Commentary

Further progress has been made in reducing the external deficit. The balance of monetary movements was favourable in the fourth quarter of 1965. This could be consistent with a small deficit on current and long-term capital account; nevertheless it is clear that, compared with the third quarter, there was a striking improvement. However, there remains some distance to go before the underlying deficit is eliminated. Because of the need to ensure restoration of a proper external balance, and because demand at home has remained high, it has been necessary to take further steps to secure continued restraint of credit.

On 1st February the Governor of the Bank of England wrote to the Chairman of the Committee of London Clearing Bankers. He recalled that in May 1965 he had asked that the clearing banks' advances to the private sector should not increase at an annual rate of more than about 5% during the twelve months ending at the March make-up date in 1966; and that the banks should apply a similar limitation to both their provision of acceptance facilities and their purchases of commercial bills.(1) He now asked that, until further review, the clearing banks' advances, acceptances and holdings of commercial bills—taken separately, and after making allowances for seasonal factors—should not rise above the levels set for March 1966. The guidance given about the direction of lending remained unchanged.(2)

The Governor also wrote to the Accepting Houses Committee and to the organisations of overseas banks in London, asking that these banks should similarly limit their sterling advances, acceptances and commercial bill holdings. The London Discount Market Association and the leading associations of hire-purchase finance houses were asked to observe a comparable degree of restraint: and members of the British Insurance Association, the National Association of Pension Funds, and the Building Societies Association were also requested to co-operate in maintaining restraint—in particular in relation to the finance of building and property development, other than housing for the owner-occupier.

On 7th February, the terms for hire-purchase and rental agreements were further restricted.(3) The maximum period for hire-purchase contracts on most goods was reduced from thirty months to twenty-four months (twenty-seven months for cars and motor cycles); and the minimum down-payment was raised from 15% to 25% (down-payments for cars and motor cycles were unchanged at 25%, the level to which they had been raised last June). Advance rentals required under hiring agreements were increased from twenty to thirty-two weeks.

These further measures to restrict credit are necessary, in the short term, in order to help correct the balance of payments.

The Government have recently announced two new plans which, in the longer term, are designed to stimulate selectively certain sectors of the economy. The first should encourage productive investment in plant and machinery by manufacturing and extractive industries—mainly through a new system of cash grants in

(1) June 1965 *Bulletin*, page 111.

(2) In the Governor's letters of 8th December 1964, 5th May 1965 and 27th July 1965: see the *Bulletins* for December 1964, page 263; June 1965, page 111; and September 1965, page 217.

(3) The measures taken in June and July 1965 were described in the September 1965 *Bulletin*, page 217.

place of investment allowances against taxable profits. Distributive and service trades and the construction industry are to receive less favourable allowances than before. Payment of the new grants is to be deferred during a transitional period, so that there is to be no immediate extra cost to the Exchequer. The second of the Government's announcements concerned the proposal to set up an Industrial Reorganisation Corporation, which is intended to help bring about further and more rapid concentration and rationalisation of industry and, with a view to greater efficiency, to promote the wider use of modern equipment and techniques. The Corporation is to be given the right to draw up to £150 million from the Exchequer in order to be able to provide finance for the schemes it sponsors, where this is not forthcoming from market sources.

The remainder of this Commentary is concerned mainly with the three months November to January. During these months sterling remained strong, despite the course of events in Rhodesia.[1] The authorities were able to continue to acquire foreign exchange for the reserves, while repaying more of the short-term assistance taken last year and reducing further their commitments in forward exchange. Interest rates, which had fallen in the previous three months, rose slightly, partly because of an increase in U.S. short-term rates.

The domestic economy

At the turn of the year the domestic economy still appeared to be fully stretched. It was noted in the December *Bulletin* that activity had fallen in the second quarter of 1965, mainly as a result of measures taken in the Budget, but had recovered a little in the third quarter. The index of industrial production, seasonally adjusted, rose a little further in the fourth quarter.

The continued high pressure of demand in the fourth quarter stemmed from the buoyancy of exports, from a renewed increase in personal consumption, and from public expenditure, especially on fixed investment. Private investment was little changed, while stockbuilding probably declined. Incomes continued to rise, and employment remained high.

Total expenditure on fixed investment, other than housing, seems to be levelling out: investment by the public sector is still growing, but only fast enough to offset a fall in the private sector, where expenditure in the second half of 1965 was nearly 3% below the first half. This fall, however, was virtually confined to the distributive and service trades; the volume of manufacturing investment remained high. The volume of stockbuilding has varied from quarter to quarter, generally rather lower than in 1964. So far as figures are yet available, it seems that, after seasonal adjustment, there was less stockbuilding in the fourth quarter than in the third.

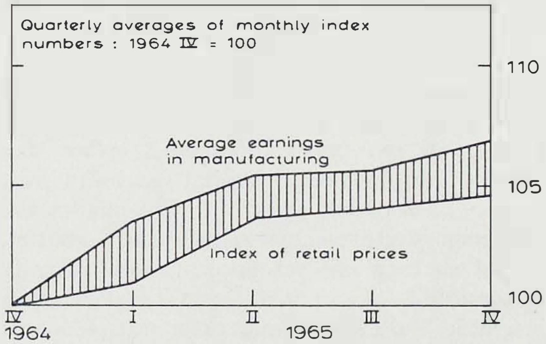
Towards the end of the year there were signs that private house building was beginning to grow again after its earlier decline. Taking seasonal factors into account, more houses were started, and more completed, in the fourth quarter than in the third. Housing starts and completions for public authorities were also higher. Building materials were not as scarce as they had been and, as noted later, building society finance was much more readily available.

Personal spending had been checked in the second quarter of 1965, after the Budget, but it soon began to recover. There are signs that it rose quite strongly in the fourth quarter, when the volume of retail trade, seasonally adjusted, was 1% larger than in the previous three months and 2% more than a year earlier. There was an unusually rapid growth during the quarter of turnover in the catering trades; and towards the end of the year the downward trend in the number of new car registrations appeared to have been halted.

The growth of personal consumption in the fourth quarter would doubtless have been greater had it not been for the tightening of hire-purchase controls in June and July and the restraint on personal borrowing from the banks. But at the same time there was a continued and rapid growth in earnings. During the quarter the average earnings of weekly-paid workers were some 7% above a year earlier. The effect on real consumer demand of this increase in earnings was all the greater because of the recent stability of prices. Retail prices, for example, rose by $4\frac{1}{2}$% during 1965,

[1] A brief record of the actions taken in this connection is given in a note on page 15.

a slightly slower rate of increase than in 1964; but about one-third of the year's rise was due to the higher duties imposed in the Budget. Thereafter the index rose 2% up to the end



In the last quarter of 1965, average earnings were 7% higher than a year earlier, and prices 4½% higher.

of the year. Manufacturers' selling prices in the home market rose by only 1% over the same period.

Demand for labour continues to be greater than can be met, and there are still acute shortages in many skilled trades. From December to February the percentage out of work remained about 1½%; after seasonal adjustment the percentage wholly unemployed was as low in January and February as 1·2%. There is some evidence that employers are reluctant to dispense with labour in the belief that, once lost, workers will be difficult to replace when the next upsurge in activity takes place.

Looking ahead, capital expenditure by the public sector will continue to grow this year, but the rate of expansion should soon begin to be more strongly affected by the decisions announced last July to defer some projects.[1] The deferment of individual projects was replaced, in February, by stricter control over the total capital expenditure of the public sector—which, while allowing programmes to be rearranged so that some projects could go ahead, would entail no greater expenditure in total than under the arrangements of last July. The volume of total public sector expenditure, excluding investment by the nationalised industries, in the coming financial year is to be kept within the target—set in February 1965—of an increase of not more than 4¼% above 1965/66.

In the private sector, the latest Board of Trade survey of investment intentions, made in November and December, suggested that businessmen then felt rather less sanguine than at the time of the previous survey in August and September. In real terms, investment expenditure by private industry may well continue in 1966 at, or perhaps a little below, the level of the second half of 1965. But within the total, expenditure on buildings is perhaps likely to fall, deterred by licensing procedures and by uncertainty over tax on land values, while that on plant and machinery may increase: the survey was conducted before the announcement of the Government's new measures, noted earlier, to encourage investment in plant and machinery by manufacturing and extractive industries.

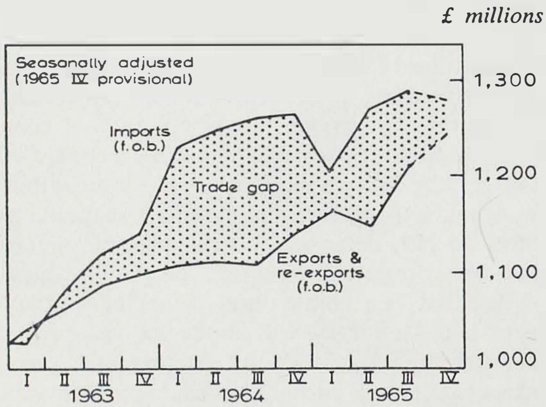
Balance of payments

Although full details are not yet available, it is clear that the balance of payments improved substantially in the fourth quarter. This was partly because of seasonal influences; but even after seasonal adjustment the deficit on visible trade, at about £40 million, was only half what it was in the third quarter.

The improvement resulted from a marked increase in exports: imports also rose, but more slowly. Before seasonal adjustment, and as recorded in the trade accounts, exports totalled £1,303 million (f.o.b.), about £120 million more than in the third quarter. A large part of this rise was due to seasonal causes; but even after seasonal adjustment the increase over the third quarter was some £35 million, or over 2½%. In terms of goods, much of the increase was due to ships, aircraft and diamonds, deliveries of which are often irregular; but, encouragingly, exports of motor vehicles increased and those of machinery continued to do well. During 1965 as a whole, exports increased by about £330 million, or 7%. Sales to the North American market accounted for nearly one-third of this rise. Exports to the sterling area also grew and there was some recovery in those to Eastern Europe and to the U.S.S.R., though

(1) September 1965 *Bulletin*, page 216.

sales to the latter remained disappointing. Exports to countries of the European Free Trade Association were higher, although after a good start to the year sales levelled out;



Exports rose strongly in the second half of 1965, while imports were little changed: the trade gap thus narrowed appreciably.

but those to the European Economic Community were virtually unchanged, a substantial growth in exports to Western Germany being largely offset by much reduced sales to France and Italy.

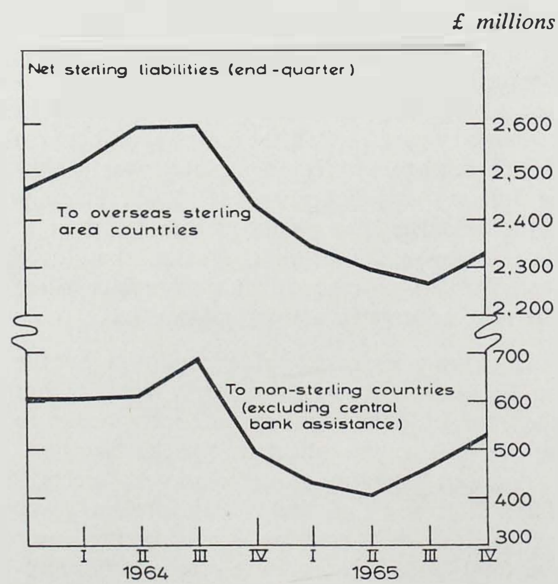
The increase in imports during the fourth quarter, of over £50 million (to nearly £1,480 million c.i.f.), was no greater than expected for seasonal reasons. Imports of food continued to increase, but more slowly than in earlier quarters. Those of finished manufactures remained high, but did not grow further; while imports of industrial materials continued to decline. During 1965 as a whole, imports were only £67 million (1%) higher than in 1964. Even this small rise, however, must be counted as a little disappointing—the surcharge was effective throughout the year, import prices were little changed, and manufacturing output was only about 3% greater than in 1964.

In January most categories of exports declined, after seasonal adjustment, though there was a particularly large fall in shipments of road vehicles. Imports were rather higher than the monthly average for the fourth quarter; and as a result the trade gap widened appreciably. Too much importance should not, however, be attached to the figures for this single month.

In the fourth quarter, the invisible and long-term capital accounts, on which complete information is not yet available, will have benefited, together, by about £62 million from the deferment of the payment of principal and interest, due in December, on the U.S. and Canadian government loans. The invisible account will have improved too, for seasonal reasons. In all, the current account may well have been in small surplus in the fourth quarter. The net outflow of long-term capital, which is frequently erratic and which was unusually large in the third quarter, was probably much smaller in the fourth. Taken together, the current and long-term capital accounts may have been in deficit on only a very small scale.

Monetary movements in the fourth quarter, so far as they are yet known, were strongly favourable. As noted later, the reserves increased by £89 million, after repayment of £99 million under the swap facility with the Federal Reserve Bank of New York. And there was a reduction of nearly £30 million in the banks' net external liabilities in foreign currencies (Table 19 of the statistical annex).

On the other hand, there was a small rise, of about £10 million, in overseas deposits with



After declining for a year, sterling holdings of overseas sterling area countries began to increase again in the fourth quarter of 1965: at the same time, non-sterling countries continued to rebuild their balances from the abnormally low level to which they had fallen.

local authorities and finance houses; and a much more substantial increase in other net external liabilities in sterling (excluding the effects of the repayment of the F.R.B. swap).

Net liabilities to countries outside the sterling area increased by nearly £60 million (again excluding the counterpart of swap repayments), partly because sterling working balances were built up again following the improvement in confidence from September onwards, and partly because of increased central bank holdings of sterling. Net liabilities to sterling area countries, whose own balance of payments may have started to improve, rose by £65 million. In addition, the banks' net external liabilities in overseas sterling area currencies rose by £13 million.

These monetary movements, taken together, were favourable during the fourth quarter by about £70 million. The total of monetary movements may be shown to be less than this when information on other items is available; but it seems clear that it will still prove to have been favourable on a substantial scale. If, as suggested above, there was only a small deficit on current and long-term capital account, there will have been quite a large positive balancing item—rather larger than might have been expected, even at a time when there could well have been an unrecorded inflow of funds and perhaps also a favourable change in the timing of payments for imports and exports.

London clearing banks

The period from mid-October to mid-January is one of heavy Exchequer deficit until around the turn of the year, followed by a week or two of the Exchequer's main revenue quarter. Bank deposits normally rise sharply, on balance, during these three months, while advances fall seasonally. This year the rise in net deposits with the London clearing banks totalled about £200 million, some £30 million more than might have been expected on seasonal grounds,(1) while their advances were little changed.

Over the three months as a whole, the seasonally adjusted rise in deposits reflected the upward trend of advances, described below: it was certainly at a considerably slower pace than the growth of some £270 million in the preceding seven months from mid-March to mid-October, when the main influence on deposits had been the general public's reluctance to acquire government debt—so that the bulk of the Exchequer's domestic borrowing requirements had had to come from the banks and discount houses.

Without seasonal adjustment, the principal changes in the banks' assets between mid-October and mid-January were increases of £162 million in their holdings of marketable government debt, of £72 million in call money to the discount market, and of £20 million in notes and coin. Their holdings of commercial bills were reduced by £31 million and their advances fell by £10 million.

The small reduction in advances, which was entirely in lending to customers other than the nationalised industries, was rather less than might have been expected on seasonal grounds; and after seasonal adjustment (on the new basis, as explained on page 46) there was an increase over the three months of about £65 million, mainly during the month to mid-January. Between mid-March 1965 and mid-January 1966, the seasonally adjusted rise in advances to customers other than the nationalised industries amounted to about £110 million, an annual rate of growth of just under 3%. At mid-January, therefore, the clearing banks were still well within the 5% limit, described earlier, which was requested by the Governor last May and is now continued.

The Governor's requests have been concerned with the direction, as well as the amount, of bank lending. The monthly analyses of the clearing banks' advances have been provided in confidence to the Bank since the middle of last year,(2) and cannot be seasonally adjusted; but the unadjusted figures show that in the eight months from mid-May to mid-January the reduction in advances was due entirely to personal and professional and financial borrowers, to retailers, and to hire-purchase finance companies. Lending to manufacturing industry continued to rise. In the most recent months, however, the decline in lending to persons seems to have slowed appreciably.

The latest figures for the clearing banks show that, in the month to mid-February, advances to borrowers other than the nationalised industries rose by £163 million. This implies, on the new basis of seasonal adjustment, an increase of £60 million more than was to be expected on seasonal grounds. Payments

(1) The seasonal adjustments have been calculated by a new method; see the article on page 46.
(2) September 1965 *Bulletin*, page 219.

of taxes between mid-January and mid-February were higher than in previous years, and it is possible that this may have influenced the need for bank finance. The rise in February brings the cumulative increase since mid-March 1965, after seasonal adjustment, up to about £170 million—an annual rate of growth of 4%. Net deposits fell much less than seasonally expected between January and February; after seasonal adjustment they rose by £175 million.

Accepting houses and overseas banks The limit on advances covers also sterling lending by the accepting houses and overseas banks. It was explained in the December 1965 *Bulletin* that, because the series of figures for these banks is of fairly recent origin, appropriate seasonal adjustments cannot be made; and it is therefore more difficult to be sure of the trend of their advances. It was also noted that there are reasons—in particular the preponderance of industrial customers with previously agreed advances limits—why the figures for these banks may have been slow to respond to the Governor's request; nevertheless, the evidence then suggested that, after September, advances by some of the banks had been appreciably reduced.

A sharp reduction is, indeed, shown in the figures for the three months to the end of December (Table 10 of the annex). Sterling advances to U.K. residents (other than banks and local authorities) fell by £30 million, to £912 million, and those to overseas residents by £6 million, to £377 million. Cumulatively, since the end of March 1965, the total of sterling advances by these banks has increased by only £16 million—a rise of £72 million between March and June being largely offset by reductions of £20 million and of £36 million in the following two quarters. This small increase, which is not seasonally adjusted, represents an annual rate of growth of only about 1½%—well within the 5% limit.

Commercial bills The growth of finance by means of commercial bills, to which the 5% limit also applies, had appeared to be slowing down in the quarter to the end of September.[1] But in the following quarter it increased sharply. At the end of 1965 the total of commercial bills held by the banking sector (Table 8 of the annex) was £109 million (12%) greater than at the end of March, and considerably higher than ever before: part of the increase, however, related to bills drawn in foreign currencies,[2] and the rise between March and December in the banking sector's holdings of sterling commercial bills was rather less than 12%.

The figures for commercial bills held by the banking sector are too recent in origin to allow seasonal adjustment; but a substantial increase seems to be usual between September and December. Nevertheless, it was clear at the end of January that a considerable reduction in the banking sector's purchases of commercial bills would be necessary between December and March if the 5% limit were not to be exceeded. Such a reduction would not easily be achieved in view of the very sharp rise during the fourth quarter in outstanding acceptances by the accepting houses and overseas banks—even though some of this increase, too, is believed to have occurred for seasonal reasons.

The discount houses, with which most bank acceptances are normally discounted, are well aware of the need to contain their purchases of commercial bills. For this reason, their buying rate for prime bank bills remained unchanged during the period at 5⅞%—a high level in relation to Bank rate—despite the fluctuations, described below, in the Treasury bill rate. For the same reason, many of the houses tended to widen further the margins over the prime bank bill rate at which they would buy and sell the best quality trade bills.

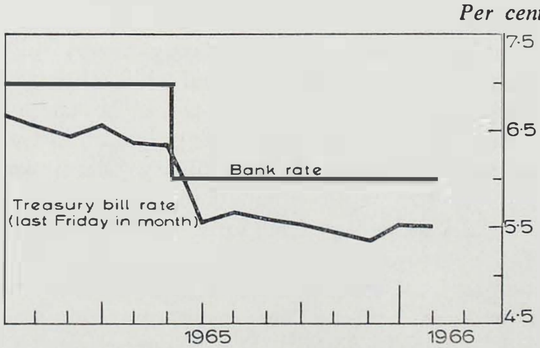
Treasury bills During the three months under review, events in Rhodesia had some impact on the Treasury bill rate, but a more important influence was the increase in the U.S. discount rate. On balance, the discount market's tender rate was fractionally higher (at 5½%) at the end of January than at the end of October. The shortage of bills

[1] December 1965 *Bulletin*, page 309.

[2] The increase in bills drawn in foreign currencies, and discounted by the accepting houses and overseas banks, can be seen by comparing the figures for total bills discounted by these banks, in Table 8 of the annex, with those for sterling bills discounted, in Table 10.

in the discount market, described in the December *Bulletin*, eased somewhat during the three months; indeed, by the end of December the houses' holdings of Treasury bills were higher than at the end of any quarter in the past two years, and no longer below their holdings of commercial bills.

Throughout most of November the rate was not much changed. There seemed little prospect of the houses' securing a marked increase in their allotment unless they substantially reduced their tender rate, and they were reluctant to do this in the early stages of the Rhodesian situation. On 26th November, however, having obtained only small allotments in the three previous weeks—and with some houses which balance their annual accounts on 31st December particularly wishing to increase their holdings—the market raised its bid sharply and the rate was reduced by $\frac{3}{32}$%, to $5\frac{25}{64}$%. In the following week the houses were twice required to borrow at the Bank.



The fall in the discount houses' tender rate since the end of July was partly reversed early in December, following the increase in U.S. short-term rates.

Even so, they were anxious not to increase the rate again until they had been able to sell some of the large allotment of bills that they obtained on 26th November; and on 3rd December they in fact reduced it further, to $5\frac{3}{8}$%. Immediately afterwards came the $\frac{1}{2}$% increase in the U.S. discount rate; and the houses were again made aware, through the enforcement of further borrowing at Bank rate, that the authorities considered that the fall in the Treasury bill rate should be reversed. The rate was raised in two steps, by $\frac{7}{64}$% on 10th December and by a further $\frac{3}{64}$% the following week, to $5\frac{17}{32}$%. In each week the rise was less than had been expected by other tenderers and the discount houses obtained good allotments. The rate fell back slightly during January, as the houses tried to obtain reasonable allotments from the very small amounts of bills offered at the tenders.

The average cost of the market's borrowed funds was probably a little higher during November to January than during the previous three months. Since the middle of December it is estimated to have fluctuated around $5\frac{3}{8}$%.

Gilt-edged In the gilt-edged market, yields were rising slightly throughout most of November to January. The movement first became evident early in November, when there was a small amount of selling, particularly of longer-dated stocks. By mid-November, however, the market had revived; demand for short and medium-dated stocks strengthened; and the authorities were able to start making sales from their holding of the short-dated stock, 6% Exchequer Loan 1970, which had been issued at the beginning of the month. Yields on longer-dated stocks, however, rose a little during November. The institutions, which normally provide a lot of the demand for such stocks, were not buying much: since the autumn there had been heavy issues of company fixed-interest securities and their accruing funds were largely needed to meet the calls on these issues.

The revival in demand for short and medium-dated maturities did not last. Early in December came the increase in the U.S. discount rate, the subsequent rise in the U.K. Treasury bill rate, and the failure to pay the interest due on a Southern Rhodesia stock (see page 15). These caused a marked fall in prices. The mood was also depressed by official warnings that there was no prospect of any early relaxation of the Government's measures to moderate the expansion of domestic demand. When prices steadied, just before the Christmas holiday, they were significantly lower than they had been during October.

After the turn of the year the high yields available, up to $6\frac{3}{4}$%, encouraged buyers again, especially of short-dated stocks. But the recovery petered out and throughout most of January there was little life in the market. On the 11th January, the price at which the authorities were willing to sell 6% Funding Loan

1993 was lowered to bring it into line with its market quotation; and towards the end of the month, when prices began to rise quite strongly throughout the market, demand for this stock increased.

Total turnover in the gilt-edged market was noticeably less than in September and October (Table 15 of the annex), reflecting mainly the generally easier tone. Nevertheless, considering the amount of discouraging news that the market had to absorb, the undertone remained firm. From time to time during the three months the authorities purchased small amounts of medium and long-dated stocks, in order to ensure that yields did not rise too rapidly; they also bought in a substantial amount of 5½% Exchequer Stock 1966, which matures on 15th March. Over the three months as a whole the authorities' purchases were largely offset by their sales, which were at their heaviest late in November.

Debentures and equities

The debenture market, which had been particularly firm in September and October, began to ease early in November, largely in sympathy with the easier trend of the gilt-edged market. Yields rose further in December, partly because it became clearer that no early fall in interest rates could be expected, and partly because of the weight of new issues. According to the F.T.-Actuaries calculation the average yield on 20-year stocks rose from 6·87% at the end of October to 7·23% just before Christmas. By the end of January it had edged up to 7·27%; this was a little over ¾% above the yield on government stocks of a similar term.

The flow of new company fixed-interest issues continued throughout the period. In November over £65 million (net) was raised from the market in this way, including a call of £20 million on the issue by Imperial Chemical Industries described in the December *Bulletin*; this was well above the previous monthly record of nearly £50 million in July. Altogether, a net total of £245 million was raised by such issues in the second half of the year—an outstandingly large sum. Turnover in company fixed-interest securities was again heavy in November and December, and in the fourth quarter as a whole it was 60% greater than a year earlier. It fell back only a little in January.

The equity market was mostly rather subdued, although turnover was consistently higher than it had been in the summer. Prices were affected, on the one hand, by reports from some large companies of declining profit margins and by official warnings of further action if the rise in money incomes threatened the restoration of the balance of payments. On the other hand there was a continuing shortage of shares, brought about mainly by the dearth of new issues and by the reluctance of investors to sell; so that a relatively small demand for shares was sufficient to keep prices steady. The F.T.-Actuaries index of industrial share prices, which stood at 113 at the end of October, fluctuated only slightly over the three months. It fell to 110 by early in January, but by the end of the month it had more than recovered, to 114.

An exceptionally large new equity issue was announced in January—a rights issue of ordinary shares by the British Petroleum Company to bring in £60 million, half payable by mid-March and the balance by mid-May. For this company, overseas taxation would be enough to offset in full any liability to corporation tax; so that a rights issue of ordinary shares was not, as for most other companies, a substantially more expensive form of raising money than borrowing on debentures. Moreover, such an issue had the advantage of maintaining a balance between the company's risk and fixed-interest capital. The Government, as majority shareholders in the company, have decided to take up their full share of the new issue (£31 million), as also will the Burmah Oil Company (£15 million), leaving £14 million to be found by other shareholders.

Local authorities

During October local authorities began to borrow more heavily again from the Public Works Loan Board.(1) They also raised considerably more by new issues of stocks and bonds during November to January than in the previous three months (£77 million, net, compared with £33 million). At the same time, income from ratepayers was still seasonally

(1) Their borrowing was restricted in late July, when authorities which had then already drawn more than half their year's quota were prevented from drawing any more until 1st October (September 1965 *Bulletin*, page 217).

high. Thus the local authorities needed to borrow less on temporary money and from mortgages. Conditions in the temporary money market, apart from a short-lived rise in rates before the turn of the year, were therefore comparatively easy; and the amount raised on mortgages, though still substantial, was probably smaller than in the three previous months.

Of the amount raised by local authorities in the new issue market, well over half came from short-term bonds[1] and much of the rest from calls on earlier issues of stock rather than from fresh issues. Activity in the market in existing short-term bonds also increased as, for the first time since they were issued, yields on these bonds had risen above the rate offered for temporary money for a comparable term. For example, in late October and early November, bonds with about six months to maturity yielded $6\frac{7}{16}$%, compared with a rate of about $6\frac{1}{4}$% on six months' deposits. This advantage lasted only a short while, however, and by the middle of December the gap had been reversed, mainly because rates for temporary money had risen but also because demand for short-term bonds had increased. In January some one-year bonds were issued at a yield $\frac{1}{4}$% below the rate on deposits for a similar period.

The easy conditions in the temporary money market continued until early in December. Rates for three months' money, which had been $6\frac{1}{8}$%—$6\frac{1}{4}$% since early in October, then rose sharply to $6\frac{1}{2}$%. This increase followed the rise in U.S. money rates, which led to expectations that rates in London would harden; but it also owed something to seasonal window-dressing of balance sheets. Companies whose financial years end on 31st December tend to withdraw money temporarily from local authorities during December, in order to show larger bank balances in their balance sheets, and to redeposit funds in the new year. For a similar reason, overseas residents tend to withdraw funds from the euro-dollar market during December, and to convert the dollars withdrawn into their own currency: thus the rate for U.S. dollar deposits in London tends to rise, and this rise can also serve to draw funds away from local authorities. With the reflux of funds in January, the three months' rate fell back again, to much the same level as in November.

As mentioned earlier, local authorities were probably relying rather less on mortgage finance than in earlier months. Mortgage rates rose little between November and January, and by less than the rise in yields on comparable gilt-edged stocks. The margin between the yield on a 20-year government stock and the mortgage rate for a similar term narrowed very slightly, but was still around $\frac{1}{2}$%.

Hire-purchase finance houses

Last May, the finance houses were requested to restrain their financing of the private sector, over the year ending in March 1966, to a degree comparable with the limit set on bank credit. Early in June, the minimum down-payment required on most goods was increased; and late in July the period allowed for repayment was reduced. The total of outstanding hire-purchase debt owed to finance houses first started to fall in September, and fell further during each of the following three months. At the end of December, however, total lending by the finance houses—either on hire-purchase or credit-sale agreements or in other ways—was still £66 million higher than at the end of March, an annual rate of growth of 9%. These figures are not seasonally adjusted; and in the three months to the end of March there is usually a seasonal dip in hire-purchase debt. Nevertheless, a more than seasonal fall in total lending during the first quarter of 1966 is needed if all the houses are to meet the authorities' request.

In view of the restraint on their business, the houses had little occasion to bid strongly for deposits during November to January—except, to a minor extent, over the turn of the year. The spread of rates for three months' deposits quoted by the main houses rose from $6\frac{1}{4}$%—$6\frac{1}{2}$% at the end of October to $6\frac{3}{8}$%—$6\frac{3}{4}$% in the last weeks of December, but fell back almost to its previous level during January.

Building societies

In the early part of 1965, housing finance was quite severely restricted by a shortage of funds in the building societies. In June the societies

[1] These have been issued for terms from one to four years, but are often referred to as 'yearling' bonds.

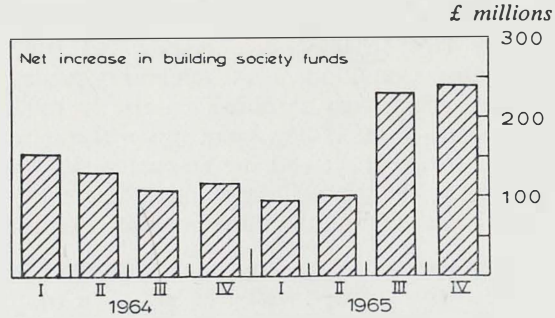
announced increases in their borrowing rates (which are now generally 4% on shares and $3\frac{3}{4}$% on deposits, both tax-paid) and since then they have received a large inflow of funds. The total sum outstanding on shares and deposits increased by £465 million during the last six months of 1965, considerably more than during the whole of the preceding twelve months.

It was noted in December that, with the increase in available funds, mortgages had started to rise again in September. In the following months they grew strongly, for demand was heavy, and record amounts were advanced (see the chart). The societies' combined liquidity ratio (cash and investments, other than mortgages, expressed as a proportion of total assets), which had risen from a low point of 13% in May to nearly 16% by the end of September, settled around $16\frac{1}{2}$%, a level fairly typical of recent years.

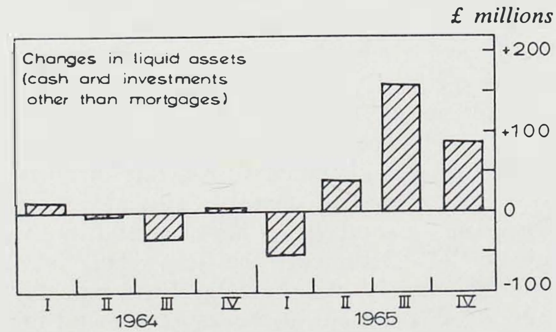
Although the average ratio of reserves to total assets fell only a little further in the fourth quarter, to 4%, the margin between the societies' earnings and their outgoings is generally considered by them to be uncomfortably small. Most mortgages still cost $6\frac{3}{4}$%, the rate recommended by the Building Societies Association.

Foreign exchange market The improvement in sterling which had developed in September and October was maintained in the following three months. Set-backs occurred from time to time, but the undertone remained generally firm and the authorities were able to buy a substantial amount of exchange.

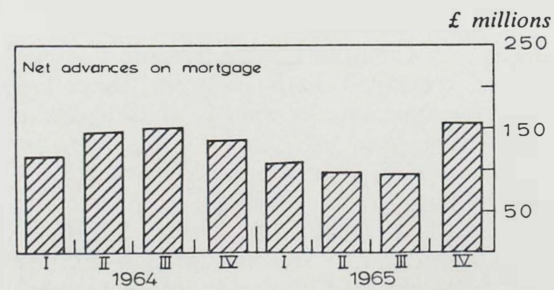
At the beginning of November there was a particularly strong demand for sterling, which took the rate against the U.S. dollar up to \$2·$80\frac{1}{2}$. Sentiment was then disturbed for a while by events in Rhodesia. But the declaration of independence itself, on 11th November, had relatively little effect, even at the outset: this may have been partly because exchange markets in North America and in some continental centres were closed on that day. Indeed, by the middle of the month the market had recovered to such an extent that the authorities were again able to acquire a substantial amount of exchange for the reserves. Towards the end of November, however, the market quietened as a general shortage of dollars developed; and the rate, which had



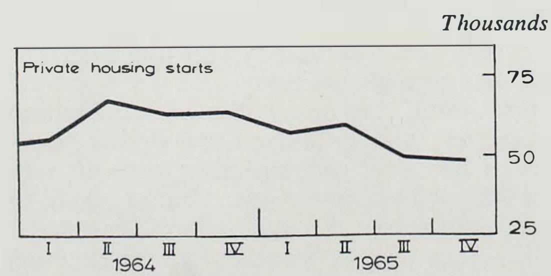
The heavy inflow into building society shares and deposits in the second half of 1965—



—at first went largely to strengthen the societies' liquidity—



—but in the fourth quarter lending on mortgages grew again, to a record level.



The number of private houses started fell a little further in the fourth quarter, but less than seasonally expected; and may well be rising now.

fluctuated for most of the month around $2·80⅜, began to fall a little.

Although there was some seasonal repatriation of funds by overseas residents for window-dressing purposes, this year the impact and the magnitude of these movements were considerably less than in the past. This was mainly because of the action taken in their own markets by a number of continental central banks, in a co-operative spirit, with the object of preventing window-dressing activities from causing undue disturbances. Nevertheless, the shortage of dollars persisted early in December; and at the same time there were renewed uncertainties about the Rhodesian situation. These developments were followed by the announcement of further measures to redress the U.S. balance of payments, and of an increase, from 4% to 4½%, in Federal Reserve Bank discount rates; this prompted some small sales of sterling early on 6th December, when the rate momentarily fell to $2·80$\frac{3}{32}$. But shortly afterwards a moderate demand for sterling developed, which eased only briefly around 20th December as dollars again became scarce; and after Christmas, once end-year dispositions had been made abroad, the demand strengthened appreciably. In all, sterling proved very resilient during December, in difficult conditions.

During January there was a steady inflow of funds. This was no doubt associated partly with the reversal of end-year window-dressing; but it also owed something to purchases of sterling by foreign oil companies in order to pay oil royalties. And sentiment was reinforced by the good trade figures for December, published on 12th January. The rate had already recovered to about $2·80$\frac{5}{16}$ at the end of December, and soon after the middle of January it touched $2·80½ again: it then settled at around $2·80$\frac{7}{16}$ until the end of the month, when it eased a little, to $2·80⅜.

As in September and October, the reserves did not benefit to anything like the full extent of the amount of exchange acquired by the authorities. Some of it went to repay debt (see below); and much was used to reduce the authorities' outstanding forward commitments with the commercial banks. Indeed to some extent the inflow of exchange stemmed from overseas residents who were closing out deals which had been contracted earlier to insure against a fall in the exchange value of their sterling assets.(1) Forward maturities were light in December, but large in the other two months; and in the prevailing state of confidence few were extended. As a result the authorities' outstanding forward commitments with the banks, which had already been sharply reduced since August, fell substantially further; and by the end of January were well below their level a year earlier.

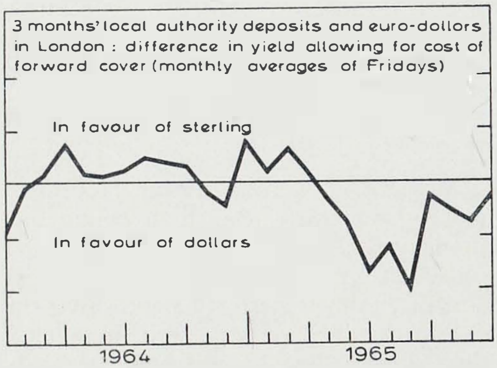
The strength of sterling during November to January was chiefly due to a continuing, though moderate, reflux of short-term capital from non-sterling countries. These countries added further to their sterling balances over the period, but the increase was less pronounced than in the preceding two months, probably because depleted working balances had already been substantially restored by the end of October. Meanwhile, the U.K. deficit will have been much reduced—partly for seasonal reasons and partly because of the better trend in the visible trade balance; and the aggregate payments position of overseas sterling countries, which should have been better for seasonal reasons alone, may also have shown some underlying improvement.

The inflow of short-term capital probably owed little to interest rate considerations. The three months' discount on forward sterling fell over the period by the equivalent of about ½% per annum, influenced by the increase in U.S. short-term rates (Table 23 of the annex). This reduction in the cost of forward cover and the slight increase in the U.K. Treasury bill rate offset the rise of a little over ½% in the U.S. Treasury bill rate. The narrow margin in favour of covered investment in U.K. Treasury bills rose a little until early in December, but was reversed by the end of that month; and the margin was just in favour of New York during most of January. Three months' euro-dollar deposits in London offered a slightly higher return than local authority money for most of the period, after allowing for the cost of forward cover. Euro-dollar rates hardened in November and early December, as the seasonal shortage of dollars was aggravated by the rise in U.S. rates. They eased somewhat

(1) December 1965 *Bulletin*, page 304.

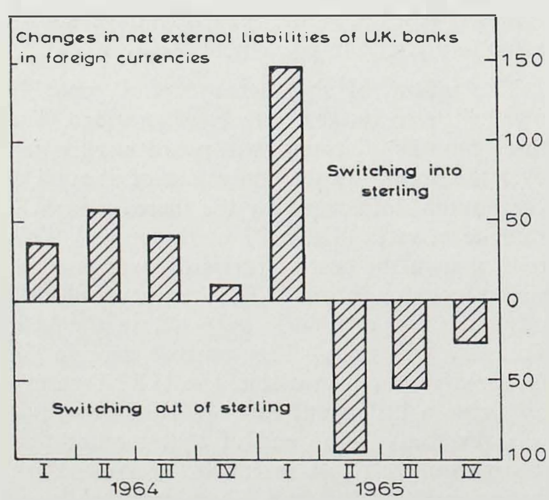
around the turn of the year, and the increase over the three months was about $\frac{3}{8}$%. The cost of forward cover fell by more than this; and

Per cent per annum



Until March 1965, relative interest rates generally made it advantageous to employ foreign currency deposits in sterling assets; but thereafter there was less demand for temporary money by local authorities, and the advantage was reversed.

£ millions



There was some switching back into foreign currencies after March; but over the last two years, on balance, there has been a substantial net switch into sterling.

the margin in favour of euro-dollars, which had briefly touched $\frac{1}{4}$% in November, was mostly small during December and January.

Reserves and special assistance As noted in December, assistance equivalent to £268 million ($750 million), which had been drawn under the swap facility with the F.R.B. during June to August, was still outstanding at the end of September. There were repayments totalling £99 million during the fourth quarter: £18 million in October, £54 million in November and £27 million in December. Despite these repayments, the reserves rose by £89 million. But an increase of this size was only achieved as a result of the deferment, mentioned earlier, of payments of principal and interest due in December, and amounting to about £62 million, on the U.S. and Canadian government loans.

Thus at the end of 1965 the amount still outstanding under the $750 million swap facility with the F.R.B. was £169 million. During January £66 million of this amount was repaid and the reserves nevertheless rose by £5 million; the balance, namely £103 million, was repaid in February, thus reconstituting the whole of the $750 million facility. In addition, during February a transfer was made to the reserves of that part, amounting to £316 million, of the portfolio of dollar securities which was held in liquid form. The reserves, as a result, rose during February by £225 million.

Investment dollar market The steep rise in the investment dollar premium, from 12% early in November to over 20% in January, attracted some attention during the period. The market in investment dollars exists because of restrictions on the use of official exchange to finance investment in countries outside the sterling area. Until recently, U.K. residents realising assets in these countries were normally allowed to sell the entire proceeds to other residents for reinvestment outside the sterling area. Since April 1965, however, one-quarter of the proceeds has had to be sold in the official exchange market; this measure alone reduced the supply of investment dollars, between April and December, by a substantial amount. In addition, certain other items, such as gifts and legacies, which had previously been allowed to be sold in the investment dollar market, have had to be sold in the official market. While the supply of investment dollars was thus restricted, the potential demand was greatly increased after July—when it was announced that for the time being no further official exchange would be provided for direct investment outside the sterling area.

The supply of investment dollars has always been limited and the premium moves erratically on quite small demand. Thus the sharp rise during November to January merely reflected, for the most part, the impact of the recent measures on supply and demand in an already thin market: it may also have owed something to the buoyancy of U.S. equity prices, because even a switch from one dollar security to another involves the surrender of 25% of the sale proceeds through the official exchange market—and therefore requires the purchase of further investment dollars if the level of investment is to be maintained.

Gold market

During November and the early part of December there was a steady demand for gold; and the dollar equivalent of the daily fixing price moved between $35·10 and $35·12⅞ per fine ounce. Demand strengthened around the middle of December, but buying was moderated by a rise in the price, which reached $35·16 shortly before Christmas. Towards the end of the month there was some selling by the U.S.S.R., and by the beginning of January the price had reacted to $35·12⅛. Demand was heavy at times later in January and by the end of the month the price had risen above $35·17. Sales by the producing countries during the period were less substantial than usual and insufficient on balance to satisfy market demand.

Gold pool

During 1965 the central bank gold pool, which was described in some detail in the March 1964 *Bulletin*, continued to operate. Despite rising supplies of new production, demand was sufficiently strong at the beginning of the year to leave the markets short of gold; and the sales consortium was brought into operation in the month of January and continued in operation until the autumn. The French President's criticism of the gold exchange standard, the war in Viet-nam, anxiety regarding the future of the pound, gold purchases on Chinese account and strife between India and Pakistan all made their contribution to the maintenance of a level of demand which exceeded available supplies. In the autumn, demand subsided somewhat and there were substantial sales on Russian account; and before the end of October all of the gold which had been subscribed by the members of the sales consortium had been repaid. From then onwards conditions were quieter and the net position of the pool at the end of the year was somewhat better than at the beginning.

Southern Rhodesia

The unilateral declaration of independence made in Rhodesia on 11th November 1965 was at once repudiated as illegal by the British Government; and economic sanctions were imposed, in order to bring about a return to constitutional rule. The developing situation made its impact upon markets in London from time to time—in particular on the gilt-edged and the foreign exchange markets. The effect upon sterling, however, was less than might have been expected; and there was no perceptible withdrawal of short-term capital from the United Kingdom.

The Bank of England have been involved mainly as the agent of H.M. Treasury in the administration of exchange control, in fulfilment of the Government's policies. On 11th November Southern Rhodesia was excluded from the list of Scheduled Territories under the Exchange Control Act 1947; Rhodesian Accounts were specially designated and payments to and from such accounts controlled; and the Rhodesian pound became a foreign currency for the purposes of the Act. Access to the London market was denied and exports of capital from the United Kingdom to Rhodesia were prohibited. Transactions in Rhodesian securities, and in securities owned by residents of Rhodesia, were restricted, but most other normal payments were affected only in so far as the Government had introduced sanctions such as the ban on purchases of tobacco and sugar. On 1st December, exchange control was extended so that virtually no current payments by U.K. residents to Rhodesia were allowed, except in respect of permitted trade; and the list of prohibited Rhodesian exports to this country was enlarged to cover 95% of the normal trade. (It was further extended, to 100%, at the end of January) Other exceptions to the ban on current payments were travel for approved business and official purposes, and gifts up to a total of £50. Permitted payments had to be made into Rhodesian sterling accounts—which could be used only for limited purposes, excluding those of a commercial character. Contractual payments such as pensions and dividends, including interest on British government stocks, were to be held back. A modification regarding pensions was proposed by the British Government at the end of December, and announced on 14th January, whereby both sides were to pay pensions in sterling through a special account in London; any balance in favour of Rhodesia could be used to buy goods and services, apart from arms and oil, in the sterling area. From the end of January payments to Rhodesian Accounts were allowed, on a limited scale, both to relieve hardship and for charitable, religious, medical and educational purposes.

On 17th December, when an embargo on oil shipments to Rhodesia was initiated, further exchange control measures were announced. The effect of these was that Rhodesia would have to pay for British goods, and related services, on or before shipment, in non-sterling convertible currencies: since 7th December Rhodesia had required sterling area countries to make inward payments in a similar manner.

Two steps were taken in respect of Rhodesian banking affairs. On 3rd December an Order in Council was issued modifying the Southern Rhodesian Act of 1964 under which the Reserve Bank of Rhodesia was established: the Order suspended from office the Governors and Directors of the Reserve Bank and appointed a new Board in London. Another Order in Council, on 6th December, laid down that U.K. banks holding Rhodesian bank assets could be required to supply information about them.

The Bank are the paying agent and registrar for all but one of the stocks issued in London for which the Government of Southern Rhodesia is liable. The prospectuses for these stocks state that the revenues of the Federation of Rhodesia and Nyasaland alone (or of Southern Rhodesia in the case of stocks issued before the Federation was created) are liable in respect of these stocks and the interest thereon,[1] and the Consolidated Fund of the United Kingdom and the Commissioners of H.M. Treasury are not directly or indirectly liable or responsible for payment of the stock or of the interest thereon.

After the illegal declaration of independence, service of these loans was made possible for a time by the receipt of funds from the Southern Rhodesian Treasury. However, no funds were received by the Bank to meet the interest payment due on 6th December in respect of Southern Rhodesia 4% Stock 1972/74, nor subsequently to meet the interest payments due on other Southern Rhodesia stocks for which the Bank are the paying agent. The position of the British Government was stated by the

[1] On the dissolution of the Federation in 1963, the Federal liability was apportioned between the three territories.

Commonwealth Secretary, in answer to a parliamentary question on 14th December. He said that the British Government had not assumed the government of Southern Rhodesia and had "... not in any way succeeded either to the assets or to the liabilities of the Government of Southern Rhodesia". Since 6th December the Bank have therefore been unable to make interest payments on any Southern Rhodesia stocks.