Commentary

During the three months from February to April, covered by this Commentary, sterling strengthened appreciably. There was a substantial inflow of foreign exchange: the balance of payments was probably in surplus during these months; leads and lags were being reversed as confidence in sterling recovered; private overseas sterling balances – which had fallen to a very low level last autumn – were being rebuilt; and the banks were switching a moderate amount of foreign currency deposits into sterling. The reserves rose in each month; a very large amount of short-term borrowing from other central banks was repaid; and there was a considerable reduction in the Exchange Equalisation Account's forward commitments to the market.

Early in April, it was announced that all short-term debt to other central banks had been repaid, although some amounts were still outstanding under the arrangements of June 1966 – which were of a continuing nature – to neutralise the effects on the reserves of changes in the sterling balances; and on 25th May the United Kingdom repaid – six months ahead of time – over half of the amount still outstanding under the 1964 drawing from the International Monetary Fund, and the whole amount borrowed in 1964 from Switzerland. Early in May, the Government applied for membership of the European Economic Community.

Monthly figures of imports have been difficult to interpret: after seasonal adjustment, they fell in February and March but rose sharply in April. Taking March and April together, however, imports averaged much the same as in February and considerably less than in January – when the figure was high after the removal of the import surcharge. Exports grew strongly in the winter months, but then fell back a little.

Interest rates overseas continued to fall. The three months' euro-dollar rate declined to under 5% at the end of April, the lowest for eighteen months. Official discount rates were reduced in a number of countries, including the United States and Western Germany. In the United Kingdom, Bank rate was reduced from 6½% to 6% on 16th March, and to 5½% on 4th May. The demand for government stock during the three months was heavy, though a little less strong than it had been in January; and net official sales of stock were again large.

In the domestic economy, there were some signs that output was beginning to recover. The Chancellor of the Exchequer judged that the likely rise in the main components of demand later in the year would probably match the prospective increase in productive capacity, and in the Budget he did not take any substantial action directly to influence private demand: he indicated that should it appear in the coming months that further measures were needed, they would be taken then.

The Chancellor stressed that it was still necessary to keep the growth of credit within modest bounds. The ceiling on lending to the private sector was discontinued for the London clearing banks and the Scottish banks, but remained in force for other banks and for hire purchase finance houses until such time as suitable new arrangements could be worked out. The Bank of England subsequently issued a notice setting out the present intentions about

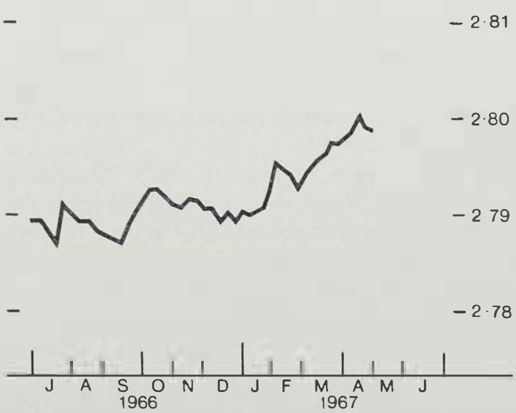
Per cent per annum

Central bank discount rates

Discount rates, both in the United Kingdom and in many overseas countries, were reduced during the early months of 1967.

$ to £

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



The spot rate for U.S. dollars rose from $\$2{\cdot}79\frac{1}{2}$ early in February to above $2·80 just after the Budget: it then declined and remained a little below parity during the rest of April.

* Weekly, Fridays.

bank advances and similar forms of credit, and the guidance that the banks and some other groups of financial institutions had received regarding the direction of their lending.

Foreign exchange market

The three months under review were good for the pound, and the marked improvement in sterling which developed around the turn of the year was well maintained. The balance of payments was probably in surplus, and leads and lags were being reversed. Moreover, there were several developments favourable to sterling, particularly during March: the announcement of satisfactory trade figures for February and of the balance of payments surplus for the last quarter of 1966; the Chancellor's reaffirmation that the 1964 drawing from the I.M.F. would be repaid in full by December 1967; and the news that all earlier drawings under swap facilities with the Federal Reserve and the U.S. Treasury had been repaid, and that the central bank facilities arranged last June had been renewed.

Two other factors were important during the three months. There were large purchases of sterling, especially during March, by foreign oil companies which had heavy tax and royalty payments to make to producing countries. And in each of the three months the market had to find large amounts of sterling as its outstanding forward purchases of foreign currency against sterling matured. Sterling purchased for this purpose does not lead to any gain to the reserves, for when forward contracts entered into for hedging purposes are closed out they are, in effect, self-liquidating.[1] But the purchases tended to strengthen the sterling rate, and this in turn helped to improve confidence.

The spot rate for U.S. dollars was $\$2{\cdot}79\frac{1}{2}$ early in February, and it fluctuated a little below this level until the middle of the month. The publication of estimates showing increased government expenditure during 1967/68 then temporarily depressed the market, and the spot rate declined to about $\$2{\cdot}79\frac{3}{16}$. Towards the end of the month sterling was again in good demand and on 1st March the rate again reached $\$2{\cdot}79\frac{1}{2}$. Throughout most of March, almost without a break, the demand for sterling continued to be strong. The E.E.A. acquired a substantial amount of exchange for the reserves, while the spot rate rose to $\$2{\cdot}79\frac{15}{16}$ just after Easter.

At the very end of the month there was some reaction to the large inflow of exchange that had taken place earlier, particularly during the previous week, and the spot rate fell back to $\$2{\cdot}79\frac{3}{4}$. Sterling strengthened again after the announcement early in April that all remaining short-term debt to overseas central banks had been repaid and on the reduction, from $4\frac{1}{2}\%$ to 4%, in the discount rates of the U.S. Federal Reserve Banks. The Budget on 11th April was well received in the market; and on the following day the spot rate rose above $2·80, for the first time since February 1966. After the middle of April, however, it fell back, and it remained a little below parity, in a rather quiet market, for the rest of the month. The forward market was firm throughout the period, and no official support was needed.

Reserves and central bank facilities

It was announced on 13th March that the arrangements entered into in June 1966[2] with nine central banks, and with the Bank for

1 December 1965 *Bulletin*, page 304.
2 September 1966 *Bulletin*, page 209.

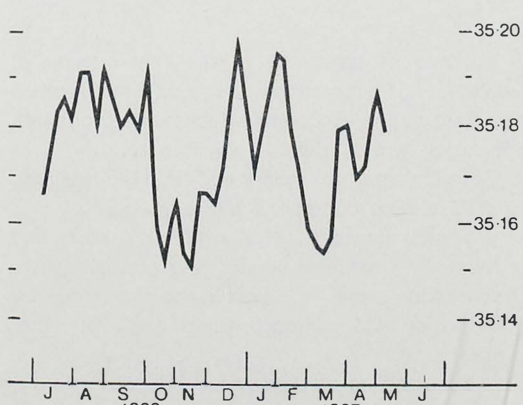
International Settlements, had been extended for a further year. These arrangements are related to fluctuations in overseas countries' sterling balances and are thus specifically designed to counter the strains to which sterling is subject as a reserve and international trading currency. The facilities arranged in September 1965 with the U.S. authorities continued in being, as did the renewable three months' credit facility with the Bank of France. It was disclosed that the total of these facilities – which are additional to the reciprocal swap arrangement with the Federal Reserve System for $1,350 million – remained at $1,000 million.

It was noted in the December 1966 *Bulletin* that at the end of September recourse to swap facilities with the Federal Reserve and the U.S. Treasury stood at £205 million, and that further borrowings were outstanding with the central banks of other countries. Net repayments began to be made in October and were very substantial during the first quarter of this year: during the six months to the end of March they totalled the equivalent of £463 million. A comparatively small amount of drawings which were linked specifically to changes in overseas countries' sterling balances remained outstanding. In the same six months, to March 1967, the E.E.A.'s oversold forward position with the market was very substantially reduced. In addition, the reserves increased by £35 million; they rose in each month except December, when the annual payment of principal and interest on the North American loans, totalling £69 million, was made.

In April, the reserves rose by £52 million. In May, when the United Kingdom repaid the equivalent of £145 million to the I.M.F. and of £28 million to Switzerland, the reserves fell by £161 million, £12 million less than the total amount repaid.

$ equivalent per fine ounce

Fixing price for gold *



Demand for gold moderated during February and the daily fixing price fell sharply. By the end of April the price had risen again – though it was still below the high level reached around the turn of the year.

* Weekly, Fridays.

Gold market

Demand for gold, which had been strong during the previous three months, moderated in February. Some gold was offered from the Continent at a time when producers' sales remained large; as a result the dollar equivalent of the daily fixing price fell steadily during the month, to close at $35·14⅞ per fine ounce, the lowest for nearly four months. Demand remained fairly modest during most of March, although it increased towards the end of the quarter; and the price rose again, to $35·18. It fell back a little early in April, but towards the middle of the month comments by American bankers on a possible change in U.S. gold policy contributed to a temporary increase in demand, which took the price up to around $35·19 again.

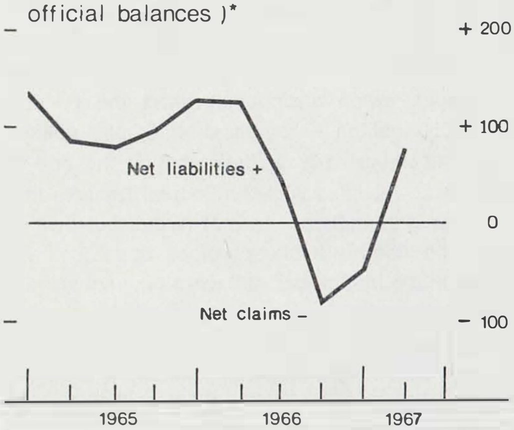
Short-term capital movements

The figures given earlier show that during the six months to the end of March 1967 the increase in the reserves, together with the repayment of borrowing from abroad, totalled nearly £500 million. Only about half of this was attributable to an increase in net external liabilities, as sterling balances were rebuilt and the banks switched foreign currency deposits into sterling. The other half reflected mainly the identified balance of payments surplus on current and long-term capital account, together with the balancing item.

The surplus on current and long-term capital account in the fourth quarter of 1966 was £121 million but, as noted below, it was substantially less than this in the first quarter of 1967. There will probably prove, therefore, to have been a large positive balanc-

£ millions

Net sterling liabilities to, or claims on, non-sterling countries (excluding official balances)*

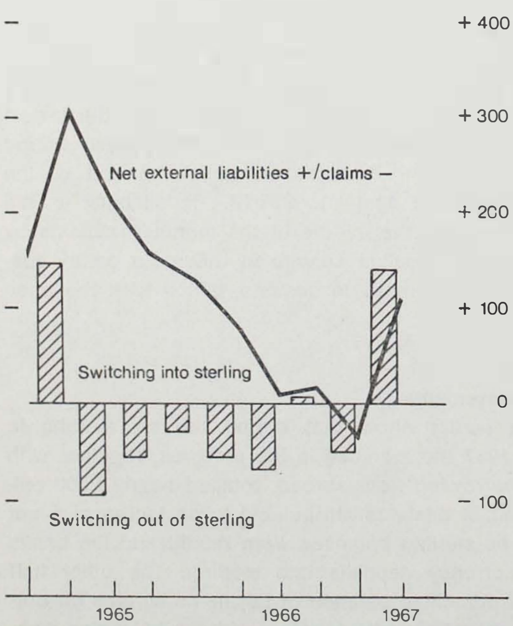


During the six months to the end of March, non-official sterling holdings rose quite sharply from the low point they had reached in September.

* Holders other than central monetary institutions; Table 21 (2) of the annex.

£ millions

U.K. banks' net external liabilities or claims in foreign currencies



In the same six months the banks' net external liabilities in foreign currencies also rose; after the turn of the year some foreign currency deposits were switched into sterling.

ing item during the six months as a whole[1] – reflecting the reversal of leads and lags on commercial payments and perhaps also some reflux of unidentified short-term funds following the revival of confidence in sterling.

Net official sterling holdings of countries outside the sterling area (Table 21 of the statistical annex), excluding the counterpart of the repayments of central bank facilities,[2] increased over the six months by £15 million; while private holdings, which had been very low at the end of September, rose substantially, and showed a net increase of £155 million. Net sterling liabilities to overseas sterling area countries, however, fell a little. The sharp drop in the fourth quarter of last year, when these countries' imports were rising strongly, was nearly reversed during the first quarter of 1967; improved exports, and some large receipts of taxes from oil companies towards the end of the quarter, contributed to this swing. There was a reduction of £24 million in net liabilities to the I.M.F., reflecting sterling drawings by other countries from the Fund, but a small rise in the sterling holdings of other international organisations.

The banks' net external liabilities in foreign currencies (Table 20 of the annex) rose by £90 million during the six months to March 1967. Throughout most of 1966 the banks were switching currency deposits, which they had previously employed in sterling, back into foreign currency: for much of the year they could obtain a better return on euro-dollars than on loans to local authorities, covered forward. In the first quarter of 1967, however, the picture became more mixed, as the demand for euro-dollars fell. During most of January and early February there was a small margin, after allowing for the cost of forward cover, in favour of loans to local authorities, while from mid-February to the end of the quarter the advantage was more often slightly the other way (see the chart on page 116). On balance, during the quarter as a whole, the banks switched foreign currency deposits into sterling – particularly during January.

Balance of payments

Full details of the balance of payments in the first quarter of 1967 are not yet available. The broad picture is of surpluses on the invisible and long-term capital accounts which, taken together, were probably slightly larger than the deficit on visible trade.

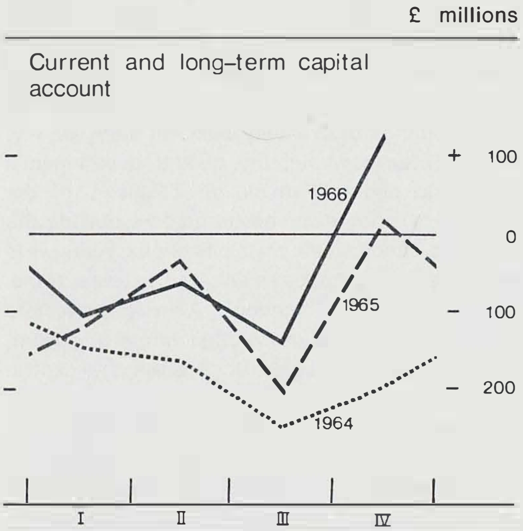
Visible trade during the first quarter, seasonally adjusted, resulted in a deficit of about £20 million, compared with a surplus of over £100 million in the previous quarter.[3] The value of exports and re-exports, as recorded in the trade accounts and after seasonal adjustment, which had already been very high in the fourth quarter of 1966, rose a little further; while imports jumped sharply after the removal of the surcharge.

The rise in exports was well spread among commodity groups, although there was a slight fall in shipments of machinery. Sales to the sterling area and to Western Europe, particularly the coun-

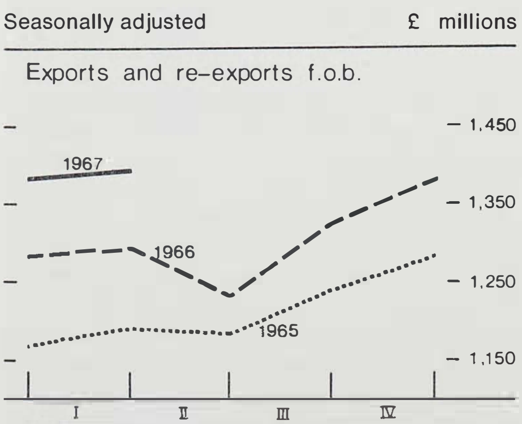
1 The balancing item in the fourth quarter of 1966 was negative to the extent of £62 million. This may have reflected a greater distortion in arrivals of goods, delayed until the surcharge had been removed, than in payments for them – together with the usual end-year influences; and might thus have been expected to be at least reversed in the first quarter of 1967.

2 Overseas sterling holdings were affected to the extent of £445 million; the balance was in the form of foreign currency deposits. See the note on the statistical treatment of aid in the March 1966 *Bulletin*, page 99.

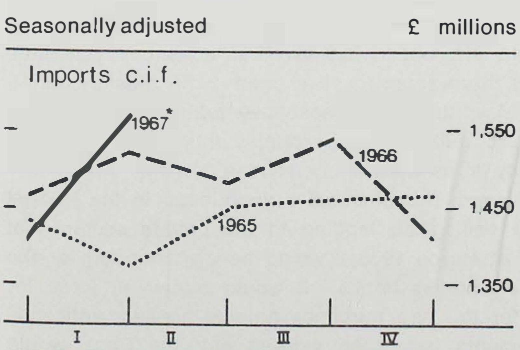
3 The figures for visible trade do not include payments in respect of U.S. military aircraft; drawings on the credit with the U.S. Export-Import Bank to finance the payments are similarly omitted when considering the long-term capital account.



The balance on current and long-term capital account improved in successive years from 1964 to 1966, and in the last quarter of 1966 showed a large surplus.



The value of exports, after seasonal adjustment, has risen steadily up to the first quarter of 1967;



imports declined sharply in the last quarter of 1966 but rose again in the first quarter of 1967, after the surcharge had been removed.

* Excludes U.S. military aircraft.

tries of the European Free Trade Association, continued to grow: exports to North America also increased further, but here the rapid growth of the last two years showed signs of slowing down.

The increase in the value of imports was largely due to the after-effects of the removal of the surcharge; there was a sharp rise in finished manufactures, some of which may have been for restocking. At the same time, imports of food, beverages and tobacco, which had been exempt from the surcharge, were high; those of basic materials – which had been largely exempt – again fell, and were about 1% lower than in the previous quarter.

In April, imports rose sharply, after seasonal adjustment. They had been low in March; and if March and April are taken together, imports averaged much the same as in February and considerably less than the very high figure in January. Exports also rose in April, though they were still below the high level at the beginning of the year: in the four months to April, on average, they were 6% higher than the average for 1966 – the rate of growth forecast by the Chancellor for the year as a whole.

On invisible account, there is likely to have been a surplus in the first quarter of 1967 which, if only for seasonal reasons, should have been greater than in the previous quarter – when interest payments had to be made on the U.S. and Canadian Government loans. The long-term capital account, too, should have improved and may well have been in surplus. The outflow on official account will have been smaller,[1] for in the previous quarter it included the instalments of principal due on the North American loans; and some big individual transactions, and the improvement in confidence, should have helped to maintain a net inflow of capital on private account.

Exchequer finance

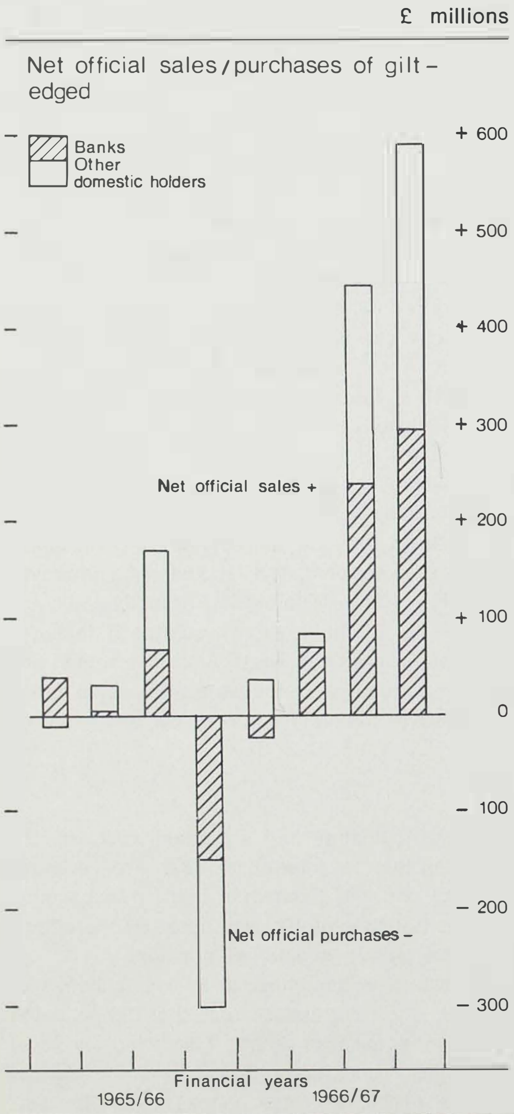
The large inflow of foreign exchange had a marked effect on the Exchequer's position during the first quarter of 1967. Tax revenues were then at their peak, and the Exchequer was in substantial surplus; but this year much of the surplus was offset by the effects of the improvement in the country's external position.

The surplus of revenue over expenditure, at £1,011 million, was slightly less than a year ago. But loans from the Consolidated Fund were large, chiefly because of heavy borrowing by local authorities from the Public Works Loan Board; and the central government's net balance (Table 1 of the annex) showed a surplus of £626 million, some £200 million less than in the same quarter a year before. External transactions took £482 million, for the reserves rose by £57 million and overseas holdings of all forms of government debt fell by £425 million, principally Treasury bills (reflecting the large repayments of central bank facilities). There was thus only £144 million – considerably less than usual in this quarter – available to repay debt to domestic holders.

Net official sales of gilt-edged stocks were very large indeed, especially in January; during the quarter they amounted to £601 million, bringing the total for the six months to the end of March to more than £1,000 million. In the first quarter of 1967, overseas holders bought £11 million, the banking sector £296 million, and other domestic holders £294 million.

Domestic holders outside the banks acquired a net total of over £200 million of government debt during the quarter; their substantial purchases of stock were partly offset by declines in

1 See footnote 3 on the previous page.



During the second half of the financial year 1966/67 net official sales of gilt-edged stock, to the banks and other domestic holders, were on an unprecedentedly large scale.

their holdings of Treasury bills and of tax reserve certificates, and by a further net withdrawal from national savings. The banking sector's holdings of government debt thus declined considerably, by £361 million; the banks and discount houses were also buying gilt-edged stocks and their holdings of Treasury bills fell very sharply.

During the year 1966/67 as a whole, the central government's borrowing requirement was about £740 million (Table 1 of the annex). Net official sales of stock to domestic holders outside the banks, concentrated in the second half of the financial year, were large enough to meet much of this requirement; and external transactions provided a small amount of finance. Although investors outside the banks reduced their holdings of other forms of government debt in total, recourse to the banks to finance the central government's deficit was quite small.

In the current year, 1967/68, the Exchequer's surplus of revenue over expenditure is expected to be smaller than last year, and loans from the Consolidated Fund, to finance the capital expenditure of the nationalised industries and of local authorities, larger Extra-Exchequer funds are expected to be in deficit and the central government's net borrowing requirement is forecast at £1,115 million, some £375 million greater than in 1966/67.[1] As noted later, the Chancellor recognised, in the Budget statement, the need to raise as much of this requirement as possible by sales of government debt, particularly gilt-edged stock, outside the banking system.

London clearing banks

Between the mid-January and mid-April make-up dates, net deposits with the London clearing banks were little changed on balance; they fell by £217 million in the two months to the middle of March, but rose by £212 million in April. They usually fall sharply in these months, which are the Exchequer's main revenue season; after seasonal adjustment, they rose by about £200 million.[2] This rise occurred mainly because, over the three months as a whole, the cost of the Exchequer's external transactions led to quite a large domestic borrowing requirement; deposits would have risen even more had it not been for the substantial official sales of gilt-edged stock outside the banking system.

The clearing banks' advances, excluding those to the nationalised industries, rose by £206 million between mid-January and mid-April. This was some £20 million less than expected for seasonal reasons: but after allowing for the uncertainty of the seasonal correction this year it seems fair to suggest that over the three months as a whole the underlying level of advances was little changed. Nor does there seem to have been much change during the month to mid-May; the small seasonally adjusted increase in advances (some £20 million) was probably little more than the margin of uncertainty in the seasonal correction.

As already mentioned, the Chancellor announced in the Budget statement that the ceiling on lending to the private sector – of 105% of the level at March 1965 – would be discontinued for the clearing banks and Scottish banks.[3] It would remain in force for other banks, and for the hire purchase finance houses, until suitable new arrangements had been worked out: the Bank would

1 *Financial Statement 1967-68.* Of the total borrowing requirement, £176 million (£124 million more than in 1966/67) is expected to be met by drawing on the aircraft credit with the U.S. Export-Import Bank.
2 The seasonal adjustment takes no account of the changed pattern of company taxation this year, and the seasonally adjusted increase in deposits is probably overstated.
3 It was also discontinued for the discount houses.

discuss with the other banks the way by which an appropriate degree of restraint in their lending could be secured. Consideration would be given to the best method of regulating the level of credit available from the finance houses.

The Bank subsequently issued a notice, setting out the guidance that the banks and some other financial institutions had received regarding the direction of their lending: the text of the notice is given on page 164. Given this guidance, and the likely developments in the economy over the coming year, credit was not expected to increase more than very moderately. However, should it become necessary to restrain the growth of credit, the Bank would call additional Special Deposits from the clearing and Scottish banks and would, if necessary, adjust these calls more frequently than in the past to keep credit conditions continuously in line with the changing needs of the economy.

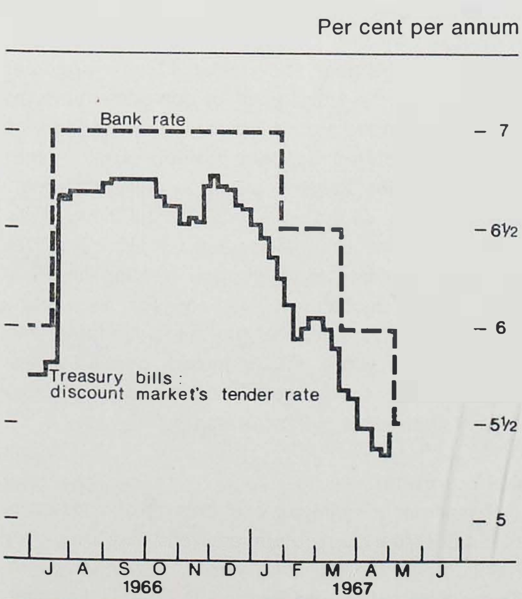
Bill rates

Money remained very short throughout most of the period. Because of the substantial decrease in Treasury bills held by the banks and discount houses, noted earlier, the Bank were at times unable to relieve fully by their purchases of bills the very large daily shortages of cash in the money market; and the discount houses needed frequently to borrow overnight from the Bank.[1] The Bank's overnight lending was mainly at rates below Bank rate; sometimes during the three months, however, it was at Bank rate and this – coupled with lending on other occasions of large amounts for seven days at Bank rate – checked the tendency for the Treasury bill rate to fall too fast.

During February the amounts of bills offered at the tenders were very low indeed, for the continuing net official sales of gilt-edged stock coincided with the peak of the main revenue season; the amounts offered during the four weeks in February totalled only £480 million, compared with £620 million a year earlier. The market was forced to borrow quite large amounts at Bank rate, for seven days, immediately before the tenders in the second and third weeks of the month; as a result the discount market's tender rate, which had fallen almost to $5\frac{15}{16}$% early in February, rose to nearly $6\frac{1}{16}$% by the end of the month.

The rate began to fall again early in March, as expectation of a further reduction in Bank rate grew; and by 10th March it was down to $5\frac{7}{8}$%. On the following Friday, after Bank rate had been reduced to 6%, the tender rate fell only a little further, to $5\frac{11}{16}$%. By the end of the month, however, when the houses bid strongly for an increased amount of bills on offer, it had fallen to $5\frac{1}{2}$%; and by the middle of April, after the Budget speech had raised hopes of a further cut in Bank rate, it was $5\frac{3}{8}$%. At this point the bill rate was well below the average cost of the discount houses' borrowed funds, noted below; so that until the cost of their money came down – and any sizable decrease was unlikely until Bank rate was further reduced – the houses were running at a loss the Treasury bills which they obtained at the tenders. At the end of April, when Bank rate was still 6%, the market's tender rate rose quite sharply, back to nearly $5\frac{1}{2}$%.

The average cost of the market's borrowed funds was fairly steady, at between $5\frac{15}{16}$% and 6%, throughout February and up to



The discount market's tender rate for Treasury bills rose a little in February, as the houses were forced to borrow at Bank rate, but thereafter resumed its fall, for further reductions in Bank rate were expected.

[1] On some occasions the Bank lent for two days, so that the discount houses' repayments did not increase a shortage of money which was already expected on the intervening day.

Per cent per annum

Difference in yield between 3 months' loans to local authorities and euro-dollars in London, covered forward *

The small advantage during January in favour of loans to local authorities, covered forward, compared with euro-dollar deposits, was reversed in February and March but re-emerged during April.

* Weekly figures.

the reduction in Bank rate on 16th March. It then fell by only about $\frac{1}{4}$% at first, because the houses were still carrying some funds at rates appropriate to a $6\frac{1}{2}$% Bank rate; but by the end of March it was estimated to have fallen to just over $5\frac{9}{16}$%, and it remained around this level throughout April.

The discount market's buying rate for three months' prime bank bills was little changed during February, at about $6\frac{3}{8}$%, but fell sharply in March and April, following the decline in the Treasury bill rate. At the end of April it was $5\frac{3}{4}$%.

Other short-term money rates

The rate for temporary money with local authorities had already fallen quite sharply during January, and it fell further during the following three months. As noted below, local authorities were borrowing heavily from the P.W.L.B. and on mortgages, stocks and short-term bonds, so that their demand for temporary money was probably not very great. Within the total of their temporary borrowing, however, authorities had an incentive to borrow for as short a period as possible, for the trend of interest rates was clearly downward: rates for loans at seven days' notice were generally above those for three months.

By the middle of March, after the reduction in Bank rate, the rate for three months' money had fallen to $6\frac{1}{8}$%, some $1\frac{1}{2}$% below the peak reached last August. It rose slightly towards the end of March, when local authorities' new borrowing requirements tend to be high because rate income is low and companies' withdrawals of funds from the market are usually heavy; but during April rates eased further. At the end of the month the three months' rate was down to $5\frac{7}{8}$%; the rate for seven-day money, at just over $6\frac{1}{8}$%, was still higher. Despite the fall in the three months' rate, however, there was some small advantage at times during April in favour of loans to local authorities, after allowing for the cost of forward cover, compared with three months' euro-dollar deposits.

Rates offered for deposits by hire purchase finance houses rose a little on balance during the last six weeks of the financial year, for the houses also suffer a withdrawal of company funds at this time. Rates declined sharply during April; and at the end of April the spread for three months' deposits quoted by the main houses was $5\frac{5}{8}$%-6%, some $\frac{5}{8}$% lower than three months earlier. The rates offered by building societies – which had been $4\frac{1}{4}$% on shares and 4% on deposits, both income tax paid, since 1st January – are less rapidly affected by a general decline in other interest rates; and remained unchanged. Demand for new mortgages was heavier than for some time, and mortgage commitments had grown appreciably; and while this demand persisted the societies did not feel justified in lowering their borrowing rates, which were bringing an increased inflow of funds.

Local authority capital borrowing

Early in April, the Government announced a change in the arrangements under which local authorities obtain part of their long-term finance from the P.W.L.B. In the financial year 1966/67 they had been entitled to borrow from the Board up to 30% (40% in some regions) of their gross long-term borrowing requirements: in future their quotas for P.W.L.B. loans would be related primarily to their capital expenditure. During the financial year 1967/68 an authority may borrow from the P.W.L.B. up to 34% of such expenditure (44% if it is in a less prosperous region); in addition, where its temporary debt exceeds 20% of its total outstanding debt, an authority may borrow up to 30% (40% in a less prosperous region) of the amount of funding which it carries out in reducing its temporary debt to the limit of 20%. The period over which local authorities are required to reduce their temporary debt to not more than 20% of total outstanding debt has been extended by one year, to 31st March 1969. As before, authorities whose total entitlement to P.W.L.B. funds under these arrangements would be less than £100,000 will be able to draw up to that amount; and the Board will continue to act as lender of last resort by standing ready to assist any local authority which cannot raise the balance of its requirements in the market.

The Budget estimates of local authorities' drawings from the P.W.L.B., under the new formula, are less likely to be greatly exceeded, because capital expenditure can be more easily predicted than the gross amount of long-term borrowing; quotas will no longer be increased in relation to the amount of long-term debt that is refinanced. In the Budget statement, the Chancellor estimated that net Exchequer issues to the P.W.L.B. in 1967/68 would be £480 million which, together with repayments of earlier debt, would enable the Board to lend about £620 million gross. This is a little less than the amount actually lent in 1966/67 – which was considerably greater than estimated in the 1966 Budget.

Meanwhile, in the three months under review, local authorities increased their borrowing from the Board substantially as they used up the balance of their quotas for 1966/67. The net amount raised by new issues of stocks and short-term bonds remained large, £53 million compared with £47 million in November to January. New mortgages, too, were heavy, though mortgage rates were falling: lenders were keen to place their money before rates fell still further. Up to the end of March, borrowing on mortgage increased local authorities' quotas with the P.W.L.B., at a favourable rate, and this may have offset the attraction to local authorities of shorter-term borrowing at a time when rates were likely to fall. Between the end of January and the end of April the rate for a 20-year mortgage fell by ⅜%, to about 6¾% – compared with a fall of ⅛% (to just under 6½%) in the yield on a 20-year government stock.[1]

Among the stock issues during the three months were three by tender. In February, the Greater London Council offered £20 million of 6½% Stock 1977 and £40 million of 6¾% Stock 1990/92, at minimum tender prices of £96¾% and £98¾% respectively. Both issues were oversubscribed. The third issue, by the London Borough of Greenwich in April, was of £20 million 6¾% Stock 1976/78. The market for corporation stocks weakened, and the minimum tender price became unattractive; almost 90% was left with the underwriters. Further corporation issues were deferred until the market in these stocks improved.

Gilt-edged

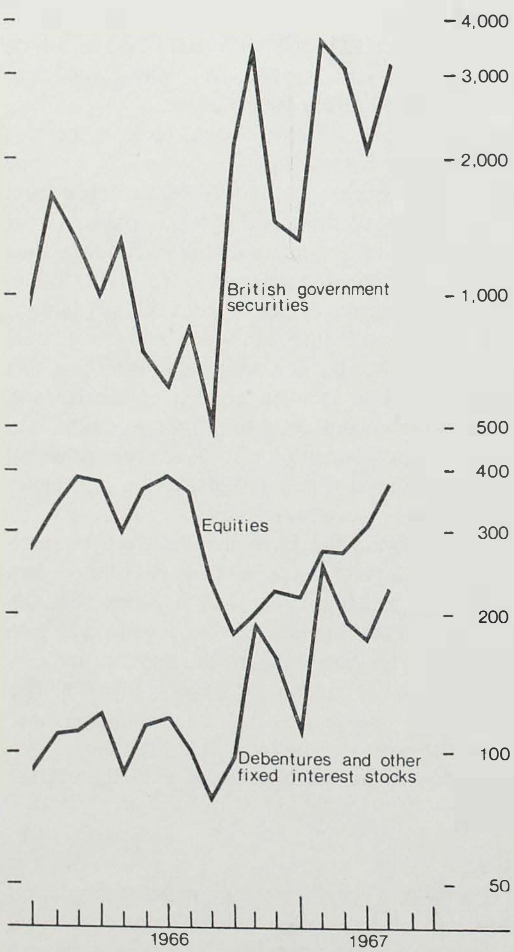
The gilt-edged market remained very firm during most of the period under review. Yields had already fallen substantially during the previous five months, and they continued to decline between the end of January and the end of April: the fall was most marked in short and medium-dated securities.

The reduction in Bank rate on 26th January, to 6½%, had been widely expected, and there were hopes that a further cut would follow before long. Demand for gilt-edged stocks was still strong,

1 The calculated yield for a 20-year government stock is shown in Table 26 of the annex.

Logarithmic scale £ millions

Stock exchange turnover*



Turnover in gilt-edged and in other fixed interest stocks fell in February and March, but picked up again in April. Turnover in equities rose sharply, almost to the high level of last spring and summer.

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

as investors sought the current high yields while they were still available. By the middle of February, yields on many stocks had fallen to below 6½%, in some cases a full 1% lower than six months earlier. The market weakened a little after the publication of the estimates of public spending in 1967/68; but it soon recovered, and by early in March it was again very firm. The expectation of a further reduction in Bank rate was encouraged by the news that the central bank facilities had been renewed, by the decline in interest rates abroad, and by the announcement of the balance of payments surplus during the last quarter of 1966. But although the market was firm it was also rather cautious, for investors were aware that quite large speculative holdings of stock had been acquired in recent months; and turnover was considerably below the very high level that it had reached in January.

The reduction in Bank rate on 16th March led to some profit-taking, particularly in short bonds and in long-dated stocks. The market then became much less active as the Easter holiday intervened and the approach of the Budget led to some uncertainty; but prices remained fairly steady. Early in April turnover picked up sharply and prices rose again after the announcement of the increase in the reserves during March and of the reduction, mentioned earlier, in the U.S. discount rate; and after the Budget, which raised hopes of a further reduction in Bank rate, demand for short-dated gilt-edged stocks remained strong for the rest of the month, although that for longer maturities eased.

Net official sales of stock during the three months were again very large, though somewhat below the high level that they had reached in January. There were net sales – sometimes on a substantial scale – in every week but two, even though the authorities were acquiring the two stocks due to be redeemed this year. By the middle of April there remained in the market's hands less than £100 million of the unconverted balance of 2½% Savings Bonds 1964/67, which was redeemed on 1st May, and well under half of the stock (5% Exchequer 1967) which falls due for repayment in November.

Debentures and equities

Yields on company fixed interest securities fell slightly during the three months, roughly in line with the decline in gilt-edged yields, while turnover, although smaller than in January, remained quite high. The fall in yields was most marked during February when, according to the F.T.-Actuaries calculation,[1] the yield on 20-year debentures and company loan stocks dropped by about ⅛%, to 7$\frac{5}{16}$%; in March and April it fell a little further, to 7¼%. The margin over the calculated yield on a gilt-edged stock of comparable term[2] was then about ¾%, slightly less than three months earlier.

The flow of new fixed interest issues by companies was well maintained up to February, but fell away in March and April. Over the three months as a whole, new issues raised a net total of only £109 million, compared with £131 million in the previous three months.

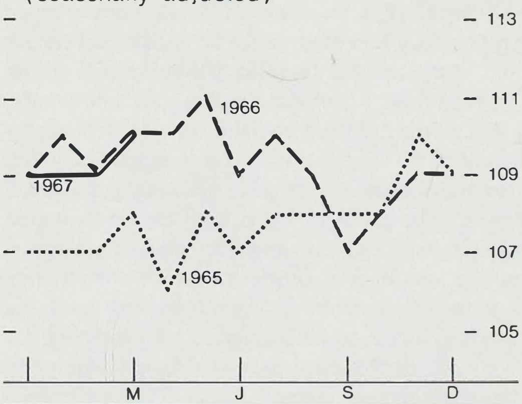
The present attractiveness of borrowing on loan capital, compared with raising finance by issuing shares, will be very slightly reduced by a Budget proposal which will bring the stamp duty on the issue of fixed interest capital into line with that on share capital. The

1 This calculation is based on representative stocks bearing various coupons but all issued before April 1964 - giving a yield which was somewhat higher than that on stocks issued more recently.

2 Table 26 of the annex.

Average 1961 = 100

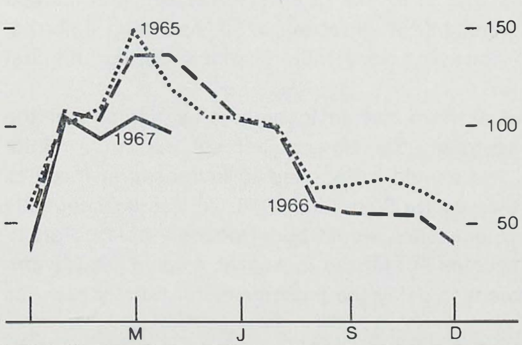
Volume of retail sales (seasonally adjusted)



The volume of retail sales continued to recover in the first quarter of 1967;

Thousands

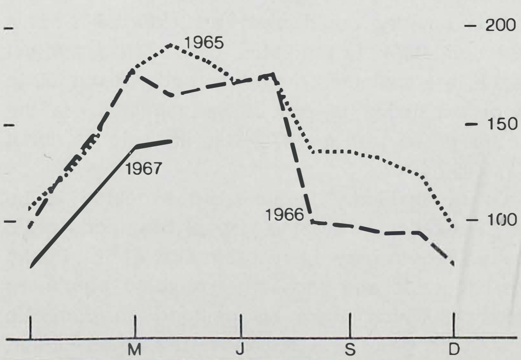
New car registrations



the number of new cars registered increased, though it was smaller than in 1965 and 1966, when sales had been inflated before the Budget;

Thousands

Hire purchase contracts*



and there was a sharp rise in new hire purchase contracts, though they were still fewer than in the two previous years.

* For cars and all other goods.

duty on the issue of loan capital will be increased from 2*s.* 6*d.* to 10*s.* per £100; and duty will also be payable in future on some forms of loan capital which are at present exempt.

New issues of ordinary shares raised £18 million during the period, largely in March, compared with only £6 million during the previous three months. The equity market weakened during February, on expectations that the increase in government expenditure during 1967/68 would entail tax increases in the Budget. Later, however, the market began to look for a neutral or even a mildly reflationary Budget, and share prices recovered. By the middle of March, the earlier losses had been fully regained, and prices continued to rise, with only temporary set-backs, until the end of April. The market was then quite strong, encouraged by switching from steel shares to other equities in advance of vesting day, which is to be 28th July: the F.T.-Actuaries industrial share price index had recovered to $111\frac{1}{4}$, the highest point since last July. Turnover increased, particularly in March and April; and by April it was back almost to the high level of last spring and summer, before the July measures.

Domestic economy

In the March Commentary it was suggested that by the end of 1966 activity, which had fallen since the late summer, might no longer have been declining. Subsequent evidence has confirmed this view, and there are signs of some recovery in output in the early months of this year. The index of industrial production, after allowing for seasonal movements, had risen in December following its fall in the autumn; and in the first quarter of 1967 it moved slowly ahead.

The volume of consumer spending, after seasonal adjustment, was little changed in the fourth quarter of 1966, having fallen sharply in the third; but in the new year it started to rise again. Retail trade appeared to be growing slowly. The number of new cars registered in the first quarter was appreciably larger than in the closing months of last year, though it fell back a little in April: part of the rise in the first quarter may have been due, however, to an easier delivery position (in the autumn there had been a strike of delivery drivers) and to some buying in advance of price increases. And although outstanding hire purchase debt continued to fall, the average monthly decrease during January to March was somewhat less than it had been in the five months after July.

Public spending and exports were still the two main factors making for growth in the economy. Statistics of public expenditure during the first quarter of 1967 are not yet available, but it is likely that both current and capital spending were well maintained. The volume of exports, though falling back in March, was substantially above the average for 1966. Private housebuilding, too, started to pick up, stimulated by the easier availability of bridging finance from the banks and of mortgages from the building societies: the impending levy on land development also contributed to the increase in the number of new houses started during the first quarter.

The volume of stocks, however, which had fallen slightly in the fourth quarter of last year, showed little sign of recovery in the first quarter of 1967, though part of the rise in imports may have been for restocking. And private industrial investment may well have continued to decline. (Fixed investment by manufacturing industry, in real terms and after seasonal adjustment, had remained steady in the last quarter of 1966, at much the same high level as in the past two years; but spending by the distributive and service industries had fallen sharply.)

After seasonal adjustment, the number of wholly unemployed rose further between February and May, to 2·1% of the total labour force. The full extent of the upward trend in unemployment earlier in the year, however, may have been disguised by the mild winter, and the increases in the most recent months do not necessarily indicate an acceleration of this trend. The number of adult vacancies notified to the labour exchanges, seasonally adjusted, continued to fall slowly. The great variation from region to region in the percentage of unemployed continues to cause concern – although the disparity is less than in previous periods with a comparable national level of unemployment – and on 5th April the Government proposed a scheme, to be discussed with industry, for the payment of a regional employment premium to manufacturing establishments in the development areas.

The index of retail prices, which had been little changed between December and March, rose sharply in April, largely because of seasonal increases in the price of some foods. Hourly wage rates rose by over 1% between December and March: they had been virtually unchanged between July and December but the transition from the period of standstill to that of severe restraint was marked by the payment of a number of increases which had been deferred. Average earnings, however, were little changed during the first quarter.

In order to avoid a sharp rise in incomes after the end of the period of severe restraint, the Government set out, in a White Paper, the criteria that should be applied to increases in incomes and prices during the year to 30th June 1968. It was subsequently announced that new legislation would be introduced, before Part IV of the Prices and Incomes Act lapsed in August, to give the Government continued powers to delay the implementation of any price or wage increase.

The Budget

In his Budget statement, the Chancellor of the Exchequer recognised the need to avoid action that might prejudice the recent improvement on external account. He rejected, however, any suggestion that a sound balance of payments could be maintained only at the cost of giving up growth in the economy. Provided that costs were kept competitive, the country could earn an external surplus sufficient to meet the obligations to the I.M.F., noted below, and yet at the same time achieve a sustained growth of national output, in line with the rate of expansion of productive capacity. In the Government's view this growth, up to 1970, was likely to be about 3% per annum.

In 1967, the main expansionary forces were expected to be exports, where the Chancellor forecast a rise of 6%, and public investment, which was likely to grow in real terms by 8½%. Public current expenditure on goods and services – excluding purchases of U.S. military aircraft, which make no demand on domestic resources this year – would grow by some 2½%. As noted earlier, the rise in public spending would lead to quite a sharp increase in the central government's borrowing requirement.

Personal consumption would also increase, partly because the restraining effect of the present hire purchase controls would gradually lessen. Private housebuilding was expected to recover.

Private industrial investment was forecast to fall during 1967; however, steps had been taken to stimulate it. In December it had been announced that investment grants had been increased for expenditure incurred in 1967 and 1968, and on 21st March the President of the Board of Trade had announced that the delay in paying investment grants would be reduced; grants for expenditure incurred in the first quarter of 1966 would be paid from 1st April 1967 instead of from 1st July.

The Chancellor did not expect unemployment to change very much over the year; he judged too that total demand and output would rise in 1967 at about the rate that could be sustained in the medium term. Accordingly, he did not propose to take any substantial action to influence demand: should it appear in the coming months that further measures were needed, they would be taken then. There were no major changes to the tax structure.

As regards credit policy, the Chancellor said that it was still necessary to keep the growth of credit within modest bounds. Apart from an easing of terms control for motor cycles, bicycles and three-wheeled vehicles, there were no changes in the hire purchase regulations. The increase in the Exchequer's borrowing requirement in 1967/68 would make it necessary to borrow as much as possible from outside the banking system. To this end, and also to encourage personal savings, there would be an improvement in the terms for company tax reserve certificates, increases in the maximum holdings of national savings certificates and of premium savings bonds, and the trustee savings banks would be given permission to set up a unit trust.

On the external situation, the Chancellor announced that the 1964 drawing on the I.M.F. – which had already been reduced from £357 million to £292 million through sterling drawings by other countries from the Fund – would be repaid not later than 2nd December, together with the £28 million borrowed from the Swiss authorities in 1964.[1] The resources to do so would be available – from the reserves, the official portfolio of dollar securities, and the balance of payments surplus expected for 1967. A continuing surplus on the balance of payments was necessary, however, for there was a further drawing on the I.M.F., of £500 million, to be repaid by 1970.

The Chancellor estimated that the total saving of government expenditure abroad would be at the rate of just under £100 million a year – the target announced in the July measures[2] – at the end of 1967/68. He acknowledged the co-operation received from industry, and from institutional investors, in connection with the voluntary programme of restraint on the export of capital to the more developed countries of the sterling area (announced in last year's Budget); and paid tribute to the understanding attitude of the governments concerned. It was proposed to continue the voluntary programme for at least a further year.

The security sterling market would be abolished from 12th April, and purchases and sales of sterling securities by non-residents would be made through the official market; as a result some of the foreign currency which had hitherto been used to buy security sterling in the free currency markets in the Persian Gulf and Hong Kong would now be used for purchases of sterling in the official market. There would be a drive against illegal transactions by U.K. residents through these free currency markets, and tighter adminis-

1 As noted earlier, a large part of this borrowing was repaid on 25th May.
2 September 1966 *Bulletin*, page 214.

tration, in consultation with the Hong Kong authorities, of the control exercised over the sterling accounts of residents of Hong Kong.

Conclusion

The Chancellor has made it plain that he has no intention of being deflected from his present course of running the economy at a sustainable level of demand, and consolidating and extending the improvement in the balance of payments. The Budget strategy was based on the expectation that output would grow by nearly 3% during the course of this year – not far different from the present estimated rate of growth of productive potential.

There are some signs of a slow recovery in output, likely to quicken later in the year, led by public expenditure and helped perhaps by some growth in exports, as well as in personal consumption. Nevertheless, there is no clear sign yet that industry is feeling more confident about the future. Private capital expenditure has started to decline, and the effects are being felt on the volume of new orders; there is concern about the short-term prospects for markets abroad, both in Europe and in the United States; and there is some fear that wage costs might rise sharply in the autumn, cutting further into profit margins. However, the growth of consumer spending is likely to strengthen before long, as the impact of hire purchase controls wears off and incomes are augmented by settlements which have been delayed. Because personal consumption is by far the largest element of demand, its growth could well lead to an improvement in confidence later this year; and improved confidence should open the way to a recovery of industrial investment.

Meanwhile, public expenditure, particularly on investment, will continue to grow. The Exchequer's borrowing requirement in 1967/68 is likely to be the largest in any post-war year; local authorities, too, are expected to borrow more from the market than last year. Unless it is to lead to an unduly large increase in monetary liquidity, the Government's borrowing requirement will have to be met, to a large extent, by substantial official sales of stock and by other borrowing from the general public, through national savings and tax reserve certificates. After the sharp set-back in May, the prospects for the gilt-edged market, however, ought not to be discouraging, despite the stock that will be created when the steel industry is nationalised. The reduction in private capital expenditure may be expected to make funds available for investment in gilt-edged; and, as long as industry's demand for bank credit remains slight, the banks themselves may well invest in government stock rather than build up excessive liquidity. Moreover, as noted earlier, a large part of the stock which has to be redeemed in November is already in official hands.

Although Exchequer borrowing this year will be large, it should not generate excessive demand in the economy while private capital spending remains low, and while the growth of consumer spending remains moderate. However, borrowing on any comparable scale would lead to difficulties when private investment begins to pick up again. In the short term, there are two main problems. The first is to ensure that the review of public expenditure, now being carried out, succeeds in moderating the growth of public spending in 1968/69: a further rapid increase in such expenditure, at a time when private investment is likely to be growing, would in all probability lead to heavier taxation – if the danger of a renewed overload on the economy were to be avoided. The second problem is to prevent prices and incomes from rising too rapidly, undermining the country's competitiveness in world markets and giving too great a boost to personal spending. Above all, in the longer term, is the continuing need to increase the country's productive capacity; and in particular the capacity to produce and sell those goods which will help further to improve the balance of payments.