Commentary

The Commentary last December dealt in detail with events during the three months of August to October; but some outline was also given of the rapid development of the sterling crisis in November and of the emergency measures taken to deal with it and to help reshape the economy. These included the import surcharge, the special Budget of the 11th November, the increase in Bank Rate from 5% to 7% on the 23rd November, the mobilisation two days later of $3,000 million of special aid for sterling, and the Governor's letters to the banks and other financial institutions early in December concerning the amount and direction of their lending.

The notes which follow go back to trace rather more fully the developments in the financial markets during November and December, and continue into January, when events took a more favourable turn. By the end of January the immediate financial crisis seemed to have been surmounted. The flight from sterling had ceased, and the benefits of a reaction, that is, the reversal of leads and lags and the covering of some short positions, were beginning to be felt. The gilt-edged market was firmer. And—part cause of these improvements—there had been better news of U.K. production and exports.

On the 10th February it was announced that those of the central bank credit facilities made available last November which were shortly due to expire would be replaced by new facilities, available to the end of May. In the meantime, the United Kingdom would seek a further drawing from the International Monetary Fund. Later in the month, on the 22nd, it was made known that the import surcharge would be cut from 15% to 10% on the 27th April.

Sterling From August onwards, sterling was under some pressure. This was mainly due to the deficit in the balance of payments, which was for seasonal reasons particularly large in the autumn; but confidence also had already faltered from time to time. In November a severe crisis of confidence developed. The net effect of the various measures announced in the Budget on both the domestic economy and the balance of payments was apparently not fully understood abroad; the uncertainty which developed in the gilt-edged and equity markets, partly as a result of the proposals for a new capital gains tax and a corporation tax, also reacted upon the foreign exchange market; and pressure intensified when, contrary to expectations abroad, no change was made in Bank Rate on Thursday the 19th November. The spot rate for sterling against the U.S. dollar, which had opened the month at a shade below $2·78½, was allowed to fall to $2·78¼ by Friday the 20th November. From then until the close of the London market on the following Wednesday, except for a brief respite after Bank Rate was raised on Monday the 23rd, sales of sterling were massive and growing.

The discount on forward sterling had increased remarkably little before the technical adjustment prompted by the rise in Bank Rate. But it then widened rapidly as demand for forward exchange built up over the next two days. Because spot sterling was weak, the development of a substantial discount in the forward market would have added to the general apprehension, and caused even more spot sales. The authorities accordingly began to give support to the forward rate.

During the 24th and 25th November $3,000 million of assistance, mainly short-term, was

assembled for sterling with the help of overseas monetary authorities.[1] Once these arrangements were made known, spot sales of sterling subsided for a while; and the spot rate against the U.S. dollar, which had been held around $2·78\frac{5}{8}$ after the increase in Bank Rate, rose above \$2·79. But the market remained uncertain. Its mood was reflected in abnormally high rates paid for accommodation in sterling over the following week-end and in continuing forward sales of sterling.

Throughout December there was a very heavy demand for forward exchange and the authorities gave continuing support to the forward market. This was done for the reason given above. But two particular considerations may also be mentioned. When the crisis developed in November, the banks began to find difficulty in matching forward sales of sterling for their customers with forward purchases of foreign exchange, and some started to cover their positions by increasing their spot holdings of foreign currencies. The authorities' intervention at this point provided the banks with the necessary forward exchange, and thus averted the further drain on the reserves which might otherwise have developed. By supporting the forward rate the authorities also lessened the cost of forward cover on short-term funds placed in the United Kingdom, more of which might have been repatriated if the cost of this cover had been excessive.

It would be mistaken to regard the large commitments undertaken by the authorities in the forward market as threatening an abnormal drain on the reserves when the deals mature. The bulk of these operations will have related to commercial transactions and were simply a form of insurance whereby traders made certain that payments which were in any event due in future months would be made on the basis of the existing rates of exchange. In so far as the forward sales of sterling were made by non-residents for the purpose of hedging sterling assets—financial, commodity, or other—they are self-reversing in the sense that the seller must sooner or later close out the hedge by buying the sterling which he has contracted to deliver, except in marginal cases where he might decide to dispose of the assets in question.

Spot sales of sterling, although still substantial by normal standards, were much reduced in December. They were then associated particularly with a sizeable reduction in the sterling balances of overseas sterling area countries, some of which was due to a deterioration—partly seasonal—in their balance of payments positions. None the less, as the pressure in the forward market showed, confidence was still weak and this led to further spot sales, notably after the monthly statement on the reserves at the beginning of December and again following publication of the poor November trade figures about a fortnight later. The spot rate against the U.S. dollar was not allowed to fall below \$2·79.

In January conditions were generally quieter, although a flurry in the gold market (described later) led to renewed pressure to sell sterling early in the month. The exchange market was still uneasy, particularly in advance of the week-ends, but official support was required less frequently. There was a distinct improvement in sentiment in the latter part of the month after the better export performance in December became known. During January the spot rate against the U.S. dollar fluctuated between $2·78\frac{15}{16}$ and $2·79\frac{1}{4}$.

Some indications of the upheaval in the foreign exchange market may be seen in the movements during the fourth quarter in external liabilities in sterling (Table 21 of the statistical annex). Non-official holdings of countries outside the sterling area, which are especially sensitive to changes in confidence, fell by £138 million. The greater part of this fall came in November. In the same month, too, sterling suffered particularly from a shift in the timing of normal commercial payments as overseas residents put off buying sterling, and as U.K. residents (including U.K. subsidiaries of foreign concerns) accelerated their purchases and delayed their sales of foreign exchange. To this extent sterling is technically in a stronger position in the aftermath of the crisis than is apparent at first sight; and the reversal of this abnormal pattern of payments as some confidence returns is already beginning to bring support to the pound.

In the early weeks of November there was generally a slight margin, after allowing for

[1] December 1964 *Bulletin*, pages 256 and 258.

the cost of forward cover, in favour of investment in U.K. rather than U.S. Treasury Bills. This was reversed for a while towards the end of the month, despite the increase in Bank Rate, when the deterioration in the rate for forward sterling, together with a modest increase in U.S. rediscount rates, outweighed slightly the rise in the U.K. Bill rate. During December and January, however, when the authorities' operations in the forward market were—especially in December—the determining influence, there was virtually no difference between the two yields after taking account of the cost of forward cover.

Local authority money, again allowing for the cost of forward cover, compared unfavourably with three months' dollar deposits in the Euro-dollar market before the increase in Bank Rate. The subsequent rise in local authority rates was soon broadly offset by the movement of the forward rate, while dollar deposit rates increased initially rather more than might have been expected in relation to the rise in U.S. short-term rates associated with the increase in rediscount rates. As a result, the differential in favour of dollar deposits rose to over $\frac{1}{2}$% per annum. The accepting houses and overseas banks substantially reduced their deposits with local authorities towards the end of November in order to buy foreign exchange. This was mainly to meet withdrawals of overseas funds but, as already noted, their spot purchases at this time were to some extent a function of their forward position. During December dollar deposit rates fell back, whereas local authority rates rose further, producing a covered margin of about $\frac{3}{8}$% in their favour at the end of the month. The premium disappeared when local authority rates eased early in January, although it was partly re-established later in the month.

During the fourth quarter as a whole there was little change in the banks' net external liabilities in foreign currencies (Table 22 of the annex). Gross liabilities rose, however, which is unusual at the end of the year, and it may be that some funds withdrawn from sterling were left with London banks in the form of dollar deposits.

Special assistance

As described in December, the $500 million swap arrangement with the Federal Reserve Bank of New York, which had been in existence since May 1963, was supplemented during September by a further $500 million of short-term facilities with other overseas central banks; and by the end of that month drawings under these arrangements amounted in all to $200 million (£71 million). At the end of October the amount drawn had risen to $415 million (£148 million). During November the balance of $585 million available under these facilities was used, and a further $200 million was taken under the arrangements made on the 25th November. Aid outstanding thus rose by $785 million during the month to $1,200 million (£429 million), of which $675 million had been provided by the Federal Reserve Bank.

At the beginning of December steps were taken to put a large part of the short-term aid on to a longer basis. Thus, on the 2nd, the United Kingdom made a drawing, repayable within three years, of $1,000 million (£357 million) under its standby facility with the International Monetary Fund, and used it to repay the $1,000 million outstanding under the initial support arrangements. As described in December,[1] the Fund made use of the General Arrangements to Borrow in order to supplement its holdings of some currencies used in the U.K. drawing. At the same time Switzerland, which, although not a member of the Fund, is associated with the General Arrangements to Borrow, provided the United Kingdom with a three-year bilateral credit in Swiss francs equivalent to $80 million (£28 million). This was additional to the I.M.F. drawing. $50 million of the Swiss credit was used to repay an earlier loan from Switzerland, outstanding from the exchange crisis of 1961.

A further $325 million of short-term assistance was also taken during December under the arrangements of the 25th November. The net increase in aid of all kinds during the month was thus $405 million,[2] little more than half November's figure. At the end of the year short-term aid outstanding, that is, aid

[1] Page 258.

[2] The repayment of the earlier Swiss loan is not offset against this figure as it was a contractual repayment; it will appear in the balance of payments tables as a long-term capital item.

excluding the Swiss credit and the I.M.F. drawing, amounted to $525 million (£188 million). Of this total, $325 million arose from swap transactions (including $200 million from the Federal Reserve Bank) and $200 million was in the form of foreign currency deposits. This distinction has no operational significance, but it affects the statistical treatment of the aid, which is explained in a note at the end of this Commentary.

Payments of principal and interest due in December on the U.S. and Canadian government loans and amounting to about £62 million were deferred in the light of the balance of payments position; as a result of this and of the aid just described the reserves fell by only £80 million in the fourth quarter.

Some further short-term aid was taken in January, but in February it was possible to start repaying these debts. Such of the facilities as expired in February were replaced by new ones, so that $3,000 million of aid will remain available until the end of May. In the meantime the United Kingdom is to seek a further drawing from the I.M.F.

Gold market The gold market, although fairly active in November, was affected relatively little by events in the foreign exchange market. Private demand was strong in December, however, especially just before Christmas and again at the end of the year. The dollar equivalent of the fixing price, which had generally been below $35·11 per fine ounce in November, rose above $35·12 from time to time in December. The greater demand was partly seasonal, at the year's end, but more particularly it reflected disquiet about the stability of the international currency system. Sterling was still under pressure, and the outflow of funds from the United Kingdom through the U.S. dollar[1] had tended to depress dollar rates in Europe.

Strong demand for gold persisted early in January, although conditions in the foreign exchanges were quieter. There was about this time some talk of reducing the legal minimum gold backing for the U.S. note circulation and for the Federal Reserve System's deposit liabilities; and rumours circulated that the French authorities intended to convert all their U.S. dollar holdings into gold. These developments provoked a wave of buying in the London market on the 8th January, when turnover was slightly larger than on any day during the Cuban crisis of October 1962. The fixing price rose to the equivalent of nearly $35·15, and the authorities met demand later in the day up to $35·19. In these circumstances the U.S. Treasury issued a statement reaffirming their determination to maintain the existing price for gold. Demand then abated and for most of the rest of the month the fixing price moved around $35·12. This respite was, however, broken by General de Gaulle's press conference on the 4th February, in which he criticised the gold exchange standard. As a result demand for gold increased again, bringing the price up to $35·15 before the middle of February.

The gold pool During 1964 the central bank gold pool (the origin and purpose of which were described in some detail in the *Bulletin* of March 1964) continued to operate and to exert a stabilising influence on the market. Substantial Russian sales of gold in the early part of the year, together with steadily rising supplies of new production, more than offset a slight increase during the year in private demand. Gold amounting to more than $600 million was shared out amongst the central banks participating in the pool, an amount very little different from that which had been shared out during the year 1963. Again, during 1964, no contributions had to be made by the participants of the gold pool to support the market.

Money markets The exchange crisis was the dominant influence in the money markets throughout most of November, December and January. Considerable liquidity problems were created by the outflow of money overseas and there was a sharp reduction, consequent upon this outflow, in the amount of Treasury Bills being offered

(1) When they need to support sterling, the U.K. authorities sell dollars. A seller of sterling who requires some other currency will then convert such dollars through the markets. If necessary the appropriate monetary authority will take these dollars off the market against its own currency.

week by week at the tender. This reflected the benefit to the Exchequer of the large amount of sterling that was flowing into the Exchange Equalisation Account in exchange for foreign currencies. Money was generally tight, and most short-term interest rates remained firm throughout the period. At times, particularly about the end of November, rates substantially above Bank Rate were conceded for overnight money in some parts of the market.

In these circumstances the authorities, in their daily operations in the market,[1] frequently gave help by the purchase of Bills, sometimes on a very large scale. An outstanding instance occurred on Friday the 27th November, when large sums were withdrawn from the market to finance heavy purchases of both foreign exchange and gilt-edged stocks. Foreign exchange deals are normally settled two days later, but, owing to the U.S. Thanksgiving holiday, Tuesday's as well as Wednesday's deals (and withdrawals were very large on both days) were mostly settled on the Friday. Meanwhile on Thursday, following the announcement of the $3,000 million international credit arrangements the previous evening, gilt-edged stocks were in great demand, and these were bought, as usual, for settlement the next day. Although on this and other occasions the authorities gave such help as was needed to allow the various markets concerned to function smoothly, they maintained firm control of money throughout.

The discount houses had raised their rate at the Treasury Bill tender on the 16th October, but they lowered it slightly at the end of the month and again at the first tender in November. In fact, for several weeks—because of the shortage of Bills—there was a tendency for rates to ease. About the middle of November, however, the pressure on sterling began to be felt in the money markets, and a rise in Bank Rate was widely expected. As a result, on the 20th the houses raised their rate by about $\frac{1}{16}$% to $4\frac{3}{4}$%. At the next tender, after the Bank Rate move, they raised it to just over $6\frac{5}{8}$%.

They made no further change until late in January, even though in most weeks they obtained only small allotments from much reduced offerings. Throughout August to October £250 million or £260 million Bills had been offered every week, but the average at the last five tenders of the year was only £210 million, while in January offerings were cut week by week to £160 million, the smallest since 1952. In the uncertain economic circumstances the houses, on balance, judged it inappropriate to bid a higher price, and so lower the rate. The authorities for their part were content to see this rate maintained and, equally, did not attempt to raise it further.

Most of the houses were, however, forced to borrow substantial amounts at Bank Rate on the 29th December. This was the first such borrowing since the end of June. As on that occasion, the Bank were unwilling to meet in the open market the full demand created by end-year window-dressing by the banks' customers.[2] The total sum advanced was £$24\frac{1}{2}$ million, half of which was for six days and half for eight days. Such advances are normally made for seven days, but where large amounts are concerned it is not unusual for a proportion to be made for eight days to lessen the impact of the repayments. The decision this time to make them for six and eight days, in equal parts, was taken to avoid repayments the following Tuesday, when the market was expected in any event to be short of funds.

On the 22nd January, in view of the more encouraging December trade figures and the subsequent improvement in the gilt-edged market, the houses did lower their rate, to $6\frac{19}{32}$%, so securing a sizeable allotment that week. The market generally remained very short of Bills, however, and the houses reduced their tender rate further on the 29th January and the 5th February, to just under $6\frac{1}{2}$%. The authorities did not wish to see the rate fall too far, and a number of houses were obliged to borrow at the Bank after each of these tenders. The publication on the 12th February of the trade figures for January brought an immediate reaction, and a rise of nearly $\frac{1}{16}$% in the houses' tender rate that day.

The reduction in market holdings of Treasury Bills increased the demand for commercial

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(1) See the article "The management of money day by day" in March 1963.

(2) September 1964 *Bulletin*, page 176.

bills. Between mid-October and mid-January the clearing banks increased their holdings by about £80 million. There had been some increase in the supply of such bills. From May onward more use began to be made of bill finance by borrowers expecting a rise in interest rates (and therefore in the cost of any bank loans they might have) and, later in the year, perhaps also by those unable to obtain loans when the clearing banks began to tighten up on their advances. Although bills were in short supply, rates were generally a full 2% higher after the Bank Rate increase than they had been for most of the four previous months. The discount market's buying price for three months' prime bank bills, for example, went up to $6\frac{13}{16}$%.

During the fourth quarter, the accepting houses and overseas banks suffered from the withdrawal of overseas money. As a result they sharply reduced their loans to local authorities, which fell by £124 million in the quarter. They also reduced their money at call to the market in October and November, though this was rebuilt in December (Tables 11 to 13 of the annex).

Through these and other withdrawals local authorities came under great pressure, which they met in a number of ways. They borrowed more under their quotas from the Public Works Loan Board; they obtained more temporary money from domestic sources; and for a while some made increased use of bank advances. Nevertheless, in order to obtain funds over the turn of the year, they had to bid up rates for one week's and one month's money as high as 8%–$8\frac{1}{4}$%. In January, when the position eased somewhat, these fell back to $7\frac{1}{8}$%–$7\frac{1}{4}$%, but this was still about $2\frac{1}{2}$% more than had been usual in the summer. As noted in the December *Bulletin*, the rate for three months' money in the local authority market had been rising since the end of September. After the Bank Rate move it went up initially by only $1\frac{3}{4}$%, to $7\frac{1}{8}$%. It rose for a short time to $7\frac{3}{4}$% towards the end of December, but fell back in January to about $7\frac{1}{4}$%.

The hire purchase finance houses also had to offer more at the end of the year when money was particularly scarce. The spread of rates quoted by the larger houses for three months' money went up to $7\frac{1}{2}$%–$7\frac{7}{8}$%, coming down to 7%–$7\frac{3}{8}$% in the middle of January, or just 2% more than had been quoted in October.

Gilt-edged market

Towards the end of October, the gilt-edged market had made a strong recovery, and it remained firm throughout the list of stocks in the early part of November. The market quietened as the Budget approached, and in the second half of the month, as the sterling crisis developed and a rise in Bank Rate began to seem probable, the easier tendency became more pronounced, particularly among the short-dated stocks. The Bank Rate move steadied the market at a lower level and demand revived, to be further helped two days later by the announcement of the $3,000 million credit arrangements for sterling.

The improvement was short-lived, however, and almost to the end of December the market remained depressed. The weakness of sterling overhung the market and there was also the continued uncertainty concerning the possible effects of the capital gains tax foreshadowed in general terms in the Budget. Moreover, the very high rates available in the money markets added to their attraction as a temporary home for investment funds. The value of turnover in over 5-year stocks was little more than half as great in December as in November (Table 16 of the annex).

In their market operations during these two months, the authorities were concerned as usual to damp down over-sharp fluctuations without, however, obstructing any strong move to a lower level of prices. In November there were official sales at the beginning and end of the month. These were mainly of short-dated stocks, but included fair amounts of the two most recently issued longer-dated stocks, $5\frac{1}{4}$% Funding Loan 1978/80 and $5\frac{3}{4}$% Funding Loan 1987/91. These sales substantially exceeded purchases made around the middle of the month. For most of December prices were falling. To some extent this represented a delayed adjustment to the rise in Bank Rate, particularly as regards the longer-dated stocks where yields had initially risen comparatively little. Selling was not heavy, however, and although the authorities, on balance, bought stock each week throughout the month, generally at slightly reduced prices, it was never

necessary to intervene on a very substantial scale. On the 16th the publication of the poor trade figures for November added yet another depressing influence to those already disheartening the market, and prices began to be marked down quite sharply. This continued on the 17th, when the jobbers showed their growing anxiety by widening their prices; but an intimation to the jobbers that the authorities would be prepared to buy at around the prevailing prices, if stock was offered, quickly brought about a steadier market.

In so far as the authorities' purchases of stocks in December to some extent retarded the rise in yields, it might be argued that they were diminishing the deflationary effect of an outflow of foreign funds at a time when the pressure of demand in the economy was undoubtedly high.[1] There was, however, as always, an overriding advantage in ensuring that the fall in prices was orderly. In the circumstances of the time, too precipitous a fall could well have led the market to collapse completely. This would have heightened the crisis of confidence, and increased the strain on sterling.

Towards the end of December sentiment improved, though the market remained quiet until the middle of January, when more encouraging news of the economy (including the better trade returns for December) helped to stimulate demand. The success of the large stock issues by the London County Council (described below) brought buyers back into the market after some initial downward readjustment of prices; and prices rose moderately from then until the end of the month. In response to the improved demand, the authorities sold fairly substantial amounts of stock throughout the range of maturities. The market's turnover in over 5-year stocks was as great in January as in November; some two-thirds of the total occurred in the second half of the month.

It was announced on the 18th January that there would be no offer of conversion for the £391 million of 4% Treasury Stock maturing on the 1st February. By early February, however, the market had improved and, to replenish official holdings of short-dated stocks, a further £450 million of 5% Exchequer Stock 1967 was issued on the 8th February at 96½. £400 million of this stock had previously been issued in June 1962.

The changes in yields in some representative securities during November to February are shown in Table 24 of the annex.

Local authority long-term borrowing The flow of capital issues by local authorities had been somewhat curtailed before the election. This situation continued until the middle of January owing to the weakness of the markets; and during this period nothing was raised in the market from short-term bonds and little from stocks. The market then became steadier and it seemed appropriate to allow a resumption of issues. On the 12th January, the L.C.C. announced two loans, each for £25 million at 6¾% and priced at par, and for terms around 10 and 25 years respectively. They proved attractive and, as noted above, this success brought a better tone in the gilt-edged market. Large sums had for some time been withheld from the capital markets, and a number of further issues which were quickly brought forward following the success of the L.C.C. loans were readily absorbed. Short-term bond issues were resumed in February.

After the rise in Bank Rate, no change was made in the Public Works Loan Board's lending rates; for borrowing within quota[2] they continued to range from 5⅝% for loans of 5 years or less up to 6⅛% for loans of 15-25 years. Drawings soon accelerated, while less was borrowed in the mortgage market where rates, as noted below, had risen appreciably. Further relief was given to the smaller authorities on the 19th January when the Chancellor announced that quotas for 1964/65 had been raised from 20% of long-term borrowing requirements or £50,000, whichever was the larger, to 20% or £100,000. For loans in excess of quota, which are made available

[1] The deflationary effects of such an outflow are sometimes over-estimated. For example, the withdrawal by overseas holders of sterling which had been invested in any form of government debt does not directly affect the liquidity of the domestic banking system. See the article "Inflows and outflows of foreign funds" in June 1962.

[2] June 1964 *Bulletin*, page 90.

where funds cannot be obtained from the market, rates were raised on the 20th January from 6⅛% to 6⅞%–7%. Rates for loans within quota were not changed.

In the mortgage market rates rose by about ⅝% after the rise in Bank Rate, to 6¾%–7% for all terms. During December and January the shorter rates—up to 10 years—rose further to 7%–7⅛%, thus re-establishing the premium on the shorter rates, as compared with the longer, which had developed towards the end of October.

Debenture and equity markets

Shortly after the election, and with uncertainty on this score removed, the markets in company securities grew stronger. Nervousness reappeared before the Budget, however, and the tax proposals soon gave rise to fresh uncertainty. Fears also gained ground that the sterling crisis might be met by severe credit restrictions which would react upon companies' earnings. Prices therefore fell for most of the remaining weeks of the year. Equities were particularly affected in this way, but debentures also tended to weaken in sympathy with the gilt-edged market. As might be expected, capital issues were few in the fourth quarter, fewer than for many years, and were particularly reduced in December. They were somewhat greater in January, when the renewed flow of local authority issues brought some life back into the debenture market.

Equity prices reached their lowest on the 18th December, when the F.T.-Actuaries index of industrial share prices was down to 103 compared with a peak of nearly 119 at the beginning of October. This was soon judged to have been an excessive fall, and by the end of January the index had risen again to 110. Turnover in January was larger than in December, but, in spite of a spurt in the second half of the month, still smaller than in November.

Debenture yields reached a peak at the end of January, when, according to the new F.T.-Actuaries calculation, the yield on 20-year stocks was nearly 6⅞%.(1) This represented a rise of about ¼% since the change in Bank Rate.

Building societies

Building societies' net receipts on shares and deposits changed little in the fourth quarter, although there is usually a rise at this time. The societies had been facing strong competition for deposits for much longer than this. National Development Bonds, first issued in May, had proved attractive. Moreover, other deposit rates had risen during the year, particularly after the Bank Rate increases in February and November. The Building Societies Association had last recommended a change in their members' rates in January 1963, when Bank Rate was 4%. Meanwhile, the demand for mortgages during the fourth quarter remained strong. Reserve ratios were consequently under pressure, and the Association decided in January to raise their recommended rates for shares by ¼% to 3¾% tax paid, and their rates for mortgages by ¾% to 6¾%.

London clearing banks

Because of the foreign exchange crisis, very large amounts of sterling accrued to the Government through the Exchange Equalisation Account during the three months to mid-January. These receipts more than covered the Exchequer's cash requirements for the Budget and extra-budgetary funds during these months and also offset an appreciable fall—resulting mainly from the withdrawal of overseas money—in the amount of government debt held outside the clearing banks.

The clearing banks' holdings of government debt, together with their loans to the discount market (which are largely invested in government debt), scarcely changed in total during the three months. They fell early in the period, but recovered later as the effects of the external situation upon the Exchequer became less marked.

The banks sold £74 million of gilt-edged stocks during the three months, bringing the investment ratio down to the very low figure of 12·9%. They lent £79 million more at call to the discount market, a larger increase in the period to mid-December (when the accepting houses and overseas banks were

(1) See Table 24 of the annex.

withdrawing funds) being partly reversed in January. Their holdings of Treasury Bills fell by £10 million. Here there was a large fall in November and December, and a rise in January, but this rise was to some extent seasonal, and associated with the reduction in the note circulation after Christmas. As noted earlier, the banks' holdings of commercial bills rose by about £80 million, to stand at a record £443 million in mid-January.

That the Exchequer was able to finance itself without recourse to the banks was the main immediate cause of the comparatively small rise which occurred in net deposits. The increase was £46 million, roughly one-third of what might have been expected on seasonal grounds. Within the total, deposit (as opposed to current) accounts increased further, by almost £100 million : such accounts, since the increase in Bank Rate, have borne interest at 5%.

Advances fell by £29 million during these three months, those to nationalised industries falling by £40 million and those to other borrowers rising by £11 million. Month by month, advances to other borrowers rose by £31 million in November, £11 million in December, and actually fell by £31 million in January. Allowing for seasonal factors, this represents a marked change in the trend of borrowing compared with the summer and autumn.

There were various reasons for this change, though it is difficult to assess their relative importance. For some time the banks' liquidity positions had been tight. And this, reinforced by the Governor's letter early in December, no doubt led them to become more selective in their lending. Advances also became much more expensive after the increase in Bank Rate, and this may well have reduced—or delayed—borrowing for the payment of trade debts and taxes, and may have discouraged stock accumulation.

Balance of payments

During the first nine months of 1964 the identified deficit on current and long-term capital account amounted to £612 million. This figure may in fact overstate the size of the deficit, because the balancing item, which includes some unrecorded commercial transactions, was favourable to the extent of £109 million. But by any reckoning the deficit was very substantial. Even so, it had only a limited impact on the reserves. This was partly due to the payments surplus of overseas sterling area countries, whose net sterling holdings rose by £131 million. Those of other countries increased also, by £86 million if the effect of aid received through official swap transactions is excluded. In addition, the banks converted well over £100 million of foreign currency deposits into sterling.

Most of the increase in the net sterling holdings of countries outside the sterling area came in the third quarter, which suggests that there was no extensive loss of confidence at that time. But the U.K. deficit, mainly for seasonal reasons, had increased sharply, and a large proportion of the commercial payments to these countries was converted in the normal course of events into foreign exchange. Moreover, and again partly for seasonal reasons, the payments surplus of overseas sterling area countries taken as a group had diminished appreciably. As a result, the reserves began to fall noticeably in the third quarter. Even so, the net fall over the first nine months of the year amounted to only £42 million, and special assistance was limited to £71 million, although the bulk of the deficit of between £700 million and £800 million expected during the year as a whole had already been incurred.

In the fourth quarter, as described earlier, the reserves came under great pressure, falling by £80 million in spite of the I.M.F. drawing of £357 million and the net receipt of £145 million of other special assistance (including the Swiss credit). This resulted from a marked change in the pattern of other monetary movements. The collapse of confidence already described was the main reason for a fall of £193 million in the net sterling holdings of countries outside the sterling area, excluding the effect of official swap transactions. The net sterling holdings of overseas sterling area countries fell by £175 million, part of which will have been due to the emergence of a deficit in their own balance of payments. Undoubtedly, too, there was a loss to the reserves arising from leads and lags in commercial payments, which are not all in the identified monetary movements.

Although information for the fourth quarter is still incomplete, it looks very broadly as

though rather more than one-half of the drain of some £580 million represented by the fall in the reserves and the receipt of special assistance during the quarter was due to confidence movements; one-quarter or more was due to the United Kingdom's own deficit on current and long-term capital account; and the remainder resulted from the adverse turn in the payments position of the overseas sterling area countries.

Few details are as yet available of the U.K. deficit in the fourth quarter. But it should be appreciably smaller than in the third. The deferment of the North American debt service relieved the invisible and long-term capital accounts of payments totalling about £62 million. More satisfying is the fact that there was, for the first time since early 1963, a clear improvement in the visible trade balance. Trade usually improves substantially in the fourth quarter, but this time the improvement went further than usual. The Board of Trade's seasonally-adjusted estimates show a reduction in the deficit from £157 million in the third quarter to £126 million. Imports appear to have been little changed and exports appreciably higher.

As measured by the trade accounts, and allowing for seasonal movements, exports rose by nearly 4% in the fourth quarter after having fallen slightly in each of the two preceding quarters. The increase owed much to a high figure in December (although there had also been small improvements in October and November). It was spread over a wide range of commodities and markets. Exports of machinery, which had been declining since the spring, turned up again; sales of road vehicles were particularly buoyant; and exports of other manufactures as a group continued to grow steadily. There was a notable rise in exports to overseas sterling countries, while those to the European Economic Community, which had fallen sharply in the third quarter, recovered somewhat despite a continuing decline in sales to Italy. Imports remained on the high plateau which they had already reached in the second quarter. Imports of industrial raw materials and fuels rose quite strongly, but there was a further moderate fall in finished manufactures and a substantial reduction in food imports.

In January both imports and exports were lower than their monthly average in the fourth quarter. At this stage, it would be wrong to attach too much significance to the fall in exports. Trade fluctuates widely from month to month and January's experience does not necessarily mean that the better trend which became apparent towards the end of 1964 will not continue.

It is difficult to assess the effect of the surcharge among other influences on imports. There was a modest but progressive fall in imports of goods subject to the levy during the first three months it was in force. Some traders may have drawn on stocks of such goods or transferred their demand to domestic sources. On the other hand, some foreign suppliers have absorbed all or part of the surcharge to maintain their sales.

Conditions abroad

The U.S. economy continued to expand strongly in 1964, partly under the influence of the income tax reductions made early in the year. The trend of industrial fixed investment was still firmly upwards at the end of 1964; and stockbuilding, which had increased only moderately in relation to the growth of output, was quickening. It was generally expected that personal consumption would expand less rapidly in 1965 once spending was adjusted to the increase in disposable incomes resulting from the tax cuts. In the Budget for 1965/66, however, the Administration proposed a reduction in indirect taxation and an increase in social welfare benefits, both to take effect around the middle of this year. These measures make it rather less likely that expansion will slow down in the second half of the year. Resources are unlikely to come under any general pressure: unemployment remains relatively high and industrial capacity is being substantially increased. The chief domestic threat to orderly expansion is the possibility of a steel strike.

Activity in the E.E.C. expanded vigorously early in 1964, but had slackened markedly by the autumn. During the year as a whole it probably rose rather less than during 1963, largely because of a recession in Italy. The measures taken in Italy to correct the external payments position also reduced the growth of export demand in other member countries. In

Western Germany expansion quickened in 1964, largely owing to a recovery in industrial fixed investment; but spare resources were increasingly absorbed and expansion is likely to be more moderate this year. In France, activity may again rise more slowly under the influence of the stabilisation plan, but in Italy it could rise quite strongly later in the year as reflationary policies take effect. It is possible that expansion in the Community may continue during 1965 at nearly the same rate as during 1964.

In the European Free Trade Association a somewhat more moderate rate of growth can be expected in 1965 as unused industrial capacity and unemployment continue to diminish, and as the pressures of high demand are met by policies of increasing restraint.

The export earnings of the primary-producing countries as a group rose appreciably in 1964, not least because commodity prices were substantially higher on average than in 1963. As a result, these countries were able to increase their imports rapidly and also, in the first half of the year, to add to their reserves. Almost certainly, however, their imports will rise more slowly in 1965. Their exports are likely to grow less in volume and their earnings from them could be diminished by lower average prices. It seems that their reserves were drawn down somewhat in the latter part of 1964, and this process cannot continue indefinitely.

It thus seems likely that there will be some slackening in the growth of world trade in 1965. Last year, however, was an exceptionally good year, and conditions abroad should still offer scope for a reasonable expansion in U.K. exports in 1965. As last year's experience shows, however, the mere existence of expanding overseas markets is not enough. The necessary increase in U.K. exports will be achieved only if these markets are cultivated, if costs are kept down and if capacity is available to meet an increase in foreign demand.

Domestic economy

After nine months' apparent stability, the index of industrial production, seasonally adjusted, rose by 2% in October. Further increases followed in November and December, making the average for the fourth quarter 3% above that for the third and as much as 5% higher than in the last quarter of 1963. In 1964 as a whole, industrial production was about 7½% greater than in 1963.

Most sections of industry seem to have contributed to the recent rise of output including, in particular, engineering, steel, vehicles and building materials. In most of these industries production has to some extent been hampered in the past year by shortages of skilled labour and of materials or components. The increase in output may therefore indicate that, with better use being made of the available resources, some of these difficulties are now being overcome. Should this be so, it would have encouraging implications for exports, as the branches of engineering which have been most affected by supply difficulties, namely those making heavy machinery and other capital goods, are also those whose exports in 1964 were most disappointing. As noted earlier, there was indeed some evidence of a recovery in exports in the fourth quarter. There has, too, been an encouraging rise recently in orders from abroad for engineering goods.

The rise in production also owes something to a rise in consumers' spending which developed in the autumn. Allowing for seasonal variations, the volume of personal consumption rose by about 1½% between the second and third quarters of 1964. Complete information for the fourth quarter is not yet available. Retail trade was busier; the catering trades were also doing well; and the number of new cars registered was a record for the time of year. This increased personal spending was superimposed upon a continuing high level of expenditure on fixed investment by private industry and the public sector. It seems probable that stockbuilding—by manufacturers and the distributive trades—may have continued in the fourth quarter at much the same rate as in the third.

In these circumstances, it is not surprising that unemployment remained low. Indeed, if seasonal influences are allowed for, it probably fell in each month up to February, when the total represented no more than 1·6% of all employees.

Wage settlements during November to January included a number of fairly large

awards which had been under negotiation for some time. Taken together, they added on the average the equivalent of between 4½% and 5% a year to the hourly rates of pay of those concerned. The increase in actual earnings will be larger than this. During most of 1964 wage rates were rising at a rate of about 4½% a year; yet earnings—taking account of overtime and other special payments—appear to have risen some 8%.

Prices generally continued to edge up, though partly from seasonal causes: for example, some food was dearer for this reason and there were higher winter prices for coal. During 1964 as a whole retail prices rose 5%, about one-quarter of which was attributable to the increased taxes imposed in April on drink and tobacco, and in November on petrol. Higher rents and local rates also contributed significantly to the rise. Manufacturers' selling prices, which were also affected by the tax increases, rose over the year by about 4%. This was probably to some extent a delayed reaction to the strong rise in import prices during 1963; during 1964 itself, import prices rose little.

Outlook The picture as seen at the end of January was thus of an active economy, moving forward on a broad front. Looking forward, it was a matter of nice judgment whether the prospective demands upon the economy were likely to be met without excessive strain on the available resources.

The full effect on imports of the surcharge remained to be seen; if they were to fall significantly, the demands on domestic resources would be increased. There were prospects of a continuing rise in central and local government expenditure, both current and capital. As regards private investment, the Board of Trade's survey of manufacturers' investment intentions taken in November and December suggested, like the previous survey three months earlier, that expenditure on fixed investment might rise by 10% in 1965 compared with 1964. Although it was perhaps too soon for this survey to reflect a change of opinion, the results of later enquiries made by the Federation of British Industries and the National Institute of Economic and Social Research also suggested that industrialists were not revising their investment plans. House building was making increasing demands on an already overloaded building industry.

On the other hand, some doubts were being expressed whether the rise in retail sales—and the very high level of activity in the motor industry—would be fully maintained in the New Year. There was also still much uncertainty concerning the eventual consequences for demand, and for business confidence, of the corrective measures taken in the Budget in November; of the increase in Bank Rate, which had made credit more expensive; and of the Governor's letters to the banks and other financial institutions, which had emphasised that the underlying rate of increase in total bank advances should now decline (as was, indeed, occurring), and had stressed the importance of directing the available funds, within that total, towards industrial investment and exports. Taken together, these measures constituted an appreciable deflationary force, the effects of which might become increasingly apparent as time went on.

In these circumstances, and for the short term, it was reasonable to take no further action until the consequences of what had already been done could be seen more clearly. Moreover, the Budget in April would provide an opportunity of taking further steps if it was then thought that they were needed.

Looking to the longer term, the Government have taken initiatives over a very wide front to alter various emphases within the economy: to make better use of labour resources by encouraging mobility and training; to work towards a better balance of regional activity through new regional bodies; to introduce some order into the movement of prices and incomes through the new machinery—announced on the 11th February—for a National Board for Prices and Incomes; to stimulate selectively those sectors of the economy which affect exports and modernisation—for example, through measures to help exporters (the subject of a separate note on page 30) and by improving the efficiency of the docks; and to secure economies in public expenditure, notably in the field of defence procurement. None of these measures will, in isolation, or by the stroke of a pen, set the economy on a sounder path; but collectively

and cumulatively, given the co-operation of all sections of industry, they must have a powerful effect.

This necessary and valuable progress towards solving the country's medium and long-term problems is of the greatest importance. But the deficit in external payments, though reduced, has not been eliminated, and it remains vital for the United Kingdom to bring these payments into balance with all reasonable speed. There is moderate encouragement in the latest months' trade figures. But a considerable further diversion of resources to export is going to be needed if the country is to pay its current way, repay debts, and rebuild the reserves.

The statistical treatment of aid

The short-term assistance from overseas central banks, described above on page 5, has been partly in the form of swaps against sterling, and partly in the form of foreign currency deposits. These, the I.M.F. drawing, and the medium-term loan from Switzerland through the General Arrangements to Borrow, are treated as follows in the statistical annex.

When swaps are made, the foreign currencies received are added to the holdings of the Exchange Equalisation Account and thus augment the gold and convertible currency reserves. There is a corresponding increase in external liabilities in sterling to central monetary institutions (Table 21); this is shown in the balance of payments figures, Table 19, under " other liabilities in sterling (net) ". In the Exchequer figures, Table 1, the sterling side of a swap shows as a cash payment (−) by the E.E.A.; the sterling is held on behalf of the central monetary institution undertaking the swap, and is usually employed for it in Treasury Bills, giving rise to an increase (+) in " marketable debt: Treasury Bills ". In Tables 2 and 3 these Bills are included with the holdings of central monetary institutions.

Foreign currency deposits are also exchanged with the E.E.A. for sterling, which is invested in Treasury Bills. There is, again, a rise in the reserves, but in this case the increase in liabilities is included in Table 19[1] among " liabilities in foreign currencies (net) ". In Table 1, the sterling cost is again shown as a payment (−) by the E.E.A., but Bills in which this sterling is invested are not regarded as market finance but recorded (+) among " other external items ".

When currencies are drawn from the I.M.F. they are added to E.E.A. holdings. There is an increase in sterling liabilities, which affects the I.M.F. items in Tables 19 and 21 (see the additional notes to those tables). In Table 1, the sterling cost is once again shown as a payment by the E.E.A., and the proceeds, which are lent by the I.M.F. to the Exchequer against interest-free notes, are recorded (+) among " other external items ".

The medium-term Swiss loan is in the form of a swap and is treated in the same way as the short-term swaps already described. The repayment of the earlier Swiss loan in December will be included in Table 19 (within " official capital transactions ") as a reduction in long-term liabilities. In Table 1 it appears as a payment (−) under " other external items ", offset by a corresponding receipt by the E.E.A.

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(1) But not in Table 22 which is confined to commercial banks' liabilities and claims.