Commentary

In the three months from May to July, covered by this Commentary, the inflow of foreign exchange, which had been substantial earlier in the year, slowed down and was then reversed. The earlier growth in exports was not maintained, because of slackening demand in some of the United Kingdom's main overseas markets; while imports, which had been expected to decline after the rush of arrivals that followed the abolition of the import surcharge, remained high. Nevertheless, taking the identified balance of payments position on current and long-term capital accounts together with the balancing item, there was probably still a small external surplus in the second quarter of 1967.

Bank rate was reduced from 6% to 5½% on 4th May; but soon afterwards domestic interest rates, which had been falling for more than six months, began to rise again. There were large net official purchases of gilt-edged stock, partly because some of those who had bought stock in earlier months were now realising their profits. The domestic economy, which had shown signs of recovery in the first quarter, no longer seemed to be expanding.

Sterling first weakened towards the middle of May. Early in the month the Government had applied for membership of the European Economic Community; and the renewed discussion of the difficulties that this might bring – notably the speculation in some circles whether entry into the Common Market might entail devaluing the pound – brought sterling under pressure. Also in May, the exchange market was faced with disappointing figures of overseas trade during April; with rising interest rates and tighter credit conditions in several centres abroad; with disturbances in the Far East; and then with the build-up of tension in the Middle East – where the outbreak of war, on 5th June, brought further pressure on the pound. Middle Eastern holdings of sterling fell substantially; much of the fall occurred, however, because balances were transferred from London banks to banks in other countries and – to the extent that these banks continued to hold the funds in sterling – the total of external liabilities in sterling, and the reserves, were unaffected. Despite all the adverse influences, sales of sterling were not on a scale comparable with a year earlier: it was generally realised that the balance of payments was considerably stronger than it had been then, and that there were ample resources available, under existing arrangements, to counter the effect on the reserves of international flows of short-term funds.

The figures of visible trade improved considerably in July. Imports fell sharply – only partly because of the closure of the Suez Canal – while exports, which had fallen in the second quarter as overseas demand declined, increased substantially. Prospects in some of the United Kingdom's more important overseas markets are expected to improve later this year; but meanwhile – combined with the effects of the situation in the Middle East – the slowing down in the growth of world trade has caused an unwelcome interruption to the recovery in the balance of payments.

In the domestic economy, the renewed growth in output seen early in the year was not maintained. In the second quarter, the decrease in exports, and a slackening in consumer spending, probably left public expenditure alone expanding significantly. However, an improvement in world trade, rising incomes, and a number of reflationary measures which have now been taken – in particular the relaxations of hire purchase terms – should lead to a gradual expansion in output from now on.

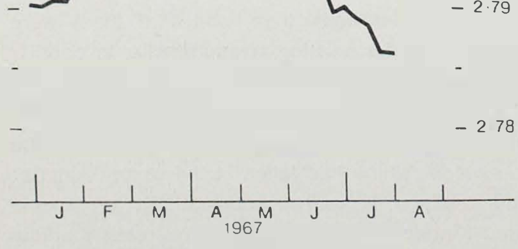
Foreign exchange market

The biggest single influence on the foreign exchange market during the three months was the situation in the Middle East. But even before this began to affect the pound, towards the end of May, there had been a sharp turn-round in sentiment and quite heavy selling of sterling.

The unfavourable turn of events started after the publication of the figures of overseas trade for April, which showed a steep rise in imports. At the same time, demand for euro-dollars had begun to increase and money was tight in some continental centres. The French reaction to the United Kingdom's application to join the E.E.C., the outbreak of rioting in Hong Kong, and the continuing terrorism in Aden all contributed to the market's anxieties. There was growing danger of a conflict between the Arab states and Israel; and it was felt that any worsening of the situation in the Middle East would be bound to have an adverse effect on the pound. At home, the announcement of increased electricity charges in the autumn was not well received by the market. The spot rate for U.S. dollars, which in the first few days of May had been only slightly below parity, fell to $2·79\frac{1}{2}$ just after the middle of the month; and although the rate rose a little, later in May, the underlying unease persisted and by the end of May the rate was again down to $2·79\frac{1}{2}$.

The uneasiness towards the end of May was partly due to sales of sterling by overseas holders, who – even then – were preparing to show larger holdings of their own currencies in their half-yearly balance sheets; but the pressure on sterling that this caused was soon eclipsed by the heavy selling which accompanied the outbreak of war in the Middle East, and which brought the spot rate down almost to $2·79. This selling, however, was remarkably short-lived, and on the news of the cease-fire a few days later sterling strengthened; the rate rose to $2·79\frac{3}{4}$; and the authorities were able to recoup much of the exchange that had been used to support the market during the preceding few days. Throughout the rest of June the market remained rather nervous, disturbed at times by reports of withdrawals of funds by Arab countries; by a rumour, quickly denied, that the United States had placed an embargo on exports of gold; and by uncertainties as to the effect of the Middle Eastern situation on the United Kingdom's overseas trade. Business was not large, but the spot rate fell back again, to $2·79.

July started with the undertone for sterling weak. There was a growing realisation that the United Kingdom would suffer from the after-effects of the war – in particular the closure of the Suez Canal, the disruption of oil supplies, and the possibility that sterling transferred from the richer oil-producing countries to other Arab countries would soon be spent outside the sterling area. A further reason for sterling's weakness at this time was the sharp increase in the rate for U.S. Treasury bills, and the continued rise in euro-dollar rates in the early part of July – despite the return of some funds to this market after the end of the half year. There were



The spot rate for U.S. dollars reached parity just after the Budget; but towards the middle of May it began to decline and by the end of July it had fallen to about $2·78\frac{9}{16}$.

* Weekly, Fridays.

occasional heavy sales of sterling early in the month, after which the market turned quieter. But in the second half of July selling was resumed; the figures of overseas trade in June were disappointing; there was discussion of devaluation of sterling in academic circles and in the press; and there were reports that sterling held for Arab countries was being sold. The spot rate for U.S. dollars dropped to $\$2{\cdot}78\frac{9}{16}$ soon after the middle of July, the lowest since November 1964, and it remained around this level during the rest of the month.

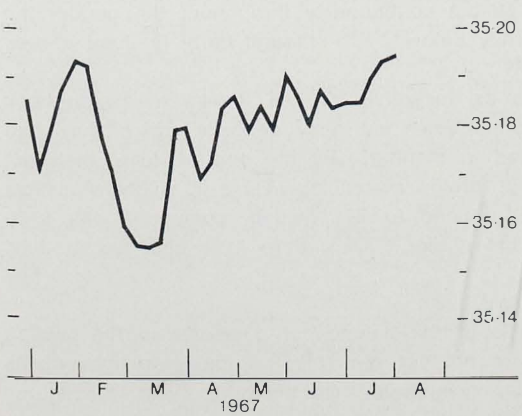
It was noted in the June *Bulletin* that at the end of March some drawings under central bank facilities, linked specifically to changes in overseas countries' sterling balances, were still outstanding; and these were repaid early in the second quarter. Also during this quarter, the U.K. liability to the International Monetary Fund and to Switzerland was reduced by almost £200 million: on 25th May the United Kingdom repaid the equivalent of £145 million to the I.M.F. – over half the amount still outstanding under the 1964 drawing – together with the whole amount (£28 million) borrowed in 1964 from Switzerland, while during the quarter as a whole the liability to the I.M.F. was reduced by a further £25 million through sterling drawings by other countries from the Fund.

During the quarter, however, there was some fresh recourse to central bank facilities. These facilities were designed precisely to meet conditions such as those of the last few months; that is, mainly to counter international flows of short-term funds – arising for example, as in May and June, from tightness of money in other centres or from international events that provoke selling of sterling. The equivalent of £81 million was drawn under the $1,350 million reciprocal swap facility with the Federal Reserve System, but – after taking into account the repayment, noted above, of the amounts outstanding at the end of March – there was a small net repayment under other facilities.

The net result of the fall in U.K. liabilities to the I.M.F. and to Switzerland, and of the recourse to central bank facilities, was a considerable reduction during the quarter in overseas borrowing; this reduction very largely counterbalanced the fall of £152 million in the reserves.

$ equivalent per fine ounce

Fixing price for gold*



Demand for gold was very heavy in May and early June, although it then fell back; the fixing price in May to July rarely dropped below $35·18.

* Weekly, Fridays.

Gold market

Demand for gold was moderate at the beginning of May, but soon after the middle of the month the suspension by the U.S. Treasury of sales of silver raised doubts in some quarters about U.S. policy on gold, and led to a spate of buying which pushed the dollar equivalent of the daily fixing price up to $\$35{\cdot}19\frac{3}{4}$ per fine ounce. The market quietened a little at the end of the month, and the price fell back to $\$35{\cdot}18\frac{1}{2}$; but the outbreak of war in the Middle East brought another short spell of heavy buying.

During the rest of June and throughout July the market was mainly quiet and demand was generally moderate. The price, however, remained high, ranging at times up to $35·20[1] and rarely falling below $35·18.

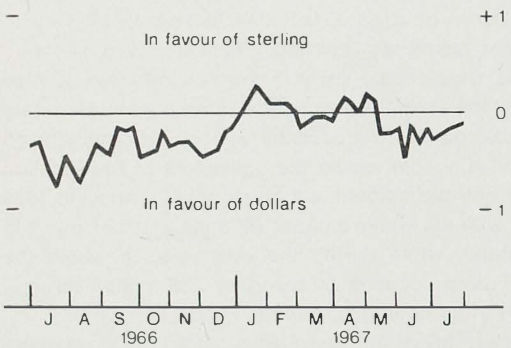
Movements of short-term funds

The outflow of short-term funds between May and July was attributable largely to events in the Middle East; but it also reflected seasonal pressures on the balance of payments of overseas sterling area countries, and rising interest rates abroad.

1 The highest fixing price in June and July, however, was $\$35{\cdot}19\frac{5}{8}$.

Per cent per annum

Difference in yield between 3 months' loans to local authorities and euro-dollars in London, allowing for the cost of forward cover*

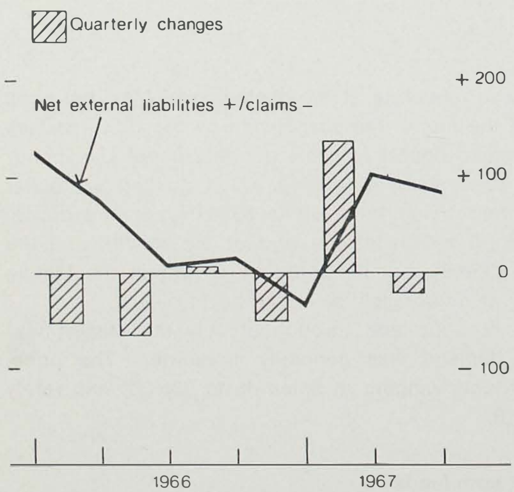


Throughout most of the three months from May to July there was a small advantage in favour of euro-dollar deposits compared with loans to local authorities, covered forward.

* Weekly figures.

£ millions

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



In the second quarter, the banks switched back into foreign currency some currency deposits which they had previously employed in sterling.

Net external liabilities in sterling, which had risen in April, fell in each of the three months from May to July. Much of the fall was attributable to overseas sterling area countries, whose balances were unchanged in May but dropped sharply in June and July. This fall was mainly due to the situation in the Middle East. Some funds were transferred (through loans or gifts) to other Middle Eastern countries, which are likely to have disposed of the sterling, while others, as noted earlier, were moved from U.K. banks to West European and other overseas banks: to the extent that these funds have not been converted into other currencies they are now included in U.K. sterling liabilities to non-sterling countries rather than to the overseas sterling area – the total of U.K. sterling liabilities being unaffected.

The net sterling holdings of countries outside the sterling area, excluding the counterpart of drawings on central bank facilities, also fell during the three months. They dropped only slightly in May and more than recovered in June – largely it seems because of the transfer of funds from Arab countries in the sterling area, mentioned above. In July, however, the sterling balances of non-sterling countries fell appreciably.

The tightness of money abroad contributed to the outflow. Rates in the euro-dollar market started to turn upwards in May – the first increase of any significance since last November – and continued to rise in June, when the increase was moderated, however, by the co-operative action taken by some central banks to channel back into the market dollars which had been withdrawn. The main reasons for the increase were tight credit conditions on the Continent; the Middle Eastern crisis, which may have led to the withdrawal of some funds from the market; window dressing operations for the end of the half year; and, starting in June, renewed borrowing by American banks through their London offices. Early in July, after there had been a sharp increase in the U.S. Treasury bill rate, euro-dollar rates rose further; and although they eased later in the month, at the end of July the three months' rate was still $\frac{1}{2}$% higher than at the end of April.

During these three months, however, the rate for temporary money with U.K. local authorities declined. The return on euro-dollar deposits exceeded that on three months' loans to local authorities, covered forward, almost continuously throughout the period: the margin was generally below $\frac{1}{4}$% – though early in June it rose briefly to around $\frac{1}{2}$%.

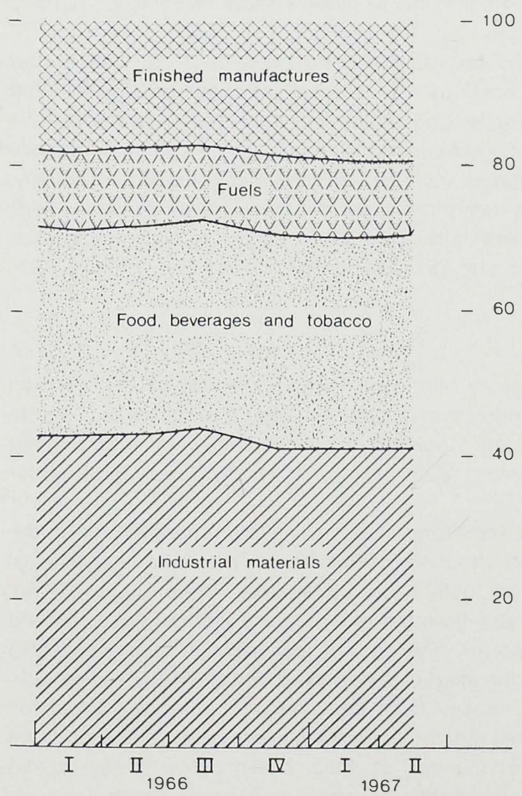
There was thus an incentive for U.K. banks to switch back into foreign currency some currency deposits which they had previously employed in sterling. By the end of June, their net external liabilities in foreign currencies (Table 20 of the statistical annex) had been reduced to £84 million, compared with £106 million three months earlier. They were little changed in July.

Balance of payments

Although full details of the balance of payments in the second quarter of 1967 are not yet available, net monetary movements were probably again favourable. On the other hand, the figures for the current and long-term capital accounts, taken together, may have shown a deficit, since the adverse balance of visible trade was probably larger than the surpluses on invisible and long-term capital transactions. If so, there will have been another positive balancing item – though smaller than that of over £150 million in the first quarter.

Per cent of total imports

Composition of imports*



The proportion of industrial materials in total imports fell after the third quarter of 1966, and has remained lower than a year ago, while the proportion of finished manufactures has increased.

* As recorded in the trade accounts and after seasonal adjustment; excluding U.S. military aircraft.

The deficit on visible trade,[1] after seasonal adjustment, was over £130 million in the second quarter, compared with about £30 million in the first.[2] Exports and re-exports, as recorded in the trade accounts and seasonally adjusted, were some 4% below the record figure for January to March (though they were still well above the average for 1966). The decline during the quarter reflected mainly the falling-off in demand in the United States and in several European countries, particularly Western Germany. Shipments to North America fell further in April but then levelled out: they may well improve later in the year, if activity in the United States continues to revive as expected. Exports to the sterling area were also down.

Imports, after seasonal adjustment, fell in May from the very high figure recorded in April, but there was little further improvement in June – despite a fall in imports of petroleum after the closure of the Suez Canal. In the second quarter as a whole, the value of imports was over 1% more than in the first, when it had been inflated after the removal of the import surcharge. Part of the continued rise was in tobacco and food, which had been largely exempt from the surcharge. Industrial materials increased slightly, perhaps reflecting some rebuilding of stocks. Finished manufactures (mainly capital goods) again rose sharply, by 7%: one reason could be that countries with surplus capacity may have been able to speed up their deliveries of outstanding orders to the United Kingdom – while at the same time offering less buoyant markets for U.K. exports.

The out-turn on invisible account in the second quarter seems likely to have been a good deal less favourable than in the first, when net earnings were exceptionally high; and the surplus may not have been much larger than in the second quarter of 1966 (£28 million). Expenditure on foreign travel will have been seasonally higher than in the previous quarter, while oil royalty and tax payments will also have been larger.

The long-term capital account may also have shown a surplus. On official account,[1] the net outflow will have been lower than in the first quarter, mainly because there were smaller disbursements on loans for overseas development. The inflow on private account may have been much the same as in the previous quarter.

Exchequer finance

The excess of ordinary expenditure over revenue in the quarter to the end of June (Table 1 of the annex) was somewhat smaller than a year earlier, because of the changed pattern of taxation: the Exchequer gained from the tax on company distributions and from selective employment tax. Loans from the Consolidated Fund, on the other hand, were larger than in the previous year; local authorities borrowed less – partly perhaps because of the new formula which relates their drawings from the Public Works Loan Board to their capital expenditure,[3] and because of the rise in P.W.L.B. lending rates, described later – but the nationalised industries, particularly gas and coal, borrowed considerably more. The central government's net balance showed a deficit of £423 million.

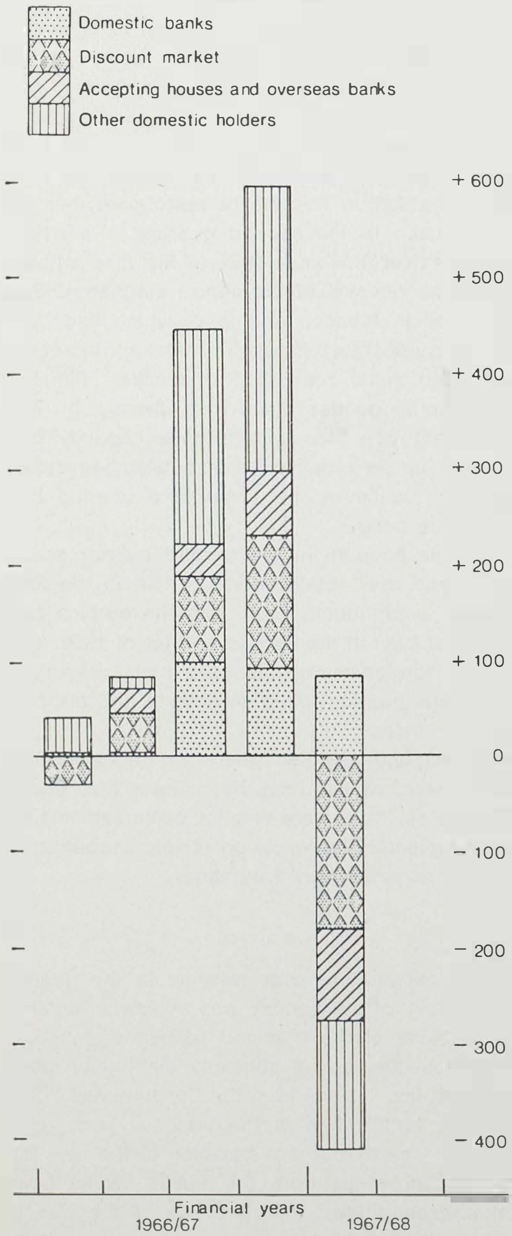
1 The figures for visible trade do not include payments in respect of U.S. military aircraft; drawings on the credit with the U.S. Export-Import Bank to finance the payments are similarly omitted from the long-term capital account.

2 Before seasonal adjustment, however, the trade deficit was probably very little different from that of over £70 million in the first quarter - the expected seasonal improvement having been offset by the underlying deterioration.

3 June *Bulletin*, page 116.

£ millions

Domestic holdings of gilt-edged



After acquiring very large quantities of gilt-edged stocks in the two previous quarters, most domestic holders began to sell during the second quarter of 1967 – though the domestic banks, and in particular the clearing banks, were still buyers.

External transactions were broadly in balance; the fall in the reserves provided the Exchequer with £152 million of sterling, but there was a similar fall in overseas holdings of government debt – mainly because the I.M.F.'s holding of non-interest-bearing notes was reduced with the U.K. repayment to the Fund. The domestic borrowing requirement was £420 million. Although domestic holders continued to buy gilt-edged stock during April – as they had on a substantial scale over the previous seven months – they sold in May and June; during the quarter as a whole they disposed of about £330 million – over half the very large total which they had acquired in the previous quarter. As a result, the Exchequer had to increase its other forms of indebtedness to domestic holders by some £750 million.

Small savings and tax reserve certificates both did well – after higher limits on holdings of national savings certificates and premium savings bonds, and better terms for company tax reserve certificates, had been announced in the Budget – and some finance was provided through an increase in notes and coin. But, inevitably, the Exchequer had heavy recourse to borrowing on Treasury bills; most of the additional bills were taken up by the banking sector, whose holdings rose by £518 million.

The banking sector

The additional Treasury bills were taken up mainly by the discount houses and the London clearing banks. But the sector as a whole was selling gilt-edged stock on a substantial scale, and the net amount of government debt which it acquired was just under £400 million.

The *discount market's* total assets were little changed during the quarter to the end of June.[1] But within the total the houses' holdings of Treasury bills were up sharply, while those of gilt-edged fell considerably from the record figure that they had reached at the end of March;[2] holdings of commercial bills were also reduced. Among the market's borrowed funds, there was a substantial fall in call money from the clearing banks; but advances by the Bank of England to the market increased – reflecting the overnight lending at the end of June, noted below – and so did call money from the accepting houses and overseas banks and from other sources. The rise in funds from these other sources – which was divided between domestic and overseas lenders – may have reflected partly the reinvestment of some of the money withdrawn from the gilt-edged market and partly perhaps the investment, by banks overseas, of sterling funds belonging to Arab countries and previously held with U.K. banks.

The *accepting houses and overseas banks* – in particular the accepting houses – also made substantial sales of gilt-edged, totalling almost £100 million, during the quarter to the end of June.[3] In aggregate, these banks' sterling assets were not much changed: loans to the discount market increased by £65 million; other money at call by some £20 million; and sterling advances, excluding those to other U.K. banks and to local authorities, by £16 million.

The increased advances went mainly to overseas residents; those to U.K. residents rose by only £2 million, much less than in the same quarter of most previous years. These banks were still

1 Table 7 of the annex.
2 June *Bulletin*, page 154.
3 Table 10 of the annex.

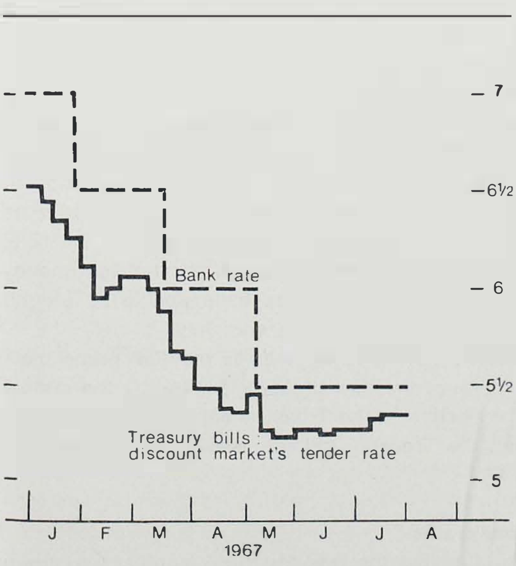
subject to the 105% limit on credit to the private sector – though discussions on the replacement of this limit by some other form of official influence on lending are in progress.

Sterling deposits with the accepting houses and overseas banks, excluding those by other U.K. banks, rose a little during the quarter. Domestic deposits increased, perhaps again reflecting the employment of funds withdrawn from the gilt-edged market; but some sterling deposits from abroad were withdrawn.

The figures for the *London clearing banks*, in Table 9 (1) of the annex, do not relate to the calendar quarter, but to the three months between the make-up dates in mid-April and mid-July. During these months, the clearing banks' holdings of Treasury bills increased sharply from the very low figure that they had reached in the spring. But unlike the discount houses, and the accepting houses and overseas banks, the clearing banks continued to buy gilt-edged stocks. In total, their holdings of government debt, and of notes and coin, increased by some £250 million in the three months to mid-July, while their lending to the discount market dropped by about £120 million.

Net deposits, however, rose by over £300 million during these months – roughly twice as much as seasonally expected – for there was a sharp increase in the banks' lending to the private sector. Advances, excluding those to the nationalised industries, rose by £147 million between April and July, whereas the seasonal expectation for these three months as a whole was for little change. After seasonal adjustment, most of the increase took place in June and July.[1] The unpublished monthly analysis of advances provided by the clearing banks indicates that there has been some resumption in lending to manufacturing industry, while builders and farmers have also borrowed more. A fair part of the increase, however, went to personal borrowers – both for financing house purchase and for other purposes.

The figures for the month to mid-August, after adjustment for the borrowing of the renationalised steel companies and for seasonal factors (the assessment of which has been complicated by recent tax changes), suggest that the upward trend in the clearing banks' lending outside the nationalised industries is continuing (see Table 9 of the annex).



The discount market's tender rate for Treasury bills was little changed throughout most of May and June; but it rose in July, after the U.S. Treasury bill rate had increased sharply.

Bill markets

During the three months from May to July, conditions in the money market were rather erratic. Despite the reduction of ½% in Bank rate, on 4th May, the Treasury bill tender rate fell by only ⅛%, on balance, over the three months; a decrease early in May was partly offset by a rise in July, after the U.S. Treasury bill rate had increased sharply.

The large official purchases of gilt-edged stock not only increased the supply of Treasury bills considerably, as noted earlier, but also made for easier conditions in the money market, for some of the funds withdrawn from the gilt-edged market were probably placed at call with the discount houses; and on occasions the Bank needed to sell Treasury bills to the houses to absorb surplus funds. After the outbreak of fighting in the Middle East, however, movements of foreign sterling balances caused some unevenness in

1 Because the make-up date in June this year was very late in the month, some banks had by then already begun debiting half-yearly interest and charges to overdrawn accounts; these debits usually fall very largely into the month to mid-July. Accordingly, the seasonal adjustments for June and July separately are very uncertain, and it is better to consider the two months together.

the flow of money, which the Bank counteracted mainly by overnight loans, in order to keep money tight from day to day.

The discount market's tender rate for Treasury bills fell by $\frac{3}{16}$%, to $5\frac{9}{32}$%, after Bank rate had been reduced. It fell a little further the following week, for there was some hope of another cut in Bank rate. This faded as it became apparent that sterling was coming under pressure; and with the gilt-edged market dull and uncertainty about the international situation growing, the tender rate rose to $5\frac{9}{32}$% again by the end of May. It was steady throughout June. The discount houses were not inclined to raise their bid, and reduce the rate, partly because of the situation abroad and partly because, even at an unchanged rate, they were obtaining large allotments at the tenders – where outside competition had fallen away. Nor were the houses disposed to lower their bid, and increase the rate; it was already high in relation to Bank rate and they feared that if it rose any more the banks would also raise their top lending rate to the market – and the Bank, in turn, would increase their rate for overnight loans.

Early in July, however, after the rise in the U.S. rate, the discount houses' tender rate increased further; and by the middle of July, at $5\frac{11}{32}$%, it was closer to Bank rate than at any time since the war. The amounts of bills offered at the tenders, which had been very small earlier in the year,[1] had increased substantially; and because of some fear that Bank rate might be raised, those outside the market were not keen to invest in Treasury bills – so the market's bill holdings continued to grow.

Except on one occasion, and then only overnight, the discount houses did not have to borrow at Bank rate during the three months. The usual shortage of money over the end of the half year was substantially greater than normal, because 30th June fell on a Friday, when the clearing banks' tills are usually very low – so that the banks had to withdraw funds from the market on a particularly heavy scale to maintain their 8% cash ratio. The Bank made very large loans to the market on 29th and 30th June, all for repayment on 1st July, when the market was expected to be in surplus: for the first time these loans over the end of the half year were all made at below Bank rate.

The average cost of the houses' borrowed funds fell by about $\frac{7}{16}$%, to about $5\frac{1}{8}$%, immediately after the $\frac{1}{2}$% reduction in Bank rate on 4th May; the houses were still carrying some funds at rates appropriate to a 6% Bank rate – and some, indeed, at rates that had been fixed when Bank rate had been $6\frac{1}{2}$%. As these fixtures began to run off, the average cost of the houses' money fell; and in the second half of May it was estimated to be around 5%, where it remained throughout June and July.

The discount market's buying rate for three months' prime bank bills dropped from $5\frac{3}{4}$% at the end of April to $5\frac{3}{8}$% by the middle of May, following the decline in the Treasury bill rate. It increased a little in July, when the Treasury bill rate was rising, and by the end of July it was $5\frac{1}{2}$%.

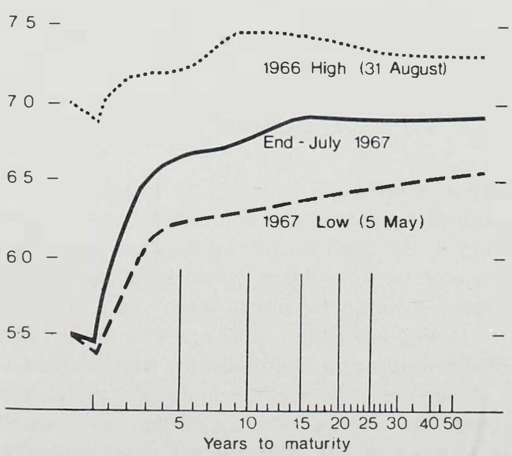
Other short-term money rates

It has been noted earlier that the rate for three months' temporary money with local authorities declined during the period under review. This fall occurred largely in the first half of May, following the reduction in Bank rate. Rates for deposits up to one month fell most, removing the distortion in the normal rate pattern caused

1 March *Bulletin*, page 6.

Per cent per annum

Time / yield curves of British government securities*



Yields on British government stocks declined early in May but then rose; and by the end of July yields were up to $\frac{1}{2}$% higher than the low point reached in May.

* The lines begin at Bank rate and continue through the yield on 91-day Treasury bills to those on British government stocks. The time to maturity is on a "discounted present value" scale, using a rate of 5% per annum. See the article in the March *Bulletin*, page 52.

by expectations of the cut in Bank rate;[1] the three months' rate fell by only about $\frac{1}{4}$%, to $5\frac{9}{16}$%.

Between the middle of May and the end of July temporary money rates were little changed. Local authorities' income from local rates was seasonally high; and they were borrowing quite heavily on stocks – through calls on earlier issues – and on short-term bonds. Moreover, the supply of short-term money to the market almost certainly increased: although, as already described, it was more profitable, after allowing for the cost of forward cover, for the banks to lend in euro-dollars than to lend in sterling to local authorities, some of the very large amount of funds withdrawn from the gilt-edged market may well have been invested for the time being in the temporary money market. At the end of July the rate for three months' temporary money was still around $5\frac{9}{16}$%.

Rates offered for deposits by hire purchase finance houses, like those offered by local authorities, fell a little during May, but rose again in June, widening the margin over comparable local authority rates. The keener bidding for money by the finance houses may well have reflected the rise in hire purchase contracts for cars which occurred after the easing of terms control at the beginning of June. In July, however, rates fell back a little; and at the end of the month the spread for three months' deposits quoted by the main houses was $5\frac{5}{8}$%-$5\frac{7}{8}$%, much the same as three months earlier.

Gilt-edged

After showing great strength earlier in the year, the gilt-edged market became less firm early in May, and weakened progressively during most of the following three months. Yields rose appreciably; and there were also large net official purchases of stock.

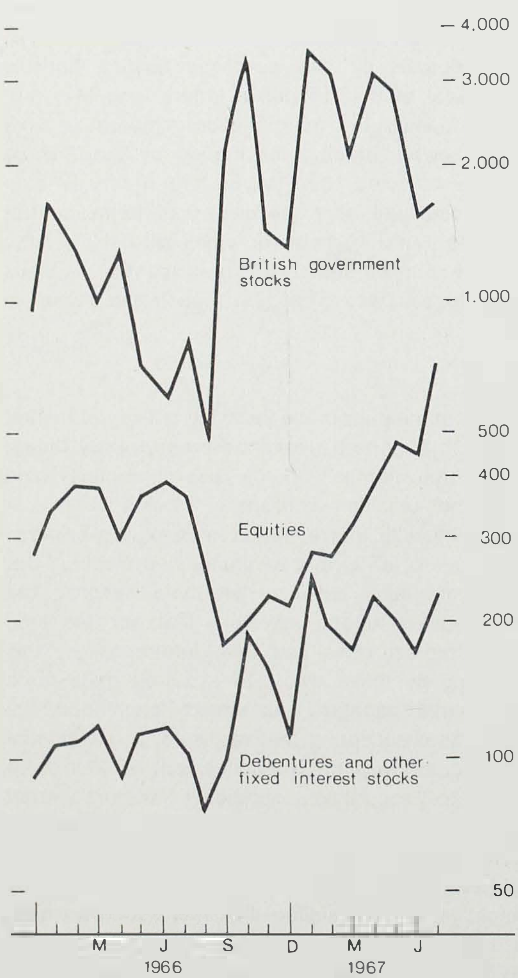
May began fairly quietly, with the reduction in Bank rate bringing a further rise in the prices of short and medium-dated stocks. But soon afterwards prices started to ease, for two main reasons. The first was the growing belief among investors that, for the time being, the decline in interest rates had little further to go; this led to some profit-taking by those who had acquired quite large holdings of stock in earlier months. As already mentioned, the discount houses and the accepting houses sold a substantial amount. The second reason was the announcement on 27th April of the vesting date for steel securities; institutional investors started switching on a large scale into these securities from gilt-edged. The attraction was the franked income[2] which could be obtained, and which, they believed, would more than compensate for any capital loss they might incur on reselling the steel securities after these were quoted ex-dividend.

The trade figures for April provoked further sales of gilt-edged, especially longer-dated stocks, and official purchases from the market became very large. In the middle of May, when a continued fall in gilt-edged prices seemed likely, official support took a new form; the Bank made it known that they stood ready until further notice to buy three stocks – $3\frac{1}{2}$% War Loan and the two tap stocks, $6\frac{1}{4}$% Exchequer Loan 1972 and $6\frac{1}{2}$% Funding Loan 1985/87 – at fixed prices, determined by the level which the market had then reached. This limited the extent to which the prices of other stocks could fall. Yields consequently steadied,

1 June *Bulletin*, page 116.
2 Dividend income derived by one company from another. Such income has already been subject to both corporation tax and income tax, and is not taxed again; the income tax which has been paid can be set off against the receiving company's income tax liability on its own dividends.

Logarithmic scale £ millions

Stock exchange turnover*



Turnover in gilt-edged stocks fell back sharply in May to July, while that in other fixed interest stocks would also have fallen but for dealings in steel securities. Such dealings, however, mostly affected equity turnover, which was a record in July.

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

particularly at the short end; and as the market was short of stock and many speculative holdings had been disposed of, the prospects for renewed net official sales of stock seemed encouraging.

Events in Hong Kong and in the Middle East, however, and the subsequent weakening of sterling, dashed these hopes. On the outbreak of war in the Middle East on 5th June, the authorities decided to withdraw their fixed price support of the three selected stocks, and allowed yields to rise fairly sharply. Thereafter the market improved, though it remained quiet – turnover in June was only about half as great as in most of the previous five months – and at the new level of yields there were some small net official sales of stock. The improvement, however, was short-lived; fears of higher U.S. interest rates, the continuing uncertainty in the Middle East, and concern about developments in the domestic economy all led the market to weaken anew. There were again large official purchases of stock to prevent yields rising too fast, for on domestic grounds a further increase in long-term interest rates was clearly inappropriate.

After this set-back, the market became much firmer early in July. A general shortage of stock began to be felt, which was met only in part by official sales, and prices improved; and throughout the rest of the month the market was fairly firm, though quiet.

On 14th July it was announced that the Government Broker would be prepared to buy, from 17th July, securities of the steel companies which were being nationalised. These securities were to be quoted ex-dividend from that date; and it was foreseen that some holders, having secured the franked income for which they had bought them, would be willing to sell even at a substantial discount – while others would sell gilt-edged if steel securities were offered cheaply. This would artificially depress the gilt-edged market. The Bank therefore bid for the steel securities at a discount starting at $\frac{3}{4}$% on compensation values, and diminishing by stages to $\frac{3}{8}$% at the vesting date; and secured large quantities. On 28th July it was announced that the compensation stock would be $6\frac{1}{2}$% Treasury Stock 1971, which at $99\frac{5}{8}$ offered a yield to maturity of £6:12:5%; on 31st July, when dealings in this stock commenced, there were quite large official purchases, the Government Broker supporting the stock at $\frac{1}{8}$% below the issue price.

Other medium and long-term rates

Following the new arrangements for local authority borrowing from the P.W.L.B., described in the June *Bulletin*, it was announced on 30th May that the Board's rates for loans within local authorities' quotas, which had been unaltered for nearly three years, were to be raised. In future, as had been the practice before the autumn of 1964, local authorities were to be charged rates which reflected those at which the Government themselves could borrow, plus a small addition to cover the Exchequer's costs; the rates would therefore be altered to keep in line with interest rates generally. The new rates, initially at $6\frac{1}{4}$%-$6\frac{3}{4}$% depending on the terms of the loan, were $\frac{5}{8}$%-$\frac{7}{8}$% higher than the points at which rates had previously been pegged.[1]

During the three months under review, local authorities borrowed much less from the P.W.L.B. than in the previous three months, when they had been using up the balance of their quotas for 1966/67. They raised much more, however, through issues of

1 The effect on local authorities of higher interest rates will be offset, so far as housebuilding is concerned, by a subsidy under the Housing Subsidies Act 1967.

stock and short-term bonds: although new issues of stock could not be made while the gilt-edged market was depressed, calls on earlier issues were very large. In total, stocks and short-term bonds provided almost £45 million (net) in May alone, only a little less than the amount raised during the whole of the previous three months: in May to July the net amount borrowed in this way was nearly £100 million.

Because P.W.L.B. quotas were no longer related to local authorities' gross long-term borrowing in the market, it was less attractive for local authorities to borrow at longer term. So whereas borrowing on stocks increased, because of calls on earlier issues, new borrowing on mortgages fell back a little. Rates for mortgages declined in the first few days of May, when gilt-edged yields were still falling, but then rose; by the end of July the rate for a 20-year mortgage had risen to 6⅞%-7%, compared with about 6¾% at the end of April. This was only marginally above the calculated yield on a 20-year government stock (shown in Table 26 of the annex) – whereas three months earlier the margin had been about ¼%.

Yields on company fixed interest securities, like those on gilt-edged, rose steadily during the period. According to the F.T.-Actuaries calculation,[1] the yield on 20-year debentures and company loan stocks increased from about 7¼% at the end of April to about 7¾% at the end of July; yields on longer-dated gilt-edged stocks also rose by about ½%, on balance, over the three months – so that the margin over the calculated yield on a 20-year government stock was little changed, at around ¾%.

New fixed interest issues by companies were comparatively small in May to July: they raised a net total of only £78 million, some £30 million less than in February to April and the lowest three-monthly figure for two years. (New issues of ordinary shares, noted below, were also quite small.) Turnover in fixed interest securities, however, was very high – particularly in July, when it included heavy dealings in securities of the steel companies (including the official purchases mentioned earlier).

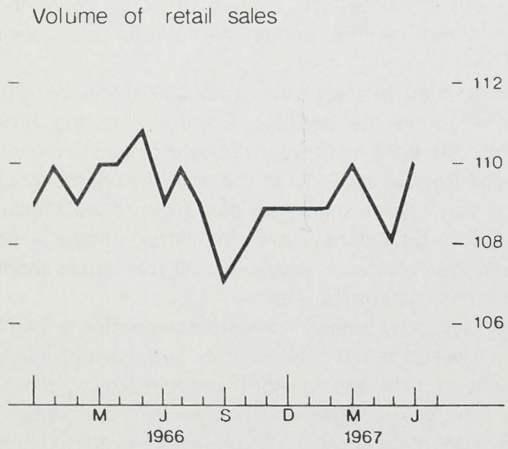
Equities

The strong improvement in equity prices during March and April continued at first in May. The market then weakened a little after the announcement of the trade figures for April, and prices drifted downwards until the outbreak of war in the Middle East, when they dropped sharply. They quickly recovered when it became apparent that hostilities would not spread, and by the middle of June the index of equity prices had more than recovered the ground it had lost since the end of April. There was quite heavy switching from steel shares to other equities – in a market which was already short of stock; and prices were helped by the relaxation of hire purchase restrictions on cars and by reports that pensions were to be increased. The market remained active in July; and by the end of the month the F.T.-Actuaries index of industrial share prices had risen a little further – to 115, some 3% higher than three months earlier.

Turnover in the market was substantially greater than during the previous three months; in July it reached the record figure of £745 million. Much of the increase was due to heavy dealings in steel shares – including, in the last fortnight of July, the official pur-

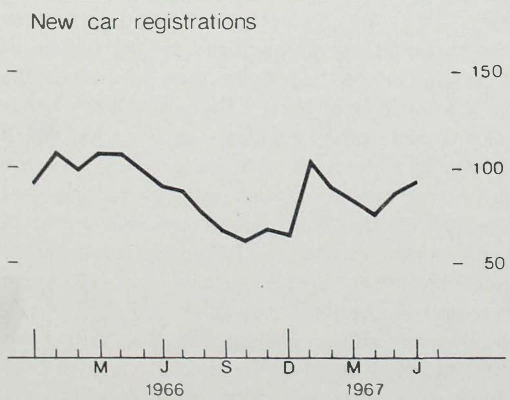
1 This calculation is based on representative stocks bearing various coupons but all issued before April 1964 - giving a yield which was somewhat higher than that on stocks issued more recently.

Seasonally adjusted Average 1961 = 100



The volume of retail sales in the second quarter of 1967 was a little lower than in the first, despite the sharp increase in June;

Seasonally adjusted Thousands



car registrations were also lower, though they picked up after April.

chases. New issues of equity capital were again small, totalling £14 million during the three months.

Domestic economy

The modest recovery in output early in the year, noted in the June *Bulletin*, was not maintained; after allowing for seasonal movements, the index of industrial production – covering roughly one half of national output – was fractionally lower in the second quarter than in the first.

There were signs that the margin of unused resources in the economy was continuing to grow; after seasonal adjustment, the number of wholly unemployed rose between May and August at much the same rate as in the previous three months, to 2·4% of the total labour force, while the number of adult vacancies notified to the labour exchanges continued to fall. A survey carried out at the end of May by the Confederation of British Industry indicated that the proportion of firms working at full capacity had fallen slightly since January – though it also suggested that some industrialists were feeling a little less apprehensive about their future prospects.

The expected recovery in total demand has been delayed partly by the set-back to exports – one of the main components which had been expected to grow – and partly by a check to the modest expansion looked for in consumer spending. After seasonal adjustment, the volume of consumers' expenditure had risen quite strongly in the first quarter, but in the second it seems to have flattened out. Retail trade was slightly lower; sales of clothing and footwear declined noticeably, though trade in durable goods was well maintained. The number of new cars registered fell, although sales showed some signs of picking up later in the quarter, helped by the relaxation of terms control on hire purchase.

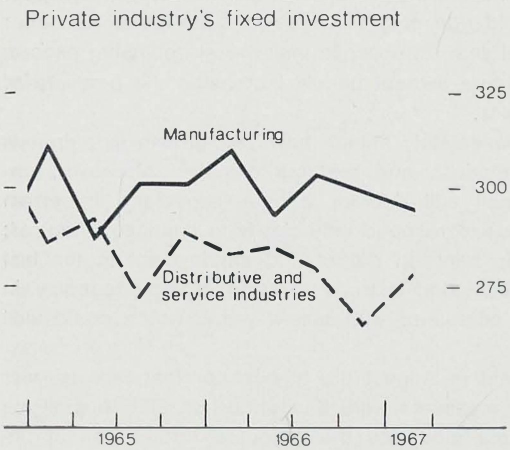
The volume of fixed investment by private industry, after seasonal adjustment, had fallen in the last quarter of 1966, but did not decline any further in the first quarter of 1967. Within the total, investment by manufacturing industry was little changed; and the Chancellor has recently forecast that it will be only 6%-8% lower in 1967 than in 1966 – rather less than the 10% drop which was forecast last November and December. Spending by the distributive and service industries, which had fallen substantially towards the end of 1966, rose in the first quarter, affected by heavy expenditure – which is often irregular – on ships; for these industries, too, the decrease in 1967 is expected to be rather less than was earlier forecast. For both manufacturing and the distributive and service industries, spending on plant and machinery held up well but that on new building was reduced; this probably reflected the desire to improve efficiency rather than to expand capacity.

The volume of stocks, after seasonal adjustment, increased again in the first quarter of 1967 after falling in the previous quarter; and since then stocks may well have grown a little further.

Investment in private housebuilding, which had fallen markedly during 1966, was unchanged in the first quarter of 1967; and some increase in new orders for private housing, the steady growth in building societies' mortgage commitments, the rise in the banks' lending for house purchase, and the recent heavy demand for bricks, all suggest that it may now have started to grow again.

It appears, on balance, that total demand has been maintained in recent months very largely by the growth in public spending; in the first quarter there were fairly sharp increases in public fixed

Seasonally adjusted, at 1958 prices £ millions



Investment by manufacturing industry was little changed in the first quarter of 1967, and not much below the level in the past two years; the rise for the distributive and service industries largely reflected expenditure (which is often irregular) on ships.

investment and in current expenditure, and it is probable that both have since continued to grow.

Starting early in June, the Government announced a number of measures which should help to stimulate growth in the future. On 7th June, hire purchase restrictions on cars were relaxed; the minimum down-payment was reduced from 40% to 30% and the maximum repayment period extended from twenty-four to thirty months. Shortly afterwards it was stated that, in the autumn, manufacturing establishments in the development areas would begin to receive the new regional employment premium; that the delay in paying investment grants would be further reduced; and that pensions and other national insurance benefits would be increased from the beginning of November (although contributions would also be raised). In July it was announced that family allowances are to be increased: in general this will not take effect until next April – and it is not yet known to what extent the increase may be financed by changes in taxation; nevertheless, larger families will receive some benefit from October. Finally, on 30th August, further relaxations of hire purchase restrictions were announced: these included the reduction of minimum downpayments – from 30% to 25% for cars and commercial vehicles, from 20% to 15% for furniture and from 33⅓% to 25% for most other goods that are subject to terms control; and the extension of maximum repayment periods – to thirty-six months in the case of cars and other vehicles and to thirty months in the case of most other goods.

The relaxations in hire purchase, the increase in personal borrowing from the banks, noted earlier, and the measures which will redistribute incomes to those more likely to spend, must all be expected to provide some boost to consumers' expenditure. Some increase in consumer spending should also follow the payment of wage and salary increases which had been deferred until after June, when the period of severe restraint ended. Wage rates which had continued to rise slowly between March and June rose sharply in July; and average earnings seem to have begun to grow again. Retail prices continued to edge upwards in the second quarter, mainly for seasonal reasons. However, charges for electricity, and possibly also for gas, are to be raised, while the temporary surcharge on oil, following the closure of the Suez Canal, will also increase industrial costs. The Government have stressed the need for continuing moderation in claims for increased prices and incomes and, though anxious to encourage the voluntary operation of the prices and incomes policy, have taken continuing powers to delay the implementation of any particular price or wage increase.

Conclusion

In the last few months, it has become clear that the growth in total demand which was looked for in the Budget has not yet materialised. This has been due largely to the set-back to exports – which, after their earlier strong rise, were affected by a slackening in the growth of world trade. The deterioration in the external trading position – temporary though it may be – contributed to the weakness of sterling, which has been aggravated by events in the Middle East.

However, the outlook still suggests expansion during the rest of this year, and an acceleration in growth in 1968. Renewed growth in exports is expected in the coming months, when demand in some of the country's main overseas markets is likely to pick up again. A recovery in consumer spending is in prospect, for the reasons noted earlier. The decline in private industry's investment is now forecast to be less steep than previously seemed likely, while there is already some revival in private housebuilding. Public expenditure remains an expansionary force; indeed, it is accepted that its present rapid rate of growth needs to be moderated after the current financial year, in order to make room for rising exports and private expenditure without unduly increasing the pressure of demand on resources.

In the months immediately ahead, however, growth in output is likely to be only modest, and perhaps uneven. Moreover, unemployment may well still rise for a time, especially in certain regions – for it tends to respond only slowly to changes in output; and the relationship between output and employment in the last few months has suggested a trend towards greater economy in the use of labour, compared with recent years, which could well continue.

With unemployment in August the highest for that time of year for 27 years, some measures were announced on 30th August, as noted above, to help moderate the expected further rise in unemployment over the winter months. The cumulative effect of all the steps taken seems likely, eventually, to give a sizable stimulus to final demand. But there will be an interval, which should not be underestimated, before the full effects of even the earlier measures have worked through the economy.

With the current degree of slack in the economy, some modest quickening of the pace of activity should not, of itself, endanger the recovery in the balance of payments. The temporary set-back to external trade, and the adverse effects of the Middle Eastern situation, however, may well delay, for a time, the achievement of a satisfactory external surplus. The overriding need to achieve such a surplus, while avoiding an unacceptable level of unemployment, will continue to require a cautious policy of demand management over the period ahead.