Commentary

The present Commentary may well begin as the last one ended, with a reminder that $1,000 million is due to be repaid to the International Monetary Fund in less than two and a half years, and a further $1,400 million in less than five years. In addition, medium-term credits totalling $120 million must be repaid to Switzerland; and, in the short-term management of sterling, use has been made of swap facilities. Against these liabilities there are of course significant reserves, and the portfolio of dollar securities not yet brought formally into the reserves; furthermore, on the widest view of the balance-sheet the United Kingdom is a net creditor, not a net debtor, internationally. None the less, these new international debts incurred by the United Kingdom require that primacy in economic policy be given to the restoration of a surplus in the balance of payments. The further far-reaching measures of control introduced by the Government on 27th July clearly reflect this priority. The measures are necessary not only to enable the United Kingdom to meet its external obligations, but also to establish a foundation for enduring economic growth at home.

Domestic economy

The three months of May to July with which this Commentary is mainly concerned were a time of considerable uncertainty. As reported in previous issues of this *Bulletin*, many initiatives had earlier been taken which, in the longer run, might be expected to foster exports, increase productivity and lead to more orderly developments in prices and incomes. These policies are indeed being further developed and should in due course show results. There was, however, a more immediate need for some early indication that the succession of restrictive measures introduced from last October onwards—increased taxes, stricter controls on hire purchase, Special Deposits and other measures to restrict credit—were succeeding in relieving the pressure on the economy. There were some signs that events were moving this way, but the evidence was inconclusive and it seemed likely that substantial relief was, in any event, some way off.

The main signs of slackening in the economy lay in the field of consumer spending. Seasonally adjusted, the volume of retail trade, which accounts for about half of all consumers' expenditure, is now thought to have been about 1½% lower in the second quarter than the first: some decline was to be expected after the heavy precautionary buying before the Budget, but trade appears to have been 1% down even compared with the fourth quarter of 1964. The number of new cars registered in May and June together was the lowest for those months since 1962, and the total for the second quarter was 10% below a year earlier. Private housing starts, too, rose less than usual in the second quarter, probably because of difficulties in obtaining finance from the banks and building societies. Shortages of building materials were also delaying the completion of houses, on both private and public account. Nevertheless total house-building activity was still very high, for there were nearly 470,000 houses and flats building at the end of June, over 8% more than a year earlier. Stockbuilding had been significantly less in the first quarter than in any quarter since the middle of 1963. This was a consequence perhaps of the high cost of finance and the import surcharge, coupled with the pre-budget buying mentioned above. But among the other main elements of home demand there was no sign of any current down-

turn—as distinct from the expectations of such a downturn some time in the future which were being fairly widely voiced.

In particular, current and capital spending by the public sector and private expenditure on industrial fixed investment were still very heavy. Manufacturers' investment had been particularly buoyant early in the year: at constant prices, and allowing for seasonal movements, it was 9% greater in the first quarter than in the last quarter of 1964. There had admittedly been some decline in new orders for engineering goods and machine tools, but there were many orders on hand and the surveys of investment intentions made by the Board of Trade and the Federation of British Industries in May had suggested, like other reports from industry, that activity was likely to continue very high throughout this year at least.

The high rate of public spending in general, and in particular the very heavy drawings made by local authorities on the Public Works Loan Board under the new and larger quotas which became available in April,[1] attracted criticism abroad as well as at home. Opinion was disturbed by rising retail prices and also by the large wage increases which continued to be negotiated, well above the recommended norm of 3%–3½%. If allowance is made for the decreasing interval between them, new wage settlements continued to add the equivalent of some 6% a year to hourly rates of pay; actual earnings were probably rising faster still.

Unemployment fell a little less than seasonally from May to July, and the excess of vacancies over unemployment was slightly reduced. It was difficult, however, to know how much significance to attach to this. In both June and July the percentage out of work was only 1·2%, and with unemployment so low the scope for further reduction in the total must have been limited. In regions where unemployment was above the national average, it did in fact continue to fall. Moreover, quite apart from the figures, the continuing complaints from many sections of industry that shortages of labour were limiting production, including production for export, made it clear that the pressure was still excessive. Exports (which are discussed later) were proving disappointing month by month, and it seemed only too likely that difficulties of supply were an important cause, if not necessarily the only one. Reports of lengthening delivery dates for exports supported this view. In other words, given the existing standards of productivity, too much was still being attempted.

Although the balance of payments had improved markedly compared with last year, the failure of exports to expand as had been hoped was beginning to throw doubt upon the possibility of achieving the Government's objective of reaching a balance on the combined current and long-term capital accounts in the latter part of 1966. The same failure, coupled with the more general continuing uncertainty about the country's economic prospects, aroused new doubts abroad; and confidence in sterling, which had shown signs of recovering in May, weakened again sharply during June and July. By the end of July it was clear that new measures were necessary, both to help the balance of payments and to reassure overseas opinion of the Government's determination to make sterling strong.

New measures

The new measures introduced by the Chancellor on 27th July fell into two groups: those intended to limit the growth of demand at home—both to help cut down on imports and so as to leave more room for exports—and those designed to improve the external payments position in more direct ways.

Expenditure by the public sector—central and local government and the nationalised industries—is being slowed down. Housing, schools and hospitals will be contained within the existing programmes; and the start of many other non-industrial capital projects will be postponed for six months. Loan sanction and grants will be refused for certain less essential local authority projects (of a kind on which expenditure has been running at £150 million a year), and the local authorities are also being asked to cut their lending on mortgage for

[1] June *Bulletin*, page 113. By the end of June about £180 million had been drawn (or half the amount budgeted for the whole year) compared with £30 million in the first quarter of the financial year 1964/65. The rise this year was not, of course, a measure of the increase in actual spending by the local authorities, for they were, at the same time, reducing their (more expensive) borrowing from market sources.

house purchase to £130 million this year compared with £180 million in 1964/65. In addition local authorities will be required to spread the remainder of their borrowing from the P.W.L.B. evenly throughout the rest of the year, with the proviso that authorities which had already drawn more than half their year's quota by late July will not be allowed any further drawings before October.

The Government are reviewing their staff establishments to avoid any unnecessary increase and are asking local authorities to do the same. All public authorities have also been asked to defer current purchases of equipment and stores and, especially, to economise in overseas expenditure. Furthermore, the general review of public expenditure begun in the spring has been completed; the total programme has been reshaped and next year's departmental estimates will be drawn up within strictly defined limits. More particularly, as a result of the review of defence expenditure, it has so far been possible to cut next year's intended spending by £100 million. The Chancellor also announced that a number of projected social reforms—an income guarantee scheme, the removal of the remaining health service charges, favourable interest rates on mortgages for owner-occupiers—had been postponed.

In the private sector, the Chancellor decided to introduce construction licences for large projects other than housing and industrial buildings, to control office building in the Birmingham conurbation, and to tighten the control over industrial development in the London and South Eastern, Midlands, and Eastern regions. To help contain personal consumption, he cut the maximum period for hire-purchase contracts on most goods from three years to two and a half years, a measure which he estimated would reduce demand by about £65 million. This new restriction followed the increase in minimum down-payments (from 20% to 25% for cars and motor cycles and from 10% to 15% for most other goods) announced in June.

The measures, aimed directly at improving the external payments position, included some further tightening of exchange control, estimated to save in all some £45 million in foreign exchange over the next year. No official exchange will be provided for the time being for any direct investment outside the sterling area; any approved projects will have to be financed with investment dollars or by borrowing abroad. The supply of new investment dollars, which was restricted in the Budget,[1] will be further limited, as certain other receipts beyond those then stipulated will in future have to be converted at the official rate of exchange, instead of being sold in the investment dollar market. The Bank of England are also to exercise more uniform control over borrowing by U.K.-registered companies controlled from outside the sterling area (in effect, long-established companies will now be subject to the same scrutiny as those more recently established when they wish to raise finance in this country). Finally—a once-for-all saving—payment for imports will not in future normally be allowed before they have been despatched (previously any time after the contract date was acceptable).

The Chancellor also announced that export credit facilities were to be even further improved.[2] Firstly, bank guarantees given by the Export Credits Guarantee Department could cover contracts of £25,000 and upwards, compared with the previous lower limit of £50,000. Secondly, the banks had agreed in principle to take part in a scheme, which is now being worked out, under which they would finance short-term export credits of from thirty days to two years at Bank rate against an unconditional guarantee by the E.C.G.D.; at present these credits are financed without guarantee at around 1% above Bank rate.

The Governor's letters

On the same day as the Chancellor announced these new measures, the Governor of the Bank wrote a further letter to the Chairman of the Committee of London Clearing Bankers and to the other main banking organisations. In May the Governor had written asking that the clearing banks' advances to the private sector should not be allowed to increase at an annual rate of more than about 5% during the twelve months to March 1966. He also then repeated the

[1] June *Bulletin*, page 105.

[2] Earlier changes were noted in the March *Bulletin*, page 30 and the June *Bulletin*, page 115.

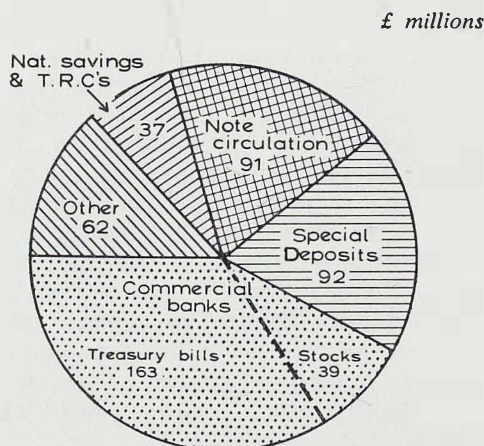
guidance given in his letter the previous December concerning the direction of the banks' lending, and emphasised that it had become more than ever important to give first place to exports and activities contributing directly to them. In similar letters the members of other banking and financial associations were asked to observe a comparable degree of restraint and to co-operate to the same ends in their own fields.[1] Subsequently the Bank approached a number of leading finance houses which were not members of one of these associations drawing their attention to the Governor's letters and asking them to co-operate similarly.

In his letter of 27th July to the banking institutions, the Governor re-emphasised the importance of encouraging exports and pointed out that the need to restore the balance of payments to equilibrium at the earliest possible date made it equally important to restrain the growth of finance for imports—especially imports of manufactured goods for home consumption and imports for stockbuilding. While appreciating that it was sometimes difficult to distinguish between credit needed to pay for imports and credit for other purposes, the Governor asked the banks to scrutinise requests for credit even more carefully than before where it appeared that their purpose might be to facilitate payment for imports.

Exchequer financing The heavy call made by the local authorities on the P.W.L.B. was the main single reason why the Exchequer Group's internal financing requirement (the balance on revenue account, consolidated fund loans and extra-Exchequer funds in Table 1 of the statistical annex) was appreciably larger in the first quarter of this financial year than in the same period of 1964/65. The amount needed was £484 million compared with £231 million a year earlier.

As shown in Table 1, the Exchange Equalisation Account and "other external items" apparently provided £244 million towards financing this deficit. But these receipts were largely the counterpart of reductions in overseas holdings of government debt: so far as they can be identified, overseas holdings of stocks and Treasury bills fell by £189 million (Table 3 of the annex), of which £93 million resulted from the net repayment of central bank assistance in the form of swaps.[2] An increase in notes and coin in circulation provided £91 million, and £121 million came from an increase in the government debt held by the Bank of England, Banking Department (including £92 million of Treasury bills held as the counterpart of Special Deposits). National savings and tax reserve certificates brought in £37 million, while other miscellaneous holdings of government debt outside the banking sector fell by £22 million. This left a further £202 million to be provided by the commercial banks and discount houses. This they did by buying £39 million more stocks and £163 million more Treasury bills.

£ millions



The commercial banks and discount houses contributed an important part of the Exchequer's internal financing requirement of £484 million during April-June. Within "other", there were substantial, and largely offsetting, changes in the finance made available from overseas and through the E.E.A.

Banking situation Comprehensive figures for the banking sector as a whole are not available beyond the end of June. More up-to-date figures are, however, available for the London clearing banks. Between the March and August make-up dates their hold-

[1] June *Bulletin*, page 111.

[2] The accounting is explained in a note on page 300.

ings of government debt increased by £73 million, their call money by £76 million, and Special Deposits by £89 million. Their lending on advances rose by £55 million and their holdings of commercial bills by £22 million. Net deposits rose in total by £358 million.

Advances other than to nationalised industries rose by only £16 million during this period. Allowing for seasonal variations this represented an annual rate of growth since March of about 2%. It is true that there were large fluctuations from month to month, and the seasonal adjustments can never be entirely reliable: for example, at a time of unusually high interest rates, there is likely to have been too little allowance for the effect on the June and July figures of the debiting of half-yearly interest charges on overdrawn accounts. Nevertheless there seems no doubt that the clearing banks have kept well within the 5% limit. They are also co-operating with the authorities by providing, for the time being, confidential information each month about the direction as well as the amount of their lending. As requested, advances to personal and professional borrowers, to hire-purchase companies and to property developers have been curtailed; and such increase as there has been in the total arises largely from lending to manufacturing industry.

It is too early to be sure of the trend of advances by other groups of banks. Some of these show quite substantial increases in the second quarter (Table 9 of the annex). But it may be recalled that the Governor's letters setting the 5% limit were sent only at the beginning of May and that many of these banks serve a rather narrower range of customers than the clearing banks, with a predominance very often of comparatively large industrial borrowers with long-standing advance facilities; this may make it more difficult to bring about an early change in the total of their lending. Moreover, although little is known about the relevant seasonal patterns because many of these statistics are of comparatively recent origin, there are indications that lending by some of these banks normally rises appreciably in the second quarter.

The limit on lending also applied specifically to acceptances and purchases of commercial bills. In the event the supply of commercial bills in the market has continued to rise quite rapidly but, as with advances, it is early to assess the exact significance of this. In some trades, for example, a need for bill finance follows many months after orders for goods have been placed, and serious embarrassment could follow too sharp or indiscriminate a reduction in facilities. The demand in many trades is also sharply seasonal, and here again comparatively little is yet known about the effect of such seasonal demands on the total of bill finance. On this question of bills, as well as advances, the Bank are keeping in close touch with the individual banks and associations concerned.

Meanwhile the Bank have reduced from 50% to 35% the proportion of inland finance bills which, for the time being, they are themselves prepared to accept in their sampling purchases of prime bank bills from the market, and only half of this smaller proportion may be hire-purchase finance bills. A number of the clearing banks have similarly become very much more selective in the paper they are prepared to buy.

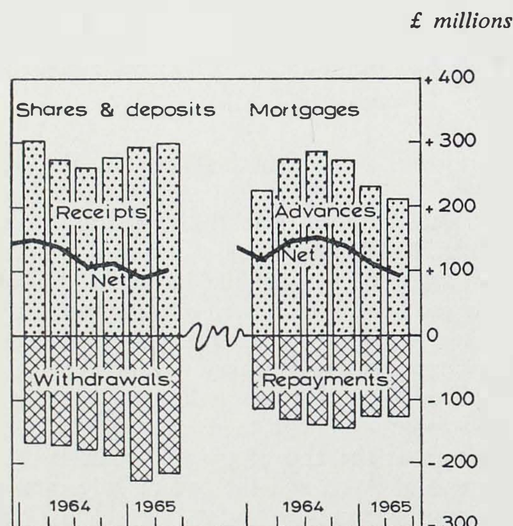
Short-term money

It was seen in the June *Bulletin* that the position of the local authorities in the temporary money market had begun to ease during April. This was partly because of the increased drawings from the P.W.L.B. referred to earlier and partly because their income from rates increased seasonally. In general, their position continued to be comparatively easy throughout the next three months, though there was as usual some pressure at the end of the half-year. Between the end of April and the end of July rates on the shorter-term deposits (at 2 days' and 7 days' notice) fell from 7¼%-7½% to 5⅞%-6¼%. Rates for three months' money, which were less closely affected by the cut of 1% in Bank rate on 3rd June, came down from 7¼% to 6⅜-6½%. The larger fall for the shorter-term deposits (where most business is usually done) partly reflected the preference for such loans of overseas depositors, who place their funds either direct or through the banks.

The hire-purchase finance houses may have experienced rather less demand for new finance. Car buying was somewhat slacker than in the months before the Budget; moreover since early in June the minimum down-

payments have been higher, so that the balances requiring finance have tended to be smaller. On the other hand, the houses' outstanding hire-purchase claims were still rising (at least up to June); and they may also have wished to take in some deposits to compensate for the repayment of bank advances. In the event, the houses' rates came down in line with the local authorities': for example, the main houses' three-months' deposit rates fell only $\frac{3}{4}$%, from a spread of $7\frac{1}{4}$%-$7\frac{3}{4}$% at the end of April to one of $6\frac{1}{2}$%-7% at the end of July.

Building societies The fall in other short-term deposit rates helped to ease the position of the building societies, which had been very tight early this year. In the second quarter, receipts from shares and deposits were almost as high as in the first quarter, although a fall would have been expected on seasonal grounds. The flow of deposits was also stimulated by the announcement early in June that the Building Societies Association had recommended increases of $\frac{1}{4}$% in their borrowing rates, to take effect from 1st July (shares went up to 4% and deposits to $3\frac{3}{4}$%, both tax paid). At the same time withdrawals, which had been exceptionally heavy in the first quarter, were reduced and, in all, the societies' available funds increased in the second quarter by £100 million.



The fall in the net amount advanced on mortgages by the building societies in the past year followed, after a time-lag, a fall in their net receipts on shares and deposits.

The societies' net advances on mortgages fell in the quarter, to £96 million, which was only two-thirds as much as they lent in the same period last year. The fall resulted from their extensive refusal of requests earlier in the year. In consequence, borrowers resorted more than usual to other lenders in the housing market, notably to local authorities.

At the end of June, the societies' average liquidity ratio (cash and investments, other than mortgages, expressed as a proportion of total assets) was 13·6%, slightly higher than at the end of March. Previously it had fallen continuously since early in 1964, when it had been 16·9%.

The restriction on local authority lending for house purchase announced at the end of July has most likely increased the pressure on the societies to lend, but their present liquidity position leaves them little room to increase their lending. The new borrowing rates have proved attractive—for example, in relation to national savings securities—and in July and August funds were coming in well. But even if this continues, the current margin between the societies' lending and borrowing rates allows them little scope for adding to their reserves, and their reserve ratios are already quite low. Although the Association have not recommended an increase in mortgage rates since February, some individual societies have begun to charge more.

Treasury bills The Exchequer's need for market finance during May to July was comparatively small and the discount houses continued to find themselves very short of Treasury bills for sale to the clearing banks and others. At the weekly tenders they had constantly to balance their desire to raise their agreed bid in order to secure a good allotment against the knowledge that, in the difficult economic circumstances, the authorities would not wish to see the rate slide too far below Bank rate.

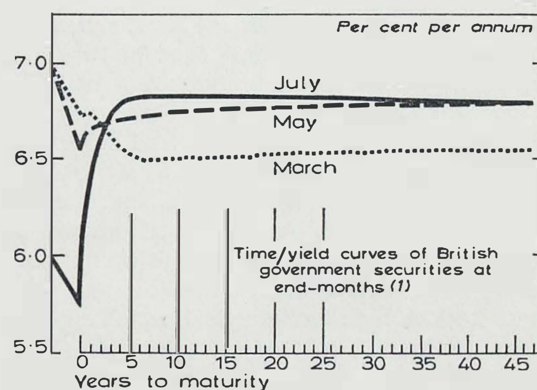
Between the beginning of April and the first tender in May the houses reduced their tender

rate from $6\frac{9}{16}\%$ to $6\frac{5}{16}\%$, at which point it was probably very little above what they were themselves paying, on the average, for their money. They made no change at the next tender, and it is an indication of the pressure they were under that they were allotted only 13% of the amount they had applied for.

At the end of May, when sterling weakened, the discount houses raised the rate to $6\frac{3}{8}\%$, but lowered it on 4th June, after the change in Bank rate, by just under $\frac{3}{4}\%$ to $5\frac{21}{32}\%$. They were still concerned to increase their allotments if they could, and lowered the rate further at each subsequent tender until 2nd July, when it was down to $5\frac{33}{64}\%$. In the last week of June several houses were required to borrow heavily from the Bank, partly in order to check this slide and partly because the Bank were unwilling, as usual, to provide all the help needed to overcome the shortage of money in the market resulting from end-June window-dressing. Further very heavy borrowing was enforced in the first week of July. Following this, the market reduced its bid at the next two tenders, raising the rate again to $5\frac{21}{32}\%$, the same as immediately after the reduction in Bank rate. There was no further change to the end of the month.

Commercial bills It was noted in the June issue that rates for commercial bills had not been subject to the same downward pressures as those for Treasury bills, and that there had been some widening in the margins between them. These wider margins were generally maintained—or increased—during May to July. Throughout June, for example, when the Treasury bill rate was slipping week by week, the market made no change in its buying rate of $5\frac{15}{16}\%$ for prime bank bills. This rate had been established early in the month immediately after the change in Bank rate, and it was in fact maintained to the end of July. In the course of the three months, the discount houses also tended to increase the margin between their buying rates for the best trade bills and those for prime bank bills: for example, in some cases where margins of $\frac{1}{8}\%$ to $\frac{1}{4}\%$ over the rate for prime bank bills have traditionally applied, margins of $\frac{1}{4}\%$ to $\frac{5}{16}\%$ have now been established. This rise has reflected the increased pressure of demand for bill finance against the background of credit restraint.

Gilt-edged The gilt-edged market continued to be heavily overshadowed during May to July by uncertainty concerning the capital gains tax, the difficult economic situation and, in particular, the persistent weakness of sterling. There was little life in the market except on a few occasions when special circumstances provided a brief stimulus.



The change in Bank rate on 3rd June was followed for a while by a fall in the yields on short-dated stocks, but continuing doubts about the economic situation soon caused most of these falls to be reversed, and more. Yields on other stocks were less affected.

The first of these occurred after the announcement late on 26th May that, as regards gilt-edged stocks issued before Budget day, the capital gains taxes would not apply to price movements within the range between the lowest price at which a stock had been issued and the redemption price. This altered the pattern of relative yields, because it increased the attraction of stocks issued at a discount for investors whose funds are subject to tax. Accordingly, although dealings were suspended for a time on the 27th while the implications for prices were being worked out, when business

(1) The lines begin at Bank rate, continue through the yield on 91-day Treasury bills and through or near redemption yields on stocks having a $4\frac{1}{2}\%$ or higher coupon; and end with that on $5\frac{1}{2}\%$ Treasury Stock 2008/12.

began again a certain amount of switching took place. As an example, the concession altered radically the relative attractions of British Transport 3% Stock 1968/73 (for which the lowest price of issue had been $73\frac{1}{8}$%) and British Electricity 3% Guaranteed Stock 1968/73 (issued at par). These had previously been regarded as practically identical stocks. For investors subject to tax there was now an advantage in buying the Transport Stock, and in the course of 27th May the price rose $3\frac{3}{8}$ points to 81. In contrast, the price of the Electricity Stock rose only $\frac{5}{8}$ of a point to $78\frac{1}{4}$. By the end of July the prices of the two stocks had moved further apart, to $82\frac{3}{4}$ and $78\frac{3}{4}$.

The market also became for a time more active during the first adjustment of prices after the change in Bank rate on 3rd June, and again following the issue on 23rd June of two new gilt-edged stocks. £100 million each of $6\frac{1}{2}$% Exchequer Loan 1969 and $6\frac{1}{2}$% Treasury Loan 1976 was offered at par for cash; and holders of 3% Savings Bonds 1955/65—a stock held fairly widely by small investors, and due for redemption on 15th August—were invited to convert at par into either or both of the new stocks. The exceptionally high coupon gave these stocks a high running yield, which allowed them to be issued with redemption yields somewhat below those prevailing in the market. The shorter stock, in particular, proved attractive to the discount houses.

Apart from the desirability of being able to make a conversion offer, the main purpose of the new issues was, as usual, to replenish official holdings of stock so as to ensure that the authorities were able to meet demand should the market recover. These issues provided new short and medium-dated tap stocks in the area where such activity as there was in the gilt-edged market was largely concentrated. In addition, it would always be possible to respond to a recovery in demand, if it seemed desirable, by allowing the queue of local authority issues to move forward faster.

Local authority longer-term borrowing

The months under review saw little change in the cost of local authority long-term borrowing, though some rates were lower for a time in June. Funds borrowed in the mortgage market mostly cost from $6\frac{7}{8}$%-$7\frac{1}{4}$%, depending on the size and length of the loans, and, as has been usual since last autumn, the longest loans were generally the cheapest. There was once again no change for loans from the P.W.L.B., whose rates of from $5\frac{5}{8}$% to $6\frac{1}{8}$%, depending on the term, continued to be below the cost of borrowing in the stock market: in July yields on new issues of local authority stocks and bonds ranged from $6\frac{3}{4}$% to $6\frac{7}{8}$%.

The heavy recourse of the local authorities to the P.W.L.B. has already been mentioned. In addition, during May to July, they continued to raise substantial sums through new capital issues—including calls on issues made earlier in the year. Over the three months they raised £45 million net on stocks and £6 million on short-term bonds (gross issues of bonds were £17 million, but these included the renewal of £11 million of maturing one-year bonds). This brought the total amount raised on new issues since the beginning of the year to nearly £130 million, much more than in the whole of any recent year except 1962, when the year's total was £136 million. By July, the market was having some difficulty in absorbing this flow and it was somewhat curtailed in August.

Debenture and equity markets

Like the gilt-edged market, other sections of the stock exchange were subdued throughout May, June and July: in general, prices drifted downward and turnover declined. Buyers were hesitant partly because of the uncertain economic prospect and partly because of difficulty in assessing the effect of the tax changes.

The debenture market had begun to improve at the end of April, but the downward trend of prices was soon resumed, and over the next three months they fell steadily, and markedly faster than gilt-edged prices. According to the F.T.-Actuaries calculation, the average yield on 20-year stocks increased by $\frac{3}{8}$% over the three months, to $7\frac{3}{8}$%, while the margin over government stocks of comparable term widened from $\frac{3}{8}$% to $\frac{5}{8}$%. Turnover fluctuated, but on balance it declined during May and June and then increased quite substantially in July.

There was a large flow of new debenture issues and in July nearly £50 million was raised, a record amount for one month. Short-term finance was being restricted by the squeeze. At the same time, because of the new corporation tax, raising money through equities has generally become more expensive in rela-

tion to borrowing on debentures; while from the investor's point of view, the capital gains tax and the uncertain economic outlook have both tended to reduce the relative attraction of equity investments. As a result, firms were prepared to borrow in the debenture market despite the high yields that had to be offered.

It follows that in the equity market new issues remained few and far between. In the twelve months to the end of July only a little over £80 million was raised in this way, or barely half as much as in just the first six months of 1964. Turnover declined during May and then remained fairly steady in June and July, though at a low level.[1] After rising a little early in May, prices fell almost continuously—by 10% in all—from the middle of the month until early July. A short recovery was offset by another fall towards the end of the month, and the F.T.-Actuaries index of industrial share prices, which had reached 110 in the middle of May, was down to 99 at the end of July. Prices were then at their lowest since February 1963.

Balance of payments Although full details are not yet available, it is clear that there was a further improvement in the balance of payments between the first and second quarters of the year. Indeed, the current and long-term capital accounts which, taken together, showed a deficit of £100 million in the first quarter, may well prove to have been roughly in balance during the second—the best quarterly result for two years. The improvement owed quite a lot to seasonal factors, as the second quarter is particularly favourable for trade, but the deficit on long-term capital account was also probably much reduced. Despite this, the reserves came under heavy pressure owing to an outflow of short-term capital: the banks were switching back into foreign currency substantial amounts of euro-dollar deposits which they had earlier converted into sterling, and there were also further reductions in overseas sterling holdings.

Exports were disappointing in the second quarter, and the strong expansion which began last autumn was interrupted. As recorded in the trade accounts, and seasonally adjusted, exports were actually a little lower than in the first quarter. (The good July figures suggest that this may indeed have been only an interruption) The fall in the second quarter was more than accounted for by reduced exports of transport equipment (excluding road vehicles), but this category is generally volatile, and deliveries of aircraft are expected to rise substantially during the second half of the year. On the other hand, exports of metals continued to do well. There were falls in many markets but exports to the United States and Western Germany rose strongly. For the future, U.K. order books for exports of engineering goods are still full, but new orders are coming in rather more slowly, and prospects in world markets are somewhat mixed. The primary-producing countries as a group are unlikely to be able to increase their imports much: their export earnings have been rising more slowly since the middle of last year, and some of them are also taking steps to restrict imports or to restrain internal demand. Among the industrialised countries, there are signs that the rate of expansion in Western Germany may slacken slightly, but demand should revive in France, Italy and Japan—countries where U.K. exports have been level or falling for some time. The extent and timing of this recovery are at present very uncertain, but there are already signs that the long decline in exports to Italy may now have levelled out.

It is difficult to be sure of the trend of imports. Allowing for seasonal movements they apparently rose by over 5% in the second quarter, but there were a number of special reasons for this. Imports of food, which had been unusually low early in the year, rose to a more normal level; and goods which had been delayed by the U.S. dock strikes, notably in February, continued to arrive and swell the figures for several months afterwards. Furthermore, the reduction in the import surcharge from 15% to 10% on 27th April was followed by a sharp rise in imports of semi-processed and finished manufactures in May, with perhaps some effect on later months also. Taking the first two quarters together to minimise

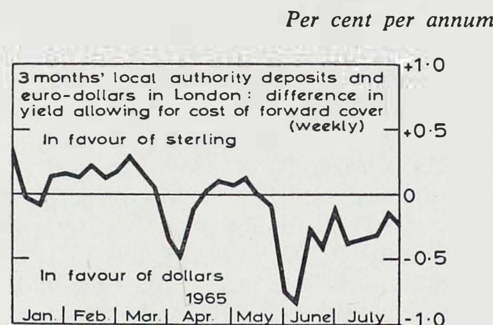
(1) Possibly the lowest level for seven years, judging by the number of stock exchange marks for company securities. The statistics of stock exchange turnover, available since September 1964, suggest that the number of marks is a reasonably accurate guide to turnover in company securities, and also that deals in equities regularly account for about 90% of all deals in company securities.

these distortions, the monthly average for all imports was 1½% lower than in the fourth quarter of 1964. The decline was mainly in food and owed something to lower prices. Imports of industrial materials also fell, while those of finished manufactures were little changed. The effect of the surcharge—against a background of high domestic activity—appears to have been considerably greater than is sometimes allowed: despite the rise in imports which followed its reduction in April, those subject to the charge averaged 6½% less during November to June than in the four preceding months, whereas other imports were 2¼% higher. Among the items subject to the charge, imports of capital goods were up 4½% but other goods were down 11½%.

The deficit on long-term capital account may well have fallen from £90 million in the first quarter to practically nothing in the second. Remittances abroad by U.K. subsidiaries of overseas companies, which had been unusually large earlier in the year, returned to a normal level. The benefit also began to be felt of surrenders of investment dollars under the 25% rule announced in the Budget;(1) these were running at about the annual rate of £50 million which the Chancellor had envisaged. There were, moreover, some special items which helped the capital account: in particular, a large company issue in Western Germany and the redemption of an Australian loan between them brought in nearly £20 million.

External liabilities and claims The commercial banks' net external liabilities in foreign currencies fell by £95 million in the second quarter, reversing much of the increase which had taken place earlier in the year (Table 22 of the annex). The withdrawal of foreign currency deposits accounted for £68 million. Most of this probably reflected the repatriation of funds by U.S. corporations in response to the U.S. measures announced in February to curb the net outflow of private capital. Withdrawals by Canadian banks, which had on-lent U.S. funds on a substantial scale in the past, were particularly heavy. Despite this loss of deposits the banks added £27 million to their total foreign currency assets, for they switched some of their sterling resources back into foreign currencies. These movements chiefly affected the accepting houses and overseas banks, which are the main intermediaries in the London euro-dollar market. An increase in sterling deposits with these banks was more than enough to enable them to accommodate

Per cent per annum



Relative interest rates, though not the only consideration, have probably been important this year in influencing the banks whether to employ funds in sterling or foreign currency assets.

their U.K. borrowers. Among these, local authorities, as has been seen earlier, were not bidding so strongly for money; and lending to other borrowers, though it rose in total, was nevertheless affected by the credit restrictions. (Table 11 of the annex).

Net sterling liabilities to overseas sterling area countries fell by £52 million in the second quarter (Table 21 of the annex). There was, as usual at this time, a marked reduction in U.K. claims, but gross liabilities fell by as much as £101 million. Although the second quarter is seasonally favourable for the overseas sterling area countries as a whole, this influence was probably more than offset by the continued underlying deterioration in their balance of payments position. In contrast, in the same quarter last year net liabilities to these countries rose by £73 million.

Net sterling liabilities to countries outside the sterling area fell by £23 million during the quarter if the effects of the net repayment of £93 million of special assistance in the form of swaps are excluded. Within the quarter, however, there were quite large movements from month to month in the sterling held by these countries—notably a rise in May and a fall in June.

(1) June *Bulletin*, page 105.

Besides these changes there was a rise during the quarter of some £30 million in overseas deposits made with local authorities and hire-purchase finance houses. These deposits are not included in the series of external liabilities and claims in sterling, which relate mainly to funds held with banks, but details may be found in a new table in the additional notes on page 300. It is not possible to distinguish the source of these funds by countries, but the rise in the second quarter was probably predominantly in deposits from sterling area countries.

All these movements in liabilities and claims reacted, as noted later, upon the foreign exchange market.

Reserves and special assistance

The reserves rose by £165 million in the second quarter, but this was only after the net receipt of £307 million of special assistance, implying an underlying loss of just over £140 million. The net increase in special assistance was made up as follows. Short-term aid from overseas central banks, which had amounted to £336 million[1] at the end of March, was repaid in full in May. In the same month £500 million was drawn from the I.M.F. and a supplementary credit of £14 million was made available by Switzerland.[2] These transactions were described more fully in the June *Bulletin*. Then, during June, sterling came under renewed pressure and £129 million was taken under the reciprocal swap arrangement with the Federal Reserve Bank of New York.

In July, some £41 million was deposited by Western Germany as provision for future purchases under the agreement to offset part of the foreign exchange cost of U.K. military expenditure in that country. Further recourse, much less substantial than in June, was also made to the swap facility with the F.R.B. Even so, the reserves fell by a further £50 million. July is seasonally a poor month for the balance of payments. As noted below, confidence remained weak, and there was some further net fall in non-sterling countries' holdings of sterling. There was also another sizable fall in the banks' net external liabilities in foreign currencies.

Foreign exchange market

The rather better tone which developed in the market about the middle of April was maintained for most of May, and the reserves benefited from a modest inflow of foreign exchange. Towards the end of the month, however, sentiment faltered again, and confidence remained weak in June and July. The trade figures continued to be disappointing (especially those for May, which were published in the middle of June) and, more generally, misgivings persisted abroad about the development of the U.K. economy. There were renewed rumours of sterling devaluation. At the same time, as noted earlier, sterling was also affected by the programme to correct the U.S. balance of payments position.

Sales of sterling were relatively small at the end of May, but heavy in the middle of June, and again in the second half of July. Substantial support was given from time to time. Sentiment improved somewhat after the Chancellor's announcement on 27th July of the further measures to restrain demand and reinforce the balance of payments, but the publication of the July reserve figures revived anxieties.

The spot rate against the U.S. dollar eased during May from around \$2·79 7/8 to \$2·79 1/4. After rallying slightly early in June, it weakened further to touch \$2·79 during the latter part of July, but recovered to \$2·79 1/4 in the last few days of the month.

Very substantial forward sales of sterling, made originally around the turn of the year and mostly renewed three months later, matured during June and July. In the uncertain conditions then prevailing, nearly all of these contracts were further extended. At the same time there was some fresh demand for forward exchange. In these circumstances, the authorities judged it appropriate to give some support to the forward market.

A comparison between the yield on three months' local authority deposits and three months' dollar deposits in London is shown in the chart on page 224. As regards Treasury bills, for most of May there was a covered differential ranging up to $\frac{1}{2}$% in favour of investment in U.K. rather than U.S. bills. Then for

[1] £236 million in the form of swaps and £100 million in the form of foreign currency deposits.

[2] This credit is in the form of a swap: see the note on page 300.

a while the balance of advantage varied from one to the other, largely because of fluctuations in the forward rate, but throughout July it stayed in favour of U.S. bills. The differential either way rarely exceeded ⅛% during June or July.

Gold market Private demand for gold was heavy at times in May, especially in the middle of the month, but little more than moderate during June and the first half of July. It then strengthened appreciably, with renewed buying on Chinese account becoming a major factor. This may well have been associated, among other reasons, with a recent improvement in China's trading position. The greater demand for gold also no doubt owed something to the disturbed conditions in the exchange market and to anxiety about the situation in Vietnam.

Sales by producers continued to be substantial and were supplemented only to a modest extent from official sources. The dollar equivalent of the daily fixing price fluctuated around $35·10 a fine ounce for most of the period, but it was allowed to rise above $35·16 as demand increased towards the end of July. Interest was sustained into August, and by the end of the first week the price had risen above $35·19½. This price was only maintained for a few days, however, after which it began to decline following reports of possible Russian sales to cover grain purchases.

Conclusion The improvement in the balance of payments suggests that, as the Government's measures take full effect, their aim of eliminating the deficit in the course of next year will be achieved. It was in the light of this improvement and the better sentiment in the foreign exchange market that the Bank, with the full authority of the Government, entered into new arrangements with a number of central banks on 10th September. This was in no sense a further support operation for sterling but was intended to provide a boost to a strengthening pound.

The main reason for the successive measures introduced since last October has been, as suggested earlier, to contain the growth of home demand so as to help make room for exports and to keep imports within bounds. Since the end of July, which is where the story has stopped in most sections of this Commentary, evidence has increased that these measures are working their way through the economy. It now seems likely that in the second quarter private fixed investment stopped rising and that the rate of stockbuilding was little changed; on the evidence of this and of bank clearings, it appears that total activity in the economy may not have increased very much, if at all.

At the beginning of August unemployment, seasonally adjusted, again increased slightly and, as in July, vacancies fell slightly. In the course of August, too, came news of reduced overtime and of short-time working in the production of cars and some consumer durable goods. This appeared to be the consequence partly of reduced demand from the public (for example, fresh hire-purchase contracts for cars showed a distinct fall in August), and perhaps partly of cuts in dealers' stocks. Further developments of this kind may be expected. Reports that orders for building materials and fitments have started to fall off suggest that the congestion in this industry may be beginning to ease. There is also some evidence in the latest figures that the increase in manufacturers' selling prices may have slackened somewhat: there was virtually no change in the official index of these prices in June and July, though cheaper imports will have played some part in this.

The new measures announced at the end of July are far reaching. They will reinforce the earlier restraints on consumers' spending and should in due course markedly reduce the pressure on the construction industry. It has yet to be seen what effect these developments may have on business confidence. A change of mood could gain hold quickly if it once began. Some reassessment of the prospects facing particular industries cannot be avoided. But it is important not to exaggerate the extent of the reduction which it is intended to bring about in the use of the country's resources. It is desirable that national output should keep rising but, for the time being, at a speed which, in relation to the underlying growth of national capacity, diminishes the strain on these resources.

Easing of the pressure is necessary because the United Kingdom, which lives so largely by its foreign trade, cannot continue for long spending more abroad on imports and in other

ways than is justified by its exports and other overseas earnings. Least of all can it do so when overseas confidence in its currency is impaired. Ultimately there need be no conflict between restraining home demand in conditions such as these and achieving the best development of our national wealth. The growth of demand cannot for long outrun the growth of capacity; it is only through the increase of capacity, in ways adequately directed towards the needs of overseas trade, that a faster growth of output can be sustained.

The various measures taken by the Government should result in a considerable and continuing easing of the pressure on resources and a corresponding improvement in the balance of payments. But there has so far been no evidence that the growth of money incomes and of productivity have been brought into better relationship. This problem needs to be tackled both by increasing efficiency and by greater restraint in the growth of incomes and prices. Lord Devlin's report on the docks and the reports of the Prices and Incomes Board have stressed this; and at the beginning of September the Government took an important new initiative in its proposals for an 'early warning system' for prices and incomes. Whatever the final outcome of this initiative, some way must be found to achieve effective restraint.