COMMENTARY

The first quarter of 1963 was a period of bitter weather, flagging output, and high unemployment; and it saw the breakdown of the Brussels negotiations and sharp, if short-lived, attacks upon sterling. The succeeding quarters of 1963 have been in strong contrast : the economy has expanded, unemployment has fallen, and sterling has been in good demand. For interest rates and the supply of credit, the year does not fall into such divisions. Medium and long-term yields rose in the first quarter, fell back rather more in the second, and then did not change much until the end of October, when they rose again; yields at the end of November were slightly higher than at the beginning of January. Short-term money rates have remained broadly stable during the whole of 1963; Bank Rate in particular has stayed at 4% since the 3rd January, when it was reduced from $4\frac{1}{2}$%. The supply of bank credit has increased almost throughout the year, and there have been some relaxations in the minimum liquidity ratios applying to the London clearing banks.

This Commentary relates largely to developments since the middle of the year.

Domestic economy

The last three months have brought confirmation that economic activity has been rising strongly. The index of industrial production in the third quarter was—after seasonal adjustment—3% higher than in the second quarter, and 4% above the peak reached in the autumn of 1962. Rising output has been accompanied by a falling trend in unemployment : although the total number out of work rose on balance by 25,000 between July and November, when it stood at 474,000, the increase was less than might have been expected on seasonal grounds.

The largest single force behind the renewed expansion has probably been consumers' expenditure. Earlier this year the index of the volume of retail sales had suggested only a rather sluggish growth of personal spending. The index, however, although still accounting for about half of all consumers' expenditure, does not always provide a good guide to short-term movements in the total. Thus it is estimated that between the first and second quarters of this year, when the volume of retail sales rose (after seasonal adjustment) by only about $\frac{1}{2}$%, the volume of consumers' expenditure in total rose by $2\frac{1}{2}$%. The lively demand for cars was one reason for this; in addition there has been a steadily rising trend of expenditure on services such as travel, entertainment and catering. Since June, the volume of retail sales has grown more quickly : in the third quarter it was 3% higher than in the second. This increase was widely spread, extending, for example, to clothing as well as to durable goods. The unusually sharp increase owed something to the income tax concessions which became effective in July. With credit plentiful, expenditure on cars also continued buoyant in the third quarter and by the end of September more new cars had been registered than in the whole of 1962. With rising output and incomes, consumers' expenditure may be expected to go on increasing, even if less sharply than in the third quarter.

The recent growth of production has also owed something to the encouraging trend of exports. In the three months July to September the value of exports and re-exports (after seasonal adjustment) was 3% higher than in the previous three months. This was partly due to higher prices : in terms of volume the increase was about 1% compared with the previous quarter—and about 5% compared with a year before. World markets appear favourable to a satisfactory rate of growth continuing into next year.

As late as November, Exchequer expenditure appeared to be increasing less rapidly than had been forecast in the Budget; there is, however, little doubt that public expenditure will continue on a rising trend. Capital expenditure by the public sector may be expected to rise much faster than its current expenditure on goods and services. A government White Paper (Cmnd. 2177) published in November estimated the total of approved capital expenditure in 1963/64 at £2,335 million, an increase of 20%

in real terms over the total for 1962/63 (which was reduced by the hard weather at the end of that financial year). A further increase of 7% is estimated for 1964/65. If practical difficulties and lack of capacity in the construction industry slow down the execution of these plans, some expenditure planned for 1963/64 may be carried over into 1964/65; in any event public investment seems certain to remain a strong expansionary influence throughout next year.

Investment will probably grow less rapidly in the private sector than in the public sector. In private manufacturing industry, for example, several large projects in the steel and motor industries have now been completed and nothing of comparable size is in sight to take their place. Evidence continues to accumulate, however, that an upturn in manufacturing investment is in prospect. For example, an inquiry by the Federation of British Industries in October showed that—for the first time for over two years—those expecting to authorise more expenditure on plant and machinery in the next twelve months slightly exceeded those expecting to authorise less. The machine tool industry might be expected to benefit from any revival in manufacturing investment, but so far the rate of new home orders remains well below the current rate of deliveries. Private investment in the distributive, transport, and service industries is likely to rise moderately during 1964, thanks in part to the recent welcome recovery in orders for ships. Private house building has been rising this year; the high rate at which new houses have been started and the strong demand for mortgages suggest continuing growth.

Areas of relatively high unemployment may in time be helped appreciably by a revival of private investment, judging from the large number of applications for government financial assistance for projects in the development districts. Two such areas, Central Scotland and the North-East of England, will benefit particularly from public investment during the next few years.

Stocks have been rising only slowly since the middle of 1961; and the available statistical evidence (mainly for the first half-year) has given no sign of any acceleration. If, however, output continues to rise strongly and stocks begin to look rather low in relation to the current level of output, there is a strong presumption that manufacturers will seek to restore a more familiar relationship; stocks would then begin to rise much faster. The timing of this development is hard to foresee, because it depends on expectations about the future trend of output and prices. However, recent signs of larger imports of industrial materials, increases in the prices of some commodities, and a few general reports suggest that stocks of some materials and perhaps of some components have already begun to rise a little more rapidly.

Home costs and prices have in general risen moderately during the past year. In October, for example, prices of materials and fuel used in manufacturing (except the food industry, whose prices were affected by the recent sharp rise in the price of sugar) were $2\frac{1}{2}\%$ higher than a year earlier and retail prices had risen over the same period by a little over 2%.

Outlook

The economy seems to be developing broadly in the way that had been hoped when measures to expand demand began to be taken in the middle of 1962. Although unemployment must be expected to rise further during the winter, thereafter not only will seasonal factors be favourable, but all the main elements of demand should be rising, and total output is likely to be expanding fast enough to bring about a further reduction in the underlying level.

Total output is probably already growing at more than the 4% per annum rate now accepted as an objective, and this may go on for a time. Because there has been a considerable amount of unused capacity in the economy, growth of output at this rate is likely to lead to an unusually rapid rise in productivity, and it would be rash to expect such a rapid pace to be maintained. Looking beyond the current phase of re-expansion, therefore, policy will need to ensure that total demand increases at a rate compatible with the growth of the labour force and of productivity in the longer run.

Balance of payments

The U.K. current balance usually deteriorates substantially in the third quarter. This year it may have worsened a little more than usual; there was a good rise in exports (as measured by the Trade Accounts and seasonally adjusted) but imports rose rather more.

The rise of 3% in the value of exports in the third quarter was rather faster than that in the second quarter and was spread over a wide range of markets. Shipments to Western Europe continued to grow rapidly. The renewed rise in exports to the United States which started in June was fully maintained; and the long decline in shipments to Canada seems to have halted. Exports to overseas sterling area countries, notably to South Africa, rose sensibly. Analysis by commodity suggests that the continuing growth of exports owed something to the success of exporters in adapting to the changing pattern of demand in Europe: sales of textiles and other consumer goods, including cars, have been growing, but sales of machinery have not. This analysis also shows that in the third quarter sales of manufactured foods, especially sugar, were exceptionally large, and deliveries of ships and aircraft, which tend to be erratic, rose sharply. This suggests that total exports may grow less rapidly. On the other hand, new orders from overseas for engineering goods have been rising faster than deliveries and the prospects look promising. In the European Economic Community measures taken to combat price inflation, especially if they have to be reinforced, may restrain demand and so slow down the growth of sales there. But in general demand abroad is likely to grow steadily and perhaps rather more quickly than seemed likely at the end of the summer. The United Kingdom's competitive position will, as always, largely determine the extent to which the opportunity, thus presented, is seized.

All the main classes of goods, except fuels, contributed to a rise of $4\frac{1}{4}\%$ in the value of imports in the third quarter. Food imports rose less rapidly than they had in the second quarter, partly because the world price of sugar fell. But arrivals of industrial materials accelerated sharply. Further growth of output and rising stocks can be expected to lead to a continuing rise in imports in the months ahead, perhaps steeper for a time than the likely rise in exports.

This prospect need not be disturbing if the rise in imports is associated with a temporary spurt in stockbuilding, and if a steady increase in exports is taking place at the same time. Furthermore, the current balance is now being sustained by improved net invisible earnings. After falling for three years, they recovered markedly in 1962, chiefly because overseas earnings of oil and other companies rose. The larger surplus continued in the first half of 1963 and seems likely to be maintained. The deficit on shipping transactions seems, on balance, unlikely to change much. Freight payments will be swollen by the expected growth of imports and probably by a rise in tramp rates stemming from the recent heavy purchases of grain by countries in the Soviet bloc. On the other hand, the costly tanker charters contracted at the time of the Suez crisis are now running off; and freight receipts should benefit from both higher rates and a rising volume of world trade. Net receipts from services other than shipping will also probably remain fairly stable. Government expenditure overseas may continue to rise, but this is likely to be offset by a further, though modest, increase in net investment income. Although domestic expansion may bring higher profits to the overseas parents of subsidiary companies in the United Kingdom, the total overseas earnings of U.K. companies are likely to rise more. Interest receipts on commercial trade credit and on loans by the U.K. Government are also growing.

Reserves; foreign exchange markets Sterling was generally firm during the three months August to October, and the reserves rose by £8 million, even though £10 million was paid to Western Germany in August in service of debt arising out of the liquidation of the European Payments Union. This increase, at a time of year when the United Kingdom's balance of payments on current account deteriorates seasonally, partly reflects the present state of the balance of payments of overseas sterling area countries; their net holdings of sterling rose by £45 million during the third quarter.

By and large there seem to have been no significant flows of short-term capital during the period August to October. Although some banking funds, mainly overseas-owned, were switched out of sterling into U.S. dollars and other foreign currencies, sterling holdings by non-official holders in countries outside the sterling area seem to have been rising. This rise probably represents a rebuilding of working balances rather than a movement of funds on interest rate grounds. The gross, or uncovered, margin between U.K. and U.S. Treasury Bills narrowed during the period. By October the difference was smaller than at any time since Bank Rate was raised from 4% to 5% in January 1960. For covered investment, there was a margin in favour of U.K., rather than U.S., Treasury Bills in August and September, but it rarely exceeded $\frac{1}{4}$% per annum. In the first half of October the narrowing of the gross margin between U.S. and U.K. Bill rates and a rise in the discount on three-months' forward sterling led to the emergence of a covered margin in favour of New York, which persisted, with only occasional interruptions, into November, but was never large.

The switching of some banking funds into foreign currency probably reflects the fact that for almost the whole of August, September and October the margin between dollar deposits in London and covered investment in comparable sterling assets was unfavourable to sterling. For much of the time the rate for three-month dollar deposits was rising, partly because of an increase in U.S. short-term interest rates and partly because demand for deposits (at first particularly by Italian banks) was strong. Meanwhile rates offered by local authorities for three-months' deposits tended to fall. Thus some holders may not have renewed their short-term sterling assets on maturity. Even so, loans by the overseas banks to local authorities were higher at the end of September than at the end of June.

The rate for sterling against the U.S. dollar was steady during the period, except in the second half of August and early in September when the switching of banking funds into U.S. dollars and other foreign currencies caused a fall in the rate from around \$2·80$\frac{1}{16}$ to around \$2·79$\frac{3}{4}$. There was an associated improvement in the rate for three-months' forward sterling: the discount, which was equivalent to nearly $\frac{3}{8}$% per annum early in August, disappeared at one stage early in September. Later in September a discount reappeared, but it remained below $\frac{1}{4}$%. That it did not return to its previous level probably reflects the narrowing of the gap between U.K. and U.S. Bill rates.

Gold market Private demand for gold has remained active. But supplies coming on to the market were augmented in September and October by heavy sales by the U.S.S.R. to finance large purchases of grain. As a result the price fell from \$35·11$\frac{1}{4}$ at the end of August to \$35·07$\frac{1}{2}$ early in November, having at one point been below \$35·06$\frac{1}{2}$; and a substantial quantity of gold accrued to Western monetary authorities. It is thought that the volume of sales by the U.S.S.R. has been considerably higher this year than in any year since the war.

International Monetary Fund The generally stable conditions which have prevailed for some time in the foreign exchange and gold markets are one result of the closer international co-operation which has been established during the past three years. Another aim of international co-operation is to solve problems of international payments with as little disturbance as possible to the rate of economic growth in the industrial countries. At the annual meeting of the International Monetary Fund in October, it was broadly agreed that the international monetary system did not need change at that time, but it was decided to promote an immediate study of the problems which might arise in the future. This study, which is not to cover two main elements of existing arrangements—the monetary price of gold and fixed exchange parities for the major currencies—will be conducted by both the Fund and the ten countries which are parties to the agreement concluded in December 1961 to augment the Fund's resources.

Short-term money rates The discount market's rate for Treasury Bills was virtually the same at the last tender in October as at the last tender in July. But within the period some sharp fluctuations occurred in response to the varying strength of diverse factors affecting the money market.

Making for lower rates was the strong competition that the discount houses had to meet from other tenderers: applications from these tenderers, which were already substantial in June and July, rose further in August and September, perhaps because industrial and commercial companies were becoming increasingly liquid. Making for unchanged or higher rates was, first, an increase in the supply of Treasury Bills: the total offered at the weekly tenders during the three months was on average some £25 million greater than in the three previous months of May to July, when the Exchequer deficit was smaller. Secondly, U.S. short-term rates were rising. Thirdly, the average cost of the market's money, though still some way below the Treasury Bill rate, was increasing. Following a long period of tight money, the clearing banks were lending a larger proportion of their funds at $3\frac{1}{2}\%$ or over; $3\frac{3}{8}\%$ became an unusual rate for overnight money, after being the most common one in the early months of the year. There was also apparently some rise in the amount lent to the discount houses at relatively high rates by other institutions, including overseas banks, which were then finding difficulty in placing short-term loans with local authorities at attractive rates. Further, the discount houses were on occasions obliged to borrow substantial amounts from the Bank of England. Such borrowing was particularly heavy during the second and third weeks of October, after the market had lowered its rate sharply and when the yield on U.K. Treasury Bills, taking the cost of forward cover into account, had fallen below the yield on U.S. Treasury Bills.

The market's buying rate for three months' prime bank bills was much closer to its Treasury Bill rate at the end of July than usually.[a] This relationship discouraged the clearing banks from buying prime bank bills, and early in August the rate for them was reduced less than the Treasury Bill rate. The more usual margin between the two rates obtained almost throughout the succeeding three months.

For many years the discount houses, when borrowing at the Bank, have found it convenient to lodge short-dated government stocks or Treasury Bills as security for an advance. Nevertheless commercial bills (including trade bills) remain eligible as security provided they are of a quality acceptable to the Bank. Early in September, at the Bank's request, the discount houses made a slight change in their practice; and they now, on occasion, lodge a small quantity of fine trade bills. For the Bank, this was the most convenient way of seeing some of the trade bills currently circulating in the market, and of indicating their views about the quality of the bills. The amount of trade paper circulating in the market, some of it at very fine rates, is known to have increased in recent years, and the time had come for the Bank to take a closer interest. The Bank's practice of buying prime bank bills for their own portfolio continues.

Local authorities do not appear to have been particularly keen borrowers of short-term funds during the period August to October, even though their capital expenditure was no doubt well maintained and although during the first two months their income from rates is likely to have been low. They were probably borrowing on longer term; stock issues provided them with appreciable amounts during the three months and it is possible that a little more than previously was borrowed on mortgage. It may be that some authorities were still anticipating the new arrangements for local authority finance set out in a White Paper (Cmnd. 2162) in October, whereby the amount of short-term borrowing is to be limited. At all events the rates for temporary money declined for most of the period. The rate for two-day money, for example, fell from $3\frac{7}{8}\%$ early in August to $3\frac{3}{4}\%$ in mid-October, and for three months' money from $4\frac{1}{4}\%$ to $4\frac{1}{8}\%$. As already mentioned, the latter rate, after allowing for the cost of forward cover, was generally less attractive than the rate offered on U.S. dollar deposits, so that it is unlikely that much foreign money reached the local authorities in this way at this time.

The published rates offered by hire purchase finance houses for three months' deposits also tended to be lower during the period August to October than previously, even though the demand for hire purchase credit remained very keen. Demand for cars was strong, and the hire purchase houses appear to have taken a larger share in the finance of sales than last year; certainly about 26% of all new cars registered in the first ten months of 1963 were bought on hire purchase, compared with about 22% a year earlier. It seems, however, that industrial and commercial companies were offering deposits to the finance houses on a substantial scale; some of these deposits may be placed directly with the houses at rates which differ from those quoted in the market.

The gilt-edged market

The fall in yields on long-dated and undated stocks, which had been a strong feature of the gilt-edged market for most of the previous eighteen

[a] September *Bulletin*, page 173.

months, came to a halt after July, and during August to October such yields were broadly unchanged. Some buyers turned instead to debenture issues, which were coming forward in quantity, or to government stocks in the five to ten-year range. Yields on the latter fell by about $\frac{3}{16}$% over the three months.

The clearing banks, which had bought few gilt-edged stocks since October 1962, added to their portfolios at this time; their holdings rose by £40 million between the middle of August and the middle of October. Among other buyers of stocks were the Scottish banks and the discount houses.

£500 million of a new short-dated stock, 4% Exchequer Loan 1968, was issued in the second half of September. The authorities wished to continue their customary purchases of the shortest-dated stocks, currently 4½% Conversion Stock 1964 and 2½% Exchequer Stock 1963/64, both of which reach the end of their lives in May 1964. Official holdings of short-dated stocks needed to be increased if the authorities were to be able to offer such stocks to those willing to switch out of the May maturities. Such an increase would also strengthen the ability of the authorities to resist any undue weakening in short-term yields. The new stock in fact proved popular, and a fair amount of switching into it took place as soon as it was issued. It is free of tax to non-residents and is available in bearer form.

Elsewhere in the market, official sales of 5% Exchequer Loan 1976/78 continued; but there was little official activity in longer-dated issues. On balance, the authorities were modest sellers during most weeks of the three months August to October.

At the end of October the tone of the gilt-edged market changed, and long and medium yields rose; at the end of November they were slightly higher than at the beginning of the year.

Other medium and long-term yields

Rates for local authority mortgages remained steady during August, September and October, and it is likely that they proved attractive to lenders because yields on other forms of local authority debt and on medium-term gilt-edged stocks were tending to decline.

Debenture yields were also steady around the levels to which they had fallen earlier, the average yield for stocks with about twenty years to maturity remaining around 6%.

Equity market

The F.T.-Actuaries index of industrial share prices rose by about 9% between the end of July and the end of October. This was the steepest rise for equities in any three months since the spring of 1961; it was largely due to a steady flow of encouraging reports about the progress of the economy, and to indications that profits were continuing to grow. Meanwhile the gilt-edged market was not providing a strong counter-attraction, and the volume of new equity issues was not great. This was partly because companies' capital investment remained modest, so that with rising profits they seem to have become more liquid, and partly because fixed interest issues were still proving popular.

Foreign bond issues

In the middle of October the Chancellor of the Exchequer announced that sterling loans which promoted exports would be treated as sympathetically as possible. Present policy on sterling loans generally was summarised in a notice which the Bank of England circulated at the same time to the institutions which would be concerned with arranging issues. Applications from the following types of borrower will be considered:

(i) central governments in the overseas sterling area or the European Free Trade Association, and borrowers whose issues are guaranteed by these governments;

(ii) public bodies in less-developed Commonwealth countries;

(iii) private borrowers in overseas sterling countries;

(iv) any borrowers where the proceeds of the loan are to be spent on additional purchases of goods and services in the United Kingdom.

Two U.S. dollar loans, for the Belgian Government and for an Italian corporation, were arranged in London during the summer.[a] At the end of October a London issuing house

[a] September *Bulletin*, page 174.

agreed to join with three continental institutions in subscribing to and reselling an issue by the City of Copenhagen of bonds to the value of sixty million Swiss francs.

Scottish banks

Although official restrictions upon credit were relaxed in May 1962, and removed a few months later, advances by the Scottish banks have not risen very steeply during the last eighteen months. There is no clear, let alone close, correlation between movements in bank advances and in industrial output, because the state of industry is only one of many factors affecting bank credit. It seems, however, that the modest expansion of bank lending in Scotland during this period may have been associated in some measure with a comparatively slow rise in industrial output there, and there are now signs that both advances and output in Scotland have begun to rise more briskly than hitherto.

London clearing banks

Unlike the advances of the Scottish banks, the advances of the clearing banks have risen strongly during the past eighteen months. The banks were at first liquid enough to lend very freely, while demand for bank credit, particularly from private individuals and financial borrowers such as property companies, was strong. Thus total advances rose by some £470 million, or about 14%, between May 1962 and March 1963, and the ratio of advances to deposits increased from about 45% to 50%. By this time some banks had already sold investments and they would have had either to sell more or to restrict new credit if they were to keep their liquidity ratios above the customary 30%. Tighter credit and higher interest rates would have been inappropriate in the circumstances, and the Bank of England therefore informed the clearing banks that no objection would be raised at that time to a liquidity ratio of between 29% and 30%.

Advances continued to rise from March to August, although the seasonal movement is slightly downward during these months,[a] and the combined liquidity ratio was little more than 31% at mid-August. It then seemed possible that the banks might be unable to keep their ratios above 30% during the early months of 1964, when the Exchequer would be in surplus, unless they made credit rather tighter than was conducive to a general expansion of the economy. In September, the Bank informed the clearing banks that they should seek to achieve liquidity ratios of not less than 28% during the period between then and April 1964.[b] The new figure not only gives the banks room to increase their advances, but is thought to accord better with contemporary ideas as to the proportion of liquid assets which banking prudence, as distinct from official monetary policy, requires.

Between mid-August and mid-November the advances of the clearing banks fell a little, but by much less than might have been expected on seasonal grounds. Thus the underlying trend in advances still appears to be upward, if less strongly than earlier in the year.

Some further rise in advances during the early months of 1964 may be expected, because a rise is customary while the Exchequer is in surplus. But the rise may be smaller than usual. In the first place, government expenditure is likely to increase, and some recipients of this extra money may repay debt to the banks, or refrain from borrowing. Secondly, company profits have grown, without, so far, a corresponding increase in spending on stocks and fixed capital, so that companies have become more liquid; at the same time the tax due to be paid during the first quarter of 1964 relates to earlier periods of generally lower profits.

(a) This is shown in the table on page 294.

(b) This was announced by the Governor in his speech at the Mansion House on the 16th October. The text of the speech is printed on page 295.

QUARTERLY ANALYSIS OF FINANCIAL STATISTICS

1st July to 30th September 1963

Changes in form

This analysis differs in two particular respects from its predecessors. First, it is for a calendar quarter, instead of for a quarter ending on the banks' make-up day. Banking statistics have now been obtained for calendar quarters,[a] and because these are the periods to which the great mass of other statistical information relates—for example on the balance of payments and the national income—it is better to relate the analysis to calendar quarters. For instance it will now be possible to use the figures of "United Kingdom External Liabilities and Claims in Sterling" to help to distinguish between private domestic purchases and private overseas purchases of Treasury Bills and British government stocks; hitherto only composite totals for "other home and overseas non-official holdings" of Treasury Bills and stocks respectively have been available.

The second change, which also flows from the new banking statistics, is that the definition of the banking sector is extended. It now covers not only the Bank of England, Banking Department, the London clearing banks and the Scottish banks, but also the Northern Ireland banks, a number of domestic banks listed in a footnote on page 288, the accepting houses, and the overseas banks in London; these last four groups had formerly to be regarded as part of the private sector. The discount houses too are now treated as part of the banking sector. Hitherto, because the discount houses drew their funds partly from the banking sector and partly from the private sector (as these sectors then were), a rather awkward convention was adopted, whereby the houses' holdings of government debt were treated as the indirect holdings of the sector supplying the funds. The discount houses draw their funds predominantly from the new banking sector and can best be regarded as part of it.

While these changes improve the theoretical consistency of the analysis, important problems still remain. First, some allowance has to be made for seasonal factors if the trends in the various sectors' surpluses and deficits are to be established. This is difficult at the best of times, but even more so when the statistics go back only a short way, as the new statistics do. Secondly, the private sector cannot yet be divided fully among persons, industrial and commercial companies, and financial institutions (other than banks). One reason is that there is little information about the take-up of public sector debt by persons and companies respectively; another, that the figures for some of the financial institutions are not available soon enough to be used in this analysis.

Analysis

The financial surplus or deficit of a sector[b] can, broadly speaking, be estimated in two ways. The first is to use the national income statistics to calculate the sector's saving, and to deduct from this the sector's investment in physical assets; the difference will be the sector's financial surplus or deficit. The second way is to use financial statistics to estimate the total net change in a sector's financial claims on, and liabilities to, other sectors; this change will represent its financial surplus or deficit. This analysis uses the second method for the most part, because little national income information for the third quarter is yet available.

The financial deficit of the public sector was almost certainly greater in the third quarter of 1963 than in the second. Some of this increase may have been seasonal, but it seems safe to assume that there was some underlying growth

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(a) The new statistics are described in an article on page 285.

(b) The four sectors examined here are:

(i) The private sector: that is persons, industrial and commercial companies, and financial institutions (other than banks).

(ii) The banking sector (as defined in the text).

(iii) The public sector, that is the Central Government, local authorities and public corporations.

(iv) Overseas.

The article "Sector Financing 1960-62" in the September 1963 issue of this *Bulletin* examined six sectors, taking the three main components of the private sector separately.

in the deficit between these two quarters; there had probably been little or no underlying growth between the first and second quarters of 1963. As the public sector's deficit increased between the second and third quarters, so did the surplus of the private sector, while the overseas sector, which had a financial deficit in the second quarter, probably moved into surplus in the third.

The analysis now examines each of the sectors. Many of the conclusions drawn must be tentative, if only because much of the statistical information for the third quarter has yet to come forward. Among the more reliable judgments are those relating to the finance of the public sector; perhaps the most striking feature in this quarter was the extent to which the public sector's deficit was financed through the banks rather than directly by the private sector or overseas sector.

Overseas sector Judging from the trade results, and from previous experience of the invisible account in a third quarter, it seems likely that the United Kingdom's current account was in deficit in the third quarter of 1963, or, in other words, that the overseas sector was in financial surplus. In the second quarter the overseas sector was in deficit. The improvement between the second and third quarters in the overseas sector's position was probably only a little greater than might have been expected on seasonal grounds, whereas between the first and second quarters there had been a distinctly greater improvement than might have been expected on seasonal grounds. Thus there would appear to have been a slowing down in the rate at which the overseas sector's financial position had been improving.

The overseas sector, as well as being in surplus on current account, probably received funds on balance from the United Kingdom as a result of private investment and U.K. government loans. The balance of monetary movements was certainly more favourable to the overseas sector during the third quarter than the likely size of the United Kingdom's current account deficit alone would imply. The sector's identified sterling claims increased by £106 million,[a] and this increase was only slightly offset by an increase of £16 million in its sterling liabilities,[b] a rise of £8 million in its gold and convertible currency liabilities to the public sector[c] and some decline in its net claims in foreign currencies on the banking sector.

Although the overseas sector was in financial surplus it was a small net borrower from the public sector. It did indeed increase its holdings of government marketable debt a little (see the table on page 263) but this increase was more than matched by borrowing from the U.K. Government (for example, by way of E.C.G.D. loans) and by the rise in the U.K. official reserves. The overseas sector also appears to have borrowed a small amount from the private sector during the quarter.

It follows that the overseas sector's net claims on the banking sector rose by more than its surplus. The increase in these claims was about £100 million. Current and deposit accounts of overseas residents with the banking sector rose by £167 million,[d] and, because transit items affect overseas residents only slightly, net deposits rose by about the same amount. On the other hand, borrowing by the overseas sector by way of advances rose by £63 million. Both the rise in current and deposit accounts and the rise in advances were partly due to transactions in foreign currencies.

Private sector During the third quarter, in contrast with the second, the private sector used its surplus more to increase its net claims on the banking sector than to add to its holdings of public sector debt. Its net claims on the banking sector are estimated to have increased by about £220 million, compared with some £80 million in the second quarter, while its net claims on the public sector are estimated to have risen by about £180 million compared with £120 million.

The smaller increase in the private sector take-up of public sector debt (and the larger

(a) These are the United Kingdom's external liabilities in sterling. See Table 22 of the Statistical Annex.

(b) These are the United Kingdom's external claims in sterling. See Table 22.

(c) These are the United Kingdom's official reserves. See Table 20.

(d) See the table on pages 286 and 287.

increase in net claims on the banking sector) was however partly the result of the vagaries of the calendar: the third quarter ended on a Monday, and the first and second quarters on Sundays. The private sector—which includes shopkeepers and companies as well as individuals—holds many fewer bank notes[a] on a Monday evening than on a Friday, Saturday or Sunday, and the banking sector holds many more, because the week-end is the peak shopping period and Monday a day when notes flow back across bank counters. Thus private sector holdings of notes and coin, which rose by £37 million in the second quarter, fell by £56 million in the third. Had it not been for the accident of timing, it seems likely that they would have risen then too.

The private sector's holdings of Tax Reserve Certificates rose by £31 million in the third quarter, a smaller increase than in the second. Its take-up of other forms of public sector debt was larger than in the second quarter. Although usually lower in a third quarter, net subscriptions to National Savings totalled £18 million, against £14 million in the second quarter. The improvement was mainly confined to deposits with the Post Office Savings Bank and the Ordinary Departments of the Trustee Savings Banks; net subscriptions to other forms of National Savings were little changed. The rise in the deposits with the Savings Banks may have been associated with rebates of income tax; the Budget reductions in the lower rates benefited taxpayers in July.

Private sector holdings of marketable government debt, which had fallen by £103 million in the second quarter, rose by £27 million in the third. This was wholly due to a marked change in its Treasury Bill portfolio: holdings had fallen by £109 million in the second quarter, but rose by £29 million in the third. Lastly, the sector's take-up of local authority debt probably increased more than seasonally; for a long time the underlying trend of local authority borrowing from the private sector has been upward, and there have been no signs of any change.

As has been noted, net claims of the private sector on the banking sector are estimated to have increased by about £220 million during the third quarter. Current and deposit accounts of the private sector rose by £282 million. They have to be adjusted for transit items to arrive at net deposits (and so measure the true liabilities of the banks to the other sectors). Assuming that all transit items relate to the private sector, then its net deposits rose by about £130 million. Meanwhile, borrowing by the private sector in the form of advances fell by £97 million; other borrowing (net) by way of call money or commercial bills rose slightly.

Even allowing for the overstatement of the rise which resulted from the calendar, and for seasonal factors, the increase of about £220 million in the private sector's net claims on the banking sector probably represented a more rapid growth than in the second quarter.

This analysis now turns to the component groups of the private sector: first, persons; then, industrial and commercial companies; and finally, the financial institutions.

Persons[b] Personal incomes after tax almost certainly increased more rapidly in the third quarter than in the second, if only because of the income tax rebates. Personal consumption, however, also rose briskly in the third quarter, and personal investment in house building continued to increase. On balance, it seems unlikely that the financial surplus of persons increased much between the two quarters.

Some support for this conclusion can be found in the statistics of personal lending and borrowing. Net claims by persons on the banking system probably rose by about £90 million during the third quarter,[c] compared with about £65 million in the second. On the other hand, net lending by persons to the public sector was probably rather lower than in the second quarter. Both these comparisons are affected by the calendar, for the reason already given.

(a) Bank of England notes are regarded as a claim on the public sector.

(b) This term includes not only individuals, but also partnerships, unincorporated businesses, etc.

(c) Current and deposit accounts of persons rose by £135 million (see column headed "other" in table on pages 286 and 287). If the transit items are divided between persons and companies in proportion to the change in their current and deposit accounts. then net deposits of persons rose by about £65 million. Meanwhile bank borrowing by persons fell by £25 million.

The financial transactions of persons with the financial institutions are discussed in detail later. The outstanding total of net personal claims on these institutions probably rose about as much in the third quarter as in the second. Persons not only increased their lending to building societies, but also added to their debt to building societies and to hire purchase finance houses at faster rates than previously. Personal lending to unit trusts (that is, by acquisition of new units) and to the Special Investment Departments of the Trustee Savings Banks rose at about the same rate in the third quarter as in the second.

Industrial and commercial companies If the financial surplus of the whole private sector increased in the third quarter, while that of persons was little changed, then the financial surplus of industrial and commercial companies probably increased, as would be normal at a time of rising output, and of steady, or even falling, investment in stocks and fixed assets.

Net claims by these companies on the banking sector certainly increased sharply during the quarter, whereas they had changed little during the second quarter. Current and deposit accounts rose by £153 million, and net deposits by perhaps £75 million, while advances fell by £65 million. There was on the other hand probably a small rise in borrowing by companies from banks by means of bills.

Companies probably also added to their holdings of public sector debt during the quarter. It is not possible to be sure, because separate figures for several groups of financial institutions are not yet available. But private sector holdings of Treasury Bills rose by £29 million, and some of this rise can probably be attributed to industrial and commercial companies. " Other " holdings of Tax Reserve Certificates—which are largely holdings of companies—also increased, as the new Table 4 of the Statistical Annex shows. This increase was, however, rather smaller than might have been expected on seasonal grounds.

Company calls on the capital market showed signs of rising during the quarter, though they were still distinctly smaller than in recent third quarters. With little change in the supply of new company securities and a strengthening demand (because the outlook for profits had improved and the counter-attraction of gilt-edged stocks weakened), equity prices rose during the quarter.

Financial institutions The financial institutions here comprise insurance companies, hire purchase finance companies, building societies, the Special Investment Departments of Trustee Savings Banks, superannuation funds, investment trusts, unit trusts, and certain special finance agencies such as the Agricultural Mortgage Corporation. Figures for several of these groups for the third quarter are not yet available and the discussion below is therefore incomplete.

Taking the group as a whole, the institutions' net position with the banking sector was unchanged in the third quarter, both deposits and advances being slightly smaller. A reliable estimate of their transactions with the public sector is not yet possible.

A little more is known about the institutions' net transactions with persons and industrial and commercial companies. Judging from the latest available figures for the various groups, the scale of the institutions' operations was probably greater in the third quarter than in the second; if so, then the institutions generally will have tended to channel more funds from persons to companies. On the other hand, the hire purchase finance houses will have channelled more funds from companies to persons,[a] while the building societies will have mostly transferred funds from one person to another.

The demand for hire purchase finance, particularly for cars, rose further in the third quarter, and outstanding debt to finance houses on hire purchase contracts increased by £18 million, or by more than might have been expected on seasonal grounds. To finance the greater business, the hire purchase houses borrowed from other parts of the private sector, notably from industrial and commercial companies on deposit.

The third quarter was exceptional for building societies, both receipts and advances being on an unprecedented scale. Liquidity ratios

[a] The finance houses borrow on deposit largely from companies, while most of their lending is to persons.

fell, but were high enough at the end of the quarter to leave room for a further increase in lending.

In the third quarter, the Special Investment Departments (which largely hold public sector debt) and the unit trusts (which largely hold private sector debt) continued to receive funds from persons on a substantial scale. Net deposits, including accrued interest, with the Departments rose by £33 million, and receipts by unit trusts amounted to £17 million.

Capital issues by the financial institutions were modest in the third quarter, as in the first half of the year.

Banking sector The new quarterly statistics for the banking sector are described in an article on page 285. The main changes in the sector's liabilities to and claims on other sectors during the two latest quarters may be summarised as follows:

£ millions

	1963 II	1963 III
Current and deposit accounts	+394	+488
Adjustment for transit items	+ 73	−153
Net deposits[a]	+467	+335
Public sector:		
Notes and coin	+ 28	+ 73
Treasury Bills	+204	+195
Government stocks ...	+ 18	+ 66
Advances to public sector	− 10	+ 56
Bank of England, Banking Department, net claims on Exchequer	+ 43	− 49
Private and overseas sectors:		
Advances: to private sector	+207	− 97
to overseas sector	+ 51	+ 63
Miscellaneous claims:[b]		
on private sector	+ 38	+ 5
on overseas sector	+ 5	+ 2

[a] These are defined in a footnote on page 286.

[b] Call money, commercial bills discounted and securities other than gilt-edged.

The figures cover transactions in both sterling and foreign currencies, and make no allowance for seasonal factors.

It will be seen that the banks' net deposit liabilities—which are largely to the private and overseas sectors—rose less in the third quarter than in the second. The banks' holdings of public sector debt—notes, Treasury Bills, stocks and advances, and the Banking Department's claims—rose by more than in the second quarter (£341 million compared with £283 million), but their advances to the private and overseas sectors taken together, which had risen strongly in the second quarter, fell slightly in the third. Thus the banks were increasingly acting as a channel for the private and overseas sectors to finance the public sector—though this may have been partly because of seasonal or chance factors.

Within the banking sector, the domestic banks increased their current and deposit accounts by much the same amount as in the second quarter. Meanwhile their advances to the private and overseas sectors fell by £126 million, after rising by £145 million. Judging from the seasonal pattern of the advances of the London clearing banks, there was, nevertheless, a continuing underlying increase in domestic advances during the third quarter. Among other assets of the domestic banks, government stocks rose by £48 million after falling by £32 million in the second quarter, while Treasury Bill holdings rose by £138 million compared with £240 million.

The Bank of England, Banking Department, reduced its lending to the Exchequer by £49 million, after increasing its lending by £43 million during the second quarter. These changes largely reflect changes in the net liabilities of the Department to the rest of the banking sector, particularly to the domestic banks and the discount houses.

Public sector The Exchequer Group had a cash deficit of £312 million in the quarter, made up as follows:

	£ millions
Budget: above the line	−197
below the line	−211
overall	−408
Internal extra-budgetary funds ...	+115
Exchange Equalisation Account ...	− 6
Other external items (net)	− 13
Cash deficit	−312

The overall budget deficit was £179 million greater than in the corresponding quarter of 1962, but there was a largely offsetting rise, of £114 million, in receipts of extra-budgetary funds (mainly departmental balances). Taking the two items together, the deficit was £65 million greater than a year earlier, whereas in the second quarter it was only £6 million greater. Expenditure rose in the third quarter, though less steeply than might have been expected from the Budget estimates for the whole year.

External items cost the Exchequer £19 million in the quarter, whereas a year earlier they contributed £23 million, so that the cash deficit amounted to £312 million compared with £205 million.

The finance of the Exchequer deficit is shown in the following table :

£ millions

	Banking sector	Private sector[a]	Overseas sector	Total financing
Net Exchequer indebtedness to Bank of England, Banking Department	− 49			− 49
Bank of England notes[b]	+ 73	−56		+ 17
Non-marketable debt:				
National Savings		+18		+ 18
Tax Reserve Certificates ...		+31		+ 31
Marketable debt:				
Stocks	+ 66	− 2	+36	+100
Treasury Bills ...	+195	+29	−29	+195
	+285	+20	+ 7	+312

[a] Including any holdings of local authorities and public corporations.
[b] Including coin.

Thus the Exchequer deficit in the third quarter was financed mainly in the form of marketable debt and very largely by the banking sector; even after allowing for the effect of the calendar on holdings of notes, the banking sector would still be the largest source of funds.

New figures analysing official stock transactions by maturity groups are given in Table 1 of the Statistical Annex. They show that in the third quarter net official sales of stocks with over fifteen years to maturity amounted to £115 million, and net purchases of shorter-dated stocks to £15 million.

The Exchequer deficit is only part of the total public sector deficit. Public corporations borrow comparatively little from outside the Exchequer; during the third quarter their gross borrowing from the banking sector rose by £35 million. Local authorities, on the other hand, obtain their finance predominantly from outside the public sector. Their debt will certainly have risen during the third quarter, but it is not at present known by how much. Their gross borrowing from the banking sector rose by £20 million. Most of local authority finance must however have come from the private sector by way of stock issues (receipts from which totalled £31 million), mortgages, or temporary money.

Prospects

The purpose of this analysis has been to throw light on monetary developments in the recent past. However, it can also be a useful guide to the ability of the financial system to deal smoothly with the demands of the future. Changes in the flow of funds reflect changes in the economy and official policy; they mostly follow rather than determine the course of the economy. But points of weakness in the financial mechanism can obstruct the desired development in the economy, and an analysis of this sort is particularly useful in identifying them.

On this occasion, the analysis accords closely with what would be expected at this stage of an economic recovery. Company liquidity has increased, and may rise further, at least for some months. Although personal consumption has risen, a relatively small part of the increase has been financed by borrowing. The public sector deficit has been growing and this rise is expected to continue : it is likely to add to the liquidity of both the private and the banking sectors. The financial mechanism is therefore unlikely, in the months immediately ahead, to be an obstacle to increased investment and consumption. Any temporary difficulties which the clearing banks might have encountered during the early part of next year, when the collection of government revenue is at its peak, will have been eased by the reduction of their minimum liquidity ratio to 28% over that period.