Commentary

The measures taken during July, described in the previous *Bulletin*, were intended to relieve the pressure on sterling and to create conditions in which the balance of payments could move into surplus. By the end of October, the latest month covered in most sections of this Commentary, it was clear that considerable progress had been made towards these ends.

The pound's recovery in the exchange markets, after the sharp break in confidence during July, was delayed at first by a further outflow of short-term capital, caused partly by rising interest rates and tight monetary conditions abroad. On 13th September, in view of the unsettled conditions in financial markets throughout the world, the Federal Reserve System announced a major increase, from $2,800 million to $4,500 million, in their reciprocal swap arrangements with other central banks, including the Bank of England: concurrently the Bank announced that they had arranged increased swap facilities with certain other central banks.

There were some signs in September that interest rates overseas might have reached a peak; and with exchange markets reacting favourably to the 13th September announcements, sterling was in short supply abroad. The outflow of liquid funds from the United Kingdom slackened, and towards the end of the month there was a marked change of trend and money began to return to this country. The authorities were able to acquire foreign exchange for the reserves, and in October they began to repay the drawings that they had made on central bank facilities during the summer and to reduce again their outstanding market commitments in forward exchange.

Between July and October interest rates at home first continued to rise, but then fell. During the summer both short and long-term rates had increased, and they reached new peaks around the end of August; the Treasury bill rate was over $6\frac{3}{4}$%, many government stocks yielded $7\frac{1}{2}$% or more, and yields on first class debentures went well over 8%. There were by then few signs that the pressure of home demand had eased more than slightly, or that rates abroad might not rise further. Since early September, however, the pressure of home demand has eased considerably. Unemployment has continued to rise, industrial output seems to have fallen recently, and imports have probably begun to decline. Exports have strongly recovered from the set-back caused by the seamen's strike. By the second half of September interest rates abroad looked steadier and then in some cases began to ease. These developments, which generated a feeling in the financial markets that Bank rate was unlikely to be increased further, led to a moderate fall in interest rates which continued during October —without, however, bringing rates below levels consistent with a 7% Bank rate. In the light of the changed circumstances, the authorities did nothing to discourage a modest fall in rates by their market policies: at the same time they were able to sell a substantial amount of government stock.

Domestic economy

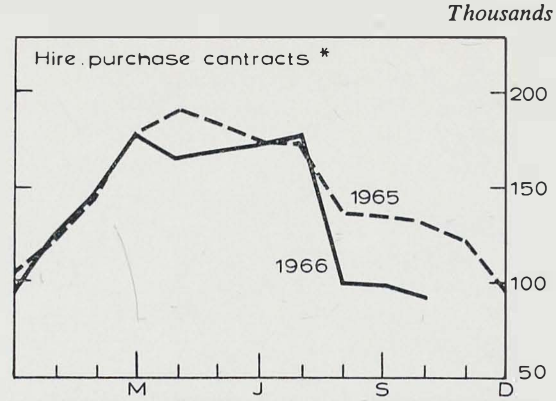
The clearest indication of the change in the internal situation is the rise in unemployment. After allowing for seasonal movements, the percentage of the labour force wholly unemployed, which had been static at the very low figure of 1·2% during the first six months of the year, reached 1·8% at the November count.

Much of the increase followed falling sales, especially in the motor and other industries which are particularly affected by hire purchase restrictions; but it also reflected some reduction in over-manning, induced presumably by the uncertain outlook for profits and for company liquidity: earlier in the year it had seemed that employers were reluctant to dispense with labour,(1) so that the number of unemployed had then remained very low. The number of vacancies reported to the labour exchanges declined, although in many industries, and in many areas, skilled labour was still short.

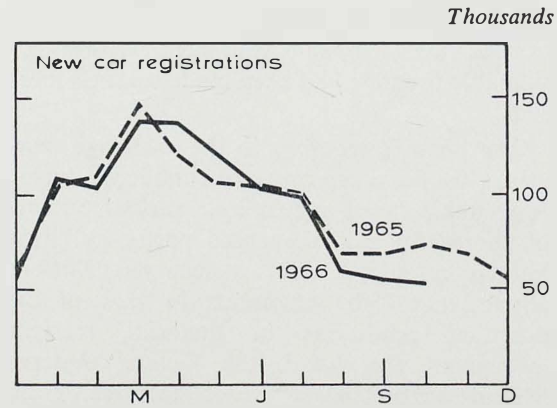
The trend of industrial output, as measured by the monthly index of production, may have been obscured by the seamen's strike;(2) but the most recent figures indicate that it has probably turned downwards. Output rose in July and August, but fell sharply in September.

The trend of imports has also been distorted by the seamen's strike, and by the impending removal of the import surcharge at the end of November, but the sharp decrease in September—when the volume of imports, after seasonal adjustment, was 4% lower than the monthly average in the first quarter of the year—also suggested some easing in home demand. Imports dropped again in October—by rather more than might have been attributed solely to the forthcoming removal of the surcharge.

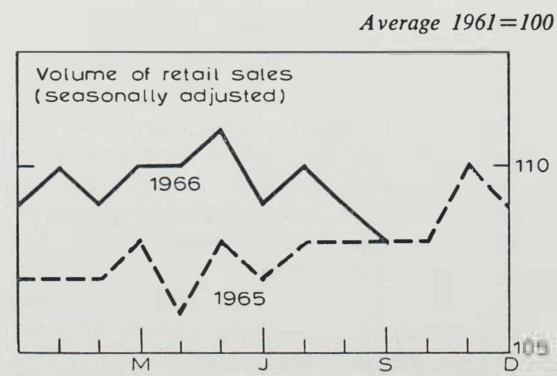
The reduced pressure on resources was also reflected in the behaviour of the indicators of some of the main components of demand. Consumer spending has declined slightly: earlier in the year it was sustained by purchases in anticipation of the Budget and by the rise in real incomes, which has now come to a halt. The easing reflects partly the increase in taxes and the tightening of control on hire purchase contracts in July; but redundancies and short time working, and fears that these may become more widespread, and the restraint—both present and prospective—on the growth of incomes, must also be affecting spending plans. Thus the volume of retail trade, after seasonal adjustment, has fallen some way below the peak it reached in May—the drop has been particularly noticeable in sales of durable goods



The tightening of terms control on hire purchase, and the increase in purchase tax, brought a substantial fall in the number of new hire purchase contracts after July;



the number of new cars registered also fell sharply;



and so did the volume of retail sales, which by September was well below the peak reached in May and about the same as a year ago.

(1) March *Bulletin*, page 5.
(2) Some firms report figures of deliveries, which were affected by the strike, rather than of output.
* For cars and all other goods.

—and the number of new cars registered fell very sharply after July.

Private capital spending has also slackened. Private housebuilding shows little sign of recovery. Other fixed investment, too, is declining: the latest seasonally adjusted estimates, for the second quarter, showed a fall in the volume of manufacturers' investment, particularly in plant and machinery, while investment by the distributive and service industries was unchanged. Altogether, fixed investment by private industry was a little less in volume in the first half of this year than in the second half of last, which in turn was lower than in the first half of 1965. The latest survey of investment intentions carried out by the Board of Trade in August and September, which took some account of industry's reactions to the July measures, pointed to a further decrease in private capital expenditure, attributable both to manufacturing and to distributive and service industries, during the rest of this year and next: the September survey by the Confederation of British Industry confirmed that a further fall in investment was to be expected.

The volume of stockbuilding, after seasonal adjustment, was maintained in the second quarter. Lower stocks of raw materials and fuel were more than offset by increases in manufacturers' stocks of finished goods and by exports held up at the ports: all these movements were influenced by the seamen's strike. Preliminary figures suggest that stockbuilding continued in the third quarter, probably at much the same rate as in the second.

While private spending, both current and capital, has fallen away, public expenditure and exports have continued to rise. Housebuilding on public account is increasing: the number of houses started in the third quarter was $6\frac{1}{2}\%$ higher than in the second, and some 13% above the average for 1965. Other public sector investment is almost certainly still growing. In the second quarter it was $5\frac{1}{2}\%$ higher, in real terms and after seasonal adjustment, than in the first. Exports have been encouraging: in October, as noted later, they reached a record level.

The index of retail prices has changed little in recent months, apart from an increase in August resulting almost entirely from the July measures (which affected drink, petrol and all goods subject to purchase tax): the effect on the index of the selective employment tax, particularly on the price of services, has been offset so far by a seasonal fall in food prices. Wage rates—and earnings—have stopped rising. Notwithstanding their earlier hope that they could rely entirely on voluntary co-operation in the prices and incomes policy, the Government found it necessary to announce, on 4th October, that Part IV of the Prices and Incomes Act would be brought into operation two days later. This gave them statutory powers, up to next August, to issue Orders preventing increases in specified wage or salary rates or prices.

London clearing banks

The decline in consumer spending, particularly on cars and durable goods, almost certainly owed something to the tightness of bank credit; in the three months from mid-July to mid-October bank advances fell very sharply. Advances by the London clearing banks, to customers other than the nationalised industries, declined by £318 million—more than double the decrease expected for seasonal reasons during these three months. In the summer, the banks had been reminded that, apart from seasonal fluctuations, the overall limit on their advances, of 105% of the level in March 1965, had to be observed; and that the needs of priority borrowers, as defined in the Bank's earlier guidance about the direction of lending, should be met within this limit. There was thus a need for the banks to secure early and substantial reductions in lending to other customers.[1] The publicity given to this reminder, together with the banks' own efforts to carry out the policy recommended, doubtless led the banks' customers to realise that there was little point in asking for accommodation which could not be regarded as having priority.

By October, the decline in the clearing banks' advances, after seasonal adjustment, seemed to be slowing down: between mid-July and mid-September it had totalled about £145 million;

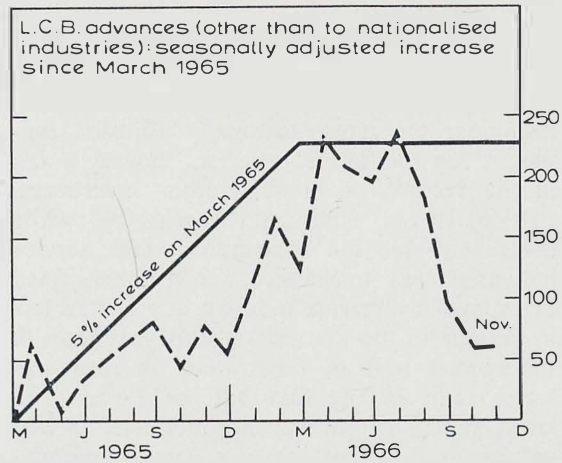
(1) September *Bulletin*, page 219.

in October it was £35 million.[1] At mid-September companies were due to pay to the Exchequer the tax they had deducted between April and August from dividend and interest payments: by mid-October these payments to the Exchequer were somewhat in arrears, and but for this the fall in advances in October might well have been smaller still. In November, after making the usual seasonal adjustment for this month, advances were little changed.

The reduction in advances between July and October was concentrated heavily on those for less essential purposes. Monthly figures, not seasonally adjusted, (the latest of which relates to mid-October) show that during these three months there were very substantial decreases in lending to personal and professional and financial borrowers, to retailers, and to hire purchase finance companies. On the other hand, advances to most categories of manufacturing industry probably fell by little more than would be expected for seasonal reasons.

At the middle of October, therefore, it seemed likely that the fall in the banks' lending reflected mainly their own efforts in reducing less essential advances, helped by the drop in applications for loans by customers in these categories: there was some doubt whether there had been much reduction in demand for bank finance by priority borrowers. On 1st November, the Bank issued a press announcement reminding such priority borrowers that the banks should have sufficient resources available over the next few months, within the 105% limit, to meet all their demands for advances which satisfied normal banking criteria. Within the categories which should be given priority, exports took first place, followed by lending in support of productive investment by manufacturing industry and agriculture: temporary bridging finance for house purchase was also of special importance at a time when the redeployment of labour needed to be encouraged. The announcement was intended to remove any unwarranted fears about the effects of the existing restrictions on credit, and did not mark any significant change in current policy.

£ millions



Between July and October the clearing banks' advances, seasonally adjusted, fell very sharply, but in November they were little changed. They were then well below the limit requested by the Governor.

Despite the sharp reduction in advances, the clearing banks' net deposits fell only slightly between July and October. A more substantial fall was expected for seasonal reasons, and after seasonal adjustment deposits rose by about £40 million. The trend changed, however, during the three months. In the two months from mid-July to mid-September net deposits, seasonally adjusted, increased by about £120 million. The first payments to the Exchequer of tax deducted from dividend payments by companies, mentioned above, did not take place until after the banks' make-up date in mid-September; and by this date the selective employment tax had been in operation for little more than two weeks. The Exchequer's borrowing requirement was large, mainly because loans from the Consolidated Fund, both to the nationalised industries and to local authorities through the Public Works Loan Board, were heavy. As noted later, the gilt-edged market was subdued for much of this period; domestic holdings of government debt outside the banks were considerably reduced and the banks' contribution to government financing was substantial.

In the month to mid-October, however, net deposits fell sharply, by some £80 million after

[1] The seasonal adjustment for August tended to overstate the underlying fall in advances (September *Bulletin*, page 218); from September onwards the reverse is probably true. Nevertheless the slackening in the downward trend seemed to be greater than could be attributed solely to the distortion of the normal seasonal pattern.

seasonal adjustment. By then the Exchequer had begun to benefit from payments of the tax deducted from dividends, and from sizable receipts of the selective employment tax; and although loans from the Consolidated Fund were again large, the central government's total borrowing requirement was quite small. Moreover, the recovery in the gilt-edged market had encouraged the general public to buy exceptionally large amounts of stock. Had companies' payments to the Exchequer of the tax on dividends all been made on time, the fall in deposits in October might well have been greater.

Bill rates

During the three months from August to October the Treasury bill rate rose to an exceptionally high level. The discount market's tender rate, which at the end of July was just under $6\frac{23}{32}\%$, increased by $\frac{1}{32}\%$ at the end of August, and in the first week of September it rose further, to slightly above $6\frac{3}{4}\%$. These increases took place because money was both tight and dear: the discount houses were repeatedly obliged to borrow from the Bank, mostly overnight, at Bank rate—forcing up the average cost of their borrowed funds.

Early in September the Bank lent money overnight for the first time at a rate below Bank rate; and during the rest of the month such lending was mostly at this lower rate—though on one occasion, when it seemed likely that the discount houses would bid more for bills at the next tender, thus reducing the bill rate, overnight lending was at Bank rate. The Treasury bill rate was considered to be high enough at this time, although it was still the authorities' policy to keep money tight.

The discount market's tender rate remained unchanged, at just over $6\frac{3}{4}\%$, from the beginning of September until early in October. After the middle of September, however, the amount of bills offered at the tenders steadily declined; as mentioned above, the Exchequer's need for funds had diminished and official sales of gilt-edged stocks were large, so that recourse to Treasury bill finance lessened. Early in October, after the discount houses had received a very low allotment of bills, the market raised its bid at two consecutive tenders in order to obtain a larger proportion of the relatively few bills on offer; and over these two weeks the rate fell by $\frac{1}{8}\%$, to just over $6\frac{5}{8}\%$. The authorities were unwilling to see it fall too far and the houses were twice obliged to borrow from the Bank at Bank rate for seven days. Nevertheless, on 28th October, following another low allotment of bills at the previous tender, the discount houses again increased their bid and the rate fell to just over $6\frac{1}{2}\%$. Subsequently, the houses were not only obliged to borrow from the Bank at Bank rate for seven days, but the rate for their overnight borrowing during the following week was again Bank rate.

The average cost of the discount houses' borrowed funds, which at the end of July was estimated to be about $6\frac{1}{4}\%$, rose steadily during August, as noted above. It increased further during September; money remained very tight and although the Bank were lending overnight to the market mostly at below Bank rate, they were usually charging the highest market rate of the day. At the end of October the average cost of the houses' money was estimated to be about $6\frac{7}{16}\%$.

In August, in an attempt to contain the volume of commercial bills that they were offered,(1) many of the discount houses started to quote rates for prime bank bills of four and six months' tenor which were higher than those for three months' bills. The buying rate for three months' bills, which had been $6\frac{15}{16}\%$ at the end of July, rose in September after the increase in the Treasury bill rate, to $6\frac{31}{32}\%$; but following the reductions in the Treasury bill rate during October it fell back by the end of that month, to $6\frac{7}{8}\%$. The rate for six months' bills was then 7%-$7\frac{1}{16}\%$.

Other short-term money rates

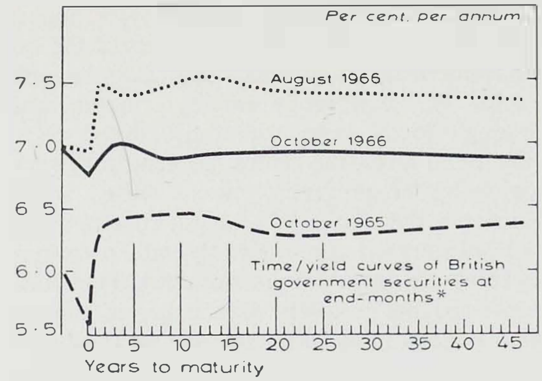
Local authorities had little need to bid up the rate that they offered for temporary money. Their total borrowing during the three months may not have been particularly heavy, because their capital spending has been restrained by the Government's measures and their current expenditure has recently been rising more slowly than current revenue. And local authorities had an incentive to take as much as possible from the P.W.L.B., rather than from the market, because the disparity between

(1) The 105% limit applies to commercial bill finance as well as advances; March *Bulletin*, page 3.

market rates and the rates, last changed in August 1964, at which they could borrow under their P.W.L.B. quotas was especially wide at this time. The amount which local authorities can draw from the Board is related to their gross long-term borrowing from the market,(1) and new mortgages, which form part of such borrowing, were large during the three months. Many existing mortgages, though nominally for a fixed term, contain an option clause allowing the lender to seek repayment at any time after a stated period;(2) during these months, when rates were probably much higher than when the mortgages were originally contracted, this option was being exercised; and after allowing for the additional quota loan which could be obtained at a lower rate from the P.W.L.B. it was probably cheaper for local authorities to borrow again on mortgage, rather than on temporary money. This new mortgage borrowing, together with the large amounts drawn from the P.W.L.B., probably left local authorities with little need to resort to the temporary loan market. Although the rate for three months' money rose slightly during August it soon settled back again; and by the end of October it was 7¼%-7⅜%, slightly lower than at the end of July.

Rates offered for deposits by hire purchase finance houses also rose during August, probably in order to attract funds to replace bank advances; but subsequently, as the houses' business continued to decline, rates fell again. By the end of October the spread of rates for three months' money quoted by the main houses was 7¼%-7¾%, ⅜% lower than at the end of July.

Gilt-edged Turnover in the gilt-edged market (Table 15 of the statistical annex) had been low during May to July, and yields had risen quite sharply. In August, turnover dropped still further, to the lowest monthly figure recorded since the series started nearly two years earlier, while yields continued to rise, in many cases to new peaks. The authorities' purchases, to steady the market and to restrain prices from falling faster and further



The end of August marked the peak in gilt-edged yields, which were then mostly a full 1% or more above October 1965.

than seemed justified by the economic situation and prospects, were quite small, for there was no great pressure to sell gilt-edged; the equity market too was weak and the outlook there was not encouraging, while calls on new fixed interest issues by companies were considerably smaller than earlier in the year. But neither were there many buyers of gilt-edged stocks. Prices were not expected to rise until sterling strengthened on the exchanges; and institutional investors had good reason to accumulate funds in order to provide for the large number of new industrial debenture issues then being announced.

Early in September the market became noticeably more active. Demand was at first concentrated among the short and medium-dated stocks, but it soon spread to the longer maturities. It began to seem likely that in the future the United States and Western Germany might rely rather less on monetary policies, and that interest rates abroad might not rise further; and some investors began to wonder whether rates at home had reached a peak. On 13th September the announcement of the enlarged swap facilities between central banks and the publication both of the improved trade figures for August and of the Bank's September *Bulletin*, which commented on the better outlook for the balance of payments, all brought further encouragement to the gilt-edged market. During September and October the market

(1) See the article on page 337.
(2) Some mortgages contain a similar 'break' clause for the borrower.
* 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% or higher coupon, and end with that on 5½% Treasury Stock 2008/12.

strengthened markedly and turnover picked up sharply. In October, turnover was higher than in any other month since the statistics began late in 1964—although judging from the number of transfers received in the Bank for registration, it was about one third below the peak in October 1962,[1] when the gilt-edged market had also been very active.

From mid-September onwards the authorities were able to sell considerable amounts of the two 'tap' stocks, 6% Exchequer Loan 1970 and 6% Funding Loan 1993; at the same time they were buying in, as opportunity offered, next year's two maturing stocks. In the middle of September, the market began to sense that official holdings of the short-dated 'tap' stock were nearly exhausted, and that its price was likely to rise further. Demand for this stock therefore became very strong, and the authorities were able to increase their price fairly quickly. With this encouragement the yield fell from around $7\frac{1}{8}$% to about 7% by early October—a level still fully consistent with Bank rate at 7%. Once the new short-dated 'tap' stock, noted below, had been announced, market interest began to shift to the long-dated 'tap' stock and the pattern was broadly repeated there, with the yield on 6% Funding Loan 1993 falling from over $7\frac{1}{4}$% early in October to about 7% towards the end of the month, when a new long-dated issue was announced.

On 13th October, £700 million of a new short-dated 'tap' stock, $6\frac{3}{4}$% Exchequer Loan 1971, was issued at $99\frac{1}{4}$, offering a yield to maturity of £6:18:8%. Market applications for this stock, partly financed by sales to the authorities of other short-dated stocks, were much larger than is usual for a new government issue. At about the same time, official holdings of 6% Funding Loan 1993 were exhausted; but for the time being the authorities were content to influence yields at this end of the market through their dealings in other long-dated stocks. Meanwhile, they allowed the queue of issues in the gilt-edged market to move forward faster, bringing issues by the Agricultural Mortgage Corporation and the New Zealand Government. Finally, on 28th October a new long-dated government stock was issued, £400 million of $6\frac{3}{4}$% Treasury Loan 1995/98 at $97\frac{1}{2}$. The yield to maturity in 1998, £6:18:11%, was in line with yields on existing stocks of a comparable term, after allowing for the attraction of the high coupon: subsequently the price at which the authorities were prepared to sell this stock had to be raised rather frequently, because, with the high coupon, accrued interest (which is included in the price) accumulates quite fast.

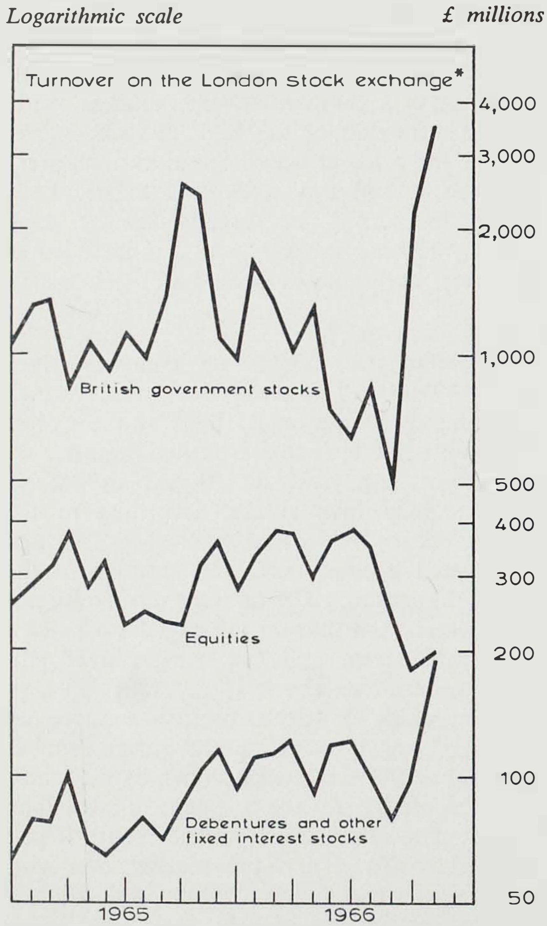
Other medium and long-term rates

Yields on company fixed interest securities, which were already exceptionally high by the end of July, continued to increase during August. By mid-August the yield on 20-year debentures and company loan stocks, according to the F.T.-Actuaries index, had reached $8\frac{3}{8}$%;[2] and it persisted around that level throughout the rest of the month. The increase during August was greater than that on gilt-edged stocks of a comparable term and the margin over gilt-edged widened to about $1\frac{1}{8}$%. Early in September, yields on debentures, like those on gilt-edged, began to decline and during October the yield on 20-year stocks, shown by the index, fell to below 8% for the first time in more than two months. By the end of the month it had dropped to $7\frac{3}{4}$%, and the margin over gilt-edged stocks had fallen to about $\frac{7}{8}$%, slightly less than at the end of July.

The net amount raised by new issues of fixed interest securities by companies was smaller in August than in most earlier months of the year but increased sharply in September and October: over the three months as a whole it totalled £147 million, compared with £107 million in the preceding three months. However, by the end of October the pressure of prospective borrowers, which had been at its heaviest early in September, was no longer so acute; some of them, perhaps because projects had been postponed or because they hoped to borrow more cheaply later on, had dropped out of the queue regulated by the Bank. The market in fixed interest securities remained very active; in October, turnover was considerably higher than in any previous month since the series began, partly because of heavy deal-

(1) December 1962 *Bulletin*, page 237.

(2) This index is based on representative stocks bearing various coupons but all issued before April 1964; the calculated yield on these stocks was somewhat higher than the yield on stocks currently being issued.



In September and October there was a strong revival in demand for fixed interest securities, and turnover reached record levels; but, with uncertain prospects for profits and dividends, turnover in equities was very low.

ings in a large issue by Imperial Chemical Industries.

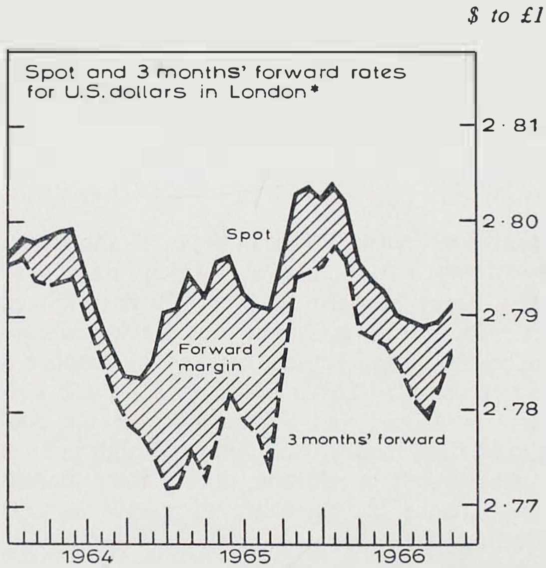
Local authorities borrowed very little new money on stocks and short-term bonds during the three months. It was not until after the middle of October that issues of local authority stock began to be made again; while issues of short-term bonds during the three months, and particularly in August and September, were mainly to replace maturing bonds. As mentioned earlier, local authorities' new borrowing on mortgages increased; partly for this reason and partly because of competition from the higher yields obtainable on gilt-edged, mortgage rates for all terms over one year rose by $\frac{1}{4}$%, to $7\frac{7}{8}$%-8%, by early in September. Thereafter they dropped back again and by the end of October mortgages for over one year offered $7\frac{5}{8}$%-$7\frac{3}{4}$%, the same as at the end of July.

Equities The fall in equity prices which had begun in July continued throughout August, when prices were affected by the weakness of Wall Street, by the restriction on dividends, and by increasing signs that the Government's measures would make profits harder to earn. On 26th August the F.T.-Actuaries industrial share price index fell to $95\frac{1}{2}$, the lowest point since November 1962; early in July it had almost reached 120. Thereafter the market recovered a little but it remained very thin: turnover fell away sharply in August and September and although it picked up slightly in October it was still very low. By the end of October, the index of prices had again fallen to the year's low point of $95\frac{1}{2}$.

Foreign exchange and gold markets The pressure against the pound, which—as described in the September *Bulletin*—had built up to a climax in July, continued during the early part of August. In the first few days of the month, sales of sterling from abroad were prompted first by fears that the loss of reserves during July had been large and then by doubts about the success of the incomes policy; and the market was both sensitive to further depressing comment on sterling in the foreign press and disappointed by the trade figures for July. But the selling diminished and became increasingly irregular; and by the middle of August it seemed that sentiment was no longer adverse. At this point, however, the general shortage of dollars experienced in June—which in July had been overlaid by the U.K. authorities' heavy sales—again emerged and brought sterling under renewed pressure. Continuing credit stringency in the United States was evidenced by a further increase in the banks' prime lending rates, and seemed likely to be intensified after the imposition of higher reserve requirements against time deposits. The U.K. authori-

* Value of purchases plus sales.

ties gave some support to the market until towards the end of the month—when, although the dollar was still in strong demand in most continental centres, the pound steadied.



By October the spot rate for U.S. dollars had risen again to above $2·79; while the forward margin, which widened sharply in July and August following heavy forward sales of sterling, had narrowed.

The market remained quiet in the first few days of September, but after little more than a week dollars were again being borrowed against sterling. On 13th September it was announced that the international swap arrangements between central banks had been expanded, to create a broader margin of safety for the stability of the world monetary system. The reciprocal facilities between the Federal Reserve System and other central banks were increased from $2,800 million to $4,500 million: within this increase the swap arrangement between the System and the Bank of England was enlarged from $750 million to $1,350 million. At the same time the Bank of England arranged additional facilities with other central banks. The expansion of these central bank facilities was prompted by the unsettled conditions in financial markets throughout the world, and by the likelihood that exchange markets would be uncertain immediately ahead of the annual meeting of the International Monetary Fund.

The announcement of the enlarged facilities, together with the publication on the same day of the trade figures for August and of the September *Bulletin*, which commented upon the improved prospect for the balance of payments, gave rise to some demand for sterling; and the spot rate against the U.S. dollar, which had fallen from $2·79 at the end of July to $\$2{\cdot}78\frac{11}{16}$ by 12th September, rose to $2·79 again during the next few days. The dollar shortage continued to affect the pound for a while afterwards, but there were signs that it might soon become less acute: in particular, it seemed likely that any further restraint on domestic demand in the United States might be achieved through fiscal, rather than monetary, measures. Moreover, conditions in the euro-dollar market tended to ease a little as fresh funds were attracted, and it then became apparent that sterling itself was in short supply abroad: the authorities were able to recoup the exchange which, earlier in the month, they had used in support.

The improvement in sentiment was reinforced in October by the announcement of a small rise in the reserves during September and by the better trade figures for that month. The demand for sterling, though uneven from day to day, was sometimes strong; and despite a reappearance of the dollar shortage towards the end of the month the authorities were able, on balance, to acquire a considerable amount of foreign exchange during October. The rate remained above $2·79. Much of the demand for sterling arose, however, because overseas residents bought it in order to close out maturing forward purchases of foreign currency contracted when the pound was under pressure.[1] Thus by no means all of the exchange which the authorities acquired in October accrued to the reserves, but their outstanding forward commitments to the market fell quite sharply. The authorities' oversold forward position had increased during August, when support was given to the market early in the month by way of outright forward sales of exchange, but had changed little in September: most forward contracts maturing during these

(1) The way in which such contracts are closed out was described in the December 1965 *Bulletin*, page 304.

* Middle closing rates, averages of weekly figures.

two months—and some of the very heavy maturities in October—were extended.

Demand for gold was generally strong in August and September and became very heavy just before and during the I.M.F. meeting. The amount offered from normal sources increased further and was particularly large in September; but even so it fell some way short of demand. The dollar equivalent of the daily fixing price throughout these months fluctuated between $35·17⅛ and $35·19⅜ per fine ounce; at the end of September deals were done outside the fixing up to $35·20. Early in October, once the I.M.F. meeting was over, demand fell away, and by the middle of October the fixing price had fallen to $35·14⅝; during the remainder of the month it fluctuated around $35·16.

Reserves and use of central bank facilities

It was noted in the previous *Bulletin* that at the end of June swaps outstanding with the U.S. authorities totalled the equivalent of £99 million. During the third quarter, as is frequently the case, use of these and other swap facilities fluctuated quite widely. At the end of September, recourse to swap facilities with the Federal Reserve and the U.S. Treasury stood at £205 million; in addition short-term borrowings were also outstanding with the central banks of other countries under facilities whose general nature was announced in June and in September. The outstanding total of these borrowings resulted for the most part from drawings during July—when the drain of foreign exchange was very substantial, in part because overseas holdings of sterling were being reduced and foreign currency deposits previously employed in sterling were being reconverted into foreign currency. After use of these facilities with the U.S. authorities and with other central banks, the loss of reserves in July was reduced to £25 million. Net recourse to these facilities during August was on a much smaller scale than during July, while the reserves fell by £19 million: in September new drawings and repayments cancelled out and the reserves rose, for the first time since early in the year, by £3 million. The demand for sterling during October, mentioned above, enabled the authorities to start repaying their earlier drawings on these central bank facilities and still show a gain in the reserves, of £20 million. Further repayments were made in November, when the reserves increased by £23 million.

Quite apart from the drawings on the facilities mentioned, the reserves derived some indirect benefit during the third quarter, especially in July, from market operations in sterling by the Federal Reserve.

Short-term capital movements

The outflow of short-term capital, which had been very heavy between May and July, continued at a lower rate in August and slackened considerably during September; and in October it was reversed. The main reasons for the outflow in August and September were the continued tight money conditions and high interest rates abroad; in addition, during these months the balance of payments of many overseas sterling area countries remained seasonally adverse.

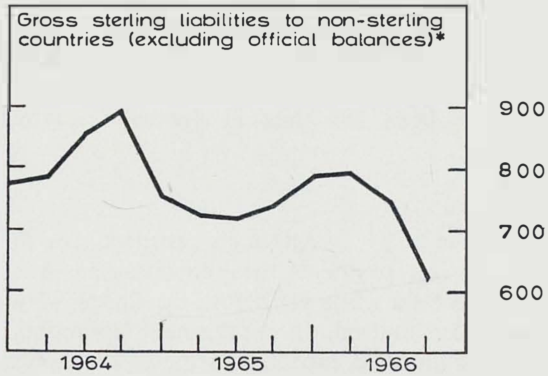
'Non-official' sterling holdings[1] of countries outside the sterling area had fallen sharply in July. They dropped again in August, despite these countries' seasonal payments surplus with the sterling area, but then steadied, and they fell only slightly during September. At the end of September non-official sterling balances of these countries were very low (see the chart) and they rose in October as confidence in sterling began to recover. Official holdings of sterling by these countries, affected by various factors including the counterpart of drawings on central bank facilities, rose during the three months.

Sterling liabilities to overseas sterling area countries, which had increased substantially in the first half of the year, fell during the third quarter. The late summer is normally the worst time for these countries' balance of payments with countries outside the sterling area, and after September the decline ceased.

The switching back into foreign currency, by U.K. banks, of currency deposits previously employed in sterling—which had persisted throughout the previous fifteen months—had continued in July. In August the banks began

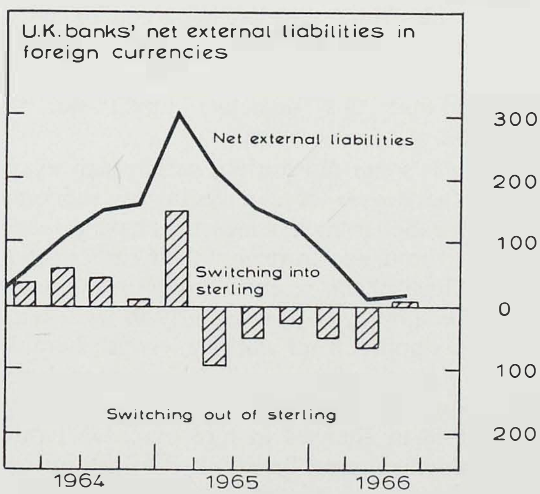
(1) That is, excluding liabilities to central monetary institutions.

£ millions



In the third quarter non-official holders of sterling in countries outside the sterling area continued to withdraw their balances; and at the end of September these were very low.

£ millions



After July the banks ceased to switch back into foreign currency funds previously employed in sterling; and in the third quarter as a whole there was a small net switch into sterling—the first since early in 1965.

to switch funds into sterling: this move may have been influenced by the reduction in the size of the position which the banks are allowed to carry in foreign exchange,(1) although in addition, as noted below, the relevant interest rate comparison became much less unfavourable to the United Kingdom as the month progressed. In September and October there was again a small net switch into sterling.

At the end of July the return on three months' euro-dollar deposits had exceeded that on three months' temporary loans to local authorities, after allowing for the cost of forward cover, by about ½% per annum. The differential then increased for a while, as forward margins widened in the uncertain mood of the market at that time. Later in August, rates paid by local authorities fell slightly, while those on euro-dollar deposits were bid up strongly because of tight money conditions abroad. But at the same time the demand for spot dollars on a swap basis resulted in a marked narrowing of forward margins; this more than offset the rise in euro-dollar rates, and their advantage over local authority temporary money, covered forward, fell back to below ½%. In September the cost of forward cover continued to ease, and euro-dollar rates declined as fresh funds were attracted to the market, so that the differential fell at times to below $\frac{1}{16}$%. Although demand for euro-dollars which would be available until after the turn of the year caused the three months' rate to rise at the end of September, and the higher rate was maintained during October, forward margins narrowed further as the authorities swapped forward some of their maturing forward contracts with the market. At the end of October the advantage of three months' euro-dollar deposits over loans to local authorities, covered forward, was only about ¼%.

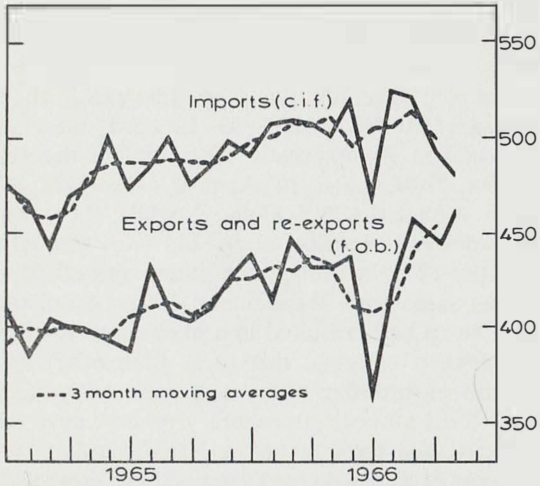
Balance of payments

Such figures as are available for the third quarter suggest that, after seasonal adjustment, the current balance will show a considerable improvement. It is known already that the seasonally adjusted deficit on visible trade was reduced from £107 million in the second quarter to just under £70 million in the third. As noted in the previous *Bulletin*, the seamen's strike had reduced imports less than exports: imports were very high in July and August, as they made up ground lost during the strike, but fell sharply in September. After seasonal adjustment, they were nearly 3½% lower in value in September than the monthly average for January to May, while exports—partly because of the backlog left by the strike—

(1) September *Bulletin*, page 211.

* Liabilities to holders other than central monetary institutions; Table 20 (ii) of the annex.

Seasonally adjusted *£ millions*



Both imports and exports have been affected by the seamen's strike. By October the trend of exports still seemed to be upwards but imports seemed to be turning down.

were nearly 3% higher. In October, imports fell further, after seasonal adjustment: part of the fall was attributable to those industrial materials which were not subject to the import surcharge—and which would thus be unaffected by its impending removal. Exports rose to a record figure, higher even than in the months immediately after the seamen's strike; and the trade balance showed a sizable surplus.

The out-turn on invisible account in the third quarter is not yet known, but for seasonal reasons alone there will have been some deterioration compared with the second quarter. Among long-term capital transactions, those on official account were probably less favourable than in the second quarter, because drawings on the line of credit with the U.S. Export-Import Bank, in reimbursement of dollar progress payments on contracts for U.S. military aircraft, were smaller and—as usual at this time of year—there were some repayments by the United Kingdom of intergovernment loans. But there are known to have been some large exceptional receipts from private capital transactions.

The deficit on current and long-term capital accounts in the third quarter, without correction for seasonal factors, may well prove to be substantial. But it should be remembered that the third quarter is normally the worst time of the year for the balance of payments, while the second quarter is the best. So for seasonal reasons alone the deficit is likely to have been considerably more than that of £53 million in the second quarter. Nevertheless, it is likely to have been less than in the third quarter of 1965.

Conclusion Although prospects for the balance of payments are encouraging it is likely to be a while yet before the figures show a surplus. Indeed, during the next few months imports must be expected to increase—though only temporarily—after the abolition of the import surcharge: thereafter, the easing of domestic demand should result in a better balance of trade. A substantial, and sustained, improvement in the external position must remain the prime objective—for confidence in the pound, which has now started to recover, could soon be withdrawn again if it were thought that this objective might not be achieved.

There is some disposition, perhaps, to exaggerate the degree of change in the economy which the Government's measures have already brought about, and to suggest their early relaxation. Much of the recent increase in the numbers of unemployed—particularly in those temporarily stopped from working—is attributable to the motor industry, which has been beset by labour disputes and which is particularly vulnerable to changes in hire purchase terms. Unemployment must be expected to rise further in the next few months, partly reflecting the seasonal increase at this time of year; but there is no evidence at present to warrant the belief that thereafter it will continue to increase rapidly. It must not be forgotten that a very large proportion of total spending by consumers —other than on cars and durable goods—is likely to be maintained; that exports should, as intended, provide an important expansionary force; and that public sector spending is indeed likely to increase.

There is no scope for any general relaxation in present restraints until the external position is more secure, for reflation too soon, quite apart from its effects on the balance of payments, would only bring a return of the crisis of confidence in sterling that was experienced in July. Selective relaxation, however, directed in particular towards private capital investment, would not carry the same threat. In the next few years higher output can be achieved only through greater productivity, for there is likely to be little increase in the working population. Yet in the immediate future, while the pressure on industrial capacity is falling, productivity will rise at most only slowly. The coming months will provide a breathing space for industry—to lay the foundations for more rapid growth in output in the future. Costs increased while profits were relatively easy to make, and must now be cut; and in a time of slack demand it may be easier to undertake investment directed towards reducing costs without disrupting production. Moreover, the easing in the labour position should help to ensure that men will be available in the industries in which they are most needed when expansion begins again.

Although restraint on demand should stimulate the sort of capital spending which will reduce costs, it undoubtedly discourages the expansion of capacity. For a short time such discouragement may not do much harm: investment carried out in response to inflationary demand may well be wasteful. But a prolonged reduction in investment will lead only to shortages of capacity when expansion is resumed.

It is vital, therefore, that private investment should not be cut for long; that business should plan ahead to meet the needs of a steadily growing economy in the future—free from over-expansion and from the subsequent periods of severe restraint. Such investment should have a high degree of priority within the economy —at the cost, if necessary, of curtailing the growth of some other spending, both by consumers and by the public sector. This is not to say that the growth of public spending should be checked indiscriminately but merely that, here too, some spending should have priority.

Productive investment in manufacturing industry, and labour-saving improvements in commerce and distribution, should be well to the fore—as should public investment directed towards such things as better transport and communications and cheaper and more certain supplies of power. This implies that the growth of private and public consumption, and of investment—either on private or on public account—which is primarily concerned with the provision of amenities, may, for the time being, have to be restrained. Such restraint, however, would be well justified if it permitted the higher investment which is necessary to achieve a more rapid improvement in the standard of living in the future.