COMMENTARY

Introductory The Commentary this time is mainly concerned with events during the three months August to October, although where appropriate it also touches upon the more important developments since then. This introductory section outlines the economic situation as it appeared during those three months, and as it developed subsequently up to the increase in Bank Rate on the 23rd November and the unprecedentedly swift extension on the 25th November by central banks of large-scale support for sterling.

During August to October, the picture at home was of an economy continuing very active, though not uniformly at full stretch. Consumers' spending had not increased as fast as had seemed likely earlier in the year; but in the investment industries, demand, from both the public and the private sectors, was very strong and there was evidence of some overloading in both building and engineering. Although imports had largely levelled out after their rapid growth at the end of 1963 and early in 1964, exports were consistently disappointing, particularly in the field of engineering capital goods.

These were circumstances which raised conflicting issues for monetary policy. Personal saving was high and there was only a slow growth in consumption. Stockbuilding, though moderately high, appeared neither to be abnormal in relation to output nor to be growing. Work in progress was reported to be rising, partly because of the nature of production, partly because of delays. Government expenditure was running at a lower rate than had been estimated in the Budget in April. Private fixed investment was increasing over a wide range of industries, and it seemed desirable that this should continue in the longer-term interests of industrial efficiency and exports. Bank advances and deposits were both rising more than seasonally; but it seemed likely that an increasing proportion of the demand for advances was coming from industry, and that the rise in deposits owed much to persons reflecting, perhaps, both their saving and a desire for liquidity.

On the other hand, it was clear that the growth of incomes was still too rapid; there was a growing shortage of labour; and there was the evident need to direct greater effort towards exports. Also, there was always the possibility that a renewed rise in personal spending or in the rate of stockbuilding, if substantial and superimposed upon the strong increase in investment, could create more general difficulties.

Against this uncertain background, to which were added the further uncertainties arising inevitably from the prospect of a general election, most domestic interest rates tended of their own accord to rise a little, but in general the capital and money markets were fairly resilient. In the foreign exchange market, sterling eased further. This was mainly due to the continuing deficit in the U.K. balance of payments, but there were occasional short periods—notably following the publication of the monthly trade figures—when the market was disturbed and a fair amount of support had to be given. Arrangements were made with a number of overseas central banks for short-term assistance in the shape of swaps and currency deposits, which were used to reinforce the reserves over the period of the election and until longer-term arrangements could be made for borrowing from the International Monetary Fund.

On the 26th October, in view of the balance of payments situation, the new Government announced a surcharge of 15% on most imports except foods and raw materials, as a strictly temporary measure, and the remission of certain indirect taxes to exporters to give them some additional incentive. These measures were put before the House of Commons on the 11th November, when the Chancellor presented a special Budget which also included, to take immediate effect, an increase of sixpence a gallon in the tax on road fuel. Taking account of all these measures, and of the fact that the budget deficit for 1964/65 seemed likely in any case to turn out some £250 million smaller than was allowed for last April, the Chancellor said that the budget deficit for the financial year

might now be of the order of £400 million to £450 million, well below the original estimate of £791 million.

Besides these immediate measures, the Chancellor proposed to increase the standard rate of income tax by sixpence next April and to raise National Insurance contributions and benefits in March. He also announced that he intended in the spring to extend the scope of the capital gains tax and to introduce a new corporation tax to take the place of the income and profits taxes now levied on the income of companies and other corporate bodies. The new tax should be less complicated than the present system of company taxation and he intended that it should encourage companies to plough back more of their profits instead of distributing them as dividends.

The collective consequences of these measures on domestic demand are not easy to predict. The import surcharge will increase government revenue and thus absorb purchasing power. At the same time, it may lead to some running down of stocks of imported goods and materials. As against this, as imports are reduced, demand on home resources must be increased. Looking only to the first few months of the scheme, and taking into account both the export incentives and the additional tax on road fuel, these measures are likely to have a moderately deflationary influence. No attempt is made here to look beyond the end of the current financial year; the prospects for 1965/66 will depend upon the shape of next April's Budget as a whole, and not merely upon the measures announced so far.

The Chancellor judged that, for the time being, these measures would be enough to prevent the total pressure of demand—already high—from rising further; and he hoped that the measures promised for the spring would help to create a climate of opinion more favourable to the acceptance of an agreed national policy for prices and incomes. Opinion abroad, however, was not reassured. Moreover, the gilt-edged and equity markets weakened sharply, mainly as a result of the uncertainty engendered by the proposals for a new capital gains tax and the corporation tax, and this weakness added to the difficulties in the foreign exchange market. Over the weekend following the Budget heavy sales of sterling were made from Europe and North America and a considerable amount of support had to be given. The position improved after the Prime Minister in his speech on Monday at the Guildhall had re-emphasised the Government's intention to defend sterling. Markets abroad, however, expected that Bank Rate would be raised the following Thursday. When no change was made, confidence weakened and there was renewed heavy selling in the market. Sales on the Friday were exceptionally large, and, as part of the Government's policy to maintain sterling at its present parity, Bank Rate was raised on Monday the 23rd November from 5% to 7%. Although an increase of this size was made mainly to help restore confidence in the foreign exchange market, it will also contribute towards the control of demand at home. A further step was taken early in December when the Governor of the Bank wrote, as described later in the Commentary, to certain banking and other financial organisations asking them to pay particular attention, when extending credit, to the need to foster exports and productive investment by manufacturing industry and to limit the facilities made available for less essential purposes.

On the 24th and 25th November, spot sales of sterling recommenced on a still larger scale and rates for forward sterling weakened also. In the face of this continued serious disturbance in markets a total of $3,000 million, separate from the short-term assistance referred to above, was made available with the aid of eleven central banks together with the Bank for International Settlements and the Export-Import Bank of the United States.

The temporary import surcharge is intended to diminish the external trade deficit in the interim until more lasting methods of adjustment begin to operate. If prolonged, such surcharges must be expected to have progressively more damaging effects, both abroad and at home. Real improvement in the balance of payments calls for steady strengthening both of invisible earnings and of visible trade. It is reasonable to expect that exports will begin to grow again as supply difficulties, which seem to have affected engineering capital goods, are overcome. Notwithstanding the poor figure for September shown by the official index of production, there is some reason to hope that industrial output will soon be seen to have risen since then from the plateau on which it

has remained, according to the index, since January.

Looking beyond this, however, improvement depends upon the success of longer-term measures to raise productivity (by breaking down restrictive practices and through technical advance and the redeployment of labour and other resources), to control costs, and to secure economies—all within a context of control over the pressure of demand. The Government's present endeavours to enlist widely-based support for these objectives are essential. But this is not a task which Government alone can complete, and success will not come without an unusual readiness on the part of all concerned to discard long-standing attitudes and traditions of thought.

Balance of payments

The identified deficit on current and long-term capital accounts amounted to £341 million in the first half of 1964. The balance of visible trade had moved from a surplus of £36 million in the same period a year earlier to a deficit of £215 million; net invisible earnings were rather lower at £90 million; and the net outflow of long-term capital had risen from £73 million to £216 million, mainly because of exceptional investment abroad by the oil companies and some net sales of U.K. securities early in the year by overseas holders. Details for the third quarter are not yet available, but the deficit must again have been large. Although there was very probably a smaller outflow on long-term capital account, the trade balance deteriorated sharply—largely, but not entirely, for seasonal reasons. Judging by the changes known in the financing items—the fall in the reserves, the assistance received from overseas central banks, and the net rise in external liabilities in sterling and foreign currencies—the deficit in the third quarter may well have been of the order of £250 million.

Both the increase in the long-term capital outflow this year and the reduction in net invisible earnings owe something to special factors. The chief cause for concern remains the state of the trade balance. The main deterioration took place around the turn of the year when imports of both industrial materials and finished manufactures increased sharply. The growth of imports has since slackened, but they were still at much the same high level in the third quarter, after allowing for seasonal factors, as was reached in the second. Imports of food rose between the two quarters; fuels were down; and there was very little change in the total of either industrial materials or finished manufactures. In the last category, imports of consumer goods fell back slightly after their rapid increase earlier in the year, but there was a further small rise in imports of capital goods.

Some expansion of imports had been foreseen as necessary to sustain and, it was hoped, to carry further last year's expansion in production. What has been disappointing is the failure of production to expand, or of exports to increase to anything like the degree to which world trading prospects earlier in the year suggested they should. Indeed, if allowance is made for seasonal movements, total exports as recorded in the Trade Accounts actually fell slightly in both the second and the third quarters. Within the total, the outstanding failure this year has been in exports of machinery and transport equipment other than road vehicles, which together account for about one-third of all U.K. exports. A fall in this group of exports has offset the substantial increases recorded by most other manufactures—notably chemicals, metals and textiles. Indeed, exports of finished and semi-processed manufactures other than machinery and transport equipment were in total 10% greater in the first nine months of this year than in the same period last year. Why exports of capital equipment have done badly is not clear. The engineering industry's order books for exports have been growing since early last year, and it may be that there is a sizeable amount of work in progress which will eventually be completed and exported. But it may also be significant that, within manufacturing industry, it is particularly among engineering firms making capital goods that there is evidence that demand has outstripped supply.

It was against this background of very heavy deficit in the balance of payments, in particular of high imports and faltering exports, that the Government issued their Statement on the 26th October on the economic situation. In this, it was said that the deficit on current and long-term capital account in 1964 as a whole was most unlikely to be below £700 million and might well reach £800 million. Although an

appreciable improvement was expected in 1965, the prospect was still for an unacceptable deficit if there were no change in policy. The Government therefore decided to take direct action on the balance of payments through the imposition of a 15% surcharge on most imports, irrespective of origin, other than foodstuffs, fuel, basic raw materials and non-ferrous metals, and unmanufactured tobacco. The surcharge is a strictly temporary measure which the Government have undertaken to reduce and abolish as soon as possible. It arises from the urgent need to bring external payments into a better balance, without waiting for longer-term remedies to become fully effective. If prolonged, it could only harm the domestic economy (quite apart from its effects on trade and activity abroad) by increasing protection and so hampering the improvement in industrial efficiency which is, basically, the country's greatest need.

The Statement also included a proposal, as a permanent measure, to remit to exporters certain indirect taxes entering into their costs of production; this rebate was expected to average about 1½% of the value of their exports. Other ways of encouraging exports are to be examined, including the possibility of organising selling combines overseas for the benefit of small firms. A review of government expenditure is being undertaken with the intention, among other objectives, of reducing the strain on the balance of payments.

Special assistance Sterling, which had weakened since the end of May, eased further during August to October. The root cause was the continuing deficit in the U.K. balance of payments. At the same time, mainly for seasonal reasons, sterling was less well insulated from the impact of this deficit by the payments position of the overseas sterling area. In addition, the market was disturbed by the succession of poor trade figures and by the uncertainties associated with the general election. This precipitated heavy selling on isolated occasions in September and October. There were further, even heavier sales of sterling soon after the November Budget and again, after a brief interval, both before and after the increase in Bank Rate.

In these circumstances, short-term facilities were obtained from overseas central banks to reinforce the reserves and strengthen confidence. A $500 million swap arrangement with the Federal Reserve Bank of New York was already in existence,[a] and a small drawing of $15 million was made at the end of August. Further use was made of this swap arrangement in September, when facilities totalling a further $500 million were also arranged with the central banks of Belgium, Canada, France, Italy, the Netherlands, Switzerland and Western Germany. The swift response of these banks provided invaluable help for sterling during a difficult period. At the end of September the total aid which had been taken under these various arrangements was $200 million (£71 million), of which $35 million resulted from swaps with the Federal Reserve Bank. Further use of these facilities was made in October and November. These drawings were repaid when the Fund drawing, referred to below, was made in December.

Towards the end of November, as described in the introduction, further assistance was arranged with the aid of these central banks, together with the central banks of Austria, Japan and Sweden, the Bank for International Settlements, and the U.S. Export-Import Bank.

I.M.F. drawing On the 2nd December the United Kingdom drew the full amount, equivalent to $1,000 million (£357 million), under its standby facility with the International Monetary Fund. The drawing, which is repayable within three years, was made in the following eleven currencies :

Currency	Equivalent in U.S.$ millions
Austrian schillings	28
Belgian francs	57
Canadian dollars	69
Deutschemark	273
French francs	163
Italian lire	23
Japanese yen	54
Netherlands guilders	66
Spanish pesetas	40
Swedish kronor	27
U.S. dollars	200
Total	1,000

[a] June 1963 *Bulletin*, page 84.

This distribution was arranged chiefly in the light of the present payments positions of the countries concerned. Of the total, the equivalent of $345 million was provided from the Fund's existing holdings of currencies, the equivalent of $405 million was borrowed under the General Arrangements to Borrow,[a] and the equivalent of $250 million was obtained by the Fund from the sale of gold.

Foreign exchange market The rate for sterling against the U.S. dollar was fairly steady in the first half of August at about \$2·78$\frac{13}{16}$, but by the middle of September it had been allowed to fall to \$2·78$\frac{5}{16}$. It remained around this level, once or twice touching \$2·78$\frac{1}{4}$, until shortly before the end of October. It then rallied slightly to about \$2·78$\frac{1}{2}$, but soon fell back again. Official support was required quite often between the middle of August and the last week of October. On a few days the amounts involved were substantial: selling pressure was heavy after the announcements of the trade figures for August and September—the latter coming immediately after the election—and again shortly before the new Government's Statement on the economic situation. After this Statement, demand for sterling improved and the authorities were able to take in a modest amount of foreign exchange. But the respite was short-lived and, as already noted, further very heavy support was needed in November.

During August to October there was little evidence of speculation against sterling as distinct from sporadic withdrawals due to loss of confidence. Forward sterling was generally steady during August and September. Around the middle of October the discount on forward sterling widened quite sharply but this seems chiefly to have been due to market expectations of a rise in U.K. interest rates. When these were not fulfilled, the rate reacted.

Treasury Bill yields in London and New York changed little during August to October. Throughout the period there was a covered margin in favour of London which ranged for the most part between $\frac{1}{4}$% and $\frac{7}{16}$%. It narrowed momentarily to $\frac{1}{16}$% in the third week of October as the cost of forward cover rose, but had reverted to $\frac{1}{4}$% by the end of that month. Rates on both local authority money and dollar deposits edged upwards during the period, but the relationship between them was broadly unchanged. Allowing for the cost of forward cover, there was little to choose between the two except for a while in October, when three months' dollar deposits were at a premium of rather more than $\frac{1}{4}$%. Nevertheless, the banks continued to switch some foreign currency deposits into sterling during August to October.

Gold market Private demand for gold was moderate for most of August but much more active in September and October. In the period as a whole it absorbed the available supplies of new production. The dollar equivalent of the fixing price, which was often below \$35·08 per fine ounce in August, later rose steadily to a peak of \$35·12$\frac{1}{4}$ in the middle of October. The greater demand seems mainly to have been associated with the approach of the U.K. and U.S. elections but it was accentuated by the fall of Mr. Khrushchev and China's atomic explosion. The resumption of the traffic between the Middle East and India at the end of the monsoon season also played a part. In the coin market there was a strong demand from time to time earlier in the period.

Domestic economy The poor performance of exports this year has already been mentioned. Among other forms of demand, personal consumption, which is the largest single category, changed little between the autumn of 1963 and mid-1964 if seasonal factors are taken into account: although incomes and employment were increasing, some purchasing power was absorbed by rising prices and personal saving went up too. In the third quarter, however, it looks as though people may have begun to buy more. Durable goods and clothes, in particular, were selling better in the shops; turnover in the catering trades was also expanding; and the demand for new cars—allowing for the wide seasonal

[a] March 1962 *Bulletin*, page 8.

variation in sales—was probably nearly as strong as in the spring. A larger proportion of these cars—around 30%—was being bought on hire purchase.

Public authorities' current spending is growing, if less quickly than suggested by last April's Budget. Stockbuilding, however, which had risen in the second quarter, had a damping effect on the growth of demand in the third, mainly because manufacturing industry added much less to its stocks than in the previous quarter.

The main expansionary force in the economy has undoubtedly continued to come from fixed investment, both on public and private account. Enquiries made by the Board of Trade from industry in August and September suggested that manufacturers expected to spend 14% more on fixed investment in 1964 than in 1963 and the distributive and service industries 15% more. Increased investment in building, plant and machinery, and vehicles all contribute to these large figures. The same enquiries, together with lengthening order books for machinery and a rising trend of approvals for industrial development certificates, also suggested that there would be a further substantial expansion in 1965. Housing, particularly on private account, looked like continuing to make heavy demands on resources. And on present plans, investment by the public sector generally will also increase substantially next year.

The pattern of demand this year has thus been far from uniform and, in total, it has grown unexpectedly slowly. Total output, which was rising for most of last year at an annual rate of some 6% to 7%, has probably risen little further this year. As recorded by the index, industrial production (which accounts for about half total output) was in fact slightly lower in September, when seasonally adjusted, than in January, after having been unchanged for seven months. That the index has not risen, when reports from industry have generally suggested that output was still expanding, remains somewhat surprising. It is possible that the index does not fully measure the considerable increase in work in progress in manufacturing industry which has occurred this year, but it must be accepted, even so, that industrial production can have risen little, if at all.

It seems likely that, for much of the year, firms making consumer goods had some spare capacity, and could have produced more if they had been able to push their exports still more strongly or to satisfy from their own production some of the home demand which was being directed towards imported products. On the other hand there is now rather more evidence that, in the field of investment, output may have been limited by difficulties of supply. In building, shortages of bricks and some fitments, and of labour, have affected output for some time; and in recent months the same sort of congestion has been becoming more evident in manufacturing industry, particularly as regards engineering capital goods. Here shortages of labour, and not only of skilled workers, are making themselves felt to an increasing extent, and there is a growing number of complaints that production is being hampered by delays in the delivery of components and materials.

Despite the pause in the expansion of industrial production, employment has increased this year, and the trend of unemployment has been steadily downward. The total out of work in November was 350,000 (1·5% of all employees). Although this was some 30,000 more than in July, which is normally the year's low point, the increase was smaller than generally occurs at this time. The contrast between rising employment and more or less static output is disturbing; on the other hand, there is usually a period of several months after a rapid rise in production, such as occurred in 1963, during which employers seek to build up their labour forces to a point which they regard as appropriate to the new and higher level of activity.

Wage settlements during August to October continued, as in earlier months, to add on the average about 4½% a year to hourly rates of pay. This is, in itself, more than the trend rate of increase in productivity, yet the rise in actual earnings, whether of wage or salary earners, has no doubt appreciably exceeded 4½%. Prices have continued to rise; manufacturers' selling prices, for example, have been rising since May at an annual rate of some 2½%. These are figures which underline the need for the new initiatives which the Government are taking in the sphere of incomes and prices.

Short-term money rates Against the rather uncertain background there was a tendency during August to October for most short-term rates to edge up a little. In the previous three months, the discount houses had from time to time lowered their bid at the weekly Treasury Bill tender, raising the rate from $4\frac{5}{16}$% to a little over $4\frac{5}{8}$%. But they made no further change during August and September. Although they several times considered whether to initiate a further rise in the rate—the average cost of their funds was rising slowly against them and they recognised the general tendency for short-term rates to rise both here and abroad—they were, in fact, receiving satisfactory allotments at the tender and were reluctant to change the rate and so, perhaps, disturb the whole pattern of short-term rates which was still reasonably favourable to them.

On the 16th October, however, immediately after the election and the publication of the bad September trade figures, the houses raised their rate at the tender to just under $4\frac{3}{4}$%. They maintained this rate the following week, but dropped it very slightly on the 30th October after the Government had announced their first economic measures and it appeared that there would be no immediate change in Bank Rate. Throughout August to October the authorities maintained firm control of money, but gave what help was required in the market from day to day so that the discount houses did not have to borrow at the Bank.

Rates for commercial bills, as for Treasury Bills, remained steady until the middle of October. The market then raised its buying rate for three months' prime bank bills from $4\frac{13}{16}$% to $4\frac{7}{8}$%.

Local authority temporary money rates had changed little with the rise in bill rates during May to July; the rate for three months' money, for example, remained around 5% until the last week in September, when it began to rise. For part of this time it is likely that the local authority market benefited from institutional funds intended eventually for investment in the stock markets but held back in the weeks before the election. In October the rate rose further, reaching $5\frac{3}{8}$% by early November. Some of this rise was due to the general rise in money rates, but it is also possible that in the second half of October, after the election, the inflow of funds from institutions was reversed.

It is likely that hire purchase finance houses also benefited for most of the period from institutional funds: deposits with the larger houses rose by nearly £20 million in August to the high figure of £444 million and remained around that level in September and October. The spread of rates quoted by the larger houses for three months' deposits was 5%–$5\frac{3}{8}$% for most of October,[a] having risen about $\frac{1}{8}$% since the end of July. The demand for new credit, which is mainly for cars, had seemed at one time to be easing, but it grew larger again during these three months.

Gilt-edged market After weakening in July, as described in the last *Bulletin*, the gilt-edged market remained fairly firm, though not very active, during August and September, and prices were mostly slightly higher at the end of these two months than at the beginning. In general, the market was resilient, although it dipped from time to time when reminded, for example by the monthly trade figures, of the growing uncertainty surrounding the economic outlook. During these months the authorities were primarily concerned to limit the fluctuation of prices as the election approached. In the event the market held steady for most of the time with little intervention. As opportunity offered, the authorities were able to buy modest amounts of the two stocks due to mature next year (4% Treasury Stock 1965 and 3% Savings Bonds 1955/65); but on balance they sold stock in response to the market's demand, the sales being concentrated particularly on short and long-dated stocks. Among the latter, fair amounts were sold of the two stocks ($5\frac{1}{4}$% Funding Loan 1978/80 and $5\frac{3}{4}$% Funding Loan 1987/91) issued earlier this year.

In the middle of October the market was affected by the election, and by the bad September trade figures which gave rise to some expectations of an increase in Bank Rate. Prices fell sharply despite official intervention, which was quite heavy for a few days par-

(a) See the new series in Table 17 of the Statistical Annex.

ticularly for the short-dated stocks, and yields rose by about $\frac{1}{8}$% on short and medium-dated stocks and $\frac{1}{16}$% on long and undated stocks. Towards the end of the month, however, after the Government had announced their first economic measures, demand recovered promptly throughout the range. At the short end, the discount houses, which had been reducing their bond holdings for some time past, began to buy heavily and, more widely, the market benefited from other institutional funds which had been held back during the previous period of uncertainty. Substantial net official sales were made at this time which appreciably outweighed the purchases made earlier in the month. In the outcome, at the end of October, yields throughout the range were much the same as three months earlier.

At the beginning of September the London Stock Exchange began to collect statistics of turnover in the gilt-edged and other markets. The statistics, which are given in Table 22 of the Statistical Annex, will be increasingly valuable as time passes and a longer run is available for comparison. They show that the aggregate number of purchases and sales of gilt-edged securities was rather more than 28,000 both in September and in October, but that the total value of the deals increased sharply between the two months. It is known that most of the increase occurred in the closing week of October when, as mentioned above, institutional buyers were re-entering the market in strength.

Debenture and equity markets

Yields on industrial debentures, which had risen somewhat during July in sympathy with the gilt-edged market, were little changed during August to October; at the end of this time, the average yield on a group of stocks with about twenty years to maturity was a little over $6\frac{1}{2}$%. New debenture issues, which had been coming forward strongly, fell off in the weeks before the election.

The equity market moved erratically, being influenced largely by political considerations and, more particularly as the date of the election drew near, by the varying results of successive public opinion polls. From a peak of 119 in the middle of August, the F.T.-Actuaries index of industrial share prices had come down to 116 by the middle of September, but with a change of sentiment this loss had been virtually recovered by early October. Prices then fell sharply and, by a somewhat uneven path, the index reached 111 on the 19th October, immediately after the election. There was some recovery—the index was at 114 at the end of October—but, as noted in the introduction, the market was depressed in November. With prices fluctuating so sharply, and in the general atmosphere of uncertainty, it was not surprising that the flow of new equity issues was reduced to a trickle in September and October.

The Stock Exchange statistics show that the total value of turnover in equities rose from £340 million in September to £380 million in October. There were no particularly striking week-by-week fluctuations, but the heaviest turnover occurred at the end of September and in the first half of October.

Local authorities' capital borrowing

The uncertain tone of the capital markets in the last month or so before the general election made it necessary to curtail somewhat the flow of local authorities' stock and bond issues. Moreover, in the new short-term bond market,[a] a number of the early issues which had been placed in the first instance with jobbers in the Stock Exchange were moving only slowly into the hands of more permanent holders. And in these circumstances the Bank maintained a firm control over the terms and timing of further new issues. Such issues amounted to £$14\frac{1}{2}$ million in August and £11 million in September. There were none in October or November.

The local authorities were not short of money, however, for there were at first ample funds in the temporary money market, and they were also borrowing a fair amount from the Public Works Loan Board. The normal rates for loans from the Board were raised by $\frac{1}{8}$% or $\frac{1}{4}$% early in August, following the rise in July in yields on gilt-edged, and were thereafter unchanged to the end of October. The rates ranged from $5\frac{5}{8}$% for loans up to 5 years up to $6\frac{1}{8}$% for loans of 15–25 years. In these circumstances, there was no particular pressure on the rates for mortgages, which stayed

[a] September *Bulletin*, page 178.

between 6% and 6⅛% for all terms throughout August and the first half of September. Rates for longer-term loans then hardened slightly to 6⅛%–6¼%, and in the second half of October rates for shorter loans (up to 10 years) went up to 6¼%. Rates for short-term loans were thus, if anything, a little higher than those for longer terms—possibly because local authorities were looking to this end of the mortgage market to replace the funds then being withdrawn, as suggested above, from the temporary money market.

London clearing banks In the early months of the year the London clearing banks' advances were rising comparatively moderately, the underlying increase after allowing for seasonal factors being about £25 million a month. In the summer, between May and August, the pace quickened to perhaps £50 million a month, partly—as appears from the analysis of advances published by the British Bankers' Association—because industrial and commercial companies, which had borrowed very little earlier in the year, were beginning to look more to the banks for finance. Their capital expenditure was rising, yet their earnings had probably ceased to expand and—from August onwards—they were raising less in the capital market. Between the middle of August and November, when on seasonal grounds the clearing banks' advances may be expected to fall sharply, there was in fact a further increase of £83 million, or £100 million if a decrease in lending to the nationalised industries is left out of account. After seasonal adjustment, the average increase was about £100 million in September and October. In the four weeks to mid-November, again allowing for seasonal movements, advances rose by £60 million, considerably less than in either of the two previous months.

Net deposits during August to November rose by £137 million; there was a strong rise in September and October—particularly in deposit (rather than current) accounts—and a fall in November. This suggests a preference for greater liquidity around the time of the election. Although the total increase over the three months was more than usual at this time of year it was less than might have been expected in view of the rise in advances. The explanation lies in the comparatively small amount of government debt which the banks were called upon to hold : their money at call with the discount market (which is mostly invested in government debt) went up by £103 million, but their holdings of Treasury Bills fell by £33 million and they sold £6 million of government stock. The net increase in all these items, £64 million, was considerably less than usual in these three months. Not only did government spending increase more slowly than might have been expected from the budget estimates last April, but the Exchequer received substantial amounts of sterling through the Exchange Equalisation Account, and receipts from National Savings kept up well. As a result the Exchequer needed to borrow relatively little in the form of marketable debt.

The combined liquidity ratio in November was 30·2%, a comparatively low figure for this time of year in relation to the accepted minimum of 28%; and looking ahead to March, when the liquidity ratio is usually lowest following the payment of taxes, the banks may well find their position tight. Their combined investment ratio in November was already down to 13·9%, almost the lowest since the war, which must limit the scope for sales of stock. At the same time, the demand for advances is likely to continue strong, if not so strong as in recent months.

In these circumstances the Governor of the Bank wrote on the 8th December to the chairmen of the Committee of London Clearing Bankers and of the other main banking associations to say that it was now the aim of official policy that the rate of growth of bank advances should decline, as indeed was likely to occur, if only on balance-sheet considerations. He stressed the importance of making the fullest possible credit facilities available for exports and for strengthening productive investment by manufacturing industry; banks were also asked to have full regard to the aims of H.M. Government on regional development.

To make this possible, it would be necessary to curtail the facilities made available for purposes of less national importance. The classes of advances from which it would be most justifiable to divert funds for this reason were advances for building and property development, except where directly related to productive manufacturing investment, advances

falling into the 'personal and professional' category and advances for hire purchase except where they served the purposes mentioned above.

The Governor wrote in similar sense to the chairmen of the British Insurance Association, the leading hire purchase associations and The Building Societies' Association, making it clear to the last of these that it was not the purpose of the letter to affect building societies' lending in the field of housing for the owner-occupier.

ANALYSIS OF FINANCIAL STATISTICS

This analysis examines developments up to the end of the third quarter in the financial positions of four sectors:

(i) the overseas sector;

(ii) the private sector: persons, industrial and commercial companies, and financial institutions other than banks;

(iii) the banking sector: domestic banks, accepting houses, overseas banks, and discount houses; and

(iv) the public sector: the Central Government, local authorities, and public corporations.

The starting-point for the analysis is a sector's financial deficit or surplus, where a " surplus " is defined as the excess of current income over current expenditure (sector saving), less additions to fixed assets, stocks and work in progress in the United Kingdom (sector investment). The surplus of domestic sectors may be used to acquire financial claims on other domestic sectors or to make net real or financial investments abroad. The financial surplus or deficit of the overseas sector is the counterpart of the deficit or surplus on current account in the U.K. balance of payments, which is taken as a measure of the United Kingdom's net external capital transactions.

Overseas sector

After making rough allowance for seasonal factors, the overseas sector's identified surplus—which was very small in the fourth quarter of 1963—rose rapidly early in 1964. In the second quarter of 1964 the surplus continued to grow, but more slowly, and it is probable that there was some further small increase in the third quarter.

The actual surplus in the third quarter, seasonally the worst, must have been considerably higher than in the second. Then, as noted in this *Bulletin* in September, the sector's surplus was partly reflected in a substantial increase in its net claims on the public sector. This is also true of the third quarter, though within the total the sector took up only £34 million of marketable debt, less than half as much as in the earlier period. The rise in overseas claims was due largely to the assistance received from overseas central banks, as mentioned on page 258. In addition, the gold and convertible currency reserves fell by £59 million during the third quarter (after rising slightly in the second), and this might be regarded as equivalent to a reduction in overseas liabilities to the public sector. These changes were offset only to a small extent by new borrowing and repayments received from the U.K. Government.

Net overseas claims on the banking sector also continued to rise, though the increase was smaller than in the second quarter, or in the third quarter of 1963. Deposits rose by £211 million, some £45 million more than a year earlier. Borrowing (advances, money at call and commercial bills), at £134 million, was over twice as large as a year earlier; much of this will have resulted from on-lending by the banks of foreign currency deposits.

Net overseas liabilities to the private sector probably continued to rise, but less sharply than in the second quarter, when the figures included the Royal Dutch Shell Group's investment in the Montecatini petrochemical concern.

Private sector The underlying surplus of the private sector was probably growing throughout 1963 and the first quarter of this year. It may have fallen a little during the second quarter; and preliminary indications suggest that there was little further change in the third. (Interpretation is complicated by the effect of tax cuts on the figures for the third quarter of 1963) The evidence for these suggestions is reviewed later in discussing the sector's three component groups: persons; industrial and commercial companies; and financial institutions.

In September it was noted that the increase in the private sector's net claims on the banks had been negligible in the second quarter, whereas in earlier quarters the sector's surplus had tended to be held with the banks rather than invested in public sector debt. In the third quarter, however, the surplus once again went mainly to the banks. The sector's net deposits rose by about £250 million,[a] though this was partly offset by increased borrowing of some £80 million, unusually high for a third quarter.

This increase of about £170 million in net claims on the banks compares with an unusually small rise, as at present estimated, in the sector's net claims on the public sector. This seems to have been mainly because local authorities borrowed very little from the private sector, but more from banks and the Public Works Loan Board—developments which are discussed in the appropriate sections below.

The private sector's net claims on the Central Government alone, as may be seen from the table on page 268, rose by £99 million. Its net holdings of non-marketable debt rose by £63 million, only about half as much as in the second quarter. The smaller figure was mainly due to a decline in the net take-up of Tax Reserve Certificates: new sales were perhaps depressed by hopes of a higher yield if Bank Rate was raised, and surrenders rose seasonally with the payment of profits tax. In contrast, the sector's holdings of marketable government debt rose by £28 million after having fallen by £83 million during the second quarter. Treasury Bill holdings fell by £12 million, against a fall of £44 million; holdings of stocks rose by £40 million, reversing the decline during the second quarter. There was a small rise in the sector's holdings of bank notes and coin.

1. *Persons*[b] In recent issues of this *Bulletin* it has been suggested that, during the first half of 1964, the underlying surplus of persons was increasing as a proportion of the total surplus of the private sector, and perhaps absolutely as well. Since September, national income estimates for the second quarter have been published, and the estimates for earlier quarters have been revised. The new figures tend to confirm the suggestion made in September that saving by persons remained high in the second quarter; indeed there may have been a small underlying rise. Persons do not seem to have been increasing their fixed investment and their stockbuilding faster than before.

Comparatively little is yet known about developments in the third quarter. As mentioned earlier, in the Commentary, there are some signs that persons' current expenditure began to respond to the growth of incomes, so the trend of personal saving may have ceased to rise. In that case, as it seems unlikely that persons reduced their fixed investment and stockbuilding, it would appear that their financial surplus—allowing for seasonal factors—was little changed, or perhaps slightly smaller.

Turning to the disposal of the surplus, it seems that in the third quarter, as in the second, persons substantially increased their claims on the banks. Their net deposits rose by some £145 million, and their bank borrowing only by some £25 million.

Persons' identified claims on the Central Government also increased during the third quarter. On balance they put £40 million into National Savings, compared with £55 million in the second quarter (when there were very large initial sales of National Development Bonds) and £26 million in the

[a] The change in transit items on this occasion was very small, and each sector's net deposits are assumed to have changed by much the same amount as its current and deposit accounts.

[b] This term includes partnerships, unincorporated businesses, etc., as well as individuals.

third quarter of 1963. Information on lending to local authorities during the third quarter is not yet available but persons are usually net purchasers of local authority debt, so that their claims on the public sector as a whole probably increased.

Persons' transactions with financial institutions, so far as they are known, are discussed below in the section on those institutions.

2. *Industrial and commercial companies* If in the second quarter the private sector's financial surplus fell, while that of persons continued to rise, then the surplus of companies (assuming, as usual, little change in the surplus of financial institutions) would have fallen. The national income figures imply that the underlying rate of growth of company saving was reduced, probably sharply. Expenditure on fixed investment, by contrast, continued to rise as in recent quarters, and companies' stockbuilding probably grew faster than before.

In the third quarter it may be that there was little further change in the underlying surplus of companies. The rise in fixed investment probably continued, but stockbuilding may have fallen and companies may have saved a little more than in the second quarter.

By contrast with earlier quarters of 1964, however, companies added to their net claims on the banks. Bank borrowing, at £32 million, was high in a quarter when a seasonal fall is usual; but it was much more than offset by a rise (perhaps partly seasonal) in net deposits, which are estimated to have risen by about £120 million.

On present information, companies' claims on the public sector were probably little changed. It seems unlikely that their claims on local authorities rose much, if at all, while the increase of about £18 million in holdings of Tax Reserve Certificates[a] will have been partly offset by the fall noted above in private sector Treasury Bill portfolios, which are largely held by companies.

Companies borrowed a little less in the capital market than during the second quarter, though still substantially more than a year earlier.

3. *Financial institutions* The main institutions included here are insurance companies, pension funds, hire purchase finance companies, building societies, the Special Investment Departments of the Trustee Savings Banks, and investment and unit trusts.

For the group as a whole during the third quarter, only the change in its position with the banks is yet known. The institutions' current and deposit accounts, which had been exceptionally high at the end of June, fell by £17 million and their bank borrowing rose by £20 million; this fall of £37 million in their net claims on the banks compares with an increase of £13 million a year earlier.

Full details of insurance companies' and pension funds' financial investments in the third quarter have not yet been published. But it is known that, while insurance companies and private sector pension funds continued to invest heavily in company securities, the insurance companies increased their holdings of gilt-edged stocks by some £30 million, much the same as in the second quarter.

Finance houses' holdings of hire purchase claims rose by £39 million, about twice as much as a year earlier. As between their sources of funds, the houses relied rather more than in recent quarters on taking deposits from the private and overseas sectors and rather less on bank finance in all its forms.

Building societies' net advances on mortgage, at £145 million, were slightly up on the previous quarter and £17 million higher than a year ago. Their net receipts on shares and deposits (including accrued interest) continued to fall; the total was £101 million, compared with £120 million a year earlier. The greater competitiveness of National Savings securities since the spring

[a] See Table 4B of the Statistical Annex: " other " holdings.

was probably the main reason for the reduced inflow. Building societies' liquidity was under continuing pressure; and this led them during the third quarter to reduce considerably their holdings of local authority debt.

The net increase in deposits with the Special Investment Departments of the Trustee Savings Banks was £33 million, much the same as in the previous quarter. Net receipts by unit trusts from the sale of units fell to £18 million from the record second-quarter figure of £21 million. And new issues by investment trusts, at £11 million, were also slightly down.

Banking sector The main changes in the banking sector's liabilities to, and claims on, other sectors during the third quarters of 1963 and 1964 are summarised in the following table. Transactions in other currencies as well as in sterling are included.

£ millions

	1963 III	1964[1] III
Current and deposit accounts	+488	+436
Adjustment for transit items	−153	+ 7
Net deposits	+335	+443
Claims on:		
Public sector:		
Notes and coin ...	+ 73[2]	− 4
Treasury Bills	+195	+199
Government stocks ...	+ 66	− 73
Advances and other securities	+ 56	+129
Bank of England, Banking Department, net claims on Exchequer...	− 49	− 19
Private and overseas sectors:		
Advances: to private sector ...	− 97	+102
to overseas sector ...	+ 63	+150
Miscellaneous claims[3]...	− 3	− 38

[1] There were ten additional contributors from the first quarter of 1964. See Table 9 of the Statistical Annex.

[2] This quarter ended on a Monday, a day when the banks' holdings of notes and coin are generally high.

[3] Call money, commercial and other bills discounted and securities.

Although the rise in net deposits was higher in the third quarter of 1964, the rise in the banks' claims on the public sector was £109 million less than a year ago. The rise in claims on the Central Government alone was £182 million less, which suggests a change in the distribution of bank finance to the public sector. The change is confirmed when, as in the following table, public sector deposits are also taken into account:

£ millions

	1963 III	1964 III
Banks' *net* claims on:		
Central Government ...	+249	+ 98
Local authorities ...	+ 19	+153
Public corporations ...	+ 34	− 3

As between the different groups of banks, most of the increase in the finance for local authorities came from the accepting houses and overseas banks (see Table 9 of the Statistical Annex). The recent increase in loans to local authorities by this group of banks, financed partly by switching foreign currency deposits into sterling, seems to have begun early in 1964: in the first half of the year, such loans rose by £139 million (£39 million a year earlier), and there was a further rise of £94 million (against £13 million) in the third quarter. As was to be expected, large movements occurred when the local authority rate for three months' deposits, allowing for the cost of forward cover, appreciably exceeded the U.S. dollar deposit rate in London—see the graph on page 336 in the Statistical Annex. Funds have, however, continued to be switched at times when the margin appeared to be negligible.

The accepting houses and overseas banks also increased their advances to overseas residents in the third quarter, by £148 million against £63 million a year earlier. Their advances to U.K. companies, by contrast, were up by £29 million, exactly the same figure as a year earlier. Their total current and deposit accounts rose by £254 million (rather more than the year before), of which £216 million was from overseas. All these comparisons are affected by the addition of new contributors to the statistics, but this does not alter the broad picture.

Deposits of the domestic banks rose by £210 million in the third quarter, against £247 million a year earlier, while their advances rose by £57 million compared with a fall last year of £84 million. For these banks, advances to companies were the main influence: they rose by £19 million in a seasonally slack quarter, compared with a fall of £93 million in the same period of 1963.

Public sector

The composition of the Exchequer Group's cash deficit was as follows:

£ millions

	1963 III	1964 III
Budget: above the line ...	−197	−152
below the line ...	−211	−261
overall	−408	−413
Internal extra-budgetary funds	+107	+ 67
	−301	−346
Exchange Equalisation Account	− 6	+ 65
Other external items ...	− 14	+ 45
Cash deficit	−321	−236

At the end of September, the cumulative deficit on internal account (budget plus extra-budgetary funds) was much the same as a year earlier. At the end of June the deficit had been £44 million smaller than in 1963; nevertheless, the deficit was still growing more slowly in the third quarter of this year than had originally been expected.

The cash deficit of £236 million in the third quarter compares with £321 million a year earlier. The sterling received by the Exchange Equalisation Account as a result of the fall in the reserves helped partly to offset the cash requirement arising on internal account. "Other external items", as explained in a note on page 292, is affected by the aid received from overseas central banks.

The contributions of the various sectors to financing the deficit in the third quarter were as follows:

£ millions

	Banking sector	Private sector[1]	Overseas sector	Total financing
Net Exchequer indebtedness to Bank of England, Banking Department	− 19			− 19
Notes and coin ...	− 4	+ 8		+ 4
Non-marketable debt:				
National Savings		+40		+ 40
Tax Reserve Certificates ...		+23		+ 23
Marketable debt:				
Stocks	− 73	+40	+18	− 15
Treasury Bills ...	+199	−12	+16	+203
	+103	+99	+34	+236

(1) Including government debt held by local authorities and public corporations.

The sector pattern of Exchequer finance was much the same as in the second quarter, except that rather more was contributed by the private sector, and rather less came from overseas. Compared with the third quarter of 1963, as noted earlier, a much smaller proportion of the Exchequer's needs was supplied by the banks; the private and overseas sectors both supplied higher proportions.

Net official purchases of stocks amounted to £15 million, compared with £123 million in the second quarter (when two stocks were redeemed), and sales of £100 million in the third quarter of 1963. As in earlier quarters of the year, however, there were net sales of long maturities (over 15 years) and net purchases of short-dated stocks (0–5 years), with only small net transactions in medium-dated stocks. Details are shown in Table 1 of the Statistical Annex.

Full figures for local authority borrowing are available only to the second quarter, when the total (excluding net borrowing from the Exchequer) was £139 million, much the same as a year earlier. Probably about half of this was borrowed from overseas, either direct or through the banks; the remainder came from the private sector, much of it from companies. In the third quarter the proportion of local authorities' market borrowing supplied by the

overseas sector and the banks almost certainly rose very sharply, and only a little is likely to have been borrowed from the private sector. The amount they required from the market was reduced in both quarters by substantial borrowing from the Public Works Loan Board under the new arrangements introduced in April.

Comment Statements about the most recent quarter remain very hazardous, but it would seem that recent trends may have been as follows. The surplus of the overseas sector, after rough seasonal adjustment, has been rising in the first three quarters of this year, but the rise has been flattening out. The private sector's underlying surplus declined in the second quarter but changed little further in the third. It follows that there was probably little net movement in the public sector's underlying deficit in the third quarter.

The main object of this kind of analysis, which brings together an unusually wide range of financial statistics, is to obtain as broad a view as possible of developments within each sector. Recently, much attention has been given to the pressure on company liquidity resulting from a decline in profit margins and rising investment expenditures, combined, in the autumn, with a reduced flow of capital issues. The high level of clearing bank advances may partly reflect this pressure and is widely taken as evidence of a ' need ' for bank advances if investment intentions are not to be frustrated. But the picture is not altogether clear, for the estimated rise of about £90 million (not seasonally adjusted) in companies' net claims on the banks in the third quarter was only some £40 million less than a year earlier, when their surplus was much larger. (Banking sector figures are probably particularly affected by the day of the week on which the quarter ends. Quarterly comparisons of banking figures are therefore somewhat uncertain, but it will not be possible to allow for this until a much longer run of figures is available)

A wider view may be obtained by bringing into account companies' take-up of public sector debt. In the third quarter of 1963 their holdings of Tax Reserve Certificates, Treasury Bills and local authority debt all rose substantially, by a total of perhaps £100 million. In the third quarter this year, their holdings of Tax Reserve Certificates rose by £18 million, their holdings of Treasury Bills probably fell by about £5 million, and it is very unlikely that there was much increase in their holdings of local authority debt. It may be, therefore, that the effect of the pressure on their liquidity during the quarter showed up primarily in their holdings of public sector debt rather than in their net position with the banks. Experience in the second quarter had been different: companies' net claims on the banks then fell sharply, compared with the second quarter of the year before, and their take-up of public sector debt rose.

It seems, then, that the pressure this year on companies' liquidity was initially reflected in their positions with the banks, but that they later tried to restore these positions at the expense of their holdings of government debt; though it is also possible that they took up less debt then because they wished to remain more liquid than usual before the election. In any event, it is clear that the trend of bank advances alone is not necessarily a good index of this pressure. Furthermore, some companies—for example, those with fast-growing expenditures—may for convenience have taken additional advances, while the net ' bank liquidity ' of companies in general was rising. This rise suggests that, even if advances had been less readily available, expansion could have proceeded with finance—no doubt more expensive—obtained through trade credit or other channels.

It may be that the pressure on company liquidity has already begun to ease as a result of the renewed rise in personal spending on consumption goods. The import surcharges mean that less of this rise will be reflected in the overseas sector's surplus and U.K. companies will benefit accordingly.