Commentary

This Commentary is mainly concerned with events during February to April, although it also covers the Budget on 3rd May. During the period there were several unsettling influences—events in Rhodesia, disappointing trade figures for January and March, rising interest rates in the United States, the general election at the end of March, and the approach of the Budget. The undertone for sterling in the foreign exchange market was somewhat less firm, but the authorities were not called upon to provide heavy support. Interest rates rose quite sharply.

The marked improvement in the balance of payments in the last quarter of 1965, noted in the March *Bulletin*, owed much to special factors and was not expected to be maintained in the first quarter of 1966. In fact, there appears to have been a considerable deficit during the first quarter on current and long-term capital accounts, taken together. However, the balance of monetary movements was probably only moderately adverse; and there was a large favourable balancing item. The deficit on visible trade, after seasonal adjustment, was about twice as large as in the previous quarter. Exports rose, but there was a higher level of imports, especially manufactures. There were still few signs of much change in the domestic economy, and the labour position continued to be very tight. Steps were taken in the Budget both to ease the pressure of home demand and to encourage a re-deployment of resources designed to help the balance of payments; in addition, more direct action was taken to limit expenditure overseas. Against this background, the expiry of the temporary import surcharge, at the end of November, was announced.

The domestic economy

As the Budget approached it seemed that total demand on resources remained very high. Exports had risen further, and in the first quarter of 1966 averaged 1% more than in the previous quarter. Personal consumption was still rising, although to some extent the increase must have been due to purchases in anticipation of the Budget. The immediate pressure on domestic resources, however, was somewhat eased by a slower growth of both public and private investment expenditure, which primarily affected building and construction; and by the unwelcome rise, of $3\frac{1}{2}$% over the previous quarter, in imports. Industrial production, as measured by the official index and after seasonal adjustment, was little changed in total, though the manufacturing component rose by nearly 1% during the quarter.

Fixed investment as a whole had grown much less fast in 1965 than in the previous year. One reason for this was that spending on housing increased less: both public and private house building had been checked in the spring of 1965, although building on public account picked up later in the year. By the first quarter of this year, however, private house building had not yet recovered, despite the easier mortgage position, while public sector house building had fallen back again. The growth of public sector investment other than housing also slowed down in 1965: investment by public authorities was much the same as in 1964, while that by public corporations rose only slightly and fell substantially short of their investment programmes.

In private industry, spending on fixed investment may have grown no further in the first quarter. Expenditure by the distributive and service trades had already fallen during the second half of last year, while manufacturing investment had levelled out. Manufacturers had spent more on plant and machinery, and this trend—encouraged perhaps by the Government's new investment incentives[1]—may well have continued, but their expenditure on building is likely to have fallen further, because of licensing procedures and the uncertainty caused by the proposed tax on land values.

The volume of stockbuilding in the fourth quarter of 1965 had been the smallest for over two years and had been due entirely to wholesalers and retailers; manufacturers' stocks had fallen slightly. On the figures so far available, stockbuilding picked up again in the first quarter of 1966; manufacturers' stocks apparently grew at much the same rate as during the first three quarters of 1965.

The increase in consumers' expenditure in the first quarter—which was undoubtedly affected by purchases in expectation of tax increases in the Budget—may have been quite sharp. The volume of retail sales rose in January, fell away during February, but recovered noticeably in March. Sales of household durable goods accounted for much of the increase in January, but they then dropped again, probably because of the further restrictions imposed on hire purchase early in February. Purchases of cars, judged by the number of registrations, were substantially larger than in the fourth quarter of 1965—by much more than might have been expected on seasonal grounds—although they were not quite as heavy as a year earlier, when there had also been a sharp increase in pre-Budget purchases.

Unemployment has continued to fall in most parts of the country and the gap between notified vacancies and the number out of work has tended to widen still further. Hourly wage rates have been rising faster this year than in the closing months of last, and in the first quarter were nearly 8% higher than a year ago. Because of a reduction in hours worked, however, weekly earnings have increased a little more slowly over the year; even so they were nearly 7% higher than a year earlier. Personal incomes have also been temporarily enlarged by the increase, described on page 116, in company dividend payments before the end of the tax year. At the same time, price increases have been relatively modest; the stability of prices compared with incomes goes some way towards explaining the continued rise, in real terms, in personal consumption.

By April there was no sign of much change in the pressure on the economy; the most evident symptom of strain was the continued high level of imports of manufactures, primarily of capital but also of consumer goods. Further steps were necessary, to ease the pressure of home demand and to strengthen the balance of payments.

Balance of payments

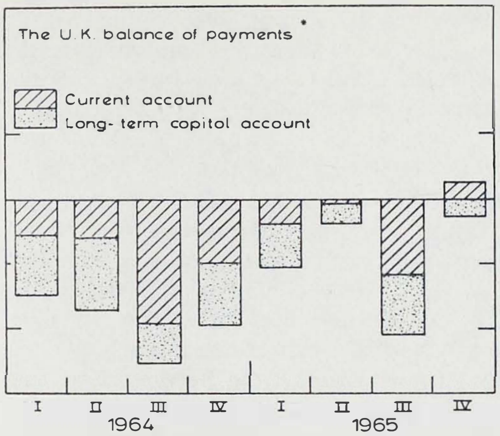
Full details of the balance of payments in the first quarter are not yet available, but it was clear by April that the out-turn would not be so encouraging as in the final quarter of 1965, when there had been a small surplus on current account. The deficit on visible trade in the first quarter, after seasonal adjustment, was £72 million. The value of exports and re-exports, seasonally adjusted, rose by about 1%, but the increase in imports was about 3½%.

The rise in exports included increases in diamonds and ships, deliveries of which can fluctuate greatly from quarter to quarter, and in food and fuels; there were decreases in motor vehicles, textiles and metals. Exports to both Canada and the United States continued to grow and in total, after seasonal adjustment, were about 20% above the average for 1965: there was strong growth too in sales to Western Europe, with the countries of both the European Free Trade Association and the European Economic Community sharing in the increase. Exports to the sterling area, however, declined, to 5% below the average for last year.

The rise in the value of imports was largely in two categories. There was a marked increase in arrivals of capital goods, particularly machinery: these may have been held back in previous months in the hope of a reduction in the import surcharge at the end of 1965. Semi-processed manufactures also increased, mainly because of higher prices for copper and a rush to import textiles before the special quota

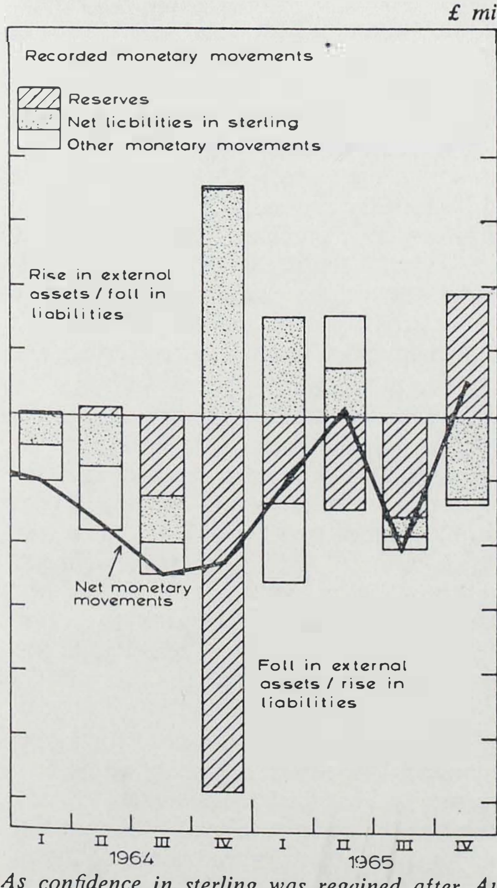
(1) March *Bulletin*, page 3.

£ millions



Both the current and long-term capital accounts contributed to the reduction of the deficit in 1965.

£ millions



As confidence in sterling was regained after August 1965, the reserves, net of special assistance, rose again; net external liabilities in sterling also increased.

arrangements for them expired. There were large arrivals of tobacco, but these were more than offset by smaller imports of food.

In April, imports were a little lower, after seasonal adjustment, than the monthly average for the first quarter. Exports were broadly unchanged; the higher level of shipments to Western Europe continued but sales to North America fell away. The trade gap narrowed slightly.

Complete information is not yet available on the invisible and long-term capital accounts in the first quarter. However, payments of oil royalties and taxes were unusually heavy, mainly because of a rephasing of tax payments to one of the major producing countries; and some of the advanced dividend payments by U.K. companies, described later, will have led to larger remittances abroad than usual. It seems likely that there was a larger net outflow of long-term capital than in the fourth quarter. Combined with the adverse balance on visible trade already mentioned—some £70 million (seasonal factors are quite small in the first quarter)—there was probably a renewed deficit on current and long-term capital accounts quite considerable in size.

Known monetary movements in the first quarter, however, were less unfavourable. The reserves actually rose by £203 million, but they were affected by the transfer from the official dollar portfolio (£316 million) and by the repayment of the remaining £169 million outstanding under the credit facilities with the U.S. authorities: without these transactions they would have risen by £56 million. There was also a further decrease, of £53 million, in the banks' net external liabilities in foreign currencies; and there was a reduction of £17 million in the deposit made by Western Germany last July in anticipation of purchases of arms and equipment from the United Kingdom.(1)

On the other hand, there was a substantial increase in net external liabilities in sterling (excluding the effects of the repayment to the U.S. authorities). Those to sterling area countries rose by £89 million: their own balance of payments continued to improve (thanks mainly to import controls in several

(1) December 1965 *Bulletin*, page 305.

* Both charts exclude the balancing item; and recorded monetary movements are adjusted to exclude changes in special assistance. "Other monetary movements" includes miscellaneous capital items and net liabilities in currencies other than sterling.

countries) and they may possibly have gained some funds from the United Kingdom in anticipation of restrictions on overseas investment in the Budget. Those to countries outside the sterling area increased by £43 million, a strong rise in January being partly offset by reductions in February and March. Overseas deposits with local authorities and finance houses (which are recorded separately from the other figures of external liabilities in sterling, see page 204) increased again, by £11 million, and the banks' net liabilities in overseas sterling area currencies rose by £23 million.

The monetary movements listed above are not quite the full story, because some items of miscellaneous capital are still unknown. The figures so far available, however, were unfavourable, taken together, to the extent of £40 million, considerably less than the probable deficit on current and long-term capital accounts. It seems, therefore, that there was again a fairly large positive balancing item, not unusual in the first quarter of a year.

It might perhaps be helpful to note here that some monetary transactions during the quarter, described on page 109, had no net effect on the total of monetary movements. First, there was the payment to the International Monetary Fund of the United Kingdom's additional subscription; this was offset by a rise in the Fund's sterling holdings. Secondly, there was the transfer to the reserves of the liquid part of the official dollar portfolio; the consequential rise in the reserves was offset by a counter-entry within monetary movements. Lastly, there was a special swap transaction with the U.S. authorities during March; but this merely offset other official transactions.

The Budget

The Chancellor thus framed his Budget against the background of a tight labour situation, high pressure of domestic demand, and the need to secure a further substantial improvement in the external position. He set out three broad objectives: a strong pound, steadily growing industrial strength, and full employment. In order to help the trade balance, he sought to ease the pressure of demand while, at the same time, encouraging a re-deployment of labour in favour of manufacturing industry.

The measures that the Chancellor announced were expected to yield £386 million in the current financial year. The Exchequer's total borrowing requirement in 1966/67, even after allowing for loans of £1,334 million from the Consolidated Fund (mainly to local authorities and nationalised industries), was estimated at only £287 million—one-half of the actual amount borrowed, £576 million, in 1965/66.

Rates of income tax and of indirect taxes were unchanged; the corporation tax was set at 40%. The principal change in taxation was the introduction of a selective employment tax, which would increase the cost of labour in most service industries and in construction but would reduce it in manufacturing. Between 1960 and 1965 only about 10% of the total increase in available labour had gone into manufacturing industry. The new tax, based on numbers employed, would be paid by all employers: some, for example transport undertakings, would later have it refunded; while manufacturers would not only have it refunded but would receive an additional payment of about 30% of the amount they had paid in tax. The Chancellor argued that the new tax—which would be broadly equivalent (if it were passed on in prices) to a purchase tax on services of 3%-4%—would contribute towards the structural changes in the economy necessary to achieve external balance and would promote a more efficient use of labour in the service and construction industries.

Employers as a whole would pay much more in tax than was returned to them, so that the new tax would represent a substantial deflationary force: its effect would not be felt until later in the current year, when it would be considerable—because the first tax payments would be made in September and the first refunds, and additional payments to manufacturers, not until February. The net yield was estimated at £315 million in the current financial year, and £240 million in a full year.

The Chancellor stressed the need for saving and announced that from July there would be a new issue of national development bonds, carrying interest at 5½% instead of the present 5%, and again with a tax free bonus of 2% at the end of five years. It was proposed also to issue a new tax reserve certificate for companies, with better terms than at present.

The balance of payments was expected to benefit not only from the easing of home demand, but also from more direct measures announced in the Budget—from which it was hoped to save up to £100 million a year.

First, to secure a further reduction in the deficit on capital account, the Chancellor announced a voluntary programme of restraint, for the next year or two, on the part of companies and firms investing in the more developed countries of the sterling area, namely Australia, New Zealand, South Africa, and the Irish Republic. He asked for any direct investment costing over £25,000 a year in any one of these countries to be postponed, where possible, for the time being; and for every effort to be made to finance projects from local sources rather than from the United Kingdom. If, however, companies still desired to proceed with their investment plans, they were invited to submit them to the Bank of England, who would examine them, with the firms concerned, to see whether they promised a quick, substantial and continuing benefit to the balance of payments. Such benefit, through additional remittances of earnings or increased proceeds from exports, should be large enough at least to equal the cost of the original investment in two or three years. Companies would be invited to withdraw or postpone plans which did not meet this criterion. A new office has been established in the Bank for the purpose of dealing with these investment projects. The Chancellor subsequently wrote to the chairmen of over two hundred of the principal companies which are involved in direct investment abroad, seeking their co-operation in this voluntary programme.

As regards portfolio investment, the aim of the voluntary programme is that there should be no significant increase, over a period of time, in total holdings of securities—denominated either in foreign currencies or in the currencies of the four sterling area countries concerned—of any one institutional investor. The Governor asked for the co-operation of the main institutional investors, through their representative bodies.

Secondly, the Government would review their own overseas expenditure—on such activities as overseas representation and military aid—with the firm objective of reducing it; and they would ask for early negotiations with the Federal German Government with a view to securing relief from the whole foreign exchange cost of keeping British forces in Western Germany: the Chancellor hoped that agreement on this would be reached by the autumn.

A further step was taken to restrict direct investment outside the sterling area. In order to obtain the necessary investment currency, companies and firms would have to show, like those investing in developed countries inside the sterling area, that their projects would bring the same quick, substantial and continuing returns to the balance of payments: direct investments over £25,000 which did not meet this criterion would be allowed, under exchange control, only if the funds were borrowed abroad. This measure will not immediately benefit the reserves, as all such investment has to be financed through investment currency or by borrowing abroad; but it should, in time, relieve pressure on the investment currency rate and thus make it cheaper for firms whose projects satisfy the criterion to invest outside the sterling area.

It was also announced that the temporary import surcharge would lapse at the end of November, when the legislation under which it had been imposed would expire.

Foreign exchange market

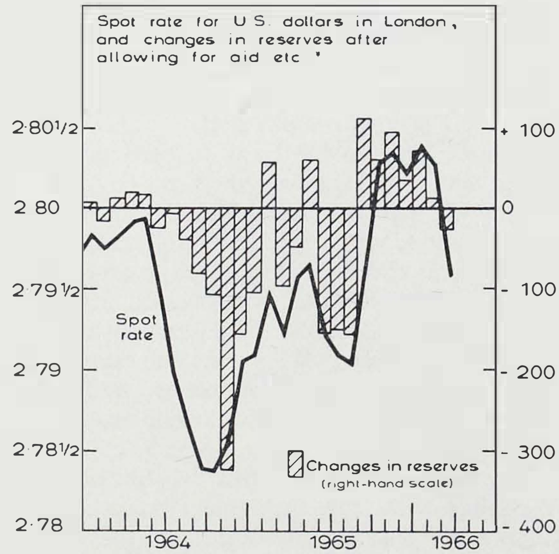
The recovery in sterling which had extended over the preceding five months was interrupted during February to April, when the easier tendency resulted mainly from a net outflow of short-term capital to the non-sterling area. The payments position of the sterling area as a whole with the rest of the world usually shows a marked improvement at this time of the year; and overseas sterling area countries, as a group, added substantially to their net sterling holdings, notably in April. But the net sterling balances of non-sterling area countries fell in each of the three months; some of these funds were doubtless withdrawn because of the political and economic uncertainties which prevailed during the period.

Moreover, the banks converted back into foreign currency some funds which had earlier been employed in sterling. At the beginning of the period there was little to choose, after allowing for the cost of forward cover, between the return on three months' local authority money and that on dollar deposits in London. But later an increase in the cost of forward cover and then a steep rise in euro-dollar rates, reflecting the shortage of dollars noted later, produced a margin in favour of euro-dollars ranging up to $\frac{7}{16}$% per annum. The differential narrowed in April, when the cost of forward cover fell, and closed at about $\frac{1}{4}$% per annum. On the comparison between U.K. and U.S. Treasury bills the balance of advantage was largely influenced by movements in the forward margin: sterling remained close to interest parity for much of February but later went to an intrinsic discount, which reached $\frac{1}{4}$% per annum at times early in March before running-off towards the end of that month. Throughout April the comparison favoured London, though rarely by more than $\frac{3}{16}$% per annum.

Pressure against the pound during the three months was sporadic and rarely heavy; and at times the authorities were still able to acquire exchange for the reserves. At the beginning of February there was a good demand for sterling but later in the month, although the authorities were often able to take in modest amounts of exchange, the undertone was not firm. Sentiment was affected by the threat of a rail strike and, shortly after this was averted, by poor trade figures for January, which revived doubts about the trend of the balance of payments. Moreover, towards the end of the month there was increasing talk about the likelihood of an early general election. The spot rate against the U.S. dollar, which had fluctuated around \$2·80$\frac{3}{8}$ early in February, fell during the rest of the month: some small support was given to moderate the movement. On 28th February, when the date of the election was announced, the rate fell below parity for the first time since September.

During the election campaign sterling continued to ease, but conditions varied considerably. Early in March there was an acute shortage of dollars and this, together with some rather gloomy estimates of the prospect for the balance of payments, brought sterling under quite heavy pressure. Support was given to moderate an abrupt fall in the spot rate, which touched \$2·79$\frac{1}{4}$ during the morning of 10th March, but at that point the selling appeared to have been overdone: the trade figures for February were expected to be good, and there was some demand for sterling in order to cover short positions which had been taken up. After the trade figures were published the market remained buoyant for a while, and the rate rose to \$2·79$\frac{11}{16}$ in the middle of March. It then fell back to about \$2·79$\frac{1}{2}$ on rumours that U.S. discount rates were likely to be raised, and continued to ease until almost the end of the month. The authorities again sold exchange to steady the market, but these losses were recouped towards the end of March, when foreign oil companies needed sterling to make tax and royalty payments.

£ millions



The spot rate for U.S. dollars dropped below parity in March; and the reserves, after rising for six months, fell.

On 1st April, once the election result was known, the rate rose by over $\frac{3}{32}$ cent to \$2·79$\frac{13}{32}$. A few days later, however, sterling was again being sold. Judging from the behaviour of forward rates, which moved strongly in favour of the pound, this was primarily due to a shortage of dollars, although there were probably some outright sales of sterling in advance of the Easter holiday. Conditions during the rest of April were much influenced by the incidence of further payments by foreign oil companies to producing countries in the Middle East. These gave rise to a strong demand for sterling shortly after Easter, but around the middle of the month sterling again came on offer: some sales were doubtless pro-

* Middle closing rate (average of weekly figures) and changes in reserves after adjusting for drawings, or repayments, of assistance. Allowance has also been made for the deposit of £41 million by Western Germany in July 1965 and for the transfer of £316 million from the dollar portfolio in February 1966.

voked by the trade figures for March, which showed that imports were still very high. Thereafter the market tended to ease until almost the end of April. The spot rate ranged between $2·79¼ and $2·79½ during the month, closing at $2·79⅜.

The authorities' maturing forward sales to the market were heavy in February. Many of these were closed out, and the authorities' outstanding forward commitments, which had been consistently reduced during the previous five months, again fell appreciably. During each of the next two months, however, when maturing forward sales were lighter than in February, there was little further change in the authorities' oversold position: most of the maturing contracts were extended.

Reserves As described in the March *Bulletin*, the reserves rose by £225 million in February: the balance of £103 million outstanding under the credit facilities with the U.S. authorities had been repaid while the liquid part—amounting to £316 million—of the official dollar portfolio had been transferred to the reserves. In March, despite difficult conditions from time to time, the reserves fell by only £27 million. During the month there were a number of inter-central bank operations, which together balanced out. Such operations can take various forms and are sometimes on a multilateral basis and not initiated by the United Kingdom. The largest of these operations during March was a special swap with the U.S. authorities for the equivalent of £54 million; this offset the reversal of other inter-central bank transactions entered into in earlier months. In April, there were again a number of inter-central bank operations; but these too almost balanced out and had virtually no net impact on the reserves, which fell by £19 million. The reserves had benefited, however, during April from a drawing of £18 million under a special line of credit with the U.S. Export-Import Bank, covering dollar progress payments on contracts for U.S. military aircraft: the drawing represented the reimbursement of payments made in earlier months.

By the end of February the necessary majority of members of the I.M.F. had consented to the proposed increase in quotas and drawing rights. In March, therefore, the United Kingdom paid to the Fund a further subscription of £175 million—£44 million in gold and the balance in sterling—so increasing its quota from $1,950 million to $2,440 million. In accordance with the procedures agreed for the general increase in quotas, the burden on the U.K. reserves of the gold payment to the Fund was mitigated by a simultaneous special drawing,(1) repayable within five years. During March some other members of the I.M.F. also bought gold from the United Kingdom to finance part of the increase in their own subscriptions, and the Fund simultaneously placed gold deposits of a similar amount with the United Kingdom.

Gold market Private demand for gold was heavy at times in February, slackened during the first half of March, but increased again towards the end of the month. During April there was some fitful selling from the Continent, while buying was rarely more than moderate; and the authorities recouped much of the gold which they had sold in February and March. But over the period as a whole, producers' sales, though more substantial than in the immediately preceding months, again fell short of net demand in the market. The dollar equivalent of the daily fixing price, after rising above $35·17 per fine ounce at times in February, fell to $35·13½ by the middle of March, but edged up to $35·15⅜ just before the end of the month. In April it fell below $35·12 at one point, before closing at $35·13⅛.

The previous control on the holding of gold coins by U.K. residents had proved defective, and new measures were introduced towards the end of April to prevent consequential losses to the reserves. Residents are now prohibited, without exchange control permission, from holding gold coins minted after 1837; except that they may continue to hold not more than four which they possessed when the new measures came into force. Special

(1) The United Kingdom made a deutschemark drawing equivalent to £44 million and with the proceeds bought gold from Western Germany to subscribe to the Fund. The Fund, in turn, replenished its holdings of deutschemark by selling the gold back to Western Germany. The net result of these transactions was that the Fund's holding of sterling was increased by the amount of the U.K. gold subscription.

arrangements have, however, been made to allow genuine collectors to pursue their interest. If a tighter control had been imposed only on gold coins, the effect would obviously have been to stimulate further the growing demand for gold medals. Accordingly, apart from those for export or for sporting and academic awards, the manufacture and import of gold medals was also banned.

Exchequer finance The Exchequer was, as usual, in substantial surplus in the final quarter of the financial year. Tax revenues are then at their peak and this year, although Consolidated Fund loans were larger than usual—chiefly because of heavy lending to local authorities through the Public Works Loan Board—the central government's net balance (Table 1 of the statistical annex) showed a surplus of £833 million, compared with £735 million in the same quarter of last year.

Sales of foreign exchange by the Exchange Equalisation Account brought in £113 million —the amount that the reserves would have fallen had there not been the transfer from the dollar portfolio. On the other hand, there was a fall of £185 million in overseas holdings of stocks, Treasury bills and other government debt: within this total, the counterpart of the repayment to the U.S. authorities fell by £169 million and that of the other inter-central bank operations reversed in March (mentioned above) by £54 million, so that there was an increase of about £40 million in other overseas holdings.(1)

External transactions thus cost the Exchequer some £70 million, but nevertheless the Exchequer repaid a very large amount of debt (£761 million) to domestic holders. Only a little over half of this was accounted for by the banking sector, and other domestic holdings of government debt fell by £320 million, considerably more than usual in this quarter. About half of this decrease resulted from a fall in holdings of gilt-edged stocks, in particular $5\frac{1}{2}$% Exchequer Stock 1966, which was redeemed on 15th March: as described on page 114 a large amount was held in the market until maturity. Holdings of tax reserve certificates fell by £129 million, rather less than in the same quarter of recent years: their popularity has been declining for some time, and relatively few certificates had been taken up in the two previous years. The amount invested in national savings also fell, because of heavy encashments of national savings certificates, whereas at this time of year it normally increases. The current series of savings certificates, even if held for six years, yielded only about $3\frac{3}{4}$% tax free, a low return compared with that on competing outlets for savings; and on 1st March the Chancellor announced the issue of a new certificate, from 28th March, to yield just over $4\frac{1}{2}$% tax free if held for five years. The new series proved popular; in April sales, net of repayments of earlier issues, brought in £27 million.

London clearing banks The unusually sharp fall in holdings of government debt outside the banking system led to a smaller fall in bank deposits than might have been expected in the tax-gathering season. On balance, between the mid-January and mid-April make-up dates, net deposits with the London clearing banks were, in fact, virtually unchanged; they fell by £114 million in the two months to the middle of March, but rose by £120 million in April. They would, indeed, have risen by some £80 million more in the month to mid-April but for the transfer on 31st March of the Irish business of the National Bank to the new National Bank of Ireland. On a seasonally adjusted basis and after allowing for this transfer, the clearing banks' net deposits increased over the three months by about £350 million.

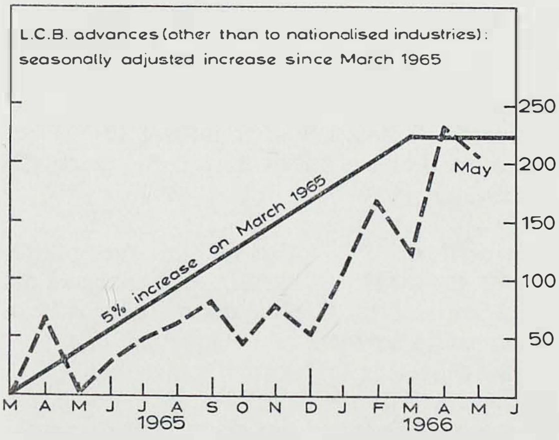
During the same period their advances, excluding those to the nationalised industries, rose substantially. In the first two months, from mid-January to mid-March, the rise was very little more than expected for seasonal reasons: calls on new capital issues were again very high and some tax payments may have been financed out of the redemption proceeds of the

(1) Inter-central bank operations do not normally affect *the total* of the Exchequer's external transactions; see the article in the March *Bulletin*, page 29. In this case, however, the counterpart of the £54 million swap with the U.S. authorities in March was held on deposit with the Banking Department: the offsetting entry to the consequent change in the reserves is not therefore in overseas holdings of government debt, but is reflected in net Exchequer indebtedness to the Banking Department.

maturing Exchequer Stock. The total increase in advances, other than to the nationalised industries, during the year to mid-March was £119 million, or $2\frac{1}{2}$%: this was well within the limit, of 5% over the figures for mid-March 1965, requested by the Governor.[1]

In the month to mid-April, however, the clearing banks' advances rose by considerably more than seasonally expected; those to bor-

£ millions



In March, the clearing banks' advances were well within the 5% limit requested by the Governor: but in May they were only slightly below the limit—giving little scope, after seasonal adjustment, for further expansion.

rowers other than the nationalised industries increased by about £120 million, after allowing for the transfer of the National Bank's Irish business. Seasonal factors in April are quite small, and there was still a rise of over £100 million after seasonal adjustment. The confidential monthly analysis of advances provided by the clearing banks showed that most of this increase was attributable to industry: some of it must have been due to the advanced dividend payments noted on page 116; part was probably caused by the late settlement of taxes before the end of the fiscal year, which usually occurs when interest rates are high; and finance may also have been taken for stocking raw materials, especially metals, as a precaution against rising prices. Whatever the reasons, at mid-April 1966 the seasonally adjusted increase in advances since March 1965 had reached 5%.

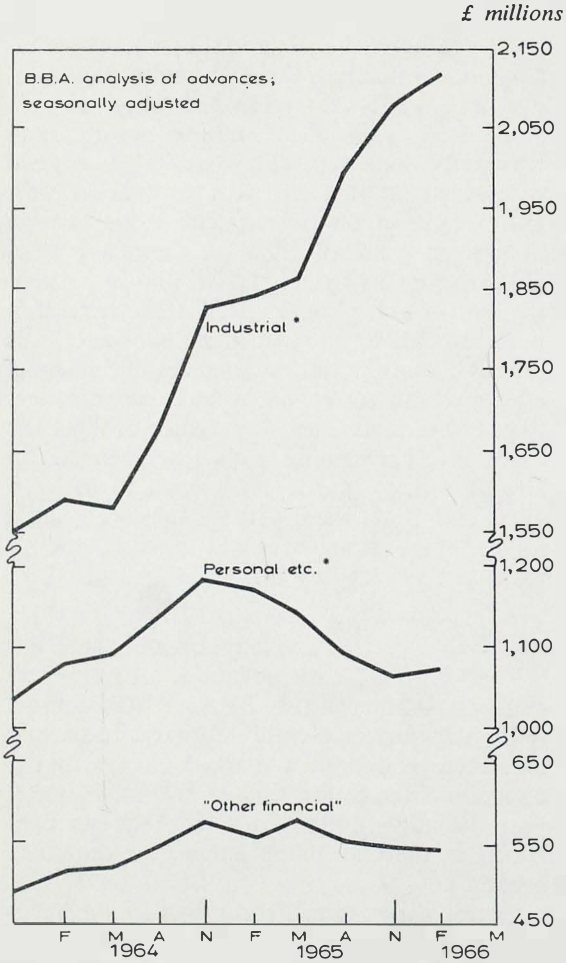
The latest figures, for the month to mid-May, show a fall of £43 million in the clearing banks' advances (excluding those to nationalised industries), partly reversing the large rise in April and some £30 million more than seasonally expected. The monthly seasonal adjustments during the year to March 1967, however, must be treated with some caution because they cannot allow for the new pattern of tax payments by companies, and in particular for the transitional effects this year: if it were possible to make such an allowance it is probable that the fall in advances during May, after seasonal correction, would emerge as less than £30 million. The May figures brought the cumulative seasonally adjusted increase in advances since March 1965 down to between $4\frac{1}{2}$% and 5%—leaving the banks very little room, apart from seasonal fluctuations, to increase their lending further.

B.B.A. advances The latest quarterly analysis of advances, covering all members of the British Bankers' Association, is for the quarter to mid-February. It showed that there had been a marked change in the direction of the banks' lending over the previous year, broadly in line with the requests contained in the Governor's letters (see the chart overleaf).

During the year to February 1966, advances to personal and professional borrowers and to hire purchase finance companies fell by £101 million, compared with an increase of much the same amount during the previous twelve months. There was a slight reduction in lending to other financial borrowers (which include property companies) and only a small increase in advances to retailers; in each case there had been quite a large rise during the previous year. In contrast, loans to manufacturing industry and to unclassifiable industry and trade continued to rise sharply; the increase of nearly £300 million, half of which was to the engineering industry, was some £40 million greater than the year before.

Accepting houses and overseas banks Sterling deposits with the accepting houses and overseas banks (Table 10 of the annex) increased only slightly between the end of December and

[1] In May 1965 and February 1966; March *Bulletin*, page 3.



The direction of the banks' lending has broadly followed the line requested by the authorities. Advances to persons, hire purchase finance houses and other financial borrowers have been markedly restrained since November 1964—making room for increased lending to industry.

the end of March. Those of U.K. residents, other than banks, fell by £56 million but overseas residents' sterling deposits rose by about £60 million.[1] The series is too recent in origin to allow appropriate seasonal adjustment to be made, but the fall in domestic deposits appears to have been substantially larger than usual in this quarter. These deposits, on which a higher rate of interest is generally paid than on deposit accounts with the London clearing banks, had increased rapidly during the previous year; they belong mainly to companies and may well have been built up in anticipation of the tax-paying season.

The accepting houses' and overseas banks' sterling advances fell slightly during the three months to the end of March. Those to U.K. residents, other than banks and local authorities, rose by £18 million—rather less than in the corresponding months of earlier years; but sterling advances to overseas residents fell by about £25 million.[1] Over the year to the end of March, the total of sterling advances by these banks was broadly unchanged—those to U.K. residents increased by £57 million ($6\frac{1}{2}\%$) but those to overseas residents fell by much the same amount.

Hire purchase finance companies As noted in the March *Bulletin*, further restraints were imposed on hire purchase credit early in February. The total of outstanding hire purchase debt due to finance houses had fallen during the last four months of 1965, but in the new year it began to rise again. After seasonal adjustment the increase in the first quarter as a whole was quite sharp—reflecting the heavy demand for new cars, which was probably associated with fears of purchase tax increases in the Budget. In the outcome, the finance houses, as a group, did not succeed in meeting the Governor's request that their financing of the private sector should not rise by more than about 5% in the year ending in March 1966: total lending—either on hire purchase or credit sale agreements or in other ways—grew by £74 million, $7\frac{1}{2}\%$, over the year. From May onwards, however, buying on credit may well rise less than seasonally expected, because it was heavy before the Budget; this would help the finance houses to cut back their lending, as they must, to the 5% limit.

The spread of rates for three months' deposits quoted by the main houses rose from $6\frac{1}{4}\%$-$6\frac{5}{8}\%$ at the end of January to $6\frac{3}{4}\%$-$7\frac{1}{8}\%$ early in

[1] Rough allowance has been made for the netting-out, from 31st March 1966, of the overseas banks' balances on inter-branch accounts—which reduced both sterling deposits by, and advances to, overseas residents by about £60 million.

* "Industrial" comprises the following categories in Table 13 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. "Personal etc." includes personal and professional, and hire purchase finance companies.

April, partly reflecting the continuing demand for credit, but mainly because of the seasonal withdrawal of funds over the end of the financial year. Rates did not fall back again after the end of March, as might have been expected.

Commercial bills The 5% limit requested in the Governor's letters applied also to the banks' holdings of commercial bills and to their acceptances. It was noted in the March *Bulletin* that, up to December 1965, finance by means of commercial bills had been increasing at a much faster annual rate than 5%; but it was thought that there would be a seasonal fall during the first quarter of 1966. There was indeed some decline between December and March in the total of commercial bills held by the banking sector; but at the end of March this total was still £100 million (11%) higher than a year earlier.(1) As explained in March, a substantial part of this increase related, however, to bills drawn in foreign currencies: the rise over the year in the banking sector's holdings of sterling commercial bills was about £60 million (7%). Some further reduction in these holdings will therefore be necessary in order to meet the Governor's request. Such a reduction may well be helped by the sharp decline during the first quarter in outstanding acceptances by the banking sector —the first quarterly decrease of any size recorded in the three years since this series of figures began.

It was also noted in March that the discount market's buying rate for prime bank bills had been showing an unusually wide margin over the Treasury bill rate, partly because of the increased supply of commercial bills and partly because the discount houses were attempting to restrict their take-up of bills. In the latest three months the rate for prime bank bills rose from $5\frac{7}{8}\%$ to $5\frac{15}{16}\%$, just below Bank rate; this increase was smaller than that in the Treasury bill rate, noted below, so that the gap between the Treasury bill and the prime bank bill rates narrowed slightly.

Treasury bills The Treasury bill rate had fallen between June 1965 and early December, but it had then risen sharply, influenced mainly by the increase in the U.S. discount rate and by the enforcement of quite heavy borrowing by the discount houses at the Bank. It was little changed during January; but in the following three months it rose again, from $5\frac{1}{2}\%$ at the end of January to nearly $5\frac{21}{32}\%$ at the end of April.

The increase occurred very largely during February, when the rate rose by just over $\frac{1}{8}\%$, to $5\frac{5}{8}\%$—despite seasonally small offerings at the weekly tenders and the rapid running down of the discount houses' holdings of bills from the higher level reached in December. American rates were still rising and, in rapid succession, came the threat of a national rail strike, poor overseas trade figures for January, and uncertainty over an early general election—all of which were also causing weakness in both the foreign exchange and the gilt-edged markets.

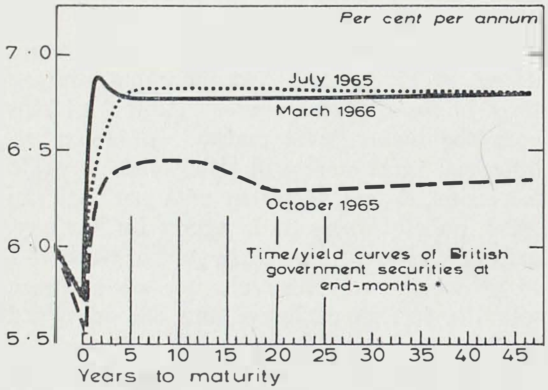
In mid-March, however, the rate fell back slightly. A considerable amount of the government stock which matured on 15th March had to be paid off in cash; the amount of bills offered at the tender on the previous Friday was comparatively large; and the houses, wishing to take full advantage of this to restore their depleted portfolios, raised their bid by 1*d*. Subsequently, competition from other tenderers was a little less keen—mainly because of uncertainty caused by the election and by the approach of the Budget—and the houses were able to obtain satisfactory allotments. The rate remained steady until almost the end of April: U.S. rates, which had fallen during March, had started to rise again and so did the discount houses' tender rate. At almost $5\frac{21}{32}\%$, it was then as high as in June 1965, just after Bank rate was reduced.

The discount houses did not have to borrow at the Bank during the three months under review and the average cost of the market's borrowed funds probably dropped a little. At the end of April it is estimated to have been just over $5\frac{5}{16}\%$, compared with about $5\frac{3}{8}\%$ early in February.

Gilt-edged market The recovery in the gilt-edged market towards the end of January, noted in the March *Bulletin*, did not last long, and during most of the next two months the market weakened. Towards

(1) These figures, given in Table 8 of the annex, include refinanceable export credits.

the end of March yields on short-dated stocks had risen above the levels of last August—the highest they had touched during 1965; yields on other stocks were also markedly higher than in January, and had lost almost all the ground that they had gained since August.



The fall in yields, which began in August, was checked in October, but was not markedly reversed until February. By the end of March, yields on short-dated stocks were higher than at any time last year, while those on most other maturities were nearly as high as at the end of July.

The market first weakened early in February, affected by much the same factors that caused the increase in the Treasury bill rate. At the beginning of March, after the election was announced, prices steadied; only to fall again quite sharply in the next two weeks, primarily because of the weakness of sterling. The authorities' policy was to keep the market as steady as possible during the election period; and they bought a substantial amount of stock, particularly short-dated, in the course of moderating the fall in prices that occurred.

After the middle of March the market again recovered. Yields on medium and long-dated maturities, many of which were over $6\frac{3}{4}$%, were attractive, and there was some demand for these stocks. On 23rd March, the authorities lowered the price at which they were prepared to sell 6% Funding Loan 1993 into line with the market quotation, indicating in this way that they expected prices at the longer end of the market to be steadier at the lower levels to which they had fallen; they were subsequently able to sell a sizable amount of this stock. The market was quiet until after Easter; it then became very firm and continued buoyant for the rest of April. Total turnover in the market, which had fallen away during March, recovered during April to the same level as in February.

The improvement in the market during April may have owed something to the dullness of equities, but the very sharp drop, noted later, in borrowing by companies on fixed interest issues was undoubtedly a contributory factor. The recovery may also have been helped by some reinvestment of the large redemption payment —over £200 million—on $5\frac{1}{2}$% Exchequer Stock 1966 on 15th March; some of this money may well have been temporarily invested in the local authority market over the end of March. The amount of the maturing stock in the public's hands at the redemption date was unusually large. It had gone ex-dividend on 7th February, and the price (less rebate interest) was then only just above the original price of issue of $99\frac{1}{2}$ and within the band, between the lowest price of issue and the redemption price, in which a stock may appreciate without attracting capital gains tax.[1] The tax free gain to redemption attracted buyers, who pushed up the price to beyond the level that the authorities were prepared to pay. The authorities therefore were not offered as much of the stock in the last weeks of its life as they would normally have been.

Local authorities Borrowing by local authorities from the P.W.L.B. had fallen in January, but it increased again in February, after the remainder of the quotas for 1965/66 became available on the 1st of the month, and rose more sharply in March, as authorities with unused facilities drew heavily on them before the end of the financial year. In April, local authorities were able to begin drawing on their quotas for the new financial year.[2] In all, their total borrowing from the

[1] September 1965 *Bulletin*, page 221.

[2] It was announced in April that the proportion of local authorities' longer-term borrowing available from the P.W.L.B. would remain unchanged in 1966/67, while longer-term borrowing would be redefined to exclude the refinancing of debt included as part of an authority's longer-term borrowing in the previous financial year.

* 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.

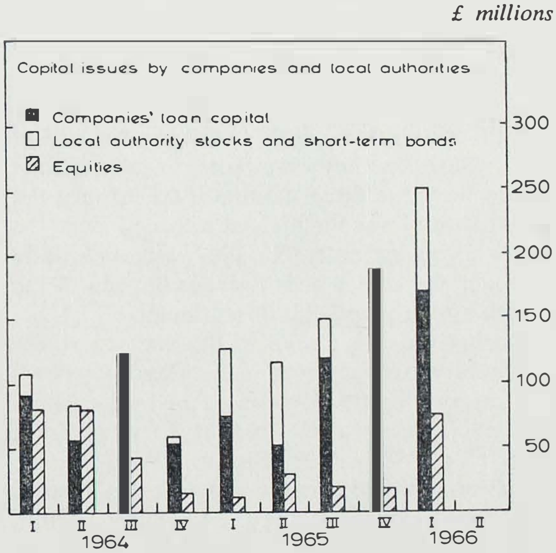
P.W.L.B. during the three months under review was substantial, some £170 million.

Further large amounts were raised at the same time by new capital issues—about £70 million (net) compared with £77 million in the previous three months. Short-term bonds accounted for about one-third of the total amount raised, a much smaller proportion than in November to January; for the first time some were issued for an initial period of eighteen months, thus increasing the variety of these bonds and slightly widening their attraction. The new issues of stock included the first calls on two made by tender; these issues were for the Greater London Council (£50 million) and for Surrey County Council (£10 million)—the first in this form by local authorities for many years.

The relatively large sums obtained from the P.W.L.B. and in the new issue market were reflected in the continuation of fairly easy conditions in the mortgage market, where rates remained unchanged from the middle of December. With the rise in yields on gilt-edged, the margin between that on a 20-year government stock and the mortgage rate for a comparable term narrowed considerably, to about $\frac{3}{16}$% at the end of the period.

Conditions in the temporary money market were also comparatively easy. Rates fell on balance during February, to around $6\frac{1}{8}$% for three months' money, but started to edge up early in March, and the three months' rate reached $6\frac{3}{8}$% by the second week. Even so, there was then a margin of about $\frac{3}{8}$%, allowing for the cost of forward cover, in favour of euro-dollars over temporary money with local authorities. But later in March, as mentioned above, the redemption of $5\frac{1}{2}$% Exchequer Stock apparently resulted in a large volume of liquid funds seeking temporary employment, and local authorities were able to obtain finance over the end of March without great difficulty, and without the three months' rate rising any further. In April the rate was little changed, held up by the very high rates being offered for euro-dollars.

Company securities Yields on debentures and other company loan stocks remained firm until early in March, although by that time 20-year securities of this kind, according to the F.T.-Actuaries calculation, yielded only about $\frac{5}{8}$% more than gilt-edged stocks of a comparable term. There was then a belated adjustment to the rise in gilt-edged yields which had taken place over the previous six weeks, and by the end of March the average yield on such company stocks had risen abruptly, from 7·25% earlier in the month to over 7·60%. The margin over gilt-edged widened to about $\frac{7}{8}$%, where it remained during April. At the end of April the average yield on 20-year company stocks was just below 7·60%.



There have been very large new issues of fixed interest securities—both by companies and by local authorities—in recent quarters. New equity issues, which had been very small since late in 1964, rose sharply in the first quarter of 1966.

Turnover in company fixed interest securities fell back somewhat in the middle of February, was a little higher again in March, but fell once more in April—when it was less than it had been in any month since August. Announcements of new fixed interest issues began to fall off in March and April. Until April, however, very large sums of money were still being raised, including calls on earlier issues; but in that month the flow almost dried up—to £8 million (net), the smallest amount for many months.

Cash raised by new equity issues during the three months was quite substantial, after a long period in which such issues had been small. In March, there was a call of £30 million on the British Petroleum issue described in the previous *Bulletin*. Another special factor was the increase in issues by investment trusts.[1]

The equity market was firm during the first half of February, despite temporary checks associated with the tightening of controls on hire purchase credit, official warnings about the balance of payments, and poor January trade figures. It was more subdued during the rest of the three months: late in February the break in prices on Wall Street coincided with election uncertainties at home and these were followed by further uncertainty about the coming Budget. The F.T.-Actuaries index of industrial share prices rose from 114 at the end of January to 117 by mid-February; it then fell back quite sharply to $113\frac{1}{2}$ by the end of the month, and drifted a little further by the end of April. Turnover in the market was greater than in the previous three months. In February the monthly total was the highest recorded since the series began in September 1964, although daily turnover declined a little towards the end of the month after the setback in sentiment.

During the last weeks of the tax year there was a very large number of dividend payments —some two or three times as many as usual. Many of these were brought forward from 1966/67 to 1965/66 in order to take advantage of the transitional arrangements in the Finance Act 1965—which allowed companies, within certain limits, to retain income tax deducted from dividends paid before 5th April this year. Under the previous tax system, income tax deducted from dividends was regarded as being accounted for to the Inland Revenue at a much later date—when companies paid income tax on their total profits. Under the new system companies no longer pay income tax on their profits: in September 1966 the tax which they have deducted from dividends paid after 5th April 1966 will have to be paid over to the Revenue—and thereafter such payments will have to be made within a month of the dividend being paid.

Building societies The opening months of 1966 saw a further large inflow of funds to the building societies; and in the first quarter the total outstanding on shares and deposits increased by £245 million. A record amount, of £105 million, was received in January but thereafter receipts fell off a little, mainly for seasonal reasons.

Concurrently with the ready supply of funds, the net amount advanced on mortgage grew further, reaching a peak of £66 million in March; the volume of mortgages to which the societies were committed also rose sharply. The societies' combined liquidity ratio (cash and investments other than mortgages, expressed as a proportion of total assets) changed little, remaining around $16\frac{3}{4}$%. The Building Societies Association had made no change in their recommended mortgage rate of $6\frac{3}{4}$%, and although an increasing number of the smaller societies were charging more than this, the ratios of reserves to total assets of most societies remained under some pressure; on average they fell during 1965 from 4·4% to 4·2%. Consequently, on 9th May the Association decided to recommend a rise in the mortgage rate, to $7\frac{1}{8}$%: subsequently, discussions were held with the Chancellor of the Exchequer, who indicated that in view of the importance of the Association's decision, in the context of the Government's economic and social policies, the issues involved would be referred to the Prices and Incomes Board. The rise in the rate has meanwhile taken effect.

Conclusion The main task ahead is to eliminate the deficit on the balance of payments, and thereafter to earn a substantial external surplus. This will be essential, even if existing assets can be drawn upon, in order to repay within the due time the large amounts that have been borrowed from abroad. The direct action that the Government have taken, in the Budget and throughout the past year, helps this task: it would, however, be mistaken to believe that the conscious support and effort of all sections in the country are not also needed.

In the coming months two factors may temporarily ease the pressure of home demand and improve the external balance. First, personal spending—which has almost certainly

(1) These were mainly of a special kind, sometimes known as 'split share' issues. In such issues two types of equity capital are offered; one gives a shareholder all, or nearly all, the available income, and the other little or no income but all, or nearly all, the capital appreciation when the trust comes to an end. These two types of equity capital are sometimes combined with an issue of fixed interest capital to provide further 'gearing'.

been inflated by pre-Budget buying—should fall. Secondly, the announcement that the import surcharge will lapse at the end of November should result in the postponement of some imports, and thus provide temporary relief to the balance of payments in the meantime. On the other hand, the balance of payments will suffer from the effect of the seamen's strike. The increased taxes imposed in the Budget will cause some easing of demand; and credit could become very tight. The combined effect of tax changes made in the 1965 and 1966 Budgets points towards an unusual strain being placed on companies' liquidity for a period after September; yet at the end of March total credit granted by the banking sector to the private sector, on advances and commercial bills together, was already very close to the limit requested by the authorities.

Official bodies, such as the National Board for Prices and Incomes and the Economic Development Councils, may do much—by calling attention to necessary changes in attitudes and in methods of working—to foster the faster growth of productive capacity which is essential if the country is to enjoy a rising standard of living and yet keep its external accounts in proper balance. The Geddes Report on shipbuilding, and earlier reports on the aircraft industry and on the docks, also point the way towards necessary reforms in the economy, though they make less contribution towards solving the immediate problems. In the short term, improvements in output, adequately directed towards the needs of overseas trade, will result only from willingness and effort.

It is essential that money incomes should not expand faster than can be justified by the present growth of output. Over the past year the large rise in incomes has not been fully reflected in higher prices, and thus demand has been more difficult to contain. The respite on prices can only be temporary: unless the incomes policy is effective, prices will rise faster—further endangering the country's competitiveness in world markets. Hence the Government have decided that voluntary restraint on incomes and prices must be reinforced by legislation.

Restraint is needed, both in the private and the public sectors, if prices are to be held in check and external balance regained. Equally important, however, is the obligation to promote, and to accept, changes in organisation and in practices which will enable the speediest increase in production to be obtained.