Commentary

The Commentary this time is mainly concerned with events during the three months August to October. The outstanding development in this period was the improvement in the position of sterling from late August, after many months under pressure. Early in September it was announced that further substantial international resources had been made available to back an already strengthening pound. Helped by this, sterling continued to gain ground. The authorities were able to acquire substantial amounts of foreign exchange for the reserves and to make a start both in reducing their outstanding market commitments in forward exchange and in repaying some of the short-term swap assistance which they had drawn earlier.

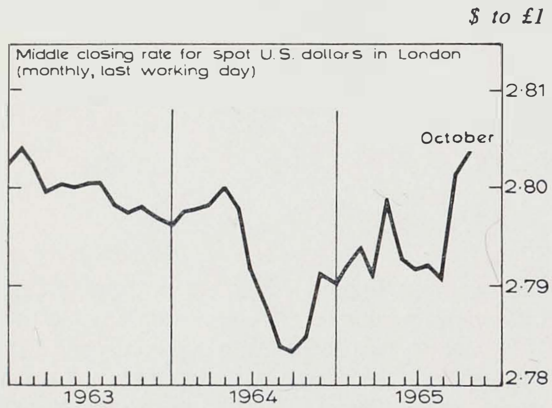
The recovery in sterling did much to bring a more confident tone to domestic financial markets, notably the gilt-edged market. Exports did well in the third quarter, but—partly for seasonal reasons and partly because of the uneven phasing of some transactions—the out-turn for the balance of payments as a whole is likely to be appreciably less favourable than in the second quarter. There is still a good way to go before the external position is secure.

Sterling After some improvement during April and May, sterling had again come under severe pressure in June and July. This eased briefly after the announcement on 27th July of the further measures to correct the economy, but was renewed when it became known on 3rd August that despite some special receipts the reserves had fallen in July by £50 million. In the early part of August substantial official support was given in both spot and forward markets. Later in the month sales of sterling were lighter, occurring commonly just before the weekends. The spot rate against the U.S. dollar was held at a little over \$2·79 throughout; the three months' forward rate moved sharply against sterling in the first week, but subsequently remained fairly steady.

Towards the end of August the selling pressure appeared to have exhausted itself, and in the first few days of September the authorities began to recoup modest amounts of exchange, while allowing the spot rate to rise a little. The announcement on 10th September that further international resources had been mobilised behind sterling gave a marked impetus to the change in sentiment, and the demand for sterling strengthened, despite the apparently disappointing trade figures for August which were published shortly afterwards. The spot rate was allowed to rise to almost \$2·80$\frac{3}{16}$ by the end of September, although the authorities also bought in substantial amounts of exchange.

Conditions were rather quieter during October, but there was a steady inflow of funds, which increased towards the end of the month when the announcement of a new government short-dated stock, described later, was widely taken as pointing against an early reduction in Bank rate. The spot rate fluctuated around \$2·80$\frac{5}{16}$ for most of October, moving up to \$2·80$\frac{3}{8}$ at the end of the month and touching \$2·80$\frac{1}{2}$ early in November. The general improvement in sentiment led to a marked reduction in the discount on forward sterling in September and October. There was less anxiety than before to take forward cover for commercial transactions at the earliest moment; and overseas residents rolled on fewer of the maturing forward sales originally contracted as a hedge for sterling assets.

The renewed pressure on sterling in August led, as might be supposed, to a further withdrawal of overseas funds. But this was not the



The return of confidence in sterling had raised the spot rate for U.S. dollars to $2·80⅛ at the end of October, the highest for over two years.

only reason for the difficult conditions in the exchange market during that month. The situation was also being aggravated by the balance of payments position, which is seasonally weak in the third quarter. Furthermore the banks were converting back into foreign currency funds which they had earlier switched into sterling for employment in this country. Interest differentials were no doubt important in this. As noted later, the return on deposits with local authorities, after allowing for the cost of forward cover, was at this time significantly less attractive than that on dollar deposits.

In September and October, the outflow of short-term capital was abruptly reversed. The commercial banks' switching operations were broadly neutral over the two months, but countries outside the sterling area began to rebuild their sterling balances on a substantial scale. The reduction in these balances during the previous year had undoubtedly created a shortage of sterling, on top of which overseas residents had large commitments to deliver sterling arising out of the very heavy volume of outstanding forward purchases of foreign currency against sterling. Once the change in sentiment became established at the beginning of September, the inflow of funds tended as usual to generate its own momentum.

The rise in the spot rate was both symptomatic of the reduced strain on sterling and itself a factor making for a further strengthening of confidence. The rebuilding of unusually low working balances and prompter settlement for exports were both encouraged as the cost of acquiring sterling could be seen to be increasing.

The improvement in sterling during September and October cannot be measured solely by the rise in the spot rate, the increase in the reserves, and the repayments of special assistance noted below. There was also a sharp reduction in the authorities' outstanding forward commitments with the commercial banks.[1] To the extent that these were the counterpart of forward sales of sterling to the banks which had arisen, not from cover on commercial transactions, but from the hedging by overseas residents of sterling assets of various kinds (in other words from forward sales of sterling to insure against a fall in its value), it was to be expected that sooner or later, as confidence revived, the contracts would be closed out. As noted earlier, this began to happen from September onwards, whereas in earlier months maturing forward contracts for hedging purposes had for the greater part been renewed.

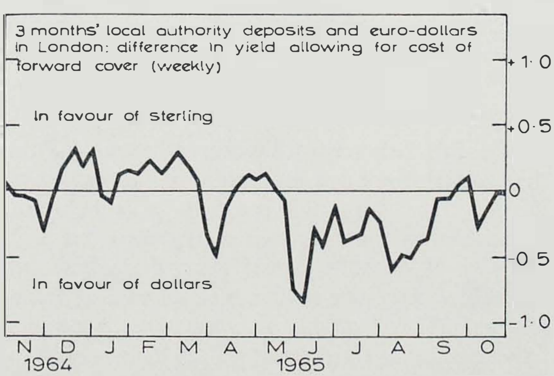
When such contracts are closed out they are, in effect, self-liquidating. The banks have to deliver foreign currency to their customers in exchange for the sterling that the latter originally sold forward; but to fulfil their side of the contracts the customers will generally need to buy this sterling from the banks, against foreign currency. The banks' spot currency position is therefore unchanged on balance but their forward commitments to their customers are reduced. In much the same way, the banks are then able to unwind their forward transactions with the Exchange Equalisation Account, whose spot holdings of currency are unaffected on balance but whose forward commitments to the banks are reduced. The demand for sterling by the banks' customers to enable them to close out their forward sales of sterling tends to strengthen the spot rate or, in many cases where the contract is closed out before maturity, the forward rates. The authorities' action in allowing rates to rise in Septem-

[1] March *Bulletin*, page 4.

ber and October provided a further incentive to close out such contracts, as the cost of buying the necessary sterling looked like continuing to increase.

The increase in the discount on forward sterling during August and the subsequent reduction from September onwards had an important influence on international interest-rate differentials. The margin in favour of investment in U.S. rather than U.K. Treasury bills, after allowing for the cost of forward cover, rose abruptly from about $\frac{1}{4}$% to $\frac{3}{4}$% per annum around the beginning of August. During September, despite a tendency for the U.S. bill rate to rise and the U.K. rate to fall, the margin narrowed steadily and towards the end of the month was reversed. It favoured U.K. bills for most of October, but was never large—rarely exceeding $\frac{1}{8}$%. The comparison between three months' euro-dollar deposits and three months' local authority deposits in the United Kingdom, again allowing for the cost of forward cover, showed sterling at a disadvantage of $\frac{1}{2}$% to $\frac{5}{8}$% during most of August although dollar deposit rates were easing. The gap

Per cent per annum



Changes in relative interest rates during August to October were tending to reduce the advantage to the banks of employing their funds in foreign currency assets rather than in sterling.

narrowed during September despite a fall in local authority rates and towards the end of the month it disappeared for a short time. It re-emerged in October, at one point touching $\frac{7}{16}$%, as local authority rates fell further and dollar deposit rates rose. The fluctuations in dollar deposit rates were themselves no doubt associated with the U.K. authorities' sales and subsequent purchases of dollars—which first increased, and then reduced, the supply of dollars in the market—as well as with tighter monetary conditions in the United States.

Reserves and special assistance As described in previous issues, outstanding short-term assistance had all been repaid in May following the U.K. drawing from the International Monetary Fund; but in June, as sterling came under renewed pressure, the equivalent of £129 million had been drawn under the $750 million (£268 million) swap facility with the Federal Reserve Bank of New York. The reserves fell by a further £50 million in July, even though £59 million more was taken under the swap facility and some £41 million was received from Western Germany as provision for future purchases under the current agreement to offset part of the foreign exchange cost of U.K. military expenditure there. The balance of £80 million still available under the U.S. swap facility was exhausted in August; and the equivalent of an additional £50 million was provided, also on a swap basis, by the F.R.B. Even so the reserves fell by £24 million. This special £50 million swap was repaid early in September; nevertheless, as a result of the turnround in sentiment, the reserves rose by £61 million over the month. There were further increases in the reserves of £42 million in October and £41 million in November, and in both months repayments were made under the $750 million swap with the F.R.B.

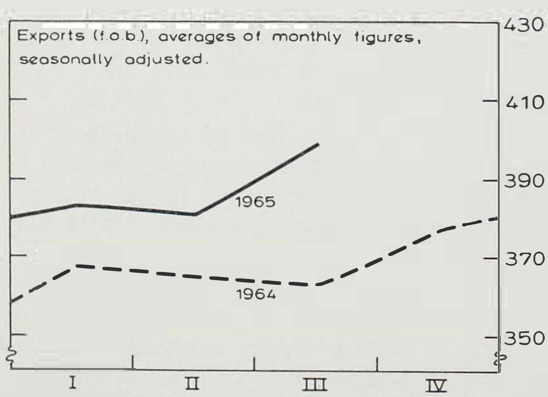
The $250 million line of credit from the U.S. Export-Import Bank, which expired in November, was renewed for a further year and will thus be available if required up to 25th November 1966.

Gold market There was considerable activity in the gold market during the months under review. Demand had increased towards the end of July, partly because of renewed buying on Chinese account and partly because the market was affected by the disturbed state of the foreign exchange market and by anxiety over Viet-nam. In the first week of August the dollar equivalent of the daily fixing price rose as high as $35·19$\frac{3}{8}$ a fine ounce. The demand was not sustained, however, and the price soon began to fall back; the decline was accentuated later in the month on the news of large Russian purchases of grain, which aroused expectations that Russia would sell gold. By the end of the third week in August the price had fallen below \$35·11.

Demand strengthened again at the very end of the month, and remained quite heavy for most of September after fighting broke out between India and Pakistan. Towards the end of the month the price rose to \$35·17 but the tension then eased. Early in October there was further talk of Russian sales; at the same time the cease-fire in India and the better tone for sterling in the foreign exchange market were no doubt helping to produce more settled conditions. As a result the price fell at one point to \$35·09 before ending the month at \$35·12, much the same as two months earlier. A marked reduction in the sterling price over the same two months reflected the increased strength of sterling in the foreign exchange market. The gold pool arrangements continued to operate during August to October and, on balance, fairly substantial amounts accrued to official holdings.

Balance of payments Exports, which had been disappointing in the second quarter, picked up again in the third. As

£ millions



After seasonal adjustment, exports resumed their growth in the third quarter. Their value in the first nine months of 1965 was 6½% higher than in the same months of 1964.

recorded in the trade accounts they totalled £1,184 million (f.o.b.). This figure, without seasonal adjustment, was some £60 million less than in the second quarter, but the fall was little more than half that normally to be expected in the holiday period. Most kinds of goods did well, especially machinery, deliveries of which appear now to be reflecting the large orders placed from abroad last year. North America, Australia and New Zealand were particularly good markets. Taking the first nine months together, the value of exports was as much as 6½% higher than in the corresponding period of 1964.

Imports are less affected by the holidays than exports. Nevertheless, the fall of only about £30 million compared with the second quarter, to a total of £1,428 million (c.i.f.), was smaller than might have been hoped. The most buoyant categories were food, beverages and tobacco (imports of which had been low earlier in the year), and finished manufactures, especially capital goods. Despite the comparatively high figures for the third quarter, total imports over the first nine months were less than 1% higher than a year earlier. It is, however, difficult to be sure of the trend of imports since the beginning of this year, because of the distortions produced by the U.S. dock strikes early in the year and the reduction in the surcharge in April. It is also possible that fears of quota restrictions or devaluation may have led to some advance ordering in the third quarter, but there is no clear evidence of this. Allowing for seasonal influences, imports and exports were both a little lower in October than the average for the third quarter.

The full balance of payments figures for the third quarter are not yet available. Nevertheless, if only for seasonal reasons, a substantial deterioration must be expected compared with the second quarter. Apart from the worsening in visible trade, the invisible account also deteriorates in the third quarter when tourists' expenditure is, on balance, a heavy charge. Moreover, in addition to seasonal factors, it is known that this year there will have been a worsening on both invisible and long-term capital account in the third quarter because of the uneven phasing of certain transactions, including those of oil companies. Some of these transactions had been exceptionally favourable in the first half of the year.

Some of the monetary movements for the quarter have already been referred to : the fall of £13 million in the reserves, the net increase of £139 million in the amount taken under the U.S. swap facility, and the West German deposit of £41 million. In addition, there were increases of about £30 million in net external liabilities in sterling (excluding the effects of the £139 million of special assistance[1]), and about £40 million in overseas deposits with local authorities and finance houses (which are recorded separately, see page 399). On the other hand, the banks' net external liabilities in foreign currencies were reduced by over £50 million (Table 22 of the statistical annex). These monetary movements are not the whole story however. Some items of miscellaneous capital are not yet known. Moreover, since the identified balance on current and long-term capital accounts cannot be expected to tally exactly with the balance of monetary movements, there will also be a balancing item one way or the other.

Exchequer financing Despite the adverse balance of payments in the third quarter, and the withdrawals of overseas funds in July and August, less than £50 million of the Exchequer Group's financing requirement on internal account during the quarter was met by accruals of sterling to the E.E.A. or by " other external items " (Table 1 of the annex). There were two main reasons why this figure was small. In the first place, in July and August the E.E.A.'s sterling receipts from sales of foreign exchange were to some extent offset by the sterling paid out in respect of the special assistance received in the form of swaps : the investment of the sterling paid out in this way by the E.E.A. does not affect " other external items ", but gives rise to an increase in overseas holdings of government debt.[1] Secondly, from the end of August the improvement in the foreign exchange market meant that the E.E.A. had to begin paying out sterling to finance a rise in the reserves, offsetting most of its gains earlier in the quarter when the reserves were falling.

On internal account the Exchequer's financing requirement—the net sum of its needs under revenue account, Consolidated Fund loans, and extra-Exchequer funds—amounted to £331 million. This was much the same figure as in the third quarter of 1964, but there were substantial differences between the two years in the composition of the total. For example, the deficit on revenue account was about £100 million less this year, mainly because receipts from income tax and profits tax were higher. On the other hand, loans from the Consolidated Fund required £100 million more. This was largely because the nationalised industries borrowed more—much as had been expected. Local authorities' borrowing from the Public Works Loan Board was also a little larger than a year earlier, although it fell sharply after the end of July when they were required to rephase their demands for the rest of the financial year.[2] In all, they took some £70 million during the quarter, almost all of it in July and early August, compared with about £180 million in the second quarter.

After setting external items against the requirements on internal account, the Exchequer was left with a cash deficit of £285 million to finance. Overseas holdings of government debt rose by £54 million (Table 2 of the annex), quite large sales being more than offset by the counterpart of the special assistance already mentioned. The Exchequer was therefore left to borrow £231 million from domestic sources. The general public's holdings of government debt increased by only £59 million, mostly through a rise in notes and coin in circulation. The public also bought some marketable government debt, but this was roughly offset by a net fall in their holdings of national savings and of tax reserve certificates. As in the previous quarter, therefore, the bulk of the Exchequer's domestic borrowing had to come from the banks and discount houses. These provided £172 million—making a total of £534 million since March, or over three-quarters of the aggregate rise since then in domestic holdings of government debt.

In September the pattern changed. Although the E.E.A. then began to pay out instead of to receive sterling (tending to increase the Exchequer's need to borrow at home), the general public—as mentioned later—were more willing to buy government debt and the Exchequer did not have to depend so much on the banks.

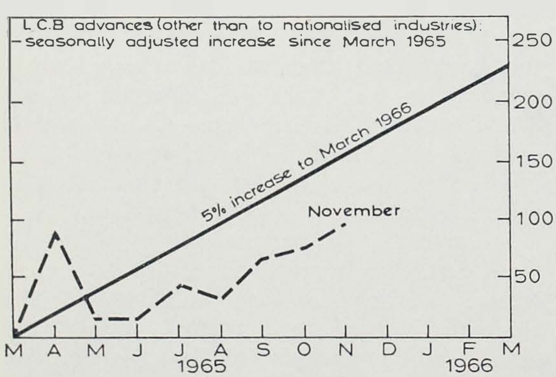
London clearing banks The lack of interest in government debt shown by the general public for much of the year was reflected in a substantial increase in bank

[1] See the note on page 400.
[2] September *Bulletin*, page 217.

deposits. Between the end of March and the end of September, net deposits with all U.K. banks increased by £660 million (Table 9 of the annex). The more recent figures available for the London clearing banks show that these banks' net deposits increased by £472 million between the mid-March and mid-November make-up dates. This was over £300 million more than was to be expected on seasonal grounds. However, most of the seasonally adjusted increase occurred by mid-September. In the month to mid-October deposits fell (seasonally adjusted). This was more than outweighed by a rise in the following month but, taking October and November together, the rate of increase was appreciably less than earlier in the year, largely because the improvement in confidence had encouraged people to start buying more government debt again.

The rise in the clearing banks' deposits between March and November was more than matched by increases of £298 million in their holdings of government debt and notes and coin, of £152 million in call money (almost entirely with the discount market), and of £90 million in Special Deposits. Their holdings of commercial bills, including re-financeable export credits, rose by £14 million; while their advances fell by £98 million.

£ millions



The increase in the clearing banks' advances since March is well within the 5% limit they have been asked to observe.

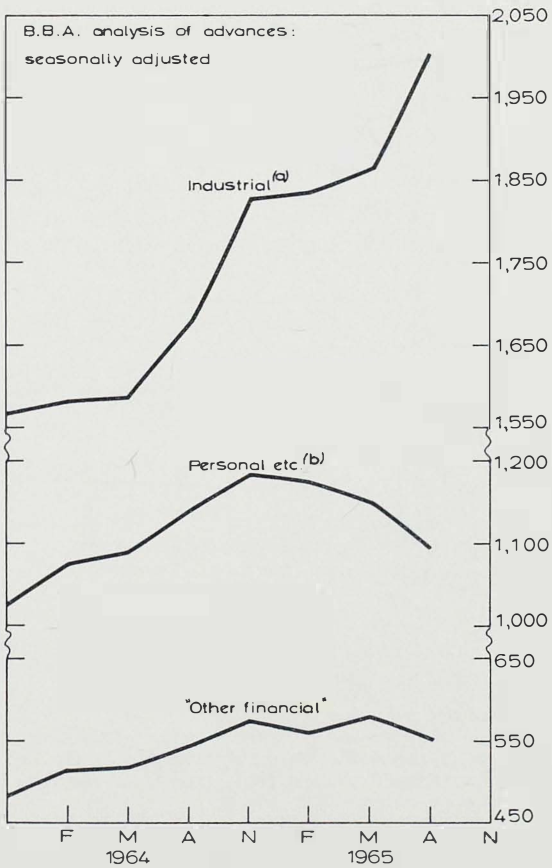
The fall in advances, which was entirely in lending to customers other than the nationalised industries, is a rather smaller reduction than might have been expected for seasonal reasons. When allowance is made for seasonal variations, advances other than to the nationalised industries have grown since March at an annual rate of 3%. This is well within the limit requested by the Governor in his letters last May, when he asked the banks not to allow their advances to the private sector to increase at an annual rate of more than about 5% during the twelve months to March 1966.

Accepting houses and overseas banks There is not a sufficiently long run of figures for the accepting houses and overseas banks to allow suitable seasonal corrections to be made. It is therefore more difficult to relate their advances to the 5% limit. Sterling advances by these banks both to U.K. residents (other than banks and local authorities) and to overseas residents rose between the end of March and the end of September by £54 million, to £1,325 million (Table 11 of the annex). This represents an annual rate of growth (without seasonal adjustment) of about 8% in total, although performance has varied considerably between different groups of banks—and appears to be in process of change. Such evidence as is available for October suggests that advances by some of these banks may more recently have been appreciably reduced.

Within the six months to September, advances rose by £74 million between March and June, but fell by £20 million in the following quarter. The increase up to June was entirely in lending to U.K. residents, predominantly companies; thereafter domestic advances rose little further, and there was a fall in advances to overseas customers. Such a pattern is not wholly surprising. The Governor's request was not made until early in May, and these banks may well have found it difficult to respond quickly. Their domestic advances are mainly to industrial customers, some of whom may have continued to draw upon previously agreed advances limits; and unlike the clearing banks they have no large body of personal customers, whose advances are the easiest to influence quickly. Moreover, although not much is known about the seasonal influences upon their lending—the figures are of fairly recent origin—there is reason to suppose that some increase is common between March and June. Nevertheless, having taken account of these considerations, it is clear that among these banks some will need to keep a tight rein on their advances over the coming months.

B.B.A. advances The quarterly analyses of advances published by the British Bankers' Association suggest broadly that, within the restrictions on total lending, the available money is being channelled in the

£ millions



Since November 1964, advances (seasonally adjusted) to persons and hire-purchase finance houses have been reduced markedly, and so—to a lesser extent—have those to the "other financial" category. Lending to industry has continued to increase sharply.

directions requested in the Governor's letters (see page 217 of the September *Bulletin*). In the nine months from mid-November 1964 to mid-August 1965 advances by B.B.A. members to personal and professional borrowers and to hire-purchase finance companies, taken together, fell by £55 million, whereas in the same months a year earlier they had risen by nearly £150 million. There was also some reduction in advances to other financial borrowers, and only a small increase in those to retailers; in each case there had been a substantial rise in these months a year before. In marked contrast, loans to industry continued to rise sharply, and by very much more than could be accounted for by seasonal influences. Judging by the more up-to-date monthly analyses of advances which, as explained in September, the clearing banks have agreed for the time being to provide in confidence to the Bank, this general pattern has continued since August. (This is confirmed by the November figures for the B.B.A. as a whole—received too late for detailed comment)

Commercial bills It was noted in September that, although the 5% limit also applied to acceptances and purchases of commercial bills, the supply of such bills in the market had nevertheless continued to rise quite rapidly. At the same time, some of the difficulties which lie in the way of bringing about an early reduction in the total of bill finance outstanding were described. Since then, there have been strong indications that the growth of such finance has at least been checked: the total of commercial bills held by the banking sector, which had risen sharply between March and June, increased more slowly between June and September, and much of this growth occurred early in the quarter. Moreover, the accepting houses and overseas banks have apparently succeeded in reducing the flow of acceptances; and the discount houses, with which most of these acceptances are normally discounted, have consequently found themselves under less heavy pressure in the market to take more bills than, given the official limit on their holdings, they should.

Although, as described later, the Treasury bill rate was tending to fall throughout August to October, the discount houses did not alter their buying rate for prime bank bills until early in October. The rate was then reduced by $\frac{1}{16}$% to $5\frac{7}{8}$%. This was, in fact, the first change since immediately after the reduction in Bank rate and it still left an unusually large margin

(a) Comprises the following categories in Table 14 of the annex: food, drink and tobacco; chemicals; iron and steel and allied trades; non-ferrous metals; engineering, etc.; cotton; wool; other textiles; leather and rubber; and unclassifiable industry and trade.

(b) Personal and professional; and hire-purchase finance companies.

of nearly $\frac{1}{2}$% over the rate for Treasury bills. At the same time the discount houses were also tending to widen further the margin between their buying rates for the best trade bills and for prime bank bills. Because of the credit squeeze, borrowers have been prepared to pay comparatively high rates for bill finance, and the houses—under pressure to observe the 5% limit—have not initiated a fall in rates which could only make observance more difficult.

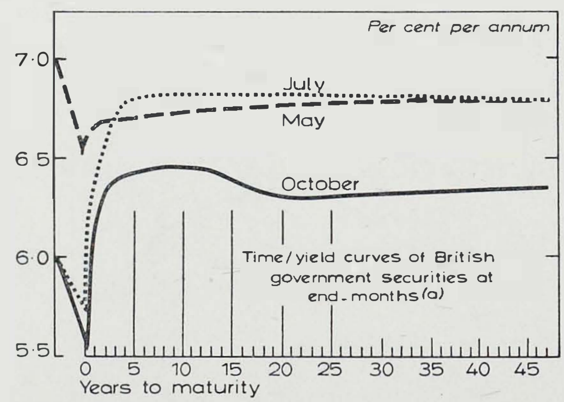
In view of the restraints upon bill finance, and the need for the authorities to be acquainted as fully as possible with developments in this market, the Bank have in recent months slightly widened the scope of their regular sampling purchases of bills, and these are no longer limited to prime bank bills.

Treasury bills The market remained short of Treasury bills during the period under review. Indeed, at the end of September the discount houses' holdings were barely three-fifths of what they had been a year earlier. In these circumstances the houses continued during August to October to feel the same conflicting pressures that they had experienced earlier in the year—wishing on their own account to raise the price at which they tendered for Treasury bills in order to obtain a good allotment, yet realising that too large or rapid a fall in the rate was likely to be unwelcome to the authorities until the economic position generally was more secure.

It was described in the September *Bulletin* how, following heavy borrowing at the Bank, the houses had reduced their bid at the weekly tenders during the latter part of July, raising the rate to $5\frac{21}{32}$%, the same figure as immediately after the reduction in Bank rate early in June. Throughout August to October the rate was tending to fall back again, though the houses were still required from time to time to borrow at the Bank, which had a restraining influence. By 8th October the houses had lowered the rate, by just over $\frac{1}{4}$%, to $5\frac{25}{64}$%; but on 15th October, with the margin between the Treasury bill rate and the average cost of their funds probably by now rather small, and with less expectation, perhaps, of an early reduction in Bank rate, the houses raised the rate again, by just over $\frac{1}{16}$%, to $5\frac{15}{32}$%.

This rate was maintained to the end of the month. It was one which, no doubt, gave the houses an adequate return in relation to the average cost of their funds (which may be put at around $5\frac{5}{16}$%-$5\frac{3}{8}$% for most of the period under review); moreover, the rate, although lower than immediately after the Bank rate change, was by no means exceptionally low in relation to a 6% Bank rate.

Gilt-edged Yields in the gilt-edged market also fell. The movement began in the second week of August when, after some six



Despite the reduction in Bank rate on 3rd June, yields on most stocks were as high or higher at the end of July as at the end of May. By the end of October, however, there had been falls throughout the range, notably on longer-dated stocks.

months in the doldrums, the market took a turn for the better and some institutional buyers reappeared. In part they seem to have been tempted by the high yields available, of up to 7%. But high yields alone would not have been enough if the market had not also been encouraged by the publication early in August of the good July trade figures and by a growing belief that the economy was beginning to respond to the Government's measures. Furthermore, the passing of the Finance Act 1965 early in August ended a period of exceptional uncertainty in the field of taxation.

Demand was at first concentrated among the longer-dated stocks, but it soon spread more

(a) 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.

widely. It was not long before the improvement in the foreign exchange market and the announcement on 10th September of fresh backing for sterling were helping to sustain the better tone. Then towards the end of September the publication of the good balance of payments figures for the second quarter brought further encouragement. Throughout September and most of October the market strengthened steadily.

On 27th September official holdings of long-dated stocks, which had been negligible for some months, were replenished by the issue of £600 million of 6% Funding Loan 1993 at 96, offering a yield to maturity of £6:6:2%. Following this, a considerable amount of switching developed, much of it from short or long-dated stocks into medium-dated. The general improvement in the market enabled the authorities to make very substantial net sales in the short and medium ranges (while continuing to buy in next year's maturing 5½% Exchequer Stock as opportunity offered), and on 1st November a further new issue was made, this time of a short-dated stock—£500 million of 6% Exchequer Loan 1970 at 99. The yield to maturity was £6:5:4%.

During this period the market was adjusting itself to a yield pattern more appropriate to the lower Bank rate—an adjustment which had been delayed in June and July by the continuing doubts about the economic situation (see the chart). The authorities' sales of stock helped to ensure that the adjustment did not take place too rapidly, as well as providing longer-term finance for the Exchequer.

The value of turnover in government stocks was very much higher in September and in October than in the preceding months (Table 16 of the annex). Although this increase largely reflected the genuine recovery of the market, the high figure for October owed something to exceptionally heavy dealings in 5% Exchequer Stock 1967 when the stock went ex-dividend on the 15th of the month. The price of the stock, after adjustment for the change from cum-dividend to ex-dividend dealing, was just above its lowest issue price of 96½. It was thus near the bottom of the neutral zone between the price of issue and the price of redemption within which, as described in September,[1] a stock may appreciate without attracting capital gains tax. This greatly increased the attraction of the stock for purchasers, both corporate and personal, normally subject to tax on the interest, especially as, on so short-dated a stock, the risk of capital loss was minimal.

Local authority finance The marked reduction in local authorities' borrowing from the P.W.L.B. after the end of July has already been mentioned. Despite this, the local authorities did not raise particularly large amounts in the new issue market. In the first half of the year they had obtained nearly £120 million on stocks and short-term bonds, but in the four months to the end of October they raised only £45 million, just over half from bonds.

In October the local authorities' financial position will have been helped by a seasonal rise in income from local rates. Moreover, during August to October they appear to have raised quite large sums in the mortgage market. Rates of interest on mortgages rose during August and early September; they eased later in September following the decline in gilt-edged yields, and during October they fell markedly. For example, the rate of interest on 10 to 15-year mortgages, which had been 7% at the end of July and which went as high as 7⅛% during September, was down to 6⅞% at the end of October. Even so the margin above yields on government stocks of comparable term increased over the period from about ¼% to ½%.

In the temporary money market, the local authorities continued to enjoy a comparatively easy position. During August the accepting houses and overseas banks, which are an important source of funds in this market, continued to withdraw money, and deposit rates rose a little; but in September and October funds from these banks again came forward in quantity, and rates eased appreciably. Three months' money, for instance, which had been 6⅜%-6½% at the end of July, and a little higher at the end of August, came down to 6⅛%-6¼%.

A development which attracted attention was the issue, in anticipation of revenue, of £3 million of 90-day bills by Manchester Corporation early in September. The whole amount was

(1) Page 221.

issued direct to the discount market at a discount rate of $5\frac{15}{16}$%, or about $\frac{1}{2}$% less than the Corporation would have had to pay for three months' deposits. Only a few local authorities have power under local Acts to make issues of bills, and then only within narrow limits. No more than about £10 million of such bills are generally outstanding. The power may relate to bills issued either in anticipation of revenue or for capital purposes; but before bills can be issued for capital purposes they require Treasury consent under the Control of Borrowing Order 1958, which is not usually forthcoming. Under the Manchester Corporation Act 1965, Manchester's powers had just been extended to cover issues for revenue purposes, and the amount increased to £3 million; previously the powers covered only £1 million, for capital purposes.

Hire-purchase finance The spread of the main finance houses' three months' deposit rates, which had been $6\frac{1}{2}$%-7% at the end of July, went up to $6\frac{3}{4}$%-$7\frac{1}{4}$% towards the end of August but then fell back to $6\frac{1}{4}$%-$6\frac{1}{2}$% by the end of October. This was comparatively low in relation to the rates for local authority deposits and it may well be that some houses were not over-anxious to attract fresh deposits—their level was already very high—in view of the present restraint on the expansion of their business. Outstanding hire-purchase debt has been increasing more slowly since May, and in September and October it actually fell. The change no doubt reflects the successive measures taken to limit hire-purchase credit—the increase, early in June, in the minimum down-payment on most goods and the reduction, late in July, in the period allowed for repayments. Nevertheless some further fall in debt will be necessary if the finance houses are to meet the authorities' request that they should restrain their financing of the private sector over the year to March 1966 to a degree comparable with the limit set to bank credit.

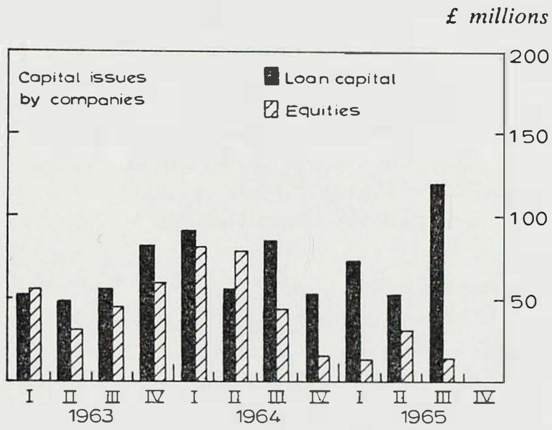
Building societies The flow of funds into the building societies, which began in June following the announcement of increased rates of interest on shares and deposits, has been well maintained. (Shares now generally pay 4% and deposits $3\frac{3}{4}$%, both tax-paid) At the same time withdrawals have not been so heavy as earlier in the year. As a result, in the four months from the beginning of June to the end of September the total sum outstanding on shares and deposits rose by some £275 million, compared with just under £100 million in the previous four months. In these circumstances the societies have been able to entertain more applications for mortgages, and after the usual time lag their advances began to grow again in September. In spite of this, they were able to raise their combined liquidity ratio (cash and investments, other than mortgages, expressed as a proportion of total assets) from a low point of 13·1% in May to 15·8%—only a little lower than usual—at the end of September. Their average reserve ratio fell further in the third quarter; and several societies—mostly smaller ones—have increased their mortgage rates to 7% in order to establish a greater margin between their earnings and their outgoings. The rate recommended for mortgages by the Building Societies Association remains $6\frac{3}{4}$%.

Debenture and equity markets As often, the debenture market shared in much of the fortune of the gilt-edged market, and was particularly firm in September and October. This was mirrored in turnover which, after falling in August, increased in both of the following months (Table 16 of the annex). Moreover, during September yields, which had previously risen more or less continuously for nearly two years, began to decline. According to the F.T.-Actuaries calculation, by the end of October the average yield on 20-year stocks had fallen from a peak of 7·45% to 6·87%.

It was noted in September that the corporation tax has increased the advantages to companies of raising money by loan capital rather than on equities. And partly for this reason the flow of new fixed-interest issues has been very heavy. In July a record amount for one month of nearly £50 million had been raised in this way; and a further £100 million followed during August to October, again an exceptionally large sum to raise in three months. Much of this money represented instalments on issues launched earlier.

Among the new issues of loan capital in September was one of £50 million $7\frac{1}{4}$% Unsecured Loan Stock 1986/91 at $98\frac{1}{2}$ by

Imperial Chemical Industries, the largest capital issue ever made by a company in this country. An interesting feature was that it took the form of a public issue, so that there was an opportunity for the public at large to subscribe. Most recent issues of this kind have been placed direct with financial institutions, notably the insurance companies and pension funds.



Since late in 1964 there has been a marked shift of emphasis in the new issue market from equities to loan capital.

In the equity market prices rose substantially in September and October. From a low point of 99 at the end of July, and after changing little in August, the F.T.-Actuaries index of industrial share prices was up to 113 at the end of October. However, the increase no doubt exaggerates the true recovery of demand in the market. There was certainly some return of confidence in the general economic prospects, helped by the better tone in the foreign exchange market, and company reports were still disclosing quite good profits. But turnover was never very large, and the increase in prices owed much to a shortage of shares in the market. This arose partly from the dearth of new equity issues this year—the obverse of the many issues of fixed-interest stocks—and partly because the capital gains tax has made investors in general more reluctant to sell.

Domestic economy

In the September Commentary a number of signs were noted suggesting that the economy was responding to the succession of official measures introduced since October 1964—measures which were designed to moderate the growth of home demand, so as to make room for more exports and limit imports, while at the same time promoting more efficient production. Some of this evidence still holds good; but it also now appears that a temporary dip in activity in the second quarter may have been interpreted as indicating a greater response to these measures than had, in fact, yet developed. Aggregate demand rose, if only slightly, during the third quarter. The index of industrial production, seasonally adjusted, had fallen by about 1% between the first and second quarters, but it recovered some of this ground in the third quarter.

New car registrations have continued to fall, and in the third quarter were 15% lower than a year earlier. The downward trend was reinforced by the tightening of hire-purchase controls in June and July, which also further affected sales of other consumer durable goods. One outcome of this, as noted earlier in the Commentary, was that the long rise in the total of hire-purchase debt outstanding was checked in September. On the other hand, the volume of total retail trade, allowing for seasonal movements, recovered in the third quarter after falling slightly in the second, partly because more food and clothing were being bought.

It may be that in the account given in September not enough allowance was made, when considering personal consumption in the second quarter, for the reaction which followed the precautionary buying before the Budget, and for the fact that the first impact after the Budget of the increase in taxes was unlikely to be fully sustained. At the same time, the continuing rapid growth of money incomes will have worked against the Government's efforts to moderate the rise in personal consumption. Wage increases negotiated during August to October added, on average, the equivalent of about 7% a year to the hourly rates of pay of those concerned. Whatever the merit of individual cases, a general advance of this size was far more than could be justified by increasing productivity. Nor could it be justified by the behaviour of retail prices. If the increase of about 2% which resulted from higher duties in the November and April Budgets is left out of account, the index had risen by less than 3% in the twelve months to October, and by barely 1% since the April Budget. Manufacturers' selling prices in the home market have also changed little since April. But this comparative stability is obviously threatened by increases in incomes of the size just mentioned.

Exports, as well as personal consumption, will have helped to explain the second quarter's dip in activity and the subsequent recovery. As noted earlier, they did quite well in the third quarter after having been disappointing in the second.

Beneath these fluctuations, continuing heavy investment expenditure on private and public account has done much to maintain the general buoyancy of the economy. In the private sector, business confidence still appears largely unaffected by the events of the past year. The latest Board of Trade survey of investment intentions, made in August and September, suggested—like earlier surveys—that expenditure on fixed investment (other than housing) may be much the same in 1966 as in 1965. This probably implies some downturn in the course of next year, and the downward movement will no doubt be reinforced—as regards the distributive and service trades—by the system of building licences introduced last July for all large projects other than housing and industrial building.(1) In the public sector, capital expenditure should continue to grow next year, but here again the rate of expansion should be affected by the decision last July to cut some projects and postpone others.(1) The July measures have already sharply reduced architects' work in hand and new orders, but no great effect on actual constructional work is to be expected until 1966.

Expenditure on house building, both public and private, seems likely to grow faster in 1966 than in 1965. As noted in September, the increase in such expenditure this year has been limited by shortages of building materials and by difficulties in obtaining finance. However, building materials are in better supply and, as mentioned earlier, the building societies have been able to start increasing their mortgage loans again.

Complete information is not yet available concerning stockbuilding in the third quarter. It would appear, however, that manufacturers' stocks rose at much the same rate as in the first half of the year; wholesalers' stocks, which had been drawn down earlier in the year, rose slightly; while those held by retailers rose quite sharply.

The labour situation in general continues very tight and from August to November the percentage unemployed remained around $1\frac{1}{2}\%$. Early in September it appeared that unemployment, allowing for seasonal changes, had been increasing slowly since April and might well continue to do so. In fact, the figures for September and the next two months went the other way. But it is difficult to know how much significance to attach to this change at a time when the level of unemployment is very low and when there may be difficulties—recently increased by changes in school-leaving arrangements—in making correct seasonal adjustments.

Conclusion Some success has been achieved in moderating the expansion of domestic demand this year. There has also been a welcome improvement in the balance of payments and, more recently, in the position of sterling. It may, moreover, be expected that the Government's various measures will have an increasingly marked effect as the coming year progresses. These measures must be pressed home, for there is no scope for relaxing the efforts being made to redirect the economy and check expansion in less essential fields.

In these circumstances, the Government have wished to have adequate warning of impending wage settlements and price increases. A government plan for statutory notification of such moves was announced in September. However, statutory powers will be invoked only if voluntary arrangements agreed by the Trades Union Congress and the Confederation of British Industry fail. The T.U.C. are vetting wage claims put forward by member unions, and delaying them for further consideration where this seems appropriate. The Confederation are to notify the Department of Economic Affairs of impending national wage claims on their members, and further reference may then be made by the Department to the National Board for Prices and Incomes. In addition, manufacturers and others who plan to increase the price of a wide range of key goods or services have been asked to inform the Government not less than four weeks beforehand; the

(1) September *Bulletin*, page 216.

increases may then be discussed with the firms or trade associations concerned, or passed to the Prices and Incomes Board for their consideration.

The National Plan, which was issued in September, sets guide lines for the economy over the next five years. It emphasises in its opening paragraphs that correcting the balance of payments, and achieving the surplus required to repay the United Kingdom's international indebtedness, are the prerequisites of economic expansion free of recurring crises. This means that the improvement already noted in the balance of payments has to be carried further. The need to increase exports is undoubtedly becoming more widely recognised in industry, and this is showing results, yet still more resources must be directed to that end. The comparatively small growth of imports this year has been helpful, but it has owed something to the protection of the surcharge and this is no permanent basis for a healthy economy.

Finally, it must not be forgotten how much the recent recovery of sterling owes to the growth of confidence abroad that the Government's measures will eliminate the external deficit during 1966 and in due course bring about a better ordering of the country's resources. This confidence could quickly be withdrawn if it were thought that the measures might be relaxed before they had had time fully to achieve their purpose.