Commentary

During the three months from May to July, covered by this Commentary, confidence in the pound deteriorated; and early in July sterling came under intense pressure. On 20th July the Government took strong measures to create the conditions in which a balance of payments surplus would be achieved.

An immediate cause of the pressure on sterling was the seamen's strike, which lasted for seven weeks; this was seen not only as delaying the prospect of achieving external balance but perhaps as resulting in permanent damage to the country's export trade. But there was also continuing apprehension abroad that aggregate home demand was still too high and that, for this reason too, the adverse balance of payments was not being corrected quickly enough.

With tight money conditions abroad, interest rates had been rising fast in many countries; and this contributed to the pressure on the United Kingdom's reserves, despite a sharp rise in rates here. Bank rate was increased from 6% to 7% on 14th July, and credit restraint was reinforced by a further call for Special Deposits, of 1% from the London clearing banks and ½% from the Scottish banks, doubling the call which had been made in April 1965.(1) Two days earlier the Chancellor of the Exchequer had announced that the existing ceiling on bank advances(2) would be maintained at least until next March; there would be no general arrangements to offset the intended effect on company liquidity of the selective employment tax.

Exports, until they were hit by the strike, had been substantially higher this year than in the same months of last year; and by July there were some mild signs, in the labour market and in surveys of private investment intentions, that home demand was no longer increasing as fast as before. But there were still danger signals. One was the buoyancy of consumers' expenditure, resulting from a rate of increase in incomes which was faster than that of prices and which—in the light of current wage negotiations—was unlikely to slacken. Moreover, the prospective level of public sector spending was likely to maintain the pressure on domestic capacity. The disinflationary effects of the Budget were not yet felt; and this added to the doubt whether, in the end, they would be disinflationary enough. Immediate action was needed to relieve the pressure on the exchanges and to restore confidence in the pound. The Government's measures, which are described later, are necessary to rectify the adverse balance of payments. Until that is done there can be no prospect of enduring economic growth at home.

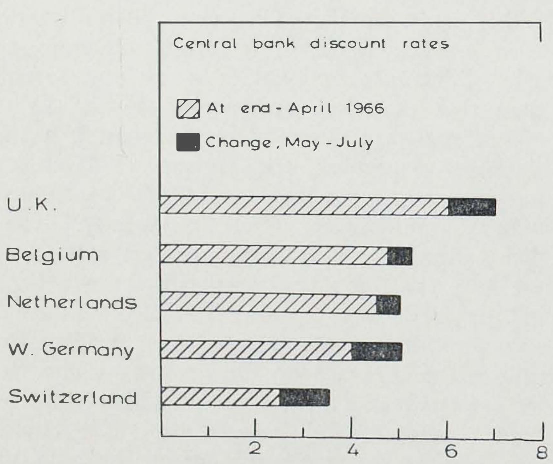
Foreign exchange market At the beginning of May conditions in the foreign exchange market were quiet and the authorities were able to buy a moderate amount of exchange. The Budget proposals evoked little reaction. When the seamen's strike began on 16th May, however, there were large sales of sterling; and this selling was renewed, though on a smaller scale, a week later when the Government took emergency powers to deal

(1) Half of the additional Special Deposits had to be made almost immediately, by 20th July, and the rest by 17th August.

(2) March *Bulletin*, page 3.

with the strike. On each occasion the pressure quickly eased and some of the exchange used to support the market was subsequently recovered. The spot rate against the U.S. dollar fell during the month from $\$2{\cdot}79\frac{3}{8}$ to $\$2{\cdot}79\frac{1}{8}$.

The publication of the loss of reserves during May, which appeared to revive apprehension about the possible effects of the strike, brought sterling under further pressure around the first week-end in June. At the same time the devaluation of the Indian rupee added to the general unease abroad and there was again some speculation about the possibility of sterling devaluation. On Monday 13th June, however, after the announcement of new international credit facilities (described later), a strong demand for sterling developed and the authorities were able to recoup much of the



Rising discount rates, reflecting tighter money conditions abroad, added to the pressure on sterling in May to July.

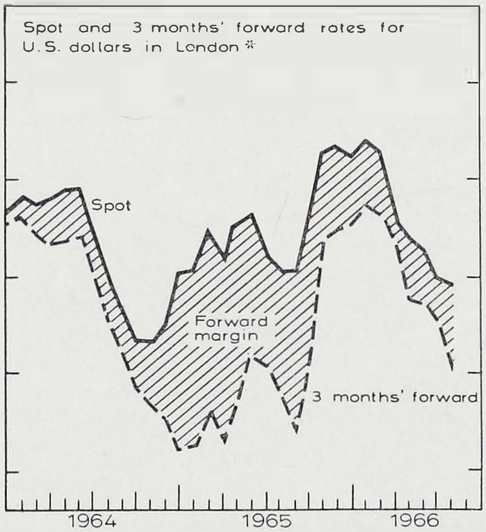
foreign exchange lost earlier in the month. The spot rate, which had fallen at one point to about $\$2{\cdot}78\frac{25}{32}$, recovered to $\$2{\cdot}79\frac{3}{16}$.

Soon afterwards the rate began to fall again, reflecting an acute shortage of dollars in exchange markets in several countries. This shortage was associated partly with window dressing operations on the Continent as the end of the half-year approached; but it also stemmed from the tightness of money, both there and in the United States, which was reflected in increased discount rates in a number of continental centres and in rising short-term and bank lending rates in the United States. The demand for dollars brought sterling under substantial pressure on 20th June, but this moderated on the following day and during the rest of the month there was some reflux of funds.

The continuing tightness of money abroad overshadowed the ending of the seamen's strike, announced on 29th June, and led to further sales of sterling early in July. At the same time, sentiment was affected by the publication of the U.K. balance of payments deficit for the first quarter and by the announcement of the fall in the reserves during June. Sterling was heavily offered after the first week-end in July and the pressure was renewed, mainly in the forward market, at the beginning of the following week: foreign opinion was disturbed by reports that no further measures were contemplated to reduce the pressure of demand, and there was fresh talk about the possibility of devaluation. The market quietened on 13th July, before the increase in Bank rate—which was widely expected in the light of higher interest rates abroad. But the accompanying call for Special Deposits was regarded solely as reinforcing the tight restrictions already imposed on bank credit; and when other measures which the market had been expecting at that time were not immediately forthcoming, heavy selling of sterling was resumed. Notwithstanding the Prime Minister's statement that further action would shortly be taken to reduce domestic demand and to cut back official spending abroad, the pressure did not lessen. Although in the event the Government's measures were introduced within a few days, during those few days the volume of sales, of both spot and forward sterling, increased considerably. The spot rate was not allowed to fall below $\$2{\cdot}78\frac{11}{16}$. After the measures had been announced there were still uncertainties in the markets; and, although the spot rate rose quickly to above \$2·79, at the end of July the undertone remained hesitant.

Forward sterling tended to weaken in the middle of May and early in June at the same time as pressure developed in the spot market. Some official support was given to the forward market on these occasions, but during the rest of the two months the market was generally firm. The authorities' matur-

$ to £1



In July the spot rate for U.S. dollars fell to its lowest point since November 1964; and heavy forward sales of sterling caused a sharp widening of the forward margin.

ing forward sales of exchange were mostly extended—although when dollars were particularly scarce some were taken up, thus alleviating pressure that would otherwise have been exerted on the spot rate. The resulting improvement in the authorities' oversold forward position broadly offset their new forward sales, so that over the two months their outstanding forward commitments to the market were little changed. In July, however, forward margins widened abruptly in anticipation of the increase in Bank rate and under a substantial weight of selling, and the authorities gave quite heavy support.

Reserves and special transactions As noted in the June *Bulletin*, a special swap with the U.S. authorities, equivalent to £54 million, was outstanding at the end of March. This was repaid early in April; but during the quarter there were further swaps with the U.S. authorities for the equivalent of £99 million (net). The net amount of foreign exchange acquired in this way during the quarter was therefore £45 million. The reserves benefited from these transactions in June, but in both April and May these and other inter-central bank operations virtually balanced out. Over the quarter the reserves fell by £106 million—£19 million in April, £38 million in May and £49 million in June.

It was also noted in the June *Bulletin* that the equivalent of £18 million was drawn in April under a special line of credit with the U.S. Export-Import Bank to reimburse dollar progress payments made in earlier months on contracts for U.S. military aircraft. In June there was a further drawing, equivalent to £12 million, in respect of similar payments made during the second quarter.

In July, when the reserves were under pressure, there was further recourse to central bank facilities, so that the loss of reserves was reduced to £25 million. In August, too, there were some drawings on these facilities, and there was a fall of £19 million in the reserves.

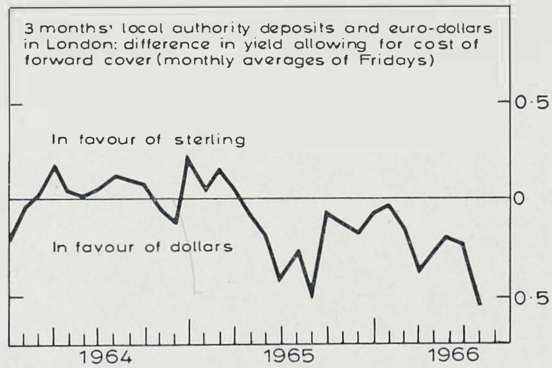
The credit facilities made available in September 1965 by the central banks of Austria, Belgium, Canada, Italy, Japan, the Netherlands, Sweden, Switzerland and Western Germany, and by the Bank for International Settlements, expired in June. On 13th June it was announced that this group were collaborating in new arrangements specifically designed to counter the stresses to which sterling is subject as a reserve and international trading currency. Under these arrangements the United Kingdom may draw on swap facilities channelled through the B.I.S.—who are also participating again in their own right—to offset the greater part of any reduction in the U.K. reserves estimated to have been caused by fluctuations in overseas countries' sterling balances, whether held by monetary authorities or privately. Such fluctuations are measured by reference to a base date early in 1966. No drawings were made on these facilities during the second quarter: in the period from the base date to the end of June a fall in non-sterling countries' balances was outweighed by a substantial increase in the balances of overseas sterling area countries.

The facilities made available last September by the United States, which are supplementary to the reciprocal swap facility with the Federal Reserve Bank of New York, continue alongside the arrangements just described. A credit facility was also concluded independently with the Bank of France.

* Middle closing rates, averages of weekly figures.

Gold market Demand for gold was generally moderate during May but strengthened during June and became very heavy at times in July, as the nervousness in the exchange market became more widespread. Producers' sales broadly matched demand in May but slackened during June and, though recovering later, fell some way short of the amount taken by the market over the period as a whole. The dollar equivalent of the daily fixing price, which had moved between \$35·10$\frac{7}{8}$ and \$35·14$\frac{3}{8}$ per fine ounce during May, rose to \$35·17$\frac{1}{2}$ towards the end of June. Early in July the price fell back to \$35·15$\frac{1}{4}$, but later it ranged up to \$35·18$\frac{5}{8}$ and was only a little below this level at the end of the month.

Per cent per annum



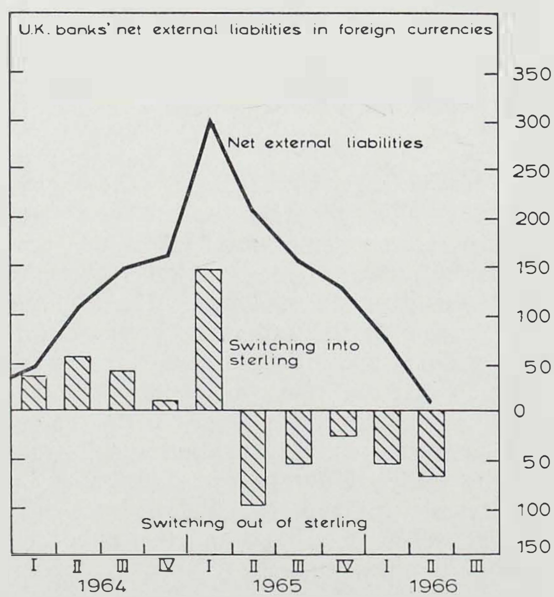
In recent months, relative interest rates have made it advantageous for funds to be employed in foreign currency assets rather than in sterling.

Short-term capital movements There was a heavy outflow of short-term capital between May and July attributable to confidence factors, the unfavourable pattern of international interest rates, and seasonally adverse influences on the balance of payments of overseas sterling area countries. Net liabilities in sterling to countries outside the sterling area were drawn down sharply, particularly in May—partly reflecting the effect of the seamen's strike on overseas confidence—and again in July. The sterling holdings of overseas sterling area countries also fell back, after rising substantially up to April.

The tightness of money abroad, together with the pattern of relative short-term interest rates, was an important influence on the outflow. Admittedly, there was a covered margin, almost throughout the period, in favour of investment in U.K. rather than in U.S. Treasury bills—but its existence did not attract funds to the United Kingdom. Dollars were acutely short, conditions in the euro-dollar market were very tight and the covered margin between euro-dollar and local authority rates—which is more relevant to movements of interest-sensitive funds—was unfavourable.

The demand for dollars caused a steep rise in euro-dollar rates during the three months, while—for the reasons mentioned on page 215—rates offered for local authority temporary money were little changed until the second half of July. In May and June, the return on three months' euro-dollar deposits had exceeded that on three months' deposits with local authorities,

£ millions



In the second quarter, U.K. banks continued to switch funds previously employed in sterling back into foreign currency; by the end of June the banks' net external liabilities in foreign currency were very small.

after allowing for the cost of forward cover, by a margin ranging between $\frac{1}{16}$% and $\frac{3}{8}$%. With the sharp increase in the cost of forward cover, this differential had risen to above $\frac{3}{4}$% just before Bank rate was raised. The widening in forward margins had largely discounted the increase in Bank rate; and with the subsequent rise in local authority rates the differential fell back to about $\frac{1}{2}$% by the end of July. Early in August, however, it increased again;

there was still a strong demand for euro-dollars and euro-dollar rates had continued to rise. But later in the month the cost of forward cover fell and by the end of August the differential was reduced to below ½%.

The persistence of this differential led U.K. banks to switch a substantial volume of currency deposits, previously employed in sterling, back into foreign currency. The banks' net external liabilities in foreign currency fell by £66 million during the second quarter, and at the end of June their external liabilities only just exceeded their external claims (Table 19 of the statistical annex). There was further switching out of sterling in July, but early in August there were signs that the banks had started to switch funds back into sterling.

On 3rd August, steps were taken to limit the extent to which the banks are free to hold short-term funds abroad—by reducing the size of the positions which they are allowed to carry in foreign exchange. Reductions were made both in open positions, which are the uncovered positions which may be carried in foreign currency, and in the amounts of spot exchange which may be held (and temporarily invested abroad) in cover of forward commitments.

Balance of payments

It was noted in the June *Bulletin* that the sharp deterioration in the balance of payments in the first quarter—when the deficit on current and long-term capital accounts was nearly £100 million—had owed something to special factors. The hope of an improvement on current account in the second quarter was dashed by the seamen's strike, which affected visible trade in June—to a large extent only temporarily—and which also led to higher shipping payments abroad and to some loss of earnings. Such information as is available on capital transactions, however, points to a sharp reduction in the net outflow on long-term capital account; and it seems likely that the overall deficit on current and long-term capital account was smaller than in the first quarter.

The overall deficit, therefore, was probably considerably less than the sum of monetary movements, so far as they are yet known.

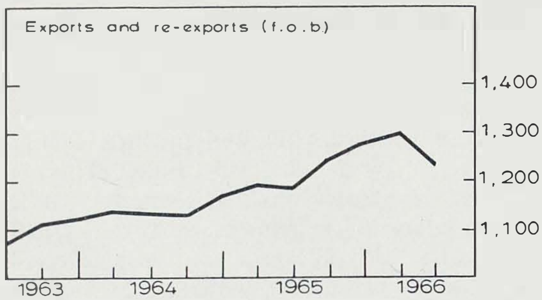
As already noted, the reserves fell by £106 million, despite the net increase of £45 million in drawings on the U.S. authorities. Net liabilities in sterling to sterling area countries increased by £169 million. There was a very sharp rise in April, followed by little change in May and by a fall during June. The net rise over the quarter was partly due to Middle Eastern countries' receipts of oil royalties and taxes, particularly in April, but it also reflected the seasonal pattern in the overseas sterling area balance of payments—reinforced this year by import controls in several countries and by generally buoyant commodity prices. On the other hand, net liabilities in sterling to countries outside the sterling area (excluding the counterpart of the drawings on the U.S. authorities) fell by £106 million; there was also the decrease of £66 million, mentioned above, in the banks' net external liabilities in foreign currencies and a fall of £14 million in their net liabilities in overseas sterling area currencies; and there was a further reduction, of £15 million, in the deposit made by Western Germany in July 1965.[1]

On visible trade, the deficit in April and May, after seasonal adjustment, was running at much the same rate as during January to March. It increased in June, because of the seamen's strike; and over the quarter as a whole the deficit was £99 million, £22 million larger than during the first quarter. The strike reduced imports less than exports because ships with British crews continued to arrive at U.K. ports throughout the month, while virtually none left.

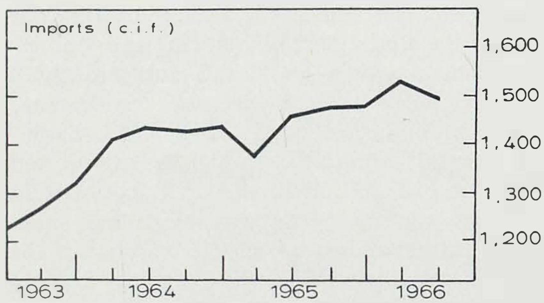
The general course of imports and exports during the second quarter was thus obscured by the strike. In April and May, the value of exports, after seasonal adjustment, was 1% higher than the monthly average for the first quarter. Exports of machinery, motor vehicles and chemicals were markedly higher. Exports to the sterling area and to Western Europe were generally well maintained in April and May, and those to Eastern Europe rose sharply; but there was a decline in sales to North America, against the recent trend. Imports in April and May, taken together, were also about 1% in value above the first quarter's average. There were smaller arrivals of tobacco and of some

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

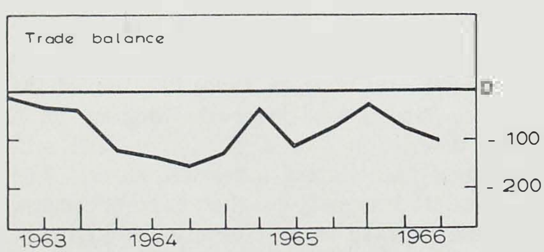
Seasonally adjusted *£ millions*



The value of exports, after seasonal adjustment, continued to increase until the interruption caused by the seamen's strike—



—but imports too had been rising rapidly.



The dislocation of shipping affected imports less than exports, and in the second quarter the trade deficit increased.

basic materials; but these were more than offset by increased imports of food and diamonds and by a rise in the value of semi-processed manufactures, caused mainly by higher prices for copper.

The trade figures for July were still adversely affected by the strike because there are greater delays in the recording of exports than of imports. The totals for both imports and exports probably included some trade which had been postponed by the strike, but the export figure related partly to shipments during the latter part of June when the strike was still operating. Nevertheless, the trade gap narrowed slightly.

Little is yet known about the out-turn on invisible account in the second quarter. Payments of oil royalties and taxes, which had been large in the first quarter, were more normal in the second; but this benefit to the invisible account is likely to have been more than offset by the effects of the strike on net shipping earnings, and by a seasonal increase in travel expenditure. On long-term capital account, the balance of official transactions benefited from the drawings on the aircraft credit with the U.S. Export-Import Bank, mentioned earlier. In addition, the evidence so far available suggests that the net outflow on private account was probably much smaller than in the first quarter.

Domestic economy

Early in July, before the new measures were taken, the pressure of total demand on resources was still high; and there was in prospect a continued expansion of public sector spending and personal consumption. Industrial output, as measured by the index of production and after seasonal adjustment, was little changed in April and May from the high level it had reached at the end of last year. The labour position was still extremely tight.

Public authorities' current expenditure, which had fallen in the first quarter, largely because of uneven timing of payments, seemed likely to have recovered in the second. Public sector investment—apart from housing, where both starts and completions were lower than a year ago—had risen during the first quarter; and a sharp recovery in the volume of orders obtained by contractors for public authorities' new building work, after the end of the six-month period of deferment imposed in July 1965,[1] suggested that it would rise further.

The volume of consumer spending had increased by $2\frac{1}{2}\%$, after seasonal adjustment, in the first quarter, but it had been expected to fall back after the Budget, because it was thought that there had been fairly heavy buying in anticipation of possible tax increases. In fact, the volume of retail trade, which accounts for about half of all consumers'

[1] September 1965 *Bulletin*, page 216.

expenditure, rose a little further in May (the latest figure available before the measures were announced). The number of new cars registered in May—the first post-Budget figure—fell sharply, but it was still considerably higher than a year before. Real incomes were still growing. Weekly earnings had risen by about 8% over the past year, much faster than prices, and this had helped to maintain the volume of consumption.

Capital spending by private industry, however, seemed less buoyant, at least in prospect. Manufacturers' investment, at constant prices and allowing for seasonal movements, was estimated to have increased by 5% between the fourth quarter of 1965 and the first quarter of 1966—largely because of higher spending on plant and machinery—but it was still no greater than a year earlier. Investment by the distributive and service industries, however, declined during the first quarter, and private industry's investment expenditure as a whole was shown to have increased by only 1% and to be lower than a year before. The surveys of investment intentions made in May by the Board of Trade and by the Confederation of British Industry suggested that industry's investment plans had begun to falter and that expenditure in real terms might well decline during the course of this year.

New private house building was still subdued; the numbers started, completed, and still under construction were all lower than a year earlier, though building materials were more readily available. Contractors' order books suggested no early recovery in activity.

The trend of stocks was rather uncertain. After seasonal adjustment, the volume of stockbuilding had been small during the last quarter of 1965, but it had picked up again during the first quarter of 1966, mainly because of an increase in manufacturers' work in progress. There were some indications that stocks might subsequently have fallen.

Although there seemed to have been a small increase in June, after seasonal adjustment, in the number of unemployed, and a fall in vacancies, the percentage of the labour force which remained wholly unemployed was only 1·2%—lower than a year ago. Reductions in the normal working week seem to have been accompanied not so much by a rise in overtime as by a relatively sharp fall in the number of hours actually worked; this may partly have reflected a desire for greater leisure but it may also have occurred because employers did not wish to part with scarce labour—even though it might be surplus to their present needs.

By the middle of July there were thus some slight signs that the trends of output, and of demand, might be levelling out—while the disinflationary effects of the Budget were yet to be felt. Even so, home demand—and imports—were still too high, and there seemed little likelihood of an early and substantial improvement in the balance of payments. And the lack of progress in achieving external balance was contributing to the crisis in the exchange market.

New measures

The measures announced by the Prime Minister on 20th July were intended partly to reduce home demand—to free resources, particularly labour, for work on exports and on essential investment and to reduce the demand for imports—and partly to make a direct impact on the balance of payments. As a result, the balance of payments is expected to show a surplus in 1967 as a whole.

Terms control on hire purchase contracts was tightened further. The minimum down-payment on cars, motor cycles and caravans was raised from 25% to 40%, and the maximum repayment period reduced from twenty-seven months to two years; the down-payment on furniture was raised from 15% to 20%, with a shortening of the repayment period from two and a half to two years; and that on most household appliances was raised from 25% to 33⅓%, the repayment period remaining at two years. Advance rentals required under hiring agreements were increased from thirty-two to forty-two weeks. It was estimated that these restrictions would cut hire purchase borrowing by £160 million. Consumption was to be further curbed by the imposition of a 10% surcharge on existing rates of purchase tax and on the duties on alcohol and on petrol and oil; after allowing for the effect on expenditure of the changes in hire purchase terms, this surcharge would yield about £150 million in a full year. A further £20 million would be taken out of the economy by raising certain Post Office charges; and a one-year surcharge of 10% on surtax due for 1965/66—payable on 1st September 1967—would then yield about £26 million. Finally, greater restraint would be imposed on private building, other than housing and industrial building, outside the development areas.

As regards public spending, demand on resources would be reduced by £150 million in 1967/68 through reductions of £55 million in investment expenditure by central and local government and of £95 million in the investment programmes of the nationalised industries. The building of houses, schools and hospitals, and of government-financed factories in development areas, would not be affected. These steps would also lead to a significant reduction in demand this year.

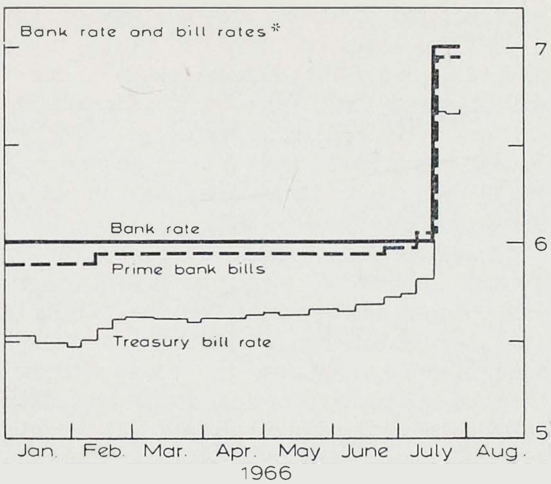
The Prime Minister estimated that these measures would reduce aggregate demand by more than £500 million. More direct action, however, was also required to help the balance of payments. The Government had decided on firm programmes which would reduce government expenditure overseas, both military and civil, by at least £100 million in 1967/68. As announced by the Chancellor in May, it was the Government's intention that the foreign exchange costs of keeping British forces in Western Germany should be reduced to a level at which they would be covered by offset and other payments; and negotiations to this end were continuing. Private expenditure overseas would also be cut. For the year commencing 1st November, the basic travel allowance for holidays in countries outside the sterling area, which would have to cover all the traveller's requirements except for fares paid in sterling in the United Kingdom, would be reduced to £50 per person: the amount available before November was also restricted. Exchange control was tightened on capital transfers by emigrants to countries outside the sterling area; and the limit on cash gifts to residents of those countries was reduced. The direct saving on overseas payments from these measures, public and private, was put at £150 million.

Finally, the Government called for a six-months' standstill on wages, salaries and other types of income, followed by a further six months of severe restraint. Existing commitments to increase wages or to reduce hours should be deferred for six months. New commitments should not be implemented during the rest of this year; nor in the following six months unless the grounds for exceptional treatment were particularly compelling. Thereafter, it would be essential to secure that the growth of incomes was resumed in an orderly manner in step with national output. The same principles would apply to other types of money income; companies, for example, must hold down their dividends during the twelve-month period. The Government similarly called for a twelve-month standstill on the prices of all goods and services, except to the limited extent that price rises were necessitated by increases in the cost of imported materials, by seasonal factors, or by the action of the Government, for example through increased taxation. The Government subsequently took temporary powers, for one year, to enforce this policy by strengthening the provisions of the Prices and Incomes Bill, which had been introduced earlier in the month. It was hoped, however, to rely on voluntary co-operation, and the special powers would be used only if this was not forthcoming.

Short-term money rates

Bill rates had already risen sharply before the increase in Bank rate. The discount houses' tender rate for Treasury bills increased only slightly, by less than $\frac{1}{16}$% to just over $5\frac{11}{16}$, between the end of April and the middle of June. Then on 21st and 22nd June, after sterling had come under pressure in the foreign exchange market, some of the discount houses were forced to borrow at Bank rate, for the first time since January; and on the following Friday the market's tender rate rose to $5\frac{3}{4}$%. In the last week of June there was further, and heavier, borrowing at the Bank, associated with the usual shortage of money in the market resulting from half-yearly window dressing; some of this borrowing was for seven days but on 30th June the market was allowed, for the first time, to borrow overnight at Bank rate. (This new technique is described below.) In the following week there was further overnight borrowing from the Bank, but the houses were also made to borrow for seven days—making it clear that the authorities wished to see the Treasury bill rate even higher. On 8th July

Per cent



Bill rates had already been rising before Bank rate was increased in July; after this increase they remained unusually close to Bank rate.

the tender rate rose to just over $5\frac{13}{16}$%, closer to Bank rate than at any time since the war. On the following Friday, after Bank rate had been raised to 7%, the market's tender rate rose by $\frac{7}{8}$% to $6\frac{11}{16}$%—still high in relation to Bank rate. It fell slightly on 22nd July but at the end of the month, after the discount houses had again been forced to borrow at the Bank —including some borrowing for seven days —the market's tender rate rose again, to nearly $6\frac{23}{32}$%.

The average cost of the market's borrowed funds, which was estimated to be just over $5\frac{5}{16}$% at the end of April, had risen a little by early June; and after the borrowing at the Bank it rose further, to about $5\frac{3}{8}$%. At the end of July, after the increase in Bank rate, it was estimated to be about $6\frac{1}{4}$%.

The discount market's buying rate for prime bank bills rose from $5\frac{15}{16}$% to $5\frac{31}{32}$% after the increase in the Treasury bill rate on 24th June; and after the tender on 8th July it was increased further, to $6\frac{1}{16}$%. It was then above Bank rate for the first time since the war. After the change in Bank rate, the rate for prime bank bills was raised by $\frac{7}{8}$%, in line with the increase in the Treasury bill rate, to $6\frac{15}{16}$%.

Subsequently, in view of the Government's measures, the Bank became more selective in the type of paper that they were prepared to accept in their purchases from the market: the maximum proportion of inland finance bills was reduced from 35% to 25%, of which less than half might be hire purchase finance bills.

Local authority temporary money rates changed very little up to the middle of July, despite the increase in bill rates. The rate for a three months' deposit, for example, was still about $6\frac{3}{8}$% early in July, the same as at the end of April—having fallen to $6\frac{1}{4}$% for a while during May and June. During the week in which Bank rate was changed, however, it rose by $\frac{7}{8}$%, as did bill rates; and by the end of the month it had risen further, to $7\frac{3}{8}$%—$7\frac{1}{2}$%.

During these three months local authorities' need for market borrowing was probably not very great. From April onwards they were able to draw on the Public Works Loan Board, at favourable rates, under the quotas for the new financial year:(1) their total borrowing from the P.W.L.B. during May to July was some £125 million. In addition, their income from local rates was seasonally high.

Rates offered for deposits by hire purchase finance houses fell during May and June, probably reflecting the restraint on the houses' lending and the reduced competition for funds from local authorities. The spread of rates for three months' deposits quoted by the main houses dropped from $6\frac{3}{4}$%—$7\frac{1}{8}$% at the end of April to $6\frac{1}{2}$%—$6\frac{7}{8}$% by early July: by the end of the month, after the increase in Bank rate, these rates had risen by about $1\frac{1}{4}$%, to $7\frac{5}{8}$%—$8\frac{1}{8}$%.

Overnight lending to the discount market

The Bank's operations in the money market have been made more flexible by their new practice of lending on occasions to the discount houses overnight, rather than for a minimum period, usually of seven days. Overnight lending, as on 30th June, may be used simply to balance out a shortage of money on one day with an expected surplus on the next —the surplus funds being absorbed by the discount houses' repayments to the Bank. It may, however, serve to keep money short, the discount houses' repayments transferring the initial

(1) June *Bulletin*, page 114.

* Weekly: Bank rate on Thursdays, bill rates on Fridays. The rate for prime bank bills is the discount houses' buying rate for 3 months' bills: that for Treasury bills the average rate on allotment.

shortage from day to day. The application of Bank rate to such lending in July and August was intended to keep short-term rates firm—by directly raising the average cost of the discount houses' borrowing and by encouraging other lenders to the houses to stand out for high rates at the end of the day's business. If, however, short-term rates were currently regarded as being high enough, the Bank might also, as was done in early September, lend overnight at a rate below Bank rate, probably at a rate broadly reflecting the level of overnight rates in the market.

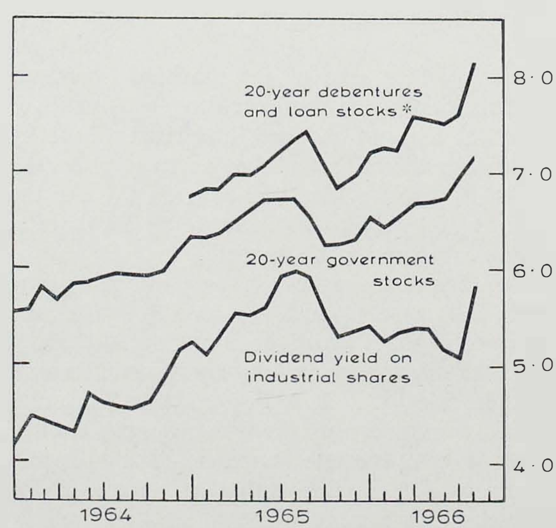
Gilt-edged The gilt-edged market was fairly firm, though quiet, throughout May and much of June. Apart from the new Basle arrangements for inter-central bank co-operation, announced on 13th June, there was little to encourage the market during these weeks: indeed, it remained remarkably resilient in the face of such unsettling influences as the seamen's strike, disappointing figures of overseas trade, and the weakness of sterling. Yields rose slowly, with the largest increases in those on short and medium-dated stocks; while turnover fell away sharply.

In the last week of June yields started to rise more quickly. The situation in the foreign exchange market was worsening, interest rates abroad were still rising, and there was growing expectation—which was reinforced after the discount market's borrowing at the Bank—that Bank rate would be increased. The ending of the seamen's strike brought a slight recovery around the end of June, but prices fell sharply again early in July. Those of some stocks, War Loan for example, were then lower than they had ever been before, and many stocks offered yields of over 7%. New issues of industrial debentures were being announced at successively higher rates; and it was to be expected that competition from this quarter for available funds would intensify in the coming months.

The increase in Bank rate on 14th July had been largely discounted and had little effect on the market, but in the next few days prices slipped further as the pressure on sterling increased. Towards the end of the month, however, there was some recovery; the foreign exchange market seemed a little firmer, after the Government's measures had been announced, and yields on gilt-edged, ranging up to $7\frac{3}{8}$% for some medium-dated stocks, began to look attractive—particularly while investors were cautious about the prospects for equities. But any substantial recovery in the gilt-edged market was unlikely while it was overshadowed by the weight of forthcoming new issues of industrial debentures.

The authorities were able on balance to sell a small amount of stock, particularly longer-dated, during May and the first three weeks of June, but thereafter they bought stock—though again in modest amounts—in order to moderate the pace at which prices were declining. Official sales were resumed towards the end of July, after the market had steadied.

Other medium and long-term rates According to the F.T.-Actuaries index, yields on 20-year debentures and company loan stocks fell slightly during May, to just over $7\frac{1}{2}$%. This was about $\frac{3}{4}$% more than the yield on gilt-edged stocks of a comparable term, compared with the rather high margin of $\frac{7}{8}$% that had obtained in April. Early in June, however, the yield on debentures and loan stocks started to rise again, and it increased



The volume of new fixed interest issues by companies contributed to a sharp rise in yields in July—to almost 1% above those on gilt-edged stocks of a comparable term. The dividend yield on equities also rose abruptly in July, as prices slumped.

* F.T.-Actuaries series; not available before December 1964.

more sharply throughout July. By the end of July it stood at over $8\frac{1}{8}\%$—an exceptionally high rate for first-class industrial borrowing—and the margin over gilt-edged stocks had widened again to almost 1%.

Despite the rise in yields there was no lack of borrowers, many of whom must have seen little prospect of obtaining bank finance. The flow of new fixed interest issues by companies, calls on which had dwindled to a trickle in April, was resumed quite strongly during May to July. Moreover, with credit expected to remain tight in the months ahead there was a long list of would-be borrowers: by the middle of July the queue, regulated by the Bank, was such that few of the latest applicants could expect to make an issue before October. Turnover in these stocks increased in May and June and remained high in July; and over the period as a whole the market was more active than in the last quarter of 1965, the previous record quarter.

As mentioned earlier, local authorities were not borrowing heavily from the public during the three months. Few new issues of stock could be made while the gilt-edged market was depressed, and calls on earlier issues were smaller than in the previous three months. Issues of short-term bonds were smaller than earlier in the year. Nor was the mortgage market under any pressure. Rates for mortgages rose by $\frac{1}{8}\%$ early in May, to 7%—$7\frac{1}{8}\%$ throughout the range of maturities, and then remained little changed until early in July, despite the rise in gilt-edged yields. By then the rate offered for a 20-year mortgage was much the same as the yield on a 20-year government stock: earlier in the year it had been about $\frac{1}{2}\%$ more. This margin was re-established after the middle of July: mortgage rates rose by $\frac{1}{2}\%$ for all terms, while yields on gilt-edged fell slightly.

Equities Equity prices increased quite strongly during May and June, despite the uncertain outlook for profits, and by the first week in July the F.T.-Actuaries index of industrial share prices had reached a new high point of nearly 120. The rise, which was little affected by the set-back on Wall Street during May, was supported by steady buying by unit trusts and other institutions in a market in which there was little stock on offer and few new issues. Sentiment changed abruptly, however, later in July, when the weakness of sterling led to expectations of further measures to reduce home demand. The index of prices dropped sharply and by 18th July was down to $107\frac{1}{2}$, the lowest since last autumn. It picked up a little after the measures had been announced, but by the end of the month it had fallen again, to 104. Turnover, which had increased in both May and June, fell substantially during July.

Building societies The inflow of funds to the building societies, which had been very large in the first quarter, slackened in the second, partly for seasonal reasons. Nevertheless, net receipts remained very high, despite the increased yield obtainable on national savings certificates—probably the main competitor for funds. The total outstanding on shares and deposits increased by £177 million during the second quarter. In July the net inflow, seasonally adjusted, fell away—and was considerably less than the average for the previous six months.

The net amount advanced on mortgage between March and June—almost £200 million, a record for any quarter—was greater than the societies' receipts: the amount of mortgages to which they were committed also reached a new peak. As a result, the societies' combined liquidity ratio (cash and investments other than mortgages, expressed as a proportion of total assets) fell slightly—from $16\frac{3}{4}\%$ at the end of March to just under $16\frac{1}{2}\%$ at the end of June. Pressure on the societies' reserve ratios had led to an increase during May in the mortgage rate recommended by the Building Societies Association, from $6\frac{3}{4}\%$ to $7\frac{1}{8}\%$;[1] the higher rate was applied to most new mortgages from June onwards but the Government asked that the increase for existing borrowers should be deferred until the report of the Prices and Incomes Board was available.

Exchequer finance The Exchequer's deficit on revenue account during the first quarter of the current financial year, at £209 million, was rather larger than during

(1) June *Bulletin*, page 116.

April to June 1965. This was mainly because revenue grew more slowly following the abolition of profits tax—one aspect of the change in the pattern of government revenue this year resulting from the new system of company taxation. Loans from the Consolidated Fund, however, were smaller than last year: in all, the central government's net balance showed a deficit of £438 million.

Sales of foreign exchange by the Exchange Equalisation Account totalled £106 million and overseas holdings of government debt rose by £186 million, of which £99 million was the counterpart of the transactions with the U.S. authorities mentioned earlier.[1] The amount which remained to be financed by domestic borrowing was therefore £146 million—only a third as much as a year ago—and most of this was provided from outside the banking sector.

Non-bank holders not only added seasonally to their holdings of notes and coin, but they also bought some marketable debt, particularly stocks; most of their purchases took place early in the quarter, when the gilt-edged market was firm. Moreover, there was some recovery in national savings (where the net withdrawal was smaller than in any of the three preceding quarters) after the introduction of a higher-yielding national savings certificate on 28th March. A further stimulus to non-marketable debt will come from the new tax reserve certificate for companies, issued on 27th June, and from the new national development bond, issued on 11th July—although the attraction of the higher interest rates offered may be limited, for the former, by the shortage of liquidity which companies may already be starting to experience and, for the latter, by the subsequent rise in competing rates.

The total increase in government debt held outside the banks was £116 million, which left only £30 million to be provided by the banking sector—significantly less than in the same quarter of earlier years.

London clearing banks The changes in company taxation this year have distorted the normal seasonal pattern of bank deposits and advances. In broad terms, the use this year of seasonal adjustments based upon experience in previous years might be expected to have understated the underlying decline in deposits between April and August and to have overstated the underlying fall in advances.

Before seasonal adjustment, net deposits with the London clearing banks rose by £62 million between the mid-April and mid-July make-up dates. This was little more than one third of the rise usually expected for seasonal reasons in these months, and substantially less than the increase of £223 million during the same months of last year. The modest growth of deposits reflected the increased purchases of government debt, mentioned above, by holders outside the banking system.

During the same three months, the clearing banks' advances, excluding those to the nationalised industries, rose by £24 million: decreases totalling £92 million in May and June were more than offset by a substantial rise, of £116 million, in July—which was largely due to the half-yearly debiting to overdrawn accounts of interest and charges. The net increase over the period was only slightly larger than expected for seasonal reasons; but if it were possible to allow for the changed pattern of tax payments, as suggested above, which will tend to have reduced the demand for bank finance in these three months, the seasonally adjusted increase in advances would probably have been somewhat greater.

The latest figures, for the month to mid-August, show a fall of £135 million in advances (other than to the nationalised industries). It is estimated that normal seasonal movements would account for a fall of only £80 million. So, even if some allowance is made for a change in the normal seasonal pattern this year, it seems that there was a fairly sharp underlying fall in advances in August—more than offsetting the net rise in the previous three months.

105% limit on credit It was noted in the June *Bulletin* that by the middle of May the London clearing banks had very little room to increase their lending, apart from seasonal fluctuations, within the limit indicated by the Governor in his letters of May 1965

[1] As described earlier, the net amount of the swap transactions with the U.S. authorities during the quarter was only £45 million. But the repayment of the £54 million swap outstanding at the end of March was not reflected in overseas holdings of government debt, see the footnote on page 110 of the June *Bulletin*.

and February 1966.(1) The fall in their advances (other than to the nationalised industries) between the middle of May and the middle of August reduced the cumulative increase since March 1965, adjusted for normal seasonal movements, from between 4½% and 5% to 4%.

Sterling advances by the accepting houses and overseas banks, excluding those to other U.K. banks and to local authorities, increased by £31 million during the quarter to the end of June. This series is too recent in origin to be capable of reliable seasonal adjustment, but the latest quarter's increase was substantially less than that in the same quarter of the three earlier years for which figures are available; it brought the total increase since March 1965, including some seasonal element, to about 3%.(2)

The banking sector's holdings of commercial bills, including refinanceable export credits, also increased between March and June, by £13 million (Table 8 of the annex). This increase too was considerably smaller than the increases in the same quarter of recent years, and may have been attributable to seasonal factors. At the end of June the banking sector's holdings of sterling commercial bills,(3) before seasonal adjustment, were about 8% higher than at March 1965.

In the Budget speech the Chancellor had said that he would consider, against the background of the general credit restraint which it was necessary to maintain, what steps might be needed to enable the banks to respond to companies' temporary demand for credit caused by the selective employment tax—payment of which would start in September while refunds, and premiums to manufacturers, would not be paid until the new year. On 12th July the Chancellor announced that he had agreed with the Governor that the ceiling on bank advances of 105% of the level in March 1965 should remain at least until March 1967; there would be no general arrangements to offset the intended effect of the new tax. Later in July the clearing banks were reminded that, apart from seasonal fluctuations, the 105% limit must be observed in the coming months; and on 9th August the Bank issued a press announcement, in which it was emphasised that the needs of priority borrowers, as defined in the Bank's earlier guidance about the direction of lending, should be met within the overall limit imposed. There was thus a need for the banks to review existing advances and advance facilities in order to secure early and substantial reductions in lending to other customers.

Outstanding debt due to hire purchase finance houses grew further during the second quarter, partly reflecting the demand for new cars; the increase of £22 million, however, was slightly less than seasonally expected. At the end of June the finance houses' total lending, on hire purchase and credit sale agreements and in other ways, was £82 million, or 8½%, higher than in March 1965; part of this increase was due to seasonal causes, and after allowing for the seasonal element the finance houses as a whole brought their total lending down a little towards the 105% limit during the second quarter. Some individual finance houses, whose lending had increased faster than the average, have discussed their position with the Bank: a sharp and general drop in outstanding debt, to within the 105% limit, is now expected following the tightening of terms control in July.

Conclusion By the middle of July a crisis of confidence in sterling had made the need to correct the balance of payments unmistakably urgent. Although domestic inflationary pressures may have begun to show some tendency to ease, they remained much too high and the balance of payments itself was not showing enough real improvement. Superimposed on this underlying situation were the effects of a number of special adverse factors, in particular the seamen's strike.

In these circumstances, the measures announced in July were necessarily severe. In addition to making direct cuts in overseas expenditure, they will reinforce earlier restraints on domestic demand—particularly on consumer spending—and they will intensify the strain on companies' profits and liquidity in the months to

(1) March *Bulletin*, page 3.

(2) Rough allowance has been made for the netting-out, from March 1966, of the overseas banks' balances on inter-branch accounts, see Table 10 of the annex.

(3) The distinction in the annex between bills drawn in sterling and in foreign currency was explained in the March *Bulletin*, page 8.

come. Profits will be harder to earn at home and there will be an incentive for firms to make the most efficient use of manpower. The easing of domestic demand for both goods and labour which is to be expected will make capacity and manpower available for the production of exports and will moderate the demand for imports. The further steps taken to halt the rise in all forms of incomes and prices should help to ensure that British products remain competitive abroad.

A substantial improvement in the U.K. balance of payments is now to be expected. Already it is possible to see signs of a slight easing in the domestic economy. The improvement in the external position will necessarily take somewhat longer to appear. The measures have to work through the system; confidence, seriously impaired, needs time to grow again; and conditions of monetary tightness abroad persist.

The measures announced in July are an earnest of the Government's resolution to maintain the exchange rate for sterling. For their full and permanent success, however, it is necessary that they should be understood and accepted by the nation as a whole. They involve unpalatable restraint, restrictions and postponements: but postponement of some expenditure—both private and public, and however desirable it may be—is the price that has to be paid, in the short term, to enable the pressure of home demand to be reduced and the balance of payments corrected. In the longer term, it is important that the price should not be damage to our productive capacity: so we should try to ensure that the cuts are not allowed to fall on industrial investment rather than on consumption.

This does not mean that the pound has been defended at the expense of the domestic economy: but, rather that, given the extent of the nation's present ability and willingness to produce, we could not afford all we were doing. To provide a stronger base for continuing economic development, it is essential to maintain external solvency—which means of course not merely external balance but the achievement of a substantial surplus before too long, in order to repay the large amounts that have been borrowed from abroad. In the longer run, however, the country's problems will only be solved by an increase in production—of which exports must take their full share—based on a widespread willingness to look afresh at old ways and adopt new and improved ones.