Commentary

The Commentary this time is mainly concerned with events during February to April, though later developments are touched on where necessary. During this time there was some further recovery in the position of sterling; it was nevertheless slower than had been hoped and the market remained sensitive. More short-term assistance was taken under the $3,000 million arrangements made last November; this was repaid when a drawing of $1,400 million was made from the International Monetary Fund in May. There has also been a further improvement in the balance of payments, though there is still a long way to go before the position is secure. Additional steps were taken in the Budget early in April to reduce the growth in domestic demand, notably through higher taxes on consumption; and other specific measures were introduced to act directly upon the balance of payments. At the end of April the existing restraints on credit were reinforced by calls for Special Deposits from the London clearing banks and Scottish banks. The Governor of the Bank subsequently wrote to the main banking and financial associations asking them to co-operate in restricting the expansion of credit in the year to March 1966 and in ensuring that it was made available only for the most necessary purposes, especially exports.

On 3rd June, following the I.M.F. drawing, and with the reserves standing at over £1,000 million at the end of May, Bank rate was reduced to 6% from the very high figure of 7% to which it had been raised during the sterling crisis last November. 6% remains a high rate, however, and the reduction to this figure does not imply any relaxation in the restrictions on the supply of credit. On the same day that Bank rate was reduced, the minimum down payments required under hire-purchase agreements for most goods were increased, reinforcing the requests made in the Governor's letters mentioned above: the minimum deposit was raised from 20% to 25% for cars and motor cycles, and from 10% to 15% for most other goods.

A severe shortage of Treasury bills made difficulties for the clearing banks and for the money market during February to April. Meanwhile many short-term rates of interest at the end of March rose even higher than at the end of December. The capital markets were subdued most of the time, overshadowed by the external situation and the Budget.

At the end of the Commentary there is a brief assessment of the outlook. Although much has now been done to reduce the growth of demand in the economy and to help correct the external balance, there is still too little understanding among the public at large of the need for these restraints.

The economic background

In the March *Bulletin* an assessment was made of the economic outlook as at the end of January, that is to say immediately after the sterling crisis and comparatively soon after the introduction of the various corrective measures taken in the closing months of 1964. Although there were grounds for fearing that the prospective demands on the economy in 1965 might outstrip the available resources, it was nevertheless early to assess the effects on demand and, more particularly perhaps, on business confidence of the measures already taken. It was therefore suggested that for the short term it was reasonable to take no further action, in the knowledge that the Budget in April would provide an opportunity of taking further steps if it then seemed desirable.

In the ensuing months it became increasingly clear that such action would be necessary. Total demand on resources was continuing to increase, and the mood in industry was still set strongly upon expansion. In these circumstances there was little reason to suppose that the high cost of credit would quickly affect activity to any considerable degree. Only in building did it seem probable that work might soon be affected by credit restrictions, and even there the possible reduction in demand seemed unlikely to do more than reduce slightly the degree of overloading in the industry. The banks had already for some time been restricting their advances for property development, while the building societies, as described later, were suffering from a shortage of funds, which has forced them to limit the growth in their lending on mortgage for house purchase.

Spending by the public sector, both current and capital, was rising strongly, and likely to go on doing so. Fixed investment by the private sector was also apparently going up. Retail sales were continuing to increase, though more slowly than in the autumn, and the demand for new cars was very heavy. The rise here, however, no doubt owed something to fears of increases in purchase tax in the Budget. Such little information as was available about stockbuilding suggested that, in total, it was proceeding at much the same rate as in the last quarter of 1964. It had also to be recognised that so far as measures to limit imports and to expand exports were successful, this would further increase the pressure on home resources.

There was little prospect of meeting these demands without undue strain. Although it was reasonable to look for some further increase in production, it was not to be expected that it would maintain the pace shown at the turn of the year. After something of a pause in the summer of 1964 the official index of production, seasonally adjusted, had risen sharply during the four months from September to January (the increase in these months is now put at 4%). The rise was in part due to the revival in personal consumption in the autumn; but some of it will have gone to sustain the continuing rise in investment, and some was associated with a welcome spurt in exports (details of which are given later). The rise in production was most marked in the steel, engineering, and vehicles industries, where output seems to have benefited from the freeing of some of the log jams which had developed following the rapid expansion of demand in 1963.

In fact, on the provisional figures, the index fell back in February and March from the high point reached in January (though it is still too soon to assess the significance of this change). Shortages and delays continued to be experienced, particularly in the supply of building materials, and throughout industry the shortage of labour was becoming more, rather than less, severe. The trend of unemployment continued downward, if more slowly, and the total out of work in May (307,000) represented only 1·3% of all employees compared with 1·6% a year earlier. More significantly perhaps, since in most areas the scope for reduction in unemployment must now be limited by a shortage of employable labour, the number of vacancies notified to the employment exchanges was rising rapidly: by May the total had reached 420,000, well above the number seeking work.

Although progress was being made in establishing machinery for the new policies on prices and incomes, and in securing broad acceptance for them from the trade unions and employers' organisations, these policies could not be expected to take effect quickly. Meanwhile current wage increases were gathering momentum, and the average award had risen to the equivalent of about $6\frac{1}{2}\%$ a year compared with $4\frac{1}{2}\%$ in last year's settlements. Wage increases of this size, if they became widespread, could not fail in due course both to stimulate consumption and raise prices.

According to the official estimates of the balance of payments made before the Budget, it seemed possible that the combined deficit on the current and long-term capital accounts would still be of the order of £350 million in 1965. This would have been very much less than in 1964 when the total deficit came out at £745 million, after £62 million of North American debt service had been deferred. But it was still much larger than could be tolerated.

The budget measures

It was against this background, and in the knowledge that opinion in many quarters abroad still needed to be convinced of the United Kingdom's ability and determination to surmount its economic difficulties, that the Chancellor introduced his Budget on 6th April. He made it clear that his main object was to reduce the prospective balance of payments deficit this year and to eliminate it in the course of 1966. In putting forward this objective he took account of the need to reduce, and later abolish, the temporary import charge (already due to be cut on 27th April from 15% to 10%) as soon as progress warranted.

To achieve his aim, the Chancellor said that it would be necessary to shift resources quickly into activities which helped the balance of payments, and to ensure that the extra output which became available as productive capacity increased was used to correct the external balance and not to meet home demand. He therefore proposed, through restraint in public expenditure and increased taxation, to reduce the domestic demand on resources—by early in 1966—by a further £250 million a year; he also announced a number of measures aimed directly at improving the balance of payments.

An immediate economy was the cancellation of the TSR2 aircraft, saving £35 million in the current financial year (and much more in the next few years). Beyond this, a general review of defence expenditure was already in hand. The Chancellor also undertook that the total growth of public sector expenditure (excluding the investment of the nationalised industries) between 1964/65 and 1969/70 would be limited to $4\frac{1}{4}$% a year at constant prices, taking one year with another. Increased taxes will yield £164 million in the current financial year and £217 million in 1966/67. This will come mainly from higher duties on motor vehicles, tobacco and alcoholic drink. In addition, increased postal charges announced shortly before the Budget will bring in £32 million to the Post Office this year.

The balance of payments should benefit from the general restraint on domestic demand, and also from a number of changes in exchange control practice—all within our obligations to the I.M.F. under Article VIII. These will chiefly affect the long-term capital account, where it is hoped to save at least £100 million in a full year. In particular, new direct investment outside the sterling area must now satisfy more stringent criteria, and show substantial short-term and continuing benefits (including associated exports) to the balance of payments, if foreign currency is to be made available at the official rate of exchange. Such investment will still be possible out of resources borrowed abroad, or with currency purchased in the investment dollar market. Investment dollars have for some time stood at a premium, which has recently ranged between 7% and 12%.

The supply of currency to this market arises from sales of U.K.-owned assets in countries outside the sterling area. This supply will now be reduced in two ways, each of which will divert substantial amounts of foreign exchange into the official market. Firstly, certain assets accruing to U.K. residents which they have hitherto been allowed to sell in the investment dollar market now have to be sold in the official exchange market at the ordinary rate; among these are gifts and receipts under wills and trusts. Secondly, one-quarter of the proceeds of the sale of foreign currency securities or investments, all of which have previously been available for sale as investment dollars or for reinvestment abroad, must also now be surrendered for sterling at the official rate. A further change is that the purchase of house property outside the sterling area will no longer be allowed out of investment dollars, but only from ‘ property currency ’ representing the proceeds of previous sales of such property by U.K. residents. A stricter control will be imposed on the issue of foreign exchange for travel purposes, and the receipt of export proceeds will be more closely scrutinised.

The Chancellor also argued that the present system of company taxation was unduly favourable to investment abroad. Accordingly, his proposals for reshaping company taxation will, in a number of ways, make both existing and new overseas investment less attractive. The new proposals will not have their full effect for some years, but it is estimated that the increase in tax received from companies with overseas investment income may ultimately amount to around £100 million. More recently, the First Secretary of State has written to a large number of companies asking them to examine their own operations to see how they might contribute to improving the balance of payments; and the Prime Minister has said that the Government for their part are determined to save £50–100 million a year in overseas military expenditure.

Balance of payments

Full details of the balance of payments in the first quarter are not yet available, but there is no doubt that the improvement which began in the fourth quarter of last year became more marked. The deficit on visible trade, seasonally adjusted, was reduced from £157 million in the third quarter of 1964 to £127 million in the fourth quarter, and to no more than £36 million in the first quarter of this year. As against this, there is evidence that remittances of profits and dividends from this country by the subsidiaries of overseas companies were again, as in the fourth quarter, larger than usual. Confidence in sterling was not fully restored, and companies may also have feared tax increases in the Budget. In addition, some companies will no doubt have been influenced by the measures to reduce the U.S. balance of payments deficit, referred to later. Even so, the deficit on the combined current and long-term capital accounts in the first quarter is likely to have fallen appreciably below the fourth quarter's figure of £180 million. The current account, taken by itself, may well have been roughly in balance.

The improvement of £91 million in the visible trade balance in the first quarter, described above, resulted both from a fall in imports and a rise in exports. As recorded in the trade accounts, total imports (seasonally adjusted) fell by 4% in the quarter. However, this may overstate the position, as a fall in imports from the United States in February, due to the dock strikes there, was not fully made good in March. Moreover, about half the fall was due to a decline in food imports, part of which was probably temporary, although it also owed something to lower prices. Imports of semi-processed and finished manufactures fell sharply. The U.S. dock strikes complicate any attempt to assess the effects of the import surcharge. Nevertheless, allowing again for seasonal changes, imports of goods subject to the charge appear to have been nearly 10% lower in the first five months of its operation than in the months immediately preceding. Those exempt, on the other hand, rose in total despite the fall in food. As these were months when the strong rise in domestic activity could well have produced a further increase in imports, this suggests that the surcharge—helped, no doubt, by expectations of an early reduction—was having an appreciable effect.

Exports rose by $1\frac{1}{2}$% in the first quarter. They increased most to Australia and the countries of the European Free Trade Association. Exports to the United States also rose slightly, but those to the European Economic Community were, on balance, unchanged. In terms of goods, the rise owed most to ships and aircraft: deliveries of these are commonly irregular but, to judge from orders already received, they may be expected on average to remain high this year. There was also a further rise in exports of machinery, on which hopes of a sustained improvement in exports as a whole very largely depend.

In April, exports generally were well maintained, but imports were up a little partly because of the arrival of goods previously delayed by the U.S. dock strikes.

Sterling After a long period of sustained pressure, the announcement of the good December trade figures in the middle of January brought some relief to sterling, and a small inflow of foreign exchange developed. This continued in the first half of February, but there was little sign that the funds withdrawn earlier were returning to London to any important extent. One reason for the generally better tone in the market was that the accepting houses and overseas banks were switching substantial amounts of foreign currency deposits into sterling, which they then lent to local authorities and other borrowers in the United Kingdom. The market remained sensitive, however, and the announcement of the disappointing trade figures for January caused a sharp, if temporary, setback.

The spot rate against the U.S. dollar fluctuated in February between \$2·79$\frac{5}{16}$ and \$2·79$\frac{5}{8}$. It tended to fall towards the end of most weeks, but this is a normal market phenomenon when interest rates in London are considerably higher than in New York. Spot deals are normally for value two business days later: thus deals entered into on a Thursday and Friday are usually for value the following Monday and Tuesday respectively. There is therefore twice the normal time lag and the spot rate on Thursday and Friday takes account of the interest advantage to the seller which arises from his being able to employ the sterling for two extra days over the weekend.

The downward adjustment between Wednesday and Thursday is accentuated by the operation of the clearing system in New York whereby dollars sold against sterling for value Friday are not effectively debited in New York until Monday, although the sterling is received on Friday. Thus those selling dollars on Wednesday will have the use of both sterling and dollars over the weekend. This will normally be reflected in a rise in the spot rate for sterling on Wednesday, which is reversed on Thursday.

U.S. dollar rates strengthened in some continental centres in February as a consequence of the wide range of measures announced on 10th February to reduce the U.S. balance of payments deficit. These broadened the scope of the interest equalisation tax, and included restraints on bank lending abroad and an appeal to corporations to repatriate available liquid funds from abroad and to reduce foreign investments. Early in March a general shortage of dollars developed as the new measures began to take increasing effect, in particular through the repatriation of liquid funds. The effects of this shortage were most readily apparent in the euro-dollar market, where rates rose abruptly. The dollar hardened noticeably on the Continent, and also strengthened against sterling. As a result the modest inflow of exchange into the United Kingdom ceased, and the trend was reversed.

From the middle of March, moreover, the approach of the Budget was causing anxiety in the market, and rumours of possible sterling devaluation (though subsequently dispelled) again became rife both at home and abroad. Very heavy selling of sterling took place on Friday 26th March, and again on the first two days of April, immediately before the weekend preceding the Budget. The usual symptoms of pressure—a sharp deterioration in the forward rate and freak rates (over 20% per annum) for day-to-day borrowing of sterling—were again apparent. The spot rate, which had eased steadily during March, was held around $2·79. The rise in dollar rates on the Continent was checked in the latter part of March; for this, the sales of dollars by the U.K. authorities to support sterling were no doubt partly responsible. The dollar improved again on the Continent later in April as sterling recovered.

Sales of sterling ceased after the Prime Minister's assurance in Paris during the weekend before the Budget that there would be no devaluation. The Budget itself was fairly well received in the market, and sentiment improved further after another speech by the Prime Minister on 14th April in New York. This made it plain that, on first taking office, the Government had rejected devaluation as a solution to the United Kingdom's balance of payments problems. Thereafter the authorities were able to recover part of the exchange lost at the beginning of April, while allowing the spot rate to rise gradually to $2·79\frac{7}{8}$ by the end of the month.

The improvement in the spot rate made it increasingly expensive for those who had previously sold sterling forward, as a hedge for sterling assets, to cover their positions; it could also be expected to encourage the reversal of leads and lags and to strengthen confidence generally.

Forward exchange market Between the end of November and the middle of January the authorities had, as described in March, assumed very heavy forward commitments in foreign exchange. Most of these matured three months later.

Several courses were then open to the market. Where the foreign currency was wanted on maturity for commercial payments, it would simply be taken up and the loss to the reserves would be no greater than if no forward commitment had existed. Where the exchange was not immediately wanted on maturity or had been bought forward simply to hedge sterling assets, the choice—unless the assets were to be sold—lay between undoing or extending the deals. If the deals were undone, the rate for sterling would tend to improve. The reserves would not be affected except where deals were undone by spot purchases in advance of maturity, when the reserves would benefit temporarily. If the deals were extended there would be no effect upon the reserves in cases where the counterpart to the original transaction had been provided indirectly by the E.E.A. and the latter also provided the counterpart to the extension of the contract. The undoing of contracts would tend to strengthen the rate (and perhaps encourage more covering); the extension of maturing contracts would tend to increase the discount on forward sterling (and perhaps tend to weaken confidence). Official policy therefore took account of these considerations during the period by allowing the spot rate to rise or by giving support to the forward rate, as seemed appropriate.

There were relatively few maturities in February. Some of these were extended. Nevertheless, the banks were able to cover the switching into sterling mentioned earlier by buying foreign currency forward within the market, and without recourse to the authorities. During March there was a very large volume of maturities, and as the market was unsettled at this time, most of these contracts were renewed. From the middle of the month, moreover, a fresh demand for forward exchange built up; and despite heavy official intervention, forward rates moved sharply against sterling until early in April. In April most contracts maturing in the first half of the month were renewed, but the subsequent revival of confidence and improvement in the spot rate encouraged the market to reverse some deals. Partly because of this, forward rates moved strongly in favour of sterling for much of the month, and at the end of April discounts were appreciably smaller than at any time since Bank rate was raised in November.

Changes in domestic money rates are discussed later. For most of February three months' local authority money offered a better return, after allowing for the cost of forward cover, than dollar deposits in London. This advantage exceeded $\frac{5}{16}$% at one time, but it disappeared after the middle of March as a result of the rise in dollar deposit rates which followed the U.S. measures referred to earlier. Later in March rates for dollar deposits eased as funds were attracted from fresh sources, while those for local authority money increased. But the rising cost of forward cover more than offset these movements, producing a margin of nearly $\frac{1}{2}$% in favour of dollar deposits at the beginning of April. From the middle of that month, as the cost of cover fell again, local authority money again became slightly the more profitable outlet; but the difference had almost disappeared at the end of the month following a sharp fall in local authority rates.

During most of the three months February to April there was a margin—allowing for the cost of forward cover—in favour of investment in U.S. rather than U.K. Treasury bills. This exceeded $\frac{1}{2}$% in late March and early April. In the second half of April, however, the balance of advantage changed as forward sterling improved.

External liabilities and claims

Sterling balances of overseas countries continued to fall in the first quarter, though by much less than in the fourth (Table 21 (i) in the statistical annex). If the effects of the official swap transactions, detailed later, are excluded, gross liabilities to countries outside the sterling area fell by £47 million. This largely reflected the pressure in the foreign exchange market at various times during the period, and compares with a fall of £184 million during the previous quarter.

As recorded, gross sterling liabilities to countries in the overseas sterling area also fell, by £30 million, in the first quarter. But this did not represent a reduction in the total sterling assets of these countries, since it arose entirely from a net transfer of funds out of Treasury bills into deposits with local authorities. Such deposits are not included in the statistics of external liabilities and claims in sterling, which mainly relate to funds held with banks.(1) The comparatively small change recorded in the gross liabilities to sterling countries this year contrasts strongly with an increase of more than £100 million in the first quarter of 1964. The change is mainly due to the deterioration which has occurred in these countries' aggregate payments position as a result of rising imports and generally lower prices for their products—especially foodstuffs—in world markets.

As usual in the first quarter, there was a strong increase (of £66 million) in U.K. claims, mainly on sterling countries. Allowing for these, total net sterling liabilities (including a fall of £14 million in those to international organisations but again excluding official swap transactions) fell by £157 million. As against this, the banks' net external liabilities in foreign currencies (Table 22 (i) in the annex) rose by £147 million in the quarter, reflecting the heavy switching into sterling noted earlier.

The reserves rose by £5 million in the first quarter, but only after a net £148 million of short-term assistance had been received from overseas central banks, as described below. These changes, together with the changes in external liabilities and claims (including the deposits with local authorities) and in other known miscellaneous capital items, point to

(1) Changes in deposits with local authorities are included in the balance of payments statistics in the item "miscellaneous capital".

adverse monetary movements in the balance of payments of about £130 million. Though still a high figure, this is over £100 million less than in each of the two preceding quarters. The indications are that the deficit on current and long-term capital account, discussed earlier, is unlikely to have been as large as £130 million in the first quarter, so there may well prove to have been a negative balancing item, reflecting unrecorded capital outflows. In the circumstances then ruling it would not be surprising if, for example, there had been some further unfavourable leads and lags in commercial payments.

Special assistance Details of central bank assistance received to the end of December were given in the March *Bulletin.* In the next three months, as mentioned above, an additional £148 million was received: a small repayment in February was substantially outweighed by drawings in the other two months. In April net drawings amounted to £56 million. Help was taken early in the month to finance the cost of withstanding the severe pressure against sterling in the period before the Budget, already referred to; but part of this was repaid later as sterling strengthened following the Prime Minister's statements.

In February the United Kingdom had announced that it intended to seek a further drawing from the International Monetary Fund. On 25th May the equivalent of $1,400 million (£500 million) was drawn, which brought the Fund's holding of sterling up to about 198% of the present U.K. quota.(1) This drawing, which is repayable within five years, was made in the following currencies:

Currency	Equivalent in U.S. $ millions
Belgian francs	82·5
Canadian dollars	107·5
Danish kroner	30·0
Deutschemark	312·5
French francs	242·5
Italian lire	182·5
Japanese yen	77·5
Netherlands guilders	87·5
Spanish pesetas	40·0
Swedish kronor	37·5
U.S. dollars	200·0
	1,400·0

To finance the drawing the Fund used $475 million of its existing currency holdings, sold $400 million of gold, and acquired the balance of $525 million through the General Arrangements to Borrow. As in December, Switzerland, which is not a member of the Fund but is associated with the Arrangements to Borrow, provided the United Kingdom with a parallel credit: this was for five years and equivalent to $40 million.

Of the total borrowing of $1,440 million, $1,097 million was used to pay off outstanding short-term debt. The balance of $343 million (£122 million) was added to the reserves, which rose in May by £181 million to total £1,021 million. The amount of assistance outstanding at the end of each month between December 1964 and May 1965 is summarised in the table below. Of the short-term assistance outstanding at the end of the first quarter, $660 million (£236 million) had resulted from swap transactions and $280 million (£100 million) was in the form of currency deposits. The way in which such transactions and the I.M.F.

$ millions

	Dec.	Jan.	Feb.	Mar.	Apr.	May
Federal Reserve Bank of New York	200	200	105	320	280	—
Other short-term assistance	325	600	600	620	817	—
Total short-term	525	800	705	940	1,097	—
I.M.F.	1,000	1,000	1,000	1,000	1,000	2,400
Swiss bilateral credits	80	80	80	80	80	120
Total	1,605	1,880	1,785	2,020	2,177	2,520
£ millions	*573*	*671*	*637*	*721*	*777*	*900*

(1) Holdings of a member country's currency are not normally allowed to exceed 200% of its quota.

drawing are treated in the annex is explained on page 15 of the March *Bulletin.*

The $750 million swap arrangement with the Federal Reserve Bank and the $250 million credit line with the U.S. Export-Import Bank[1] remain available to the United Kingdom. In addition, part of the portfolio of U.S. dollar securities which was vested in the Government during the war has recently been put into more liquid form and is thus readily available to reinforce the reserves in case of need. The market value of this portfolio has recently averaged around $1,250 million.

The gold market Demand for gold was exceptionally heavy in February. This was partly due to rising political tension over Vietnam, but a more important influence was the French authorities' declared intention in future to settle their external payments in gold. Although demand moderated to some extent early in March, a change probably associated with the growing scarcity of dollars, it remained heavier than usual for the rest of the month and during the first half of April; it then eased considerably. Producers increased their sales of gold appreciably in this period, but not sufficiently to satisfy demand. The gold pool continued to operate. The dollar equivalent of the daily fixing price rose steadily from $35·12 per fine ounce at the beginning of February to almost $35·18 early in March. It then eased somewhat and towards the end of April moved down quite sharply to below $35·11.

The banking situation To the extent that there were sporadic outflows of foreign exchange between mid-January and mid-April, substantial amounts of sterling continued from time to time to accrue to the Exchequer through the Exchange Equalisation Account. Moreover, for much of this period, the Exchequer also benefited from the seasonal inflow of tax revenue. In these circumstances the liquidity of the London clearing banks came under pressure, for the consequent fall in the market's holdings of government debt was largely in Treasury bills, and it showed up particularly in the holdings of the banks. Treasury bills held by the clearing banks, Scottish banks and discount houses together fell by over £550 million.

The clearing banks' combined liquidity ratio fell from 32·1% in January to 29·5% in March and April. They also sold more than £120 million of gilt-edged stocks, and their combined investment ratio fell over the period from the already low figure of 12·9% to 11·4%.

Despite the pressure on their liquidity, the decline in the rate of increase in the clearing banks' advances which developed at the end of 1964, as described in the March Commentary, was soon reversed. On a seasonally adjusted basis their advances (excluding those to nationalised industries) fell by £80 million in the two months to mid-February, but then rose by as much as £135 million in the next two months (see Table 10 in the annex). At the same time, and again allowing for seasonal adjustment, their net deposits, which had fallen sharply in the month to mid-January, then rose strongly in the next three months.

The increase in both advances and net deposits was particularly marked at the April make-up date, when net deposits rose by £153 million—considerably more than usual at this time—and advances—which are usually little changed—rose by £73 million. The April figures covered changes since mid-March, and part of the rise in advances probably reflected the late payment of taxes; the high cost of borrowing appears to have led many customers to delay taking advances for this purpose earlier in the year. In addition, the uncertainty in the capital market probably increased the demand for advances from companies. Even so, the increase was disquietingly large.

The rise in the clearing banks' deposits in the month to mid-April was largely matched by the increase in their lending to the private sector. Besides the increase in their advances, there was a sharp increase of some £60 million in the month in their holdings of commercial bills. Following earlier increases this brought their total holdings of such bills to £506 million, against £370 million in April 1964. The use of bill finance has increased appreciably over the past year, particularly in recent months, while the banks have been trying to limit the growth in their advances both for their own liquidity

(1) Described in a White Paper (Cmnd. 2610) published in March 1965.

reasons and in accordance with the Governor's request in December. There were thus more commercial bills on offer in the market; at the same time the clearing banks bought more than usual in view of the severe shortage of Treasury bills.

The Chancellor had emphasised in the budget speech that further steps would be taken to control bank lending should it appear necessary. Accordingly on 29th April, as soon as the April banking figures were known, the Bank of England called for Special Deposits of 1% from the clearing banks and $\frac{1}{2}$% from the Scottish banks.(1) To allow the banks time to readjust their resources, and to lessen the impact on the money market, the Special Deposits were to be made in two stages : one-half by 19th May and the rest by 16th June.

Following this announcement the Governor wrote on 5th May to the Chairman of the Committee of London Clearing Bankers. He emphasised that the authorities wished the call for Special Deposits to be fully reflected in the banks' lending policies and that it should therefore be mitigated as little as possible by the sale of investments. For the present the aim was that the London clearing banks' advances to the private sector should not increase at an annual rate of more than about 5% during the twelve months to March 1966. At the same time the banks should similarly limit their acceptances and purchases of commercial bills. The guidance given in the Governor's letter last December concerning the direction of lending in general still stood; but it was now more than ever important to give first place to exports and activities contributing directly to them.

The Governor wrote in similar terms to the other main banking associations, including the Accepting Houses Committee and the London Discount Market Association, asking them to observe a comparable degree of restraint. He also wrote to the British Insurance Association, the National Association of Pension Funds, the Building Societies Association, and the leading associations of hire-purchase finance houses, asking them to co-operate to the same ends in their own fields.

The latest figures, for the month to mid-May, show a fall of £76 million in the clearing banks' advances (excluding those to nationalised industries), reversing the rise in April. The fall was spread over all the banks and perhaps partly reflects the absence of the exceptional tax payments which influenced the April figures, as mentioned earlier, and partly a genuine change in the trend.

Bill markets The situation in the Treasury bill market during most of February to April was not easy either for the authorities or for the market. The difficulty of forecasting developments in the foreign exchange market (including the uncertain disposition of the very large forward sales of sterling which matured in this period) made it unusually difficult to estimate the Exchequer's need for market finance and hence to judge the number of Treasury bills to be offered week by week at the tender. There were complications, too, in the daily management of the market. It is often possible, for example, when the market is short of money at the beginning of a week, to relieve the shortage—wholly or partly—by buying bills due to mature later the same week on days when the market is likely to be in funds.(2) For reasons already described, however, the market was extremely short of Treasury bills at this time and it was not always possible to obtain bills of the desired maturity to ensure tight control day by day.

The discount houses' Treasury bill portfolios were severely depleted; and they sometimes had difficulty both in finding bills to lodge with the banks as security for call money and in meeting the banks' full requirements for their own account. In this situation, the houses were inclined to raise their bid at the weekly tenders in order to secure as big an allotment as possible of the relatively few bills on offer. In the second half of January their tender rate had come down by $\frac{3}{32}$%; and between the end of January and mid-March they lowered it further, by nearly $\frac{3}{16}$%, to just under $6\frac{3}{8}$%. The authorities, although recognising the market's difficulties, were unwilling to see the rate slip in this way while sterling remained weak, and the houses were obliged on a number of occasions to borrow substantial amounts from the Bank at Bank rate.

(1) The mechanism of Special Deposits was described in the December 1960 *Bulletin*, page 18.
(2) See " The management of money day by day " in the March 1963 issue.

As a result of this pressure, and conscious of the position of sterling, the houses cut their bid sharply on 19th March, raising the rate by $\frac{3}{16}$%. They maintained this rate at the next two tenders, but after the Budget they began to raise their bid again. By the end of April the rate was back to $6\frac{3}{8}$%.

The market in commercial bills continued active. As noted earlier, more bills were coming on offer and the banks were buying heavily in view of the shortage of Treasury bills. Rates fell, but less than for Treasury bills: the discount market's buying rate for three months' prime bank bills, for example, eased from $6\frac{3}{4}$% at the end of January to $6\frac{11}{16}$% at the end of April.

Other short-term money The special circumstances which caused some decline in bill rates did not apply to other short-term money rates, which mostly remained as high during February to April as in the previous three months, or even went higher. In the first quarter the accepting houses and overseas banks were again lending substantial sums to the local authorities, but the new money replaced only two-thirds of the amount withdrawn in the fourth quarter (Table 11 in the annex). The local authorities remained short of funds, and their difficulties were accentuated in March by the usual repayments at the end of the financial year to the Public Works Loan Board. It is likely, too, that funds were being withdrawn from them to pay taxes. At the same time, with Bank rate at 7%, they remained reluctant to borrow other than at short term. At the end of March over 9% was being paid for seven-day money and 8% for three months' deposits. The position eased somewhat during April, when the local authorities were able to make use of their new annual quotas with the P.W.L.B. and as they entered a period in which revenue from local rates is large. At the end of April rates for seven-day money were down to about $7\frac{1}{2}$% and for three months' to $7\frac{1}{4}$%.

The hire-purchase finance houses, faced with continuing heavy demands for finance, particularly to buy cars, competed actively for funds. They came under some of the same end-March influences as the local authorities. The spread of the main houses' three months' deposit rates rose from 7%–$7\frac{3}{8}$% at the end of January to a peak of $7\frac{1}{2}$%–$8\frac{1}{8}$% early in April. They subsequently eased, and by the end of that month were down to $7\frac{1}{4}$%–$7\frac{3}{4}$%.

Gilt-edged The improvement in sentiment which developed in the gilt-edged market in mid-January was broadly maintained during February and the first half of March. Nevertheless, some of the buoyancy went out of the market in the middle of February, when the publication of the disappointing trade figures for January dispelled the hopes which had begun to develop of an early reduction in Bank rate. Early in February, as mentioned in the last *Bulletin*, 4% Treasury Stock 1965 was redeemed, and a further tranche of 5% Exchequer Stock 1967 was issued to replenish official holdings of short-dated stocks. On balance, during these six weeks, the authorities were selling stocks to moderate the rise in the market. This intervention was mainly in short and medium-dated stocks. At the longer end of the range the same purpose was served by allowing a fairly rapid succession of new issues by local authorities and public boards, most of which were handsomely oversubscribed.

In the second half of March the market weakened again, mainly as a result of the renewed weakness of sterling. The approach of the Budget also added to the uncertainty. There was no great weight of selling; but the market was in a sensitive state and some modest support was given to moderate—though not to stop—the fall in prices. Total turnover in the London market in March was the lowest in any month since last September when the statistics of turnover began (Table 16 in the annex).

During April turnover remained small, but the mood changed almost from week to week. At the very beginning of the month, before the Budget, there was a slight rally, but prices were marked down afterwards while the market took stock of the situation. The main activity at this time was a certain amount of switching by financial institutions from low-coupon to high-coupon long-dated stocks as a result of the capital gains tax. Immediately before Easter the improvement in sterling again put some heart in the market, as it led to renewed expectations—which were encouraged by press comment over the Easter weekend—of an early reduction in Bank rate. But these hopes in turn were dispelled at the end of the month by the call for Special Deposits. The authorities bought or sold stock as appropriate during April to lessen price fluctuations, though on balance they sold. Besides smoothing prices, they also continued, as usual, to acquire stocks of the nearest maturities as opportunity offered, while selling those of longer maturity.

Yields in general rose during February to April. As shown in Table 24 in the annex, the redemption yield on 3% Transport Stock 1978/88 rose from 6·17% to 6·56%. As an illustration of the greater demand which developed for the higher-coupon stocks, the comparable rise for 5¾% Funding Loan 1987/91 was only from 6·44% to 6·62%.

Local authority long-term borrowing

The initial stages of the programme to give local authorities greater access to the P.W.L.B. have been described in previous issues of this *Bulletin*.[1] Eventually they will be allowed to obtain up to 50% of their annual long-term requirements by borrowing from the Board at relatively favourable rates. Meanwhile, for the current financial year their quotas have been raised to 30% of requirements or £100,000, whichever is the greater (against 20% or £100,000 last year). In addition, the Chancellor announced in the Budget that to assist regional development he would allow authorities in less prosperous areas (to be named later) to borrow up to the full 50% this year. Drawings from the Board increased appreciably in April when the new quotas became available.

Throughout February to April rates on these loans were unchanged at 5⅝% to 6⅛%, depending on the term, as they have been since last August. Holding these rates below market rates—they are not, for example, as high as the corresponding gilt-edged yields—has helped local authorities to limit the rise in their burden of debt interest, which has grown considerably in recent years.

During these months the local authorities were able to raise £75 million net from the market by the issue of short-term bonds (£15 million) and stocks (£60 million), compared with a total of only £9 million in the four previous months. This borrowing, together with that from the P.W.L.B., enabled them to borrow less in the mortgage market, and mortgage rates changed little during the three months. At the end of April they ranged from 7⅛%–7¼% for terms of two to five years down to 6⅞% for over thirty years.

Building societies

In March it was noted that the pressure on their resources had impelled the Building Societies Association to recommend increases in both borrowing and lending rates. These came into effect on 1st February, but the societies' difficulties continued to increase. During the first quarter new money still came in quite well, but a record amount was withdrawn. Some of this was probably for transfer to local authorities, which were offering a higher return. Some, also, will have been used for down-payments on mortgages: recently many societies have been willing to lend only to those who have previously saved with them. In all, net receipts on shares and deposits amounted to £93 million, compared with £165 million in the same quarter a year earlier. At the same time, new advances on mortgages remained very high. Net of repayments, they totalled £110 million, well in excess of the net inflow of funds. In consequence, the societies' average liquidity ratio (cash and investments, other than mortgages, expressed as a proportion of total assets) fell to 13·2% at the end of March, as against 14·5% three months earlier and 16·5% in March 1964. There was little change in the position in April.

It would seem that the new rates are insufficient in present circumstances either to attract the desired volume of funds or to contain the demand for loans. Some potential borrowers may have had recourse to other lenders when turned away by the societies, but many will have had to forgo a mortgage. The societies would be reluctant to see their liquidity ratios fall further, and they will thus be unwilling to

[1] June 1964, page 90, and March 1965, page 9.

finance much more lending except as their receipts allow. Their position seems unlikely to ease significantly until circumstances allow some reduction in competing short-term rates.

Debenture and equity markets Sentiment in the debenture and equity markets had begun to recover in January, but the improvement was short-lived. The poor January trade figures announced in mid-February seemed to undermine the recent growth in confidence and thereafter, in March and April, the markets for the most part remained dull, with no clear trend.

In the happier interval up to the middle of February, a substantial number of capital issues were announced, largely of debentures. In February and March together U.K. companies raised £65 million from the market, but in April there was a sharp drop to £6 million (net of £14 million redeemed preference shares). During the three months, over £70 million was raised in debentures and other loan stocks compared with some £16 million in equities (Table 15 (ii) in the annex).

The equity market was strongly influenced before the Budget by uncertainties over the proposed corporation and capital gains taxes; while afterwards, with many details still to be revealed in the Finance Bill, the complexity of the measures prevented any firm assessment and the market remained subdued. Turnover rose for a time just before the Budget, but for most of April it was distinctly lower than in February and March. The F.T.-Actuaries index of industrial share prices edged up from 110 at the end of January to 111 at 18th February, but a month later it was down to 104; it then moved irregularly to 107 at the end of April.

Debenture yields had reached a peak at the end of January. According to the new F.T.-Actuaries calculation, the average yield on 20-year stocks was then nearly $6\frac{7}{8}\%$, rather more than $\frac{1}{2}\%$ above the yield on government stocks of comparable term. Yields changed little in February, but the rise was renewed in March. After approaching $7\frac{1}{8}\%$ in the middle of April, the yield on these 20-year stocks eased to 7% at the end of the month. The margin over comparable government stocks was then $\frac{3}{8}\%$.

Outlook Although incomes have recently been rising rapidly, the tax increases introduced last November and April, together with the restrictions on credit, should distinctly limit the increase in personal consumption this year. Fixed investment by the private sector, while still probably one of the most buoyant components of demand, is likely to increase less quickly as the year progresses: this was implied in the results of the Board of Trade's survey of investment intentions last December, and there seems to be some support for this expectation in the fact that the sharp increase in the flow of new home orders for engineering goods, which developed during 1964, has recently levelled out. Prospects for stocks are always particularly difficult to assess, but they will probably rise less this year than last, partly because of the discouragement of the import surcharge, and partly because of the high cost of borrowing and the restrictions on credit. These restrictions will, more generally, reinforce the other factors tending to limit the growth of demand and activity in the private sector, although every effort will be made to avoid any check to production for export.

In the public sector a further strong increase must be expected in capital expenditure this year, both by the nationalised industries and by central and local government. A continued increase is also envisaged in the current expenditure of local authorities, but that of the central government may rise comparatively slowly, mainly because of the cancellation of the TSR2. The search for further economies in government spending continues.

The improvement in overseas trade in the opening months of this year was encouraging. It owed something to special factors on the import side, notably the surcharge (which was reduced at the end of April), unusually low food imports, and the U.S. dock strikes. As a result, later months may look correspondingly worse. Nevertheless it is possible to be guardedly optimistic for the future, provided, of course, that costs are kept under control. The restrictions on home demand should help to restrain the growth of imports and they are also intended to help create the conditions in which the recent rise in exports can be maintained. Here they have been combined with measures of direct encouragement, such as the tax remissions for exporters announced last October and the better credit facilities made available in January.[1] Demand in the main world markets continues to expand, and export orders for engineering goods have indeed recently risen further. In all, therefore, prospects for exports are reasonably hopeful. Apart from the improvement in visible trade, the balance of payments will benefit from the specific measures announced in the Budget to improve the capital account, and from the savings looked for in government expenditure overseas. As the balance of payments improves, the strain on sterling should lessen accordingly and confidence revive.

The measures which have been taken by the authorities to remedy the economic situation and to right the balance of payments should have a marked and increasing impact. It is possible to doubt, however, whether the public at large even now fully realise the extent of the crisis from which the country is emerging or accept its consequences. Recovery must be a joint effort, and it can only be jeopardised if the public try to offset the Government's measures of restraint by making excessive demands for higher money incomes, or if they refuse to accept that some expenditure—public and private—must be postponed. Not everything which may be desirable can be afforded immediately, particularly by those already in heavy debt. Over the past year the United Kingdom has incurred debt to the I.M.F. of $2,400 million : of this, $1,000 million falls due for repayment in two and a half years from now and the balance within five years. This vast financial help has been made available from abroad to provide a breathing space in which the United Kingdom can re-order its affairs, but it is only by its own efforts that the country can re-establish itself. It is essential that the borrowed time be properly used to this end.

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[1] See March *Bulletin*, page 30. Further improvements in export credit facilities were announced on 8th April. Unconditional guarantees given by the Export Credits Guarantee Department directly to banks in respect of fixed-rate loans will now normally cover 100% of any losses instead of 90% and will be available for credits of two years or more instead of three years or more (the minimum contract value of £50,000 is unchanged). The premium for this kind of cover is reduced by 50%. In addition, the proportion of credit covered by other E.C.G.D. guarantees against losses through insolvency or protracted default will now be 90% instead of 85%. On 1st June premiums for all E.C.G.D. guarantees on U.K. exports, other than bank guarantees, were cut by 10%.