Commentary

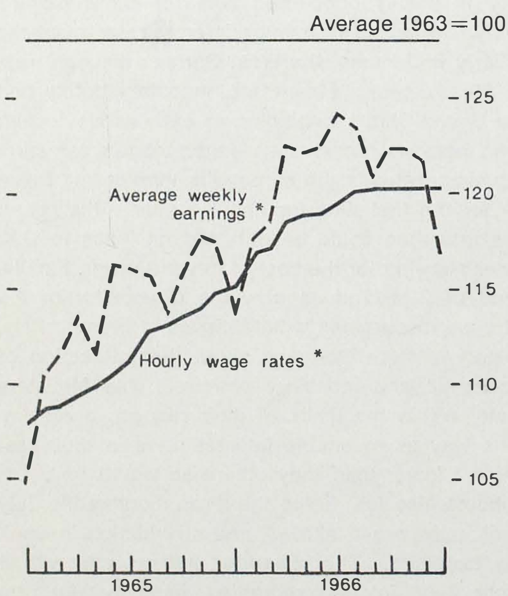
The overseas trading position of the United Kingdom has improved considerably. Exports increased sharply in the last quarter of 1966, and their growth was strongly maintained into the new year; in the four months from October to January, after seasonal adjustment, they were 10% higher, on average, than in the previous six months. The trend of imports appears to be downwards: in the same four months – which include the very low arrivals in anticipation of the removal of the import surcharge, and the subsequent rise – they were 2% lower, on average, than during the previous six months. There are thus promising signs of progress towards the achievement of an external surplus in 1967. Sterling has strengthened, and the authorities have been able to acquire a very substantial amount of foreign exchange – nearly all of which has been used to repay earlier short-term borrowings. On 26th January, Bank rate was reduced from 7% to 6½%. The modest reduction indicated the authorities' concern that there should be no general reflation until the external position was more secure. Credit policy remained unchanged.

This Commentary is mainly concerned with the three months November to January. During these months interest rates overseas fell quite sharply. Early in January, the West German discount rate was reduced from 5% to 4½%. Meanwhile, monetary policy had been relaxed in the United States, beginning as early as November; and American banks were no longer such eager bidders for euro-dollars. By early-January rates in the euro-dollar market had fallen substantially and – for the first time for about a year – the return on euro-dollars was less than could be obtained on loans to U.K. local authorities, after allowing for the cost of forward cover. Finally, during the week-end of 21st-22nd January the Chancellor of the Exchequer held informal discussions with Ministers of France, Italy, the United States and Western Germany about the interaction of their countries' economic and monetary policies. The Ministers agreed to co-operate, within the limits of their respective responsibilities, "in such a way as to enable interest rates in their respective countries to be lower than they otherwise would be".

Interest rates at home also fell during the three months; the July measures took effect, rates eased abroad, and a reduction in Bank rate became widely expected. The gilt-edged market, and with it the market for other fixed interest securities, became very firm and active; and from the end of December demand for gilt-edged stocks was heavy. The authorities were concerned that yields should not decline too fast, and net official sales of stock were very large.

Some lessening of pressures in the domestic economy, noted immediately below, had led in December to a move to stimulate industrial investment: the Government announced an increase in investment grants for expenditure incurred in 1967 and 1968. A month earlier, the Bank of England had reminded borrowers that bank finance should be readily available for the priority categories, including the finance of exports and productive investment by manufacturing industry and agriculture.[1] Towards the end of 1966 there was no reason, on domestic grounds alone, why Bank rate should not be reduced from the crisis level at which it had stood since

1 December 1966 *Bulletin*, page 314.



Hourly wage rates have remained virtually unchanged since July: average weekly earnings fell between June and November, because of reduced overtime and increased short-time working, and fell again sharply, mainly for seasonal reasons, in December.

* All workers, in all industries and services.

July; and in January this was made possible by the easing of interest rates overseas.

Domestic economy

Since the late summer the pressure of demand has fallen substantially; but the rate of decline has eased in recent months, and by now may well be levelling out. After allowing for seasonal movements, the number of wholly unemployed rose a little further between November and February, to 1·9% of the total labour force; but the rate of increase in these three months was very much slower than in the previous three. The number of adult vacancies notified to the labour exchanges, which had fallen by nearly 55,000, or about 20%, between August and November, fell only slightly between November and February. The seasonally adjusted index of industrial production, which up to August had changed little since the beginning of the year, dropped sharply in September, but fell less steeply in October and November. During these months, there were large falls in the output of vehicles (partly because production was affected by a strike of delivery drivers) and in textiles and steel. The latest figures, for December, show a recovery to the level in October, and suggest that by the end of 1966 production may have steadied, at a level some 2% lower than a year earlier.

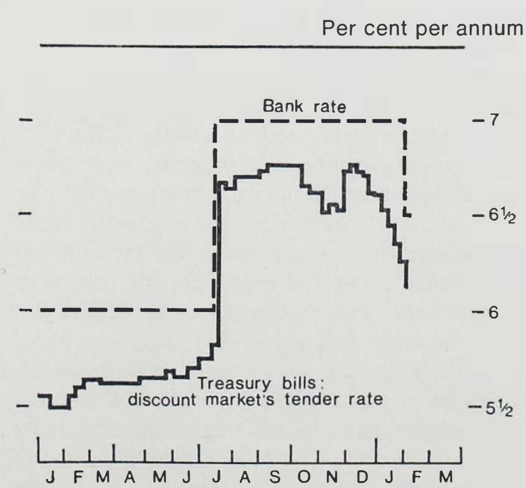
The decline in activity towards the end of 1966 would have been sharper had it not been for the buoyancy of exports and – though figures are not yet available – probably also of public expenditure, especially on fixed investment. The volume of investment by manufacturing industry had been well maintained up to the third quarter, but other types of private investment had slackened; and total private investment, in real terms and after seasonal adjustment, may have fallen a little further in the fourth quarter. The volume of consumer spending, too, may have declined slightly; and it seems likely that the rate of stockbuilding, which had been fairly substantial earlier in the year, fell sharply in the fourth quarter.

The standstill in incomes and prices, between July and December 1966, was remarkably effective. The index of hourly wage rates remained virtually unchanged after July; while average earnings fell slightly up to November, because of a reduction in overtime and increased short-time working, and more sharply, mainly for seasonal reasons, in December. Retail prices edged upwards; but the rise of $1\frac{1}{2}$% between July and December was due mainly to tax changes – the 10% surcharge on purchase tax and on the duties on alcohol and petrol imposed in July, and the introduction of the selective employment tax in September – and to seasonal factors (higher prices for coal and for some foods).

The reduction in real earnings, together with the restraint on credit, resulted in a drop in the volume of consumer spending, especially on cars and durable goods: consumption would have fallen more had there not also been a decline in personal saving. In the third quarter of 1966 the total of consumers' expenditure, after allowing for seasonal factors, was about 2% below the second quarter. The evidence so far available for the fourth quarter suggests a further small decrease. The volume of retail trade, which accounts for about half of consumer expenditure, picked up a little after October, and in the fourth quarter as a whole was much the same as in the third; but the number of new cars registered fell sharply.

Private housebuilding was particularly depressed during the last quarter of 1966: the number of new houses started was the lowest since early in 1963 – when building was held up by the very bad weather – and more houses than usual remained unsold. In private industry, the latest figures, for the third quarter, show that the volume of capital expenditure was fairly well maintained throughout 1965 and the first nine months of 1966. In the third quarter, however, there were signs of slackening in spending by the distributive and service industries; but expenditure by manufacturers, largely on plant and machinery, has remained high for almost two years. The survey of investment intentions, carried out by the Board of Trade in November and December, broadly confirmed the results of the survey made three months earlier: it suggested that capital spending by both manufacturing and distributive and service industries would fall by about 10% in 1967 but would show little further change in 1968. The survey carried out in January by the Confederation of British Industry also indicated a fall in private investment during 1967 – though it suggested that some firms were less pessimistic than they had been four months earlier. To stimulate investment expenditure, as mentioned earlier, the Government announced in December an increase in the rates of investment grants for expenditure incurred in 1967 and 1968.

Although total private investment fell slightly during the third quarter, fixed investment as a whole was sustained by a substantial rise in public spending; and this pattern almost certainly continued in the fourth quarter. Housebuilding on public account grew rapidly during the second half of 1966; housing starts and completions were both about one tenth greater than a year earlier. Other fixed investment, both by public authorities and by the nationalised industries, also grew; in the first nine months of 1966 it was nearly 5% higher, in real terms, than in the same period of the year before.



The discount market's tender rate rose sharply in November but then fell steadily, partly because the houses bid strongly for the small amounts of bills on offer and partly because the reduction in Bank rate was widely expected.

Bill rates

In the money market, the period falls into two distinct parts. In November the discount market's tender rate rose sharply, from just over $6\frac{1}{2}$% at the end of October to $6\frac{25}{32}$% – even higher than the previous peak reached in September. Thereafter it started to fall, mainly because the market expected Bank rate to be reduced, and it declined at each subsequent tender until early in February.

The rise during November occurred towards the end of that month. During October the discount houses had reduced the rate at which they tendered, in order to obtain larger allotments of the relatively few bills that were on offer; and had subsequently been forced to borrow at Bank rate, both for seven days and overnight.[1] As a result, the discount market's tender rate rose slightly on 4th November, but it fell again the following week. As it then appeared to be falling further than was justified with Bank rate at 7%, the houses were again forced to borrow heavily from the Bank at Bank rate, both on the day of the tender and on two occasions during the following week; some of this borrowing was overnight and some for seven days. The discount houses then raised their tender rate substantially, by $\frac{7}{32}$% to almost $6\frac{3}{4}$%; and there was a further rise, to $6\frac{25}{32}$%, on 25th November. This sharp increase gave the market ample room to reduce the rate in subsequent weeks – so helping, in particular, those houses which balance their annual accounts at the end of the year to enlarge their Treasury bill portfolios – without widening the margin between bill rate and Bank rate too far.

By the middle of December, the discount market's tender rate had fallen almost to $6\frac{5}{8}$%; and thereafter it was reduced further. The

1 December 1966 *Bulletin*, page 315.

U.S. Treasury bill rate was then falling, and early in January the West German discount rate was reduced by $\frac{1}{2}$%. These moves strengthened hopes of an early reduction in Bank rate. Moreover, the amounts of bills offered at the tenders were small (indeed by mid-January they were the lowest for over twenty years), partly for seasonal reasons but mainly because, as noted below, the authorities were selling very large amounts of gilt-edged stock. The discount houses, not wishing to be outbid at the tenders, reduced the rate during January quite sharply – despite the enforcement of further borrowing at Bank rate, both overnight and for seven days. By 20th January the discount market's tender rate had dropped to just over $6\frac{1}{4}$%; at the last tender in January, after the reduction in Bank rate, it fell to $6\frac{1}{8}$%.

The average cost of the market's borrowed funds, which was estimated to be about $6\frac{7}{16}$% at the end of October, had increased to almost $6\frac{1}{2}$% by early January, because of the heavy borrowing at Bank rate and the continued tightness of money generally. At this point the houses were running at a loss the Treasury bills which they were currently obtaining at the tenders – and would continue to do so until their money costs came down. At the end of January, after Bank rate had been lowered, the average cost of money was estimated to have fallen to about $6\frac{1}{16}$%.

After the increase in the Treasury bill rate on 18th November, the discount houses' buying rate for three months' prime bank bills rose to $6\frac{15}{16}$%. It did not then fall as fast as the Treasury bill rate because the houses, aware that the 105% limit applied to commercial bills as well as to bank advances, did not wish to encourage bill finance unduly. At the end of January the rate was again $\frac{1}{16}$% below Bank rate, at $6\frac{7}{16}$%.

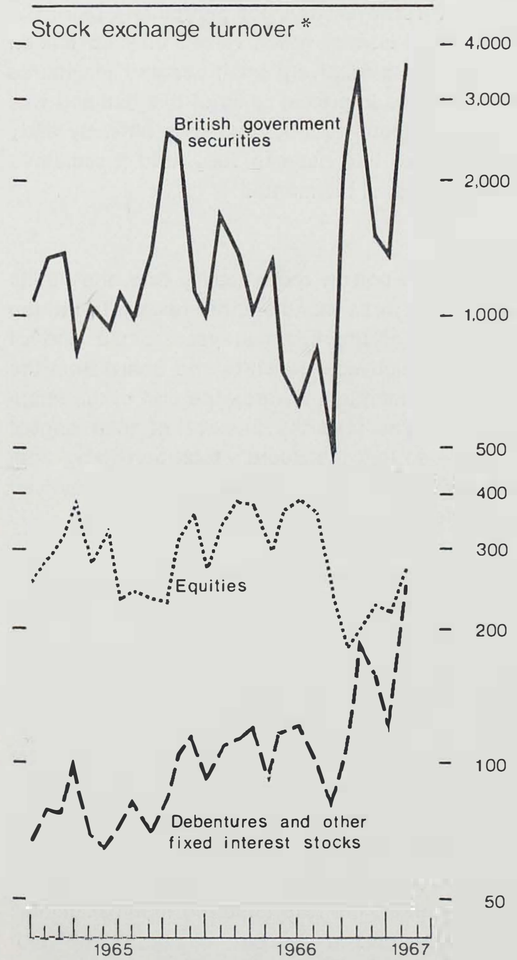
Gilt-edged

Yields on gilt-edged stocks had started to fall in September from the peak that they had reached around the end of August. This movement continued, though more gradually, in the three months from November to January.

During November itself yields were very little changed. The market was much quieter than in October, and suffered three sharp, though temporary, set-backs. The first came early in the month, after the authorities had forced the discount market to borrow at Bank rate, and the second followed the marked rise in the Treasury bill rate on 18th November, noted above: on each occasion, prices of short-dated stocks fell sharply, and the weakness spread to the longer maturities. After a brief recovery, the mood was again depressed by concern over Rhodesia. At all three times, however, the market quickly revived. In the middle of November it became clear that demand for medium-dated stocks had been temporarily satisfied by the new corporation and other issues which had recently been made; but here too prices picked up again when it was realised that the authorities had no medium-dated government maturities to sell.

The market weakened again early in December after the breakdown of the negotiations on Rhodesia; but it quickly steadied after the authorities had shown their willingness to buy stock at market prices. The good trade figures for November brought some encouragement, and in the second half of December the market was noticeably more active. It became even firmer after the turn of the year, as expectation of a decrease in Bank rate became more widespread. There was not only a very substantial investment and specu-

Logarithmic scale £ millions



Turnover in gilt-edged and in other fixed interest securities fell back in November and December from the very high levels in October; but in January it reached new peaks, as expectation of a decrease in Bank rate became widespread. Turnover in equities remained modest.

* Value of purchases plus sales on the London stock exchange.

lative demand for the long-dated tap stock, $6\frac{3}{4}$% Treasury Loan 1995/98, but also considerable activity in other maturities; the authorities sold a substantial amount of the short-dated tap stock, $6\frac{3}{4}$% Exchequer Loan 1971. In the four weeks before Bank rate was reduced, the authorities' net sales of stock were on a larger scale than ever before. The reduction in Bank rate had been very largely discounted in advance; and at the end of January demand for gilt-edged stocks, especially longer-dated maturities, continued to be very strong, as investors acted on their belief that the current high yields would not be obtainable much longer. The market remained very firm and exceptionally active.

On 30th January two new issues of government stock were announced: £400 million of $6\frac{1}{4}$% Exchequer Loan 1972, at $98\frac{1}{2}$, and £500 million of $6\frac{1}{2}$% Funding Loan 1985/87, at $98\frac{3}{4}$. The shorter-dated stock offered a yield to maturity of £6:11:7% and the longer-dated, to 1987, a yield of £6:12:3%. In addition to the amounts offered for cash, holders of $2\frac{1}{2}$% Savings Bonds 1964/67 – a stock due for redemption in May – were invited to convert into either or both of the new stocks. The offer of conversion into $6\frac{1}{4}$% Exchequer Loan 1972 was accepted by official and private holders in respect of about £510 million of $2\frac{1}{2}$% Savings Bonds 1964/67; there is therefore some £910 million of the 1972 stock outstanding, including official holdings. Official and other holders of a further £60 million or so of $2\frac{1}{2}$% Savings Bonds accepted the conversion offer into the 1985/87 stock, making a total of some £560 million of this stock outstanding. There remains about £180 million of $2\frac{1}{2}$% Savings Bonds, some of which is already in official hands, to be redeemed on 1st May; and the authorities were provided with new tap stocks to replace $6\frac{3}{4}$% Treasury Loan 1995/98, official holdings of which ran out at the end of January, and $6\frac{3}{4}$% Exchequer Loan 1971, when official supplies of that were exhausted.

Turnover in the gilt-edged market fell sharply in November and December (Table 16 of the statistical annex). It picked up over the turn of the year, and in January it slightly exceeded the previous peak reached in October,[1] when the market had also been very active.

Debentures and equities

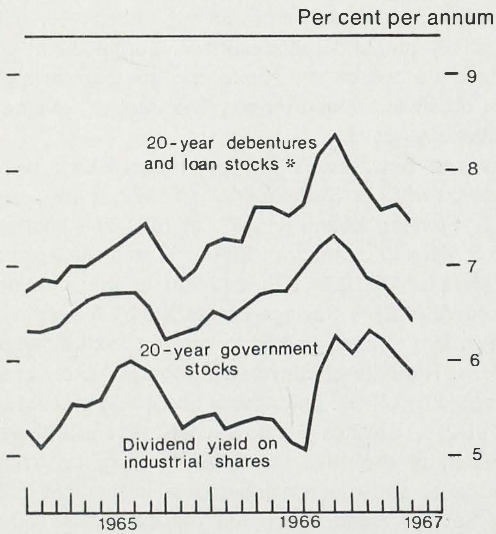
The market in company fixed interest securities, like the gilt-edged market, had begun to recover in September, and had become very active in October. During the following three months, yields continued to fall on balance; turnover lessened markedly until after the turn of the year, but then revived.

The yield on 20-year debentures and company loan stocks, according to the F.T.-Actuaries index,[2] fell from $7\frac{3}{4}$% at the end of October to just over $7\frac{1}{2}$% a month later; and the margin shown by the index over yields on gilt-edged stocks of comparable term narrowed to $\frac{3}{4}$%. This gap then started to widen again, for gilt-edged yields fell during December while those on company securities rose a little, and by the end of the year it was a full 1%. In January, however, demand for company fixed interest stocks increased. The yield fell to $7\frac{7}{16}$% by the end of January, but the margin over gilt-edged stocks remained at about 1%.

Fewer new fixed interest issues were announced by companies during the period; some deferred or cancelled their borrowing, and

1 Statistics of turnover are available only since late in 1964.

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 issued more recently.



During November to January, yields on gilt-edged and other fixed interest stocks fell further from the peaks that they had reached in the late summer. The dividend yield on equities also fell, as prices recovered a little.

* F.T.-Actuaries series, see footnote 2 on the previous page.

the queue of forthcoming issues, which is regulated by the Bank, dwindled appreciably. The net amount of cash raised during the three months, however, was still large, £131 million, compared with £147 million in the previous three months. Turnover dropped quite sharply in November and again in December – when it was little above the low figure for August – but revived strongly in January.

The equity market remained weak early in November, and on 8th November the F.T.-Actuaries industrial share price index fell to 93¼, the lowest point for four years. The market recovered a little on the publication of good trade figures for October and on the announcement of the Government's intention to seek entry into the European Economic Community, and continued fairly firm, with prices rising slowly, into the new year. Turnover was not particularly high, but the continued dearth of new issues, which raised only £6 million during the period, meant that a relatively small demand for shares was enough to cause some rise in prices; some of this demand was associated with speculation about possible take-over bids. By early in January the index of prices had risen to 102½, and it remained around this level during the rest of the month.

Local authorities

Local authorities continued to borrow quite heavily from the Public Works Loan Board during the three months under review. In the ten months from the beginning of the financial year to the end of January as much as £333 million was drawn by the Board from the Exchequer. Drawings usually increase towards the end of the financial year – as local authorities take the balance of their annual quotas from the P.W.L.B. – so that the Board's total borrowing from the Exchequer during 1966/67 as a whole seems likely to exceed considerably the estimate in last year's Budget, of about £400 million.[1]

Local authorities' borrowing from the P.W.L.B. in the three months to the end of January was not associated with any great increase in their need for finance. Indeed, income from ratepayers was seasonally high, and although local authorities' capital spending may have continued to rise (in the first half of the current financial year it was 9% higher than a year earlier) their lending for house purchase was still restrained. The need to raise money from the market, therefore, was not very acute. It was met to a considerable extent by issues of stock and short-term bonds; some funds were probably provided through mortgages; and there may well have been a net repayment of temporary money.

In the temporary loan market, the rate for three months' money, which was 7¼%-7⅜% at the end of October, changed little until after the turn of the year, but by mid-January it had fallen back to 6⅞% – the lowest point since Bank rate was increased last July. The local authorities, expecting a reduction in Bank rate, preferred to borrow for much shorter periods than three months – and offered as much as 7% or more for money at seven days' notice. After Bank rate had been reduced, the three months' rate fell to 6½%.

New borrowing on mortgages was quite substantial during the period, particularly in January. Rates dropped slightly up to the turn of the year, in sympathy with the better tone in the gilt-edged market; by the end of January they had fallen to 6¾%-7⅛%, some ¾% lower than three months earlier.

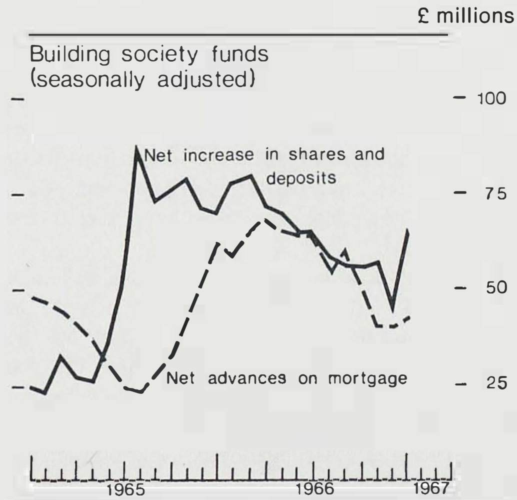
1 See the article "Local authorities and the capital and money markets" in the December 1966 *Bulletin*.

In the middle of November the very small quantity of local authority bills in existence was augmented by an issue by tender, of £25 million of 91-day bills, for the Greater London Council.[1] The average rate of discount was just over $6\frac{5}{8}$%, $\frac{3}{32}$% more than the Treasury bill rate at the previous tender but about $\frac{1}{2}$% lower than the rate offered for three months' temporary money.

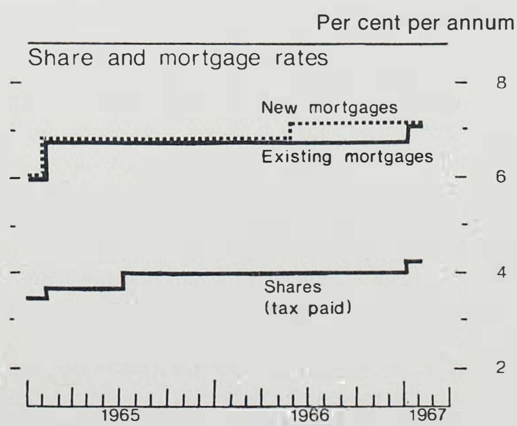
Hire purchase finance companies

The total of outstanding hire purchase debt owed to finance houses started to fall in August, after terms control had been tightened in July;[2] it declined further in each subsequent month up to the turn of the year, by £115 million in all. At the end of December total lending by the finance houses was well below 105% of the level at March 1965.

Because their business was contracting, the houses had little need to bid for funds during November to January – except, to a minor extent, to meet the usual shortage over the end of the year. The spread of rates for three months' deposits quoted by the main houses, which was $7\frac{1}{4}$%-$7\frac{3}{4}$% at the end of October, rose a little by mid-December but had fallen back to $7\frac{1}{4}$%-$7\frac{1}{2}$% by the end of the year. By the end of January, in common with the rate for local authority temporary money, it had declined further, to 6%-$6\frac{3}{4}$%.



The inflow of funds to building societies declined in November, but in December it revived strongly after the societies had announced that their rates on shares and deposits would be increased from 1st January. Net advances on mortgage dropped sharply between August and October and were still low at the end of the year.



Building societies

The net inflow of funds to building societies, after seasonal adjustment, had started to fall off in the early months of 1966 and continued to slacken appreciably during the summer, when other interest rates were generally rising; at the same time net advances on mortgage remained very large. In November the inflow of funds declined sharply, to the lowest figure for eighteen months; and on 9th December the Building Societies Association recommended that rates paid to shareholders and depositors should be raised by $\frac{1}{4}$% from 1st January 1967 – to $4\frac{1}{4}$% on shares and 4% on deposits, both tax paid. They also recommended that the mortgage rate charged to existing borrowers should be increased at the same time, from $6\frac{3}{4}$% to $7\frac{1}{8}$%.[3] This increase had been recommended earlier, but had not been implemented while the Prices and Incomes Board were investigating the financial position of the societies. The Board's report, in November, had suggested that mortgage rates should be raised only if it became necessary for the societies to increase the rates for shares and deposits. In December, in anticipation of the increase in rates, the net inflow of funds to the societies jumped sharply (see the chart).

London clearing banks

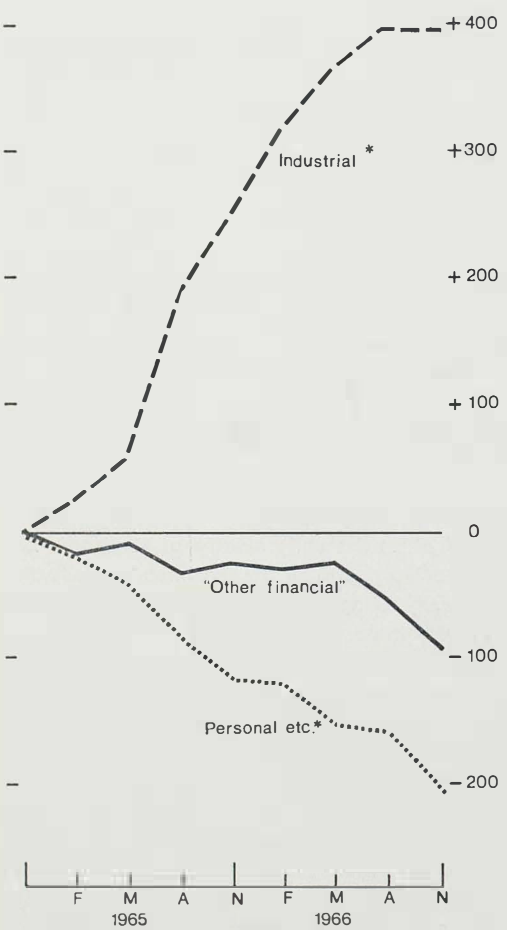
During the three months from mid-October to mid-January, advances by the London clearing banks continued to fall – but much more slowly than in the preceding three months.

In the summer of 1966, the banks' lending had been very close to the limit, of 105% of the level at March 1965, which they had been asked to observe. Yet the first payments of selective employment tax were to be made in the autumn; and companies would then also be due to pay to the Exchequer the tax that they had deducted between April and August from dividend and interest payments. These developments could be expected to increase com-

1 See the article "Local authorities and the capital and money markets" in the December 1966 *Bulletin*.
2 September 1966 *Bulletin*, page 213.
3 The rate for new borrowers had been $7\frac{1}{8}$% since May 1966.

£ millions

B.B.A. analysis of advances (seasonally adjusted); cumulative changes since November 1964



In the two years to November 1966, advances to industry have risen strongly and those to less essential borrowers have been markedly restrained. More recently, however, advances to persons and hire purchase finance companies, and to other financial borrowers, have fallen more steeply – while lending to industry has levelled out.

* "Industrial" comprises the following categories in Table 13 of the annex: food, drink and tobacco; chemicals; iron and steel and allied trades; non-ferrous metals; engineering etc.; cotton; wool; other textiles; leather and rubber; and unclassifiable industry and trade. "Personal etc." includes hire purchase finance companies.

panies' demand for bank finance, and if the banks were to keep within the overall limit on their advances it seemed necessary for them to secure a very sharp reduction in their less essential lending.

The banks' efforts coincided, however, with a slackening in the demand for advances, as business opinion about the future level of activity became less optimistic after the measures taken in July; and during the late summer advances fell substantially. The quarterly analysis by members of the British Bankers' Association shows that the reduction was concentrated in the less essential categories. After seasonal adjustment, lending to personal and professional and financial borrowers and to retailers fell very sharply indeed between August and November. On the other hand, advances to industry were little changed (see the chart): it seems that although payments of tax to the Exchequer were larger than usual they were on a smaller scale than had earlier been expected, and a decline in the rate of stockbuilding, too, may have eased the liquidity of some companies.

The success of the banks' drive to reduce their less essential advances gave them ample leeway, within the 105% limit, to accommodate priority borrowers – who were reminded by the Bank's press statement of 1st November, mentioned earlier, that the banks should have sufficient resources available, in the following few months, to meet all their demands for advances which satisfied normal banking criteria. There has therefore been less need for the banks to press for a further reduction in their non-priority lending – though new credit for borrowers in these categories has remained tight. Thus the decline in advances has slowed down; those by the clearing banks, to customers other than the nationalised industries, fell between mid-October and mid-January by only about £55 million more than might have been expected for seasonal reasons, compared with a decrease of some £165 million, after seasonal adjustment, during the previous three months.

Net deposits, after seasonal adjustment, also declined between October and January, by about £40 million in all, reflecting the downward trend of advances. The Exchequer's domestic borrowing requirement was larger than usual during the three months: receipts from the new taxes were offset by increased lending from the Consolidated Fund to the nationalised industries and, through the P.W.L.B., to local authorities, and "external transactions"[1] required a substantial amount of finance, because of an inflow of foreign exchange. There were sizable withdrawals from national savings. On the other hand, however, there were the heavy official sales of gilt-edged stock to the general public, noted earlier.

The latest figures for the clearing banks show that, in the month to mid-February, advances to borrowers other than the nationalised industries were little changed, after allowing for seasonal factors. However, the seasonal adjustment cannot take full account of the changed pattern of taxation this year – including the substantial refund to companies of selective employment tax – so the underlying trend of advances in February may have been rather more buoyant than the figures suggest.

Foreign exchange market

The improvement in sentiment during September and October, described in the December *Bulletin*, continued in the first few days of November. There was a strong demand for sterling, and the authorities were able to acquire a substantial amount of exchange for the

1 As defined in Table 1 of the annex.

reserves. In the second week of November, however, the market quietened. There was some expectation of a reduction in Bank rate and the demand for spot sterling fell away; instead, sterling was borrowed against foreign exchange by means of short-dated swaps. This borrowing soon ceased when it became apparent that there was little prospect of an early change in Bank rate. The Prime Minister's announcement of a fresh approach to the E.E.C. was well received in the exchange market, but it also revived some false expectations that entry into the Common Market might eventually entail devaluation of the pound. In this uncertain atmosphere the announcement of good overseas trade figures for October made little impact.

The market remained quiet until almost the end of November, when the pound came under pressure from the seasonal repatriation of funds by overseas residents in preparation for end-year window dressing. As in 1965, much of the strain on sterling which might have been caused by these operations was eased by the co-operation of other central banks – which took action to channel the dollars which were withdrawn back into the London market. Even so, the U.K. authorities had to give some support to the pound towards the end of November.

At the beginning of December the Rhodesian situation again became a dominant factor and after the rejection of the proposed settlement there were some sales of sterling. The authorities intervened to prevent rates falling too far; the market quickly improved and the exchange which the authorities had used in support was soon recouped. Sterling then became quite firm, helped by the announcement of the overseas trade figures for November, and although the rate eased later in December – mainly because dollars were flowing out to Western Germany for window dressing purposes – demand for sterling revived appreciably at the end of the month. The spot rate for U.S. dollars, which had remained above \$2·79 almost throughout November, fluctuated between about \$2·78$\frac{7}{8}$ and \$2·79$\frac{1}{8}$ during most of December.

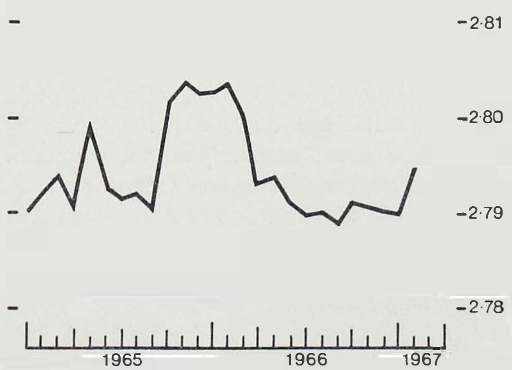
At the end of the year, overseas residents were again borrowing sterling by means of swap transactions; and these swaps continued to be a feature of the market during January. Some overseas residents had taken up short positions in sterling at the end of December and early in January, covering themselves by borrowing sterling from day to day. This had proved expensive, yet they were reluctant to buy sterling outright until confidence in the pound was stronger – so they now covered their positions by means of three or six months' swaps against foreign exchange. Some further swaps arose from the pattern of relative interest rates. Rates abroad had fallen faster than those in London; but Bank rate was expected to be reduced, so there was an incentive to invest short-term funds in London while existing rates were still available. The increased attractiveness of short-term investment in the United Kingdom, after allowing for the cost of forward cover, is shown in the chart on page 12.

Demand for sterling continued during January, and strengthened after the reduction in Bank rate. The authorities were able to acquire very large amounts of foreign exchange, while the spot rate for U.S. dollars rose rapidly to reach almost \$2·79$\frac{1}{2}$ at the end of the month, the highest since last May.

The forward market was generally firm during the period, although some support was given when sterling came under pressure at the end of November and again after the breakdown of the Rhodesian negotiations.

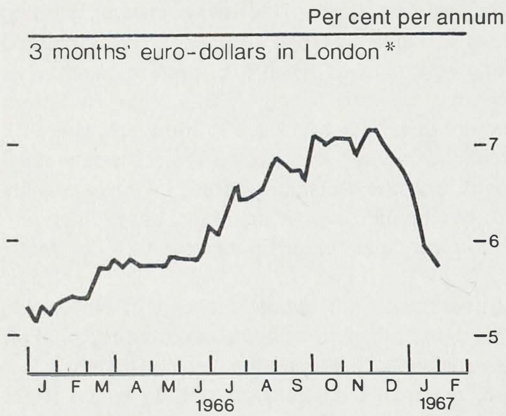
\$ to £

Middle closing rate for spot U.S. dollars in London *

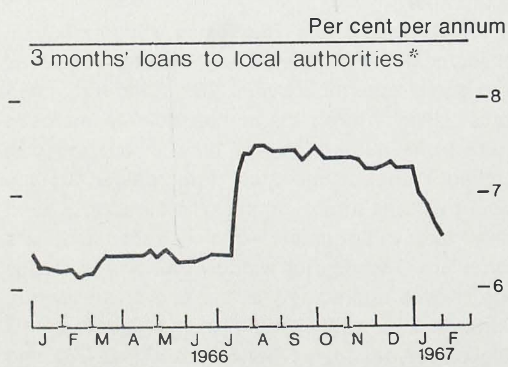


The spot rate for U.S. dollars, which had fluctuated around \$2·79 during most of December, rose sharply in January – to reach almost \$2·79$\frac{1}{2}$ by the end of the month.

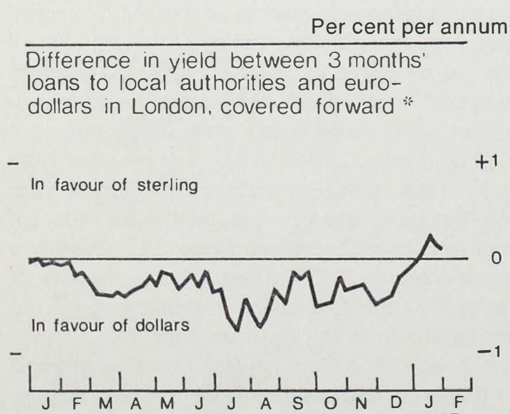
* Monthly, last working day.



The rate for euro-dollars continued to rise until early in December, but then declined sharply;



the rate for three months' temporary money fell more slowly;



and in January, for the first time for about a year, a small margin emerged in favour of covered investment in local authority temporary money.

* Weekly figures.

The reserves rose in October and November, by £43 million in all, but fell by £65 million in December – when £69 million was paid in respect of principal and interest on the North American loans. In each of these three months there was some net repayment of short-term borrowings made earlier under facilities with the U.S. authorities and with central banks of other countries: but for these repayments the reserves, instead of falling by £22 million during the fourth quarter of 1966, would have increased. Further substantial repayments were made in January and February 1967, when the reserves rose by £11 million and £14 million respectively.

It has been noted that, during November to January, short-term investment in the United Kingdom became increasingly attractive. The covered differential between the U.K. and the U.S. Treasury bill rates was consistently in favour of the United Kingdom – at times by over 1% per annum. A more relevant comparison, however, for movements of interest-sensitive funds is that between euro-dollar and local authority rates. Rates for euro-dollar deposits tended to increase until early in December because of the withdrawal of funds for window dressing purposes; by then the rate for a three months' deposit, at above 7$\frac{1}{8}$%, was exceptionally high. Rates for local authority temporary money declined slightly; and the advantage of three months' euro-dollar deposits over loans to local authorities, covered forward, rose from about $\frac{1}{4}$% per annum at the end of October to $\frac{1}{2}$% a month later. Subsequently, however, euro-dollar rates fell sharply. The co-operative action by other central banks, mentioned above, which made dollars available for redeposit in the euro-dollar market, helped to alleviate the shortage – as did an easing of money conditions in New York. By mid-January the three months' euro-dollar rate had fallen well below 6%. Rates paid by local authorities fell more slowly, and early in 1967 the margin in favour of euro-dollars disappeared for the first time for about a year; in fact by mid-January there was an advantage of a little over $\frac{1}{4}$%, after allowing for the cost of forward cover, in favour of loans to local authorities. By the end of January a decline in local authority rates had reduced this advantage to about $\frac{1}{16}$%.

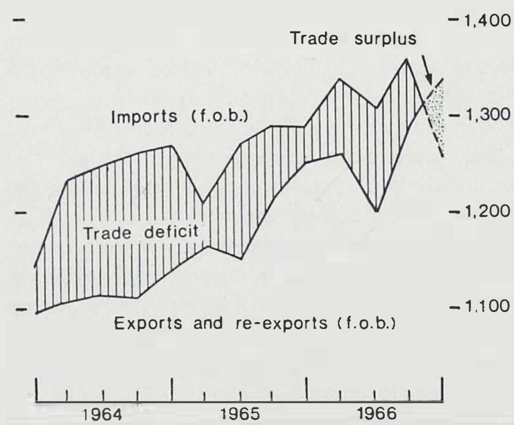
Gold market: gold pool

The gold market was quiet at the beginning of November, but as the month progressed demand for gold increased and on some days was quite strong. Demand was stimulated in December by uncertainty over the possible extension of economic sanctions to South Africa, by political troubles in the Middle East and by the usual end-year influences; and although it fell away early in the new year, it revived after renewed French talk of an increase in the gold price. Producers' sales were heavy throughout the three months but were often insufficient to meet the demand, particularly in December and January. The dollar equivalent of the daily fixing price rose from about $35·15 at the beginning of November to $35·19$\frac{3}{4}$ just before Christmas; it fell back to $35·16$\frac{7}{8}$ early in January but rose again to reach $35·19$\frac{5}{8}$ towards the end of the month.

The central bank gold pool, which was described in some detail in the March 1964 *Bulletin*, continued to operate during 1966. Demand for gold was erratic during the first half of the year but became heavy from July onwards under the influence of the exchange crisis in the United Kingdom, continuing French criticism of the gold exchange standard, the war in Viet-nam, and the possibility that South Africa might become involved in the Rhodesian dispute. Nevertheless, demand for gold was much lower in 1966 as

Seasonally adjusted: latest quarter provisional

£ millions



The strong growth in exports during the fourth quarter of 1966, and a marked drop in imports, resulted in a substantial trade surplus.

a whole than in 1965. The supply of gold was also less, partly because of the absence of sales on Russian account and partly because sales by South Africa were very low early in the year – though they picked up later.

Balance of payments

Although full details are not yet available, it is clear that the balance of payments improved considerably in the fourth quarter of 1966. A substantial surplus on current account, due mainly to the improvement in visible trade, is likely to have been more than large enough to cover the deficit on long-term capital account.

The balance of visible trade, after seasonal adjustment, swung sharply from a deficit of £73 million in the third quarter to a surplus of about £85 million in the fourth; there was a marked increase in exports, while imports fell. Seasonal factors will have led to a much larger swing in the unadjusted figures.

Before seasonal adjustment, and as recorded in the trade accounts, exports totalled about £1,425 million (f.o.b.), some £180 million more than in the third quarter. After seasonal adjustment the increase over the third quarter was about £55 million, or over 4%; but the underlying growth was certainly greater than this, because the after-effects of the seamen's strike inflated exports in the third quarter much more than in the fourth. In 1966 as a whole, exports increased by nearly 7%, much the same as in 1965. Roughly half of the increase was due to rising prices; but in a year in which some loss of exports must have resulted from the Rhodesian situation and from the seamen's strike, an increase in volume of just over 3% was no mean achievement. Exports to the sterling area fell but those to most non-sterling markets, particularly North America, did well. By commodity, over a third of the rise was in exports of machinery, which increased by nearly 10%; deliveries of ships, aircraft and diamonds also increased markedly.

Imports fell by over £80 million (to £1,416 million c.i.f.) during the fourth quarter; after seasonal adjustment the fall was even greater. The sharp drop was attributable mainly to anticipation of the removal of the import surcharge at the end of November; not all the goods that were held back in earlier months arrived in December. In part, however, it reflected the measures taken in July: arrivals of basic materials, for example – which were largely unaffected by the import surcharge – fell, after seasonal adjustment, in each of the last four months of the year. In the year 1966 imports were 3½% higher than in 1965. The trend was distorted by the effects of the seamen's strike and its aftermath, and later by the impending removal of the surcharge; but it seems that after rising sharply at the beginning of the year, imports levelled out during the summer and in the last few months of the year turned downward.

The out-turn on invisible account in the fourth quarter of 1966 is likely, for seasonal reasons alone, to have been better than in the third; a reduction in expenditure on travel should have outweighed the interest payments, in December, on the U.S. and Canadian government loans. The long-term capital account, however, is likely to have been worse than in the third quarter – if only because of the end-year repayments of capital on the North American loans and the payment in November of a further annual instalment (£12 million) of the United Kingdom's supplementary contribution to the International Development Association.

Monetary movements, so far as they are yet known, were favourable by about £80 million. The sterling holdings of sterling area countries, whose imports were rising strongly in the closing months of the year, fell by £91 million in the fourth quarter; and there were reductions, totalling £55 million, in the banks' net external liabilities in foreign currencies and in overseas sterling area currencies. On the other hand, the reserves fell by £22 million, as already mentioned, after repayments of some earlier drawings on central bank facilities. Despite these repayments, official sterling holdings of countries outside the sterling area increased slightly during the quarter and non-official holdings rose from the very low level that they had reached in September; in all, net external liabilities in sterling to these countries increased by £33 million. Sterling holdings of international organisations also rose, by £12 million, reflecting the payment to the I.D.A. noted above.

Conclusion

The improvement in overseas trade during the last few months, some growth in new export orders obtained by the engineering industry, and a reasonably favourable outlook in overseas markets all help to reinforce the expectation that, in 1967 as a whole, the balance of payments will move into surplus.

Growing confidence in the country's ability to correct the external balance has contributed to the recent strengthening of sterling; and the authorities have already been able to repay a very substantial part of last summer's short-term borrowings from the U.S. authorities and from the central banks of other countries. There remains, however, some $900 million to be repaid to the International Monetary Fund and to Switzerland by the end of this year; and a further $1,440 million of similar borrowing is due to be repaid by 1970. A sizable external surplus needs to be achieved in 1967, and to be maintained for some time to come.

Much of the improvement in overseas trade has been attributable to the easier supply position at home. Capacity has become available to meet overseas orders; some weakness in domestic markets has increased the incentive for many firms to seek and to cultivate markets abroad; and export prices have been held steady. At the same time, the drop in stockbuilding, partly no doubt in anticipation of the removal of the import surcharge, has helped to moderate the growth of imports – though this advantage is only temporary. A return to the excessive level of home demand that existed before last July would cause imports to rise and would reduce the incentive to export; and would thus undermine the benefits that have been gained.

This year is already likely to see a renewal of growth. Consumer spending seems to have ceased falling; and the coming into effect of a number of wage settlements, deferred until after June, must be expected to encourage an increase later in the year. A fall in investment by private industry is likely to be offset by higher public spending; private housebuilding, after a bad year, may pick up again; and exports are likely to increase further.

Thus the problem in 1967 is unlikely to be a shortage of demand, but rather that of ensuring that the encouraging developments of 1966 – the check to costs and prices, and the attainment of a healthier balance in the economy – are not reversed. It will be essential that prices and incomes do not rush ahead again, after the end of the present period of severe restraint. Similarly, if the manifest advantages to the balance of payments of a slightly easier supply position are to be maintained, it will be necessary to prevent any over-expansion of demand during the course of the year.

This does not, of course, preclude some growth in total expenditure – but it must be matched by an improvement in capacity.

The fundamental way out of our difficulties lies not in the illusory and self-defeating gains of increasing the pressure on the country's capacity to produce but in improving that capacity – and in particular improving the capacity to produce and sell those goods which will help the balance of trade. In the short term, this will be achieved only through greater efficiency in utilising the country's present resources. In the longer term, modernisation of industry, directed both towards greater efficiency and towards the expansion of capacity, is also essential; and the most favourable climate for this is one in which steady growth in the economy seems likely – rather than over-expansion and consequent periods of restraint.

To avoid over-expansion, total demand must be controlled. Equally important, however, is the need to strike the right balance within total demand – to allow room for the revival and growth of productive investment and for the seizing of export opportunities. In achieving these aims, fiscal policy and incomes policy must play their full part. For monetary policy cannot affect the growth of public expenditure, nor by itself can it adequately restrain the growth of consumer spending. Yet if consumer spending and public expenditure are allowed to take too large a share of the resources available, exports and, in the long run, productive investment in the private sector will suffer – and on these activities the future largely depends.