-03. Details of any future switch auction stocks will be announced at the same time as the end-

quarter announcements of forthcoming outright auctions.

Reviews to the remit

23. The remit, and in particular the number of auctions and the allocation between conventional maturity bands and index-linked, may be varied during the year in the light of substantial changes in the following:

- the Government's forecast of the gilt sales requirement;
- the level and shape of the gilt yield curve;
- market expectations of future interest and inflation rates; and
- market volatility.

24. Any revisions to this remit will be announced.

B) Exchequer Cash Management Remit

Objective

The DMO's primary objective in carrying out its Exchequer cash management operations will be:

"to offset, through its market operations, the expected cash flow into or out of the National Loans Funds. It aims to do so in a cost-effective manner, taking account of risk."

The DMO aims to:

- manage cash flows without influencing the level of short-term interest rates;
- take account of the operational requirements of the Bank of England; and
- take account of its impact on the efficiency of the sterling money market.

2. The DMO will carry out its objective primarily by a combination of:

- weekly Treasury bill tenders;
- bilateral market operations with DMO counterparties; and
- ad hoc tenders of Treasury bills (and repo or reverse repo transactions).

3. The DMO and the Bank of England will work together to avoid clashes in the delivery of their respective objectives in the money markets. The DMO will not take speculative positions on interest rate decisions by the Bank of England nor hold operations which by their nature or timing in the day could be perceived to clash with the Bank's open market operations.

Treasury bill tenders

Timing and schedule of announcements

4. The DMO will hold Treasury bill tenders on the last business day of each week. When announcing the results, the DMO will also announce the quantity and maturity of Treasury bills on offer in the tender in the following week and may give the maturity and indicative size of any ad hoc tenders in the following week.

5. Following the final tender at the end of each quarter, the DMO will issue a notice outlining the maturities of Treasury bills likely to be available via tenders over the following quarter.

Maturities

6. The DMO's Treasury bill tenders in 2002-03 may be of the following maturities:

- one month (approximately 28 days);
- three months (approximately 91 days);
- six months (approximately 182 days); and
- twelve months (approximately 364 days).

7. The DMO expects to begin issuing six-month Treasury bills in 2002-03, alongside one- and three-month bills.

Level of stocks

8. The DMO will manage Treasury bill transactions with a view of running down the stock of bills in months of positive cash flows and increasing it in months of higher net expenditure. The DMO will aim to build up the stock of Treasury bills in market hands to £14 billion by end-March 2003.

Interaction with Bank of England's money market operations

9. The DMO may also issue Treasury bills to the market to assist the Bank of England in its management of the sterling money markets. In response to a request from the Bank, the DMO will add a specified amount to the size(s) of the next bill tender(s) and deposit the proceeds with the Bank, remunerated at the weighted average yield(s) of the respective tenders. The amount being offered to accommodate the Bank's request will be identified in the DMO's weekly bill tender announcement. Treasury bill issues at the request of the Bank will be identical in most respects with rest of the stock of Treasury bills outstanding.

Ad hoc tenders

10. The DMO may also issue short maturity Treasury Bills (up to 28 days) at ad hoc tenders. The objective of such tenders will be to provide additional flexibility for the DMO in smoothing Exchequer cash flows. Treasury bills issued in ad hoc tenders will be identical in every respect with those issued by weekly tenders.

11. In addition to issuing Treasury bills, the DMO may also execute repo or reverse repo transactions at ad hoc tenders. For such transactions, collateral used would either be gilts or Treasury bills.

12. The DMO may also hold ad hoc tenders for buying in gilts (or gilt strips) with a residual maturity of less than six months.

Timing of ad hoc tenders

13. The DMO will usually announce its intention to hold ad hoc tenders in the weekly announcement of the tender result. Such announcements will indicate the day(s) of the following week on which ad hoc tender(s) are expected to be held, together with a guide to the expected maturity and size.

14. The precise details of the maturity and nominal on offer will be announced at the opening of the offer on the morning of the tender (usually at either 8:30 a.m. or 10:00 a.m.).

Bilateral operations with the market

15. In pursuit of its cash management objectives, the DMO expects to trade on a daily basis with its counterparties across a range of instruments. The full range of instruments is set out in the DMO's Exchequer Cash Management Operational Notice.

16. The DMO's bilateral operations may comprise of:

- purchase from the market for future resale (reverse repo);
- sale to the market for future repurchase (repo);
- outright sale and purchase of gilts, Treasury bills and eligible bills, certificates of deposit, commercial paper, selected bank bills and other short-term debt issued by high quality issuers, including supranationals and foreign governments;
- unsecured cash borrowing and lending with its counterparties; and
- short-term foreign currency swaps, Forward Rate Agreements (FRAs) and interest rate futures may also be used to manage foreign currency and interest rate exposures. All foreign currency exposure will be hedged back into sterling.

17. The DMO would give prior notice to the market if it planned to introduce additional instruments for use in its

bilateral operations.

18. Other than gilts and Treasury bills, collateral used in the repo and reverse repo transactions may include selected euro-denominated government securities, eligible bank bills, supranational sterling and euro-denominated securities. In carrying out these transactions, the DMO may make use of those of its own holdings of marketable gilts and of funds managed by National Debt Office (NDO) for collateral purposes.

DMO cash collateral

19. If required, in order to aid the DMO in the efficient execution of their cash management operations, HM Treasury may issue gilts and Treasury bills to DMO for collateral purposes.

BANK OF ENGLAND'S REMIT FOR THE MANAGEMENT OF THE OFFICIAL RESERVES 2002-03

Introduction

This remit sets out the objectives and strategy, which the Bank of England ("the Bank") is to pursue in managing the Exchange Equalisation Account (EEA) as agent for Her Majesty's Treasury ("the Treasury"). The EEA is subject to the provisions of the Exchange Equalisation Account Act 1979 which sets out the purposes for which it is to be used. In addition, the Treasury has published a Service Delivery Agreement (SDA) objective under which it undertakes to minimise the cost of holding the Government's foreign currency reserves, while reducing risk.

Objectives

2. In order to fulfill the functions laid down in the EEA Act 1979 and meet the published SDA objective, HM Treasury and the Bank have agreed that the Bank will:

- i carry out in a legal and proper form foreign currency and gold transactions on behalf of HM Treasury and other Government Departments efficiently and cost- effectively;
- ii manage the official reserves so as to maintain their liquidity and security within limits agreed with HM Treasury and ensure that the public funds entrusted to the Bank in the EEA are properly and well managed and safeguarded;
- iii subject to ii above, manage the official reserves so as to maximise their return;
- iv monitor and report on the level of risk and return on holding the reserves;
- v ensure that effective management systems, including financial monitoring and control systems, are in place;
- vi ensure that proper financial procedures are followed and that accounting records are maintained in a form suited to the requirements of management as well as in the form prescribed for the published accounts;
- vii provide accurate and timely accounting and statistical information and analysis as requested by HM Treasury;
- viii advise HM Treasury on foreign exchange market conditions;
- ix advise HM Treasury on the financing of the reserves, including as necessary the management of foreign currency borrowing (covering new borrowing, hedging and repayments) and implement agreed strategy in this area.

Composition of the Reserves and discretionary management

3. The reserves will be invested in a specified range of instruments and relative to currency and other benchmarks as agreed with HM Treasury, with limited scope to deviate from these constraints in order to enhance the return on the reserves.

Operational standards

4. In carrying out these tasks, the Bank will so far as possible ensure that its internal systems and controls are adequate for the size, nature and complexity of operations on the EEA and compare well with best market practice.

Monitoring and controlling risk

5. The Bank will measure the exposure of the EEA portfolio to market risk in three main ways: using a Value at Risk (VaR) measure to aggregate risk consistently across the components of the portfolio; using sensitivity measures for a more detailed analysis of risk; and using stress tests that quantify the potential loss from worst-case scenarios.

6. The Bank will continue to measure and manage the EEA's exposures to banks, securities houses and issuers using the existing credit system. This system, and the credit limits which it provides, will be kept under review in the light of market or institutional developments affecting the position of counterparties. The Bank will provide HM Treasury with a monthly report of limit excesses or management overrides, and a full statement of credit limits after each six-monthly meeting.

Audit arrangements

7. The Bank agrees to provide regular written reassurance to the EEA Accounting Officer that risks affecting the Bank's management of the EEA and the systems that generate the EEA's annual accounts are properly controlled; and that the Bank has complied with this remit. The Bank's internal audit arrangements will accord with the professional standards set by the Institute of Internal Auditors UK and

Ireland and have regard to the objectives, standards and practices set out in HM Treasury's "Government Internal Audit Manual" and the guidance provided in the "Government Information Systems Audit Manual". Bank internal audit follow a risk-based programme of work, agreed with Treasury staff.

Accounting and NAO access

8. The Bank will maintain accounts for the EEA based on UK Generally Accepted Accounting Practice (UK GAAP) in accordance with the relevant Accounts Direction, and will prepare draft accounts for the EEA for 2001-02 by the 31 July 2002 for immediate submission to the National Audit Office.

9. For the purposes of the examination and certification of the EEA accounts, or for any examination pursuant to Section 6(1) of the National Audit Act 1983 concerning the economy, efficiency and effectiveness with which the Bank has managed the EEA, the Comptroller and Auditor General may require access to such documents, Bank buildings, and factual explanations as he considers necessary.

Review of reserves management

10. To enable HM Treasury to monitor the management of the reserves, the Bank will provide HM Treasury with accurate and timely accounting and statistical information. In particular, the following will be provided: a monthly management information report, which will be discussed at a monthly meeting chaired by the Debt and Reserves Management team leader, and a quarterly report on performance which should enable the Accounting Officer to check progress in meeting HM Treasury's SDA target on reserves management.

11. The Accounting Officer for the EEA, or delegated senior officials, will meet the Bank every six months in order to review strategy and to agree on analysis to be commissioned from the Bank. Changes to this remit and meetings to discuss individual issues may be proposed at any time by HM Treasury or by the Bank, and in such cases the Bank will provide relevant information as requested by HM Treasury.

Publications policy

12. Figures on the United Kingdom's net reserves and the Bank's net holdings of foreign currency and gold will be published in a Press Notice at 9:30 a.m. on the third working day of every month. This will disclose the amounts, currencies and dates of any intervention operations undertaken during the period, with explanations as to why the intervention was undertaken. The format of this monthly Press Notice will be in line with the requirements of the IMF's Special Data Dissemination Standard and will be aligned with the conventions of the G10/IMF reserves template published simultaneously on the Bank of England's website.

Cash management

13. Subject to meeting its objectives under this remit, the Bank will as far as is possible aim to manage the EEA so as to avoid conflict with the DMO's sterling cash management operations.

Intervention

14. Specific prior authority from Treasury Ministers is required for intervention designed to influence sterling's exchange rate using the EEA, or for EEA participation in concerted intervention in support of any other currency. The Bank will subsequently report on the extent to which any such authority was used, and to what effect, by letter.

NATIONAL SAVINGS AND INVESTMENTS' FINANCING REMIT 2002-03

Introduction

National Savings and Investments (NS&I) is an Executive Agency of the Chancellor of the Exchequer. Its role is to act as an integral part of the UK's debt management arrangements, and its aim is to help reduce the cost to the taxpayer of Government borrowing now and in the future. To achieve this NS&I's strategic objective is to:

- provide retail funds for the Government that are cost-effective in relation to funds raised on the wholesale market.

2. Key business objectives for NS&I to deliver its strategic objective are:

- to improve the competitiveness of the overall offer to customers;
- to ensure levels of customer service which meet standards of best practice in the retail financial services sector; and
- to develop a more flexible and responsive business that can deliver a range of net financing requirements to the Treasury.

3. In pursuit of its cost-effectiveness strategy, NS&I will operate fairly, transparently and pro-competitively, engendering customer loyalty and securing new business by offering attractive products on fair terms.

Responsibility for setting product terms

4. HM Treasury is ultimately responsible, under the National Loans Act 1968, for setting the terms of NS&I products.

5. NS&I will normally take the lead in bringing forward proposals to Treasury Ministers on product development (including proposals for new products) or on product terms (including interest rates). If the proposals are consistent with NS&I's objectives and this remit, Treasury Ministers would expect to endorse them.

Volume of financing in 2002-2003

6. Sales and deposits (including accrued interest) of NS&I products are assumed to be around £10.8 billion in 2002-03. After meeting expected maturities and withdrawals, NS&I is expected to make a negative net contribution to Government financing of £1.5 billion.

Cost of financing

7. The average cost of NS&I products should lie within a reasonable range of the cost of equivalent gilts or other short-term comparators.

8. NS&I or HM Treasury can initiate a review of product terms at any time. NS&I will carry out each review. Any proposed changes will take account of the cost of NS&I financing, the achievement of this remit and the need for NS&I to retain the capability and market presence to contribute to government financing over the medium-term.

Review of remit

9. HM Treasury or NS&I may initiate a review of this remit in the course 2002-03 in the light of any relevant factors.

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