Commentary

Devaluation

On 18th November the Government announced that the par value of the pound in terms of the U.S. dollar had been reduced by one-seventh, from \$2·80 to \$2·40; this change in the exchange rate was made with the approval of the International Monetary Fund. The effect of the change is that values expressed in sterling now represent less than before in terms of U.S. dollars by 14·3% and values expressed in U.S. dollars represent 16·7% more than before in terms of sterling.

The measures taken earlier with the intention of securing an improvement in the United Kingdom's balance of trade, particularly those announced in July last year, had brought some improvement by reducing the pressure on resources of competing domestic demands and freeing more of those resources for fulfilling export orders. The balance of payments benefited, and exports recovered quite markedly towards the end of 1966 and early in 1967. At that time it seemed possible that the United Kingdom economy would produce an external surplus large enough to repay the accumulation of external debts, provided that the necessary growth of exports was not again impeded by an undue rise in demand at home.

This improvement, however, was still heavily dependent on the persistence of favourable conditions in export markets. The United Kingdom has to ensure that its balance of payments is strong enough to avoid swinging into deficit even in less favourable conditions; the events of the spring and summer, however, showed very clearly that this necessary objective was still far from being achieved. As the growth in world trade began to slow down, U.K. exports ceased to expand; but the level of imports remained high. Confidence in sterling began to weaken; and talk of devaluation was revived following the decision to apply again for membership of the European Communities. The Middle East crisis led first to an outflow of short-term funds and then, when the Suez Canal was closed, to importers incurring heavy additional freight costs, to more expensive imports, and to delays in export shipments. Cumulatively these developments imposed a sharp set-back on the U.K. recovery and cast some doubt on the underlying trends. The balance of payments seemed still, despite the measures taken earlier, to be dangerously vulnerable to changes in world conditions; and strikes, such as those in the Liverpool and London docks, were an additional cause of damage to the prospects for higher exports.

The events abroad that had exposed again the underlying weakness of the United Kingdom's external position seemed likely to persist for a time; and the implications of this for the sterling exchange rate, in the absence of further stringent corrective measures, caused widespread apprehension. Short-term rates in the United States and in the euro-dollar market had begun to rise; and this added considerably to the pressures on sterling. There were heavy and growing losses of foreign exchange in recent months, seriously depleting the facilities made available by other central banks and monetary authorities for the support of sterling.

These losses might have been endured for a time had there been a firm expectation of an early improvement in the balance of payments, with a surplus emerging to provide for the repayment of the

United Kingdom's short-term debts. Instead, however, the prospect for world trade remained uncertain as did the timing of the reopening of the Suez Canal. Furthermore, there was a prospect that strongly rising domestic demand could prevent the planned redeployment of resources into building up a surplus on visible trade. It seemed inevitable that, without severe new measures, there would be another substantial deficit in the balance of payments next year; and the widespread conviction that the measures taken would include devaluation of sterling precipitated a further outflow of funds.

Devaluation took place on 18th November. At the same time a number of associated measures were announced. Domestic demand is to be restrained by an increase in the cost of credit – Bank rate was raised from 6½% to 8%; by restrictions on bank lending to other than priority borrowers such as exporters;[1] and by more stringent hire purchase terms for cars. There will be reductions in the expenditure planned by government and public bodies, designed to make savings of the order of £400 million a year. Part of the saving by government is to be achieved by abolishing selective employment tax premiums except those payable to manufacturers in the development areas, and the rebate of certain indirect taxes to exporters – each with effect from 1st April 1968. The rate of corporation tax is to be raised from 40% to 42½% in the next Budget. The Government recognise that if the desired improvement in the balance of payments is to be achieved, further measures may be needed to restrain home demand. They stand ready to take them, if and when required.

A very large re-orientation of industrial and marketing effort towards exports and import-saving is required; this will take time. Meanwhile, to establish the strength of sterling at its new rate, a one-year standby facility of $1,400 million has been provided by the I.M.F. and more than $1,500 million of credit facilities have been made available by central banks. An outstanding feature of the devaluation has been the understanding with which it has been accepted without widespread devaluation of other important currencies, and the great help extended to the United Kingdom by authorities in many countries, both by loyal holders of sterling, and by those who have given support before and after the event.

The problems facing the United Kingdom in 1967 are such that devaluation is in itself no solution. But the devaluation can be used so as to aid their solution. It requires, even more urgently than before if this be possible, both that efficient production at home shall increase and that home demands which are not immediately essential to a rise in productivity shall be restrained.

At present there is some margin of unused resources that can safely be brought into production. But there must be a further substantial diversion of resources from the production of goods for the home market in order to meet the increase in net exports which must occur if the balance of payments is to be restored, notwithstanding the burden which the rise of import prices imposes. The measures announced on 18th November are necessarily aimed, therefore, at diverting resources from the production of goods for the home market.

The potential advantages of devaluation will be lost if wage costs rise, so success also turns on the patience with which hardships in the form of higher prices and taxation, and of postponements of public sector programmes, are tolerated. Only when the external

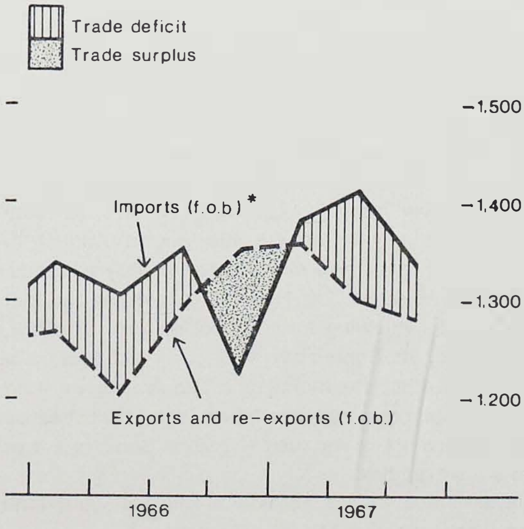
1 See page 348.

position is restored on an enduring basis – a restoration that includes the repayment of much external debt incurred in recent years – can the growth of domestic production be available for domestic needs.

The rest of this Commentary is concerned mainly with the three months from August to October or with the third quarter; but some events early in November are discussed. In the third quarter the identified balance of payments deficit was heavy – though to a large extent for seasonal reasons – and the balancing item was probably adverse. The outflow of short-term funds was seriously influenced at the beginning of the quarter by the effects of the conflict in the Middle East and, in September and October, by weakening confidence. The loss of exchange in the third quarter was considerable. It was offset, to a large extent, by drawings on special facilities.

After August the Bank's operations in the money market were designed to mitigate the adverse effects on sterling of a rise in short-term interest rates in the United States and in the euro-dollar market. Bank rate was raised from 5½% to 6% on 19th October and to 6½% on 9th November. During the period, demand at home began to rise, primarily because consumer spending increased, but also because investment by the public sector continued to grow. Output of manufacturing industry rose slightly, the rise in unemployment was checked and business confidence was a little improved.

Seasonally adjusted
latest quarter provisional £ millions



In the third quarter exports continued to decline but imports fell more.

* Excluding payments made to the United States for military aircraft and missiles.

Balance of payments

At the time of writing details of the balance of payments in the third quarter had not been published, but it was clear that the identified deficit on current and long-term capital account was a good deal larger than the £43 million recorded in the second quarter; and it seemed that there was also a negative balancing item. The heavy deficit owed much to adverse seasonal influences, but it was due in part to the continuing weakness in demand in some of the United Kingdom's main overseas markets, and to the Middle East crisis. The average monthly cost to the balance of payments of the closure of the Suez Canal is officially estimated to have been about £20 million. The cost is likely to diminish, however, as time goes on.

The deficit on visible trade (excluding payments made to the United States for military aircraft and missiles) was smaller, after seasonal adjustment, than in the second quarter. It was almost £60 million, compared with £114 million. This was due mainly to a reduction in imports; their value, as recorded in the trade accounts and seasonally adjusted, was 3% lower, notwithstanding a sharp rise in the cost of imported oil. There were substantial reductions in imports of food and tobacco and smaller ones in semi-manufactured goods – the latter reflecting lower commodity prices. There was no further increase in imports of finished manufactures.

Exports also fell. After seasonal adjustment, their value was 2% lower in the third quarter than in the second. Though exports to North America stopped falling, shipments to Western Europe were lower, as were those to overseas sterling area countries. By

September shipments had begun to be affected by the stoppages in the Liverpool and London docks.

It is likely that there was a smaller surplus on invisible account in the third quarter than in the second (£34 million), for expenditure on foreign travel usually reaches its peak then and, presumably, the overseas earnings of the British oil companies suffered because of higher freight costs and a switching to more costly sources of supply. Official long-term capital transactions were in deficit during the quarter, partly because of some annual debt repayments; on private account, however, there may have been a continued net inflow of investment.

Movements of short-term funds

The outflow of short-term funds continued during August – though on a smaller scale than in July – because confidence in sterling remained weak, the balance of payments of overseas sterling area countries was still adversely affected by seasonal influences, and short-term interest rates in the United States continued to rise. In September and October, however, the net movement of short-term funds was small, though confidence became, if anything, weaker.

The net sterling holdings of overseas sterling area countries rose on balance during the period. Holdings fell sharply in August, but began to rise in September and increased still more in October, a month in which revenue from oil production tends to be high and when the seasonally unfavourable period for the overseas sterling area's balance of payments comes to an end. In October, moreover, some Middle East sterling that had been placed on deposit with banks outside the United Kingdom in June and July[1] was redeposited with U.K. banks and other financial institutions.

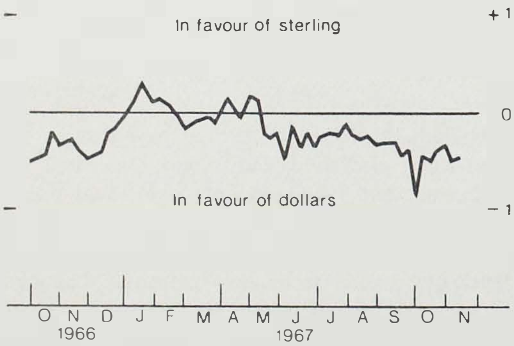
The sterling holdings of countries outside the sterling area, excluding the counterpart of drawings on central bank facilities, continued to decline: they fell more slowly in August and September than in July, but dropped quite sharply in October – only partly because of the transfer of Middle East sterling just mentioned.

In the United States, short-term interest rates had begun to rise in June and July, clearly influenced by the prospect of a heavy Treasury borrowing requirement. President Johnson's request to Congress, early in August, for a surcharge on personal and company taxes was taken to mean that upward pressures on interest rates would diminish; but it soon became clear that the legislation would not be passed quickly. Notwithstanding the Federal Reserve's easy money policy, the rising trend in U.S. Treasury bill rates continued, with little interruption, throughout the period August to October; and, in November, the trend still seemed clearly upwards. The margin by which the return on U.K. Treasury bills exceeded that on U.S. Treasury bills, after allowing for the cost of forward cover, became very narrow and, in September and early October, disappeared at times. Even after the increase in Bank rate on 19th October the margin, at best, remained small; and it had disappeared – because the cost of forward cover rose – before Bank rate was again increased on 9th November.

By contrast, interest rates in the euro-dollar market were little changed on balance between the end of July and mid-September. But they began to rise in the second half of September, when U.S. banks, which had not been bidding strongly for funds since the early part of August, re-entered the market as borrowers. The rate for three months' deposits increased sharply at the end of Septem-

Per cent per annum

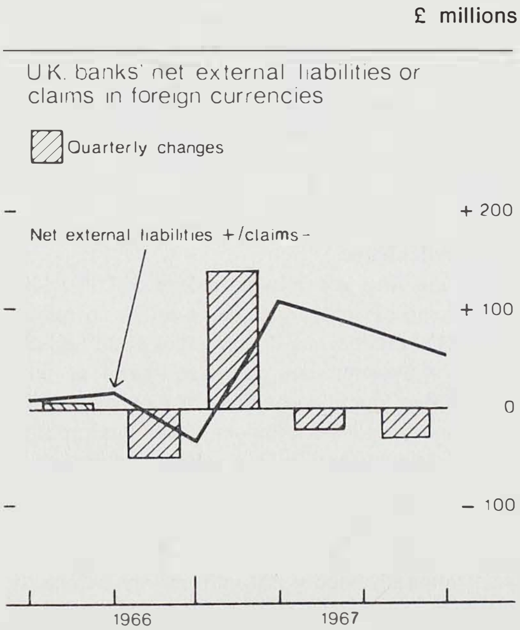
Difference in yield between 3 months' loans to local authorities and euro-dollars in London, allowing for the cost of forward cover*



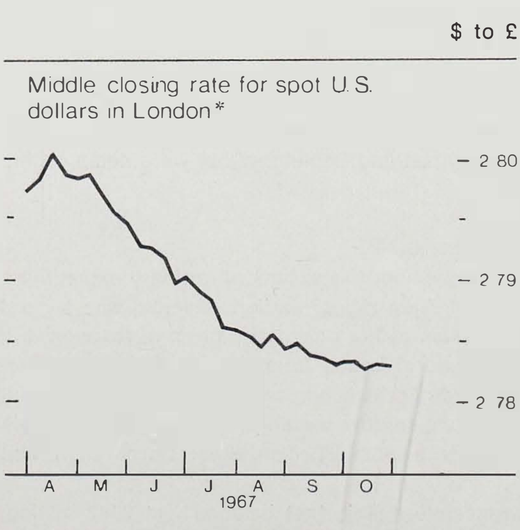
After widening from the end of July, the covered margin in favour of investment in euro-dollars increased sharply at the end of September. It was reduced in October because the local authorities' rate for three months' deposits increased; but widened again in November when the cost of forward cover rose.

* Weekly figures.

1 September *Bulletin*, page 222.



Banks in the United Kingdom continued to switch back into foreign currency funds previously employed in sterling; in the third quarter, their net external liabilities in foreign currencies were reduced by £30 million.



Sterling remained weak from August to October and the spot rate for U.S. dollars had declined to a little over $\$2{\cdot}78\frac{1}{4}$ by the end of the period.

* Weekly, Fridays.

ber, when the market first dealt in funds that carried over the end of the year – and so were available for window dressing. The margin by which the return on euro-dollar deposits exceeded that on three months' loans to U.K. local authorities, covered forward, rose to more than $\frac{3}{4}$%. Early in October, a sharp rise in the local authorities' rate narrowed the differential; and the margin was again reduced as the local authority rate moved up in response to the increase in Bank rate on 19th October. However, it had widened again by early November, as the cost of forward cover had risen. By the time Bank rate was again increased, on 9th November, there was the prospect that euro-dollar rates would soon resume their upward movement.

During the period under review, banks in the United Kingdom continued, on balance, to switch back into foreign currency funds previously employed in sterling, though not to any great extent. At the end of September the banks' net external liabilities in foreign currencies had been reduced to £54 million, compared with £84 million three months earlier.

Foreign exchange market

Sterling remained weak throughout the period. In September and the early part of October, however, the market was generally quieter than it had been since the end of May.

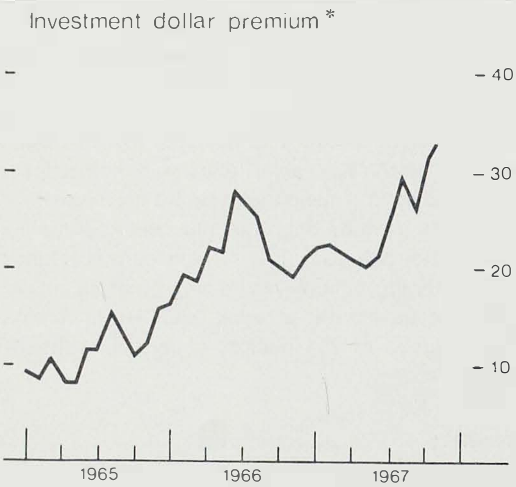
In the first half of August there was some quite heavy selling of sterling, and on 10th August the spot rate for U.S. dollars, which had fluctuated around $\$2{\cdot}78\frac{9}{16}$ since the middle of July, fell below $\$2{\cdot}78\frac{1}{2}$. A slightly better tone developed after the publication of the trade figures for July, and, towards the end of August, the market was much encouraged by the news of the Group of Ten[1] proposals for the creation of special drawing rights with the International Monetary Fund. As a result, the authorities were able to recover some of the losses incurred earlier in the month.

Within a few days, however, there was an abrupt turn-round following the announcement of further relaxations in hire purchase restrictions and, for a short time, there were fairly heavy sales of sterling. September began, therefore, with the undertone for sterling again distinctly weak. Nevertheless, though the spot rate dropped to about $\$2{\cdot}78\frac{5}{16}$ during the month and the market required support at times, official intervention was on a smaller scale than in August. Towards the end of September U.S. banks and others wishing to show a more liquid position in their balance sheets over the end of the quarter were bidding heavily for spot dollars but, in the last day or two of the month, the pressure diminished and the spot rate recovered slightly.

Early in October, following advance accounts in the press of the European Commission's views on the U.K. economy and the overseas sterling holdings, the undertone weakened again, and, in the second week, the market was very disturbed by the poor trade figures for September. Uneasiness was increased by labour disputes, particularly in the docks, and, for a day or two, there were heavy sales of sterling, both spot and forward. The spot rate, which, until then, had fluctuated narrowly around $\$2{\cdot}78\frac{3}{8}$, fell below $\$2{\cdot}78\frac{1}{4}$. There was then some buying of sterling in expectation of an early increase in Bank rate. After the rise in Bank rate on 19th October, there was a short spell during which sterling was sold fairly heavily – seemingly because an increase of 1% had been expected – but, towards the end of the month, the market became quieter, the spot rate remaining at a little over $\$2{\cdot}78\frac{1}{4}$.

1 See page 376.

Per cent per annum



The investment dollar premium has risen steeply in recent months, and it reached a new peak at the end of October.

* Last working day in month.

The investment dollar premium, which had fluctuated between 25% and 30% since early July, went above 30% in late September and reached a new peak of $33\frac{1}{8}$% at the end of October. In the last two years the premium has increased roughly threefold; as was noted in the March 1966 *Bulletin*,[1] the supply of investment dollars has been much reduced, and the premium now tends to move erratically on quite small demand. The size of the premium in recent months has been due partly to a steady reduction in the supply of dollars – as a result of the exchange control measures introduced in April and July 1965 – but also to lack of confidence in sterling.

Reserves and central bank facilities

During the third quarter the reserves showed a loss of £36 million after regular annual servicing of debt, costing £14 million in August. The equivalent of about £150 million was drawn under swap facilities with the Federal Reserve System; use was also made of other facilities. As noted above, the identified balance of payments deficit during the quarter was heavy and the balancing item was probably adverse; and in July and August there was a substantial outflow of short-term funds.

Gold market

Demand for gold was generally moderate until shortly before the middle of October, though there were two brief spells of greater activity earlier in the period. Towards the end of August, demand increased because of doubts whether the Group of Ten would reach agreement on a scheme for providing additional world liquidity. There was also some buying in advance of the I.M.F. annual meeting at the end of September, reinforced by demand from certain European banks for end-quarter balance sheet purposes. However, demand was on a smaller scale than before the Fund meeting in 1966. The dollar equivalent of the daily fixing price remained high, rarely falling below \$35·18 per fine ounce, and rising above \$35·19 on the two occasions noted above.

Some heavy buying began in the second week of October, though it eased towards the end of the month. Most of the demand apparently came from private buyers. The fixing price reached \$35·19$\frac{7}{8}$.

Producers' sales, which had been rather low in July, returned to more normal levels in August and September but were again on the low side in October.

Exchequer finance

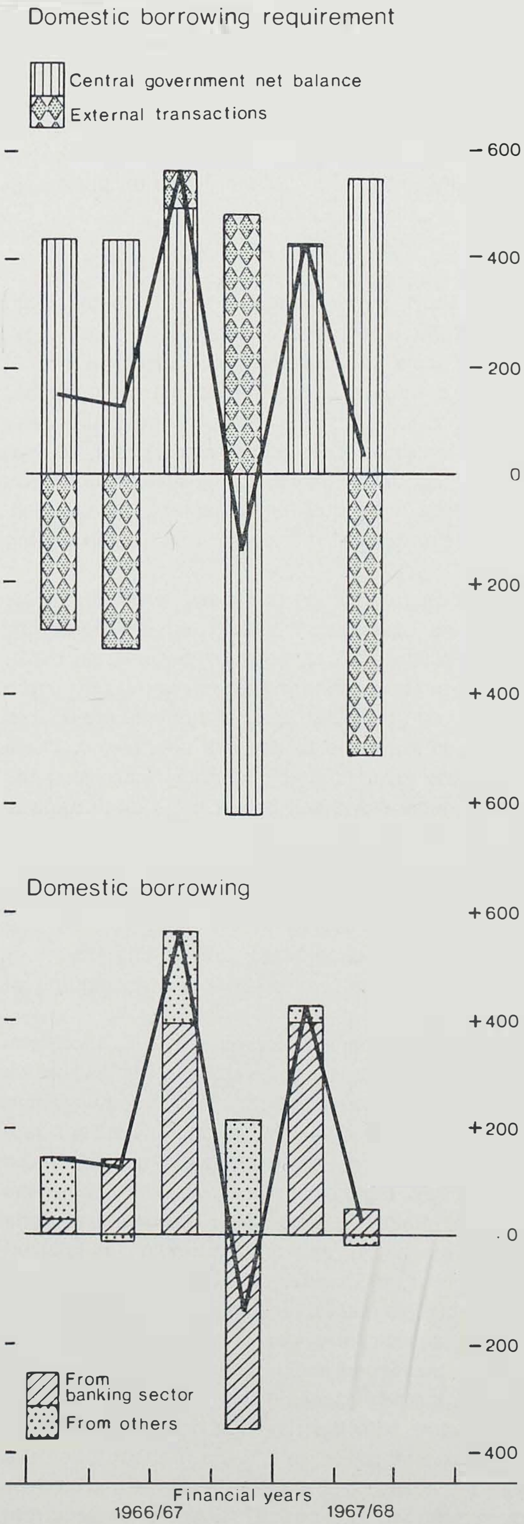
In the quarter ended September the excess of ordinary expenditure over revenue was greater than a year earlier. Revenue was a good deal higher, partly because of the changed pattern of taxation, but expenditure rose even more. Loans from the Consolidated Fund, too, were larger; local authorities borrowed less, but the nationalised industries took considerably more – the electricity industry's requirement was greater and the British Steel Corporation had begun to borrow.

The central government's deficit (net balance), at £542 million, was, therefore, appreciably greater than in the third quarter of 1966. Largely because of the heavy outflow of foreign exchange, the sterling produced by external transactions offset a very large part of the central government's deficit; so that the domestic borrowing requirement was no more than £28 million.

Domestic holders – mainly the banking sector – sold on balance

1 Page 14.

Exchequer finance £ millions



In the third quarter the Exchequer's domestic borrowing requirement was small and it was more than covered by debt taken up by the banking sector.

a total of £61 million of gilt-edged.[1] They bought in August and during the first three weeks of September, but sold in July and at the end of the quarter. Net Exchequer indebtedness to the Banking Department of the Bank of England fell by £108 million – reflecting the running-down of bankers' balances with the Bank from the seasonally high point that they had reached on 30th June. As a result, other forms of domestic indebtedness increased by a little under £200 million; for seasonal reasons, small savings did not contribute any finance, but there was an increase in tax reserve certificates outstanding and a smaller one in notes and coin. In the event, the Exchequer had to increase its domestic borrowing through Treasury bills by £162 million; nearly all of them were taken up by the banking sector.

In aggregate, the banking sector acquired £34 million of government debt, slightly more than the whole of the domestic borrowing requirement.

London clearing banks

Between the mid-July and mid-October make-up dates net deposits with the London clearing banks rose by £187 million: but, after seasonal adjustment, the rise was about £290 million, evenly spread over the three months. The increase in deposits was associated, in the main, with a continued rise in the banks' lending to their customers.

The clearing banks bought a small amount of gilt-edged, and their holdings of Treasury bills also rose – though much less than in the previous three months. But their main contribution to the Exchequer's financing requirement was indirect, through an increase of about £100 million in their lending to the discount market – almost reversing the movement between mid-April and mid-July. There was some reduction in their holdings of commercial bills in the month to mid-October, no doubt partly in anticipation of the rise in Bank rate.

Advances by the clearing banks, excluding those to the nationalised industries, fell by about £70 million between mid-July and mid-October. After adjustment for seasonal factors, however, and for the transfer from the private to the public sector of the advances that were outstanding on vesting day to the re-nationalised steel companies, there was an underlying increase in advances during the three months of some £175 million. The latest figures, for the month to mid-November, show a further rise – after seasonal adjustment – of about £70 million.

Over the six months to mid-October, advances other than to the nationalised industries rose by about £330 million, seasonally adjusted. A sizable part of the increase in lending was to personal customers for house purchase and other purposes – such personal borrowing had previously fallen very sharply – but there was also a strong underlying increase in lending to industry. Though the seasonally adjusted figures must always be interpreted with caution, it seems clear that the banks' lending to industrial and commercial companies did not fall as might have been expected. This may have been due in part to the need of companies for working capital, as their output began to recover, and to the unexpected buoyancy of their expenditure on plant and machinery. (Capital issues were small during the period, and it may be that companies were continuing to finance their requirements through bank borrowing until

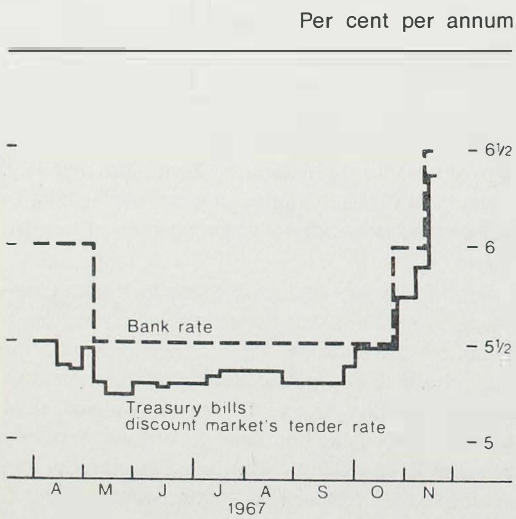
1 Including their large sales of steel company securities between 17th July and vesting day (September *Bulletin*, page 228).

economic recovery had gathered pace.) And there may have been some liquidity shortages among companies – to which higher tax payments contributed.

The London clearing banks and the Scottish banks announced in August that they were prepared to make special medium-term loans available to purchasers of machine tools that are manufactured in the United Kingdom. Loans will be for up to five years at normal overdraft rates; repayments will be small at first, becoming larger towards the end of the life of the loan, as the return on the equipment increases.

Bill markets

Money was generally short throughout the three months from August to October, and the Bank gave assistance on most days, usually on a substantial scale. During the first half of the period the discount houses were frequently required to borrow overnight from the Bank, but only at market rates. On 1st August, the Bank lent (for the first time) for seven days at the market rate, so that repayments would fall at the time when the large official purchases of steel company securities were due for settlement. On 6th September, lending was for five days at the market rate (again for the first time).



During September and October the discount market was obliged to borrow heavily and frequently at Bank rate, and its tender rate for Treasury bills rose to well within $\frac{1}{32}$% of Bank rate. Bank rate was raised from $5\frac{1}{2}$% to 6% on 19 October; and to $6\frac{1}{2}$% on 9 November, after which the tender rate rose to $6\frac{3}{8}$%.

Early in August the houses continued to receive large allotments of the increased offerings of Treasury bills. Their bill portfolios, however, did not rise as fast as before, because the clearing banks were again buying bills from them and the Bank were relieving more of the daily shortages through bill purchases. At this time the houses saw little alternative but to leave the tender rate unchanged. There was no reason for them to lower their bid, thereby increasing the rate, for they were now managing to sell bills. On the other hand, a reduction in the rate would have been unwelcome to the authorities, as U.S. short-term rates were rising. On 18th August, however, encouraged by the better trade figures for July, the houses increased their bid and the rate fell by nearly $\frac{1}{16}$%. For the next four weeks they kept their bid unchanged; during this time they secured smaller allotments at the tender, because the amount of bills on offer was rather less.

By the second half of September, the increase in U.S. short-term rates and the sharp rise in euro-dollar rates obliged the authorities to seek an increase in the Treasury bill rate. On 21st September the market was forced to borrow a very large amount at Bank rate – for the first time since 7th June – both overnight and for seven days. On the following day, the houses lowered their bid at the tender, the rate rising by almost $\frac{3}{32}$% to $5\frac{3}{8}$%. Borrowing at Bank rate continued (mainly overnight) and the houses again lowered their bid on 29th September, the tender rate rising to well within $\frac{1}{32}$% of Bank rate – the smallest margin for a great many years.

During the next three weeks there was some further borrowing at Bank rate, though on a reduced scale. Nevertheless the houses left their bid unchanged, for they assumed that the authorities were satisfied, for the time being, with the rise that had taken place in the rate. After Bank rate was raised to 6% on 19th October – a smaller increase than the houses had expected – they lowered their bid, so that the tender rate rose to almost $5\frac{3}{4}$%. And after Bank rate was again increased, to $6\frac{1}{2}$%, on 9th November, the tender rate rose to $6\frac{3}{8}$%.

Until about the middle of September the average cost of the houses' borrowed funds remained fairly stable, at a little below

$5\frac{1}{16}\%$. By mid-October, frequent borrowing at Bank rate and the rise in overnight borrowing rates had raised the average cost to around $5\frac{1}{8}\%$; and it had increased to about $5\frac{1}{2}\%$ by the end of the month.

The houses' buying rate for three months' prime bank bills remained at about $5\frac{1}{2}\%$ from the end of July to almost the end of September. By the end of October, it had been raised to $5\frac{15}{16}\%$, for the houses were being offered large quantities of bills by the banks.

In the quarter to the end of September the houses' holdings of Treasury bills continued to grow – though less sharply than in the previous quarter – and they added to their holdings of commercial bills. On the other hand, taking the quarter as a whole, they were again sellers of gilt-edged. (They sold more in October, in anticipation of the rise in Bank rate.) Their borrowed funds rose in total, chiefly because call money from the clearing banks increased substantially.

Other short-term rates

For local authorities the period falls into two parts; between the end of July and the middle of September there were plenty of short-term funds available, thanks in part to official purchases of steel shares, and, on balance, the rate for three months' money with local authorities declined slightly. But it began to move upwards in the second half of September, for local authorities needed to borrow more, and temporary money, other than for very short periods, was proving harder to find. Some funds that had sought short-term outlets in August were being withdrawn, and local authorities' interest rates had become out of line with those for euro-dollar deposits. The local authorities' rate for three months' money rose sharply early in October, and again, after the rise in Bank rate on 19th October. By the end of the month the rate was about $\frac{3}{4}\%$ higher than it had been at the end of July.

During the period a number of local authorities made bill issues in anticipation of revenue.[1] The larger issues were an offer by tender by the Manchester Corporation of £$4\frac{1}{4}$ million 122-day bills – taken up at an average rate of $5\frac{1}{2}\%$; a placing with the discount market, at $5\frac{5}{8}\%$, of £$3\frac{3}{4}$ million 91-day bills by the Liverpool Corporation; and an offer by tender by the Greater London Council, renewing £25 million 91-day bills, taken up at just under $5\frac{3}{4}\%$.

Rates offered for deposits with hire purchase finance houses fell a little in the first half of the period under review, because of the ample supply of funds; later, other borrowers were bidding more strongly for short-term funds, and rates increased. At the end of July, rates for three months' deposits were just under $5\frac{3}{4}\%$; by the end of October they had risen close to $6\frac{1}{2}\%$.

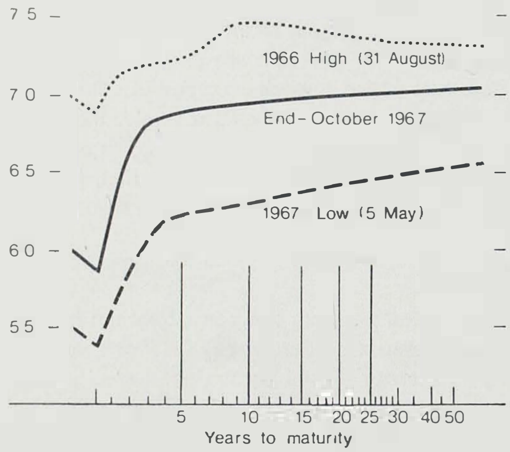
Gilt-edged

The market remained generally firm throughout August and the first three weeks of September and there were, on balance, quite large official sales of stock, while yields declined slightly. At the beginning of August the full effects of the steel compensation issue had still to be absorbed; official support of the compensation stock ($6\frac{1}{2}\%$ Treasury Stock 1971) had been given on 31st July, when dealings began, and this continued on 1st August; but demand then increased and support was withdrawn. The market became much firmer after hopes that interest rates might be stabilised had been encouraged by the proposals for higher personal and company taxes in the U.S.A.

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

Per cent per annum

Time / yield curves of British government securities*

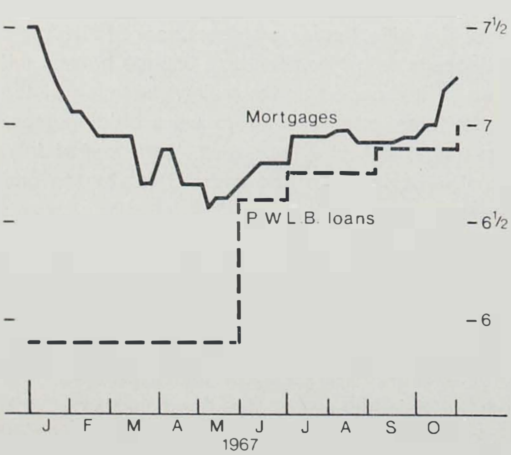


Yields continued to rise on balance and, by the end of October, most were over ½% above the low point reached six months earlier.

* The lines begin at Bank rate and continue through the yield on 91-day Treasury bills to those on British government stocks. See the article in the March *Bulletin*, page 52.

Per cent per annum

P.W.L.B. loans and local authority mortgages: 5–10 year rates



Since the end of May P.W.L.B. lending rates (which are now related to rates at which the Government itself can borrow) have been close to market rates paid by local authorities for mortgages of similar term.

The smooth working of the market was disturbed temporarily by delays in settlement for official purchases, in the two weeks before 28th July, of the securities of the steel companies which were being nationalised. Before these settlements could be made, transfers had to be certified; but dealings had been so heavy that the steel company registrars were overburdened. The Bank, therefore, took steps to curtail the settlement procedure, arranging for the Government Broker to pay for official purchases against notifications from the Stock Exchange that transfers had been lodged with the registrars. Even so, some of the monies that had been due on 8th August took a week or more to emerge.

Shortly afterwards, the market was encouraged by the better trade figures for July, and official sales of stock became heavy. Activity declined towards the end of August, and the market remained quiet but firm until early in September, when a marked improvement took place, and official sales of stock – including, for the first time, 6½% Treasury Stock 1971 – again became heavy. Official sales continued, though on a smaller scale, despite the upward trend in U.S. short-term interest rates, the growing belief that the balance of payments recovery would take longer than previously supposed, and, finally, the adverse trade figures for August.

The news that the discount houses had been obliged to borrow at Bank rate on 21st September, followed by the increase in the Treasury bill rate, caused an abrupt change in sentiment. For a time, official support was necessary and yields rose sharply – those on longer-dated stocks rising almost to 7%. By the second week of October, however, a firmer tendency had developed and, for a time, there was a resumption of official sales, particularly of short-dated stocks. The market weakened again after the announcement of the poor trade figures for September, and selling increased as the continued rise in the U.S. Treasury bill rate made it seem inevitable that Bank rate would be raised. Yields soon seemed to be discounting a full 1% rise in Bank rate and, after the rise of ½%, on 19th October, the market remained uneasy, looking to a further rise in the near future.

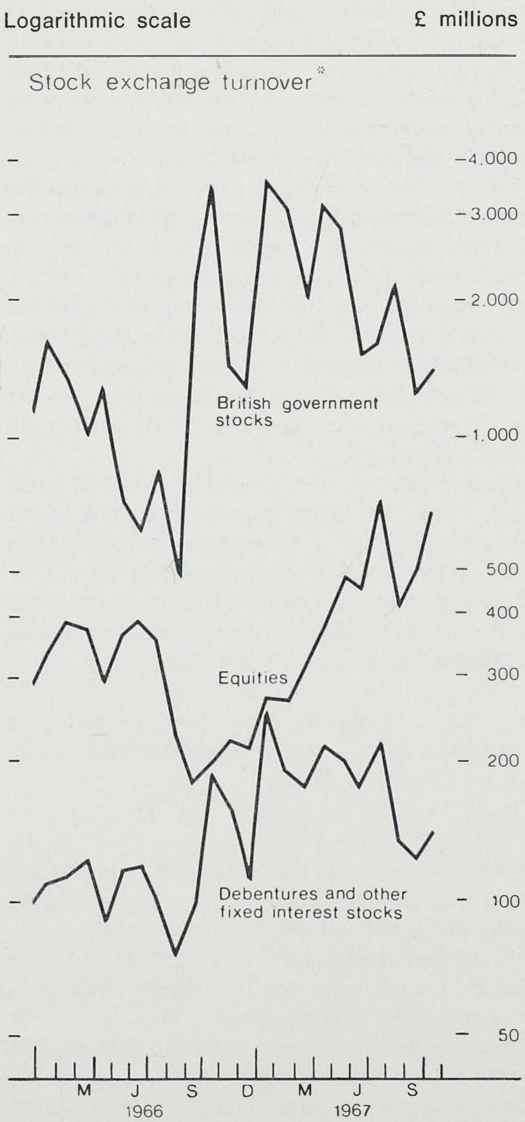
By the end of October yields on short-dated stocks were about ¼% higher than three months earlier, and those on longer-dated stocks were between $\frac{1}{16}$% and ⅛% higher. Turnover during the three months under review was appreciably lower than in the previous three.

Other medium and long-term rates

Borrowing by local authorities from the Public Works Loan Board, which had been low in July, recovered to some extent in August, but fell away again in September. As noted above, ample short-term funds were available until mid-September. There was, moreover, a general increase, early in September, in P.W.L.B. lending rates. Since 31st May, when the Board's lending rates were raised to reflect the full cost of the Exchequer's own borrowing,[1] P.W.L.B. rates had been close to rates for market mortgages of similar term. By the end of October, P.W.L.B. rates for most lending had been raised to 7%.

At the beginning of August the limit on the amount of short-term bonds that a local authority might issue on the London market was altered from £1 million to between £1 million and £5 million – the exact figure being determined by the total amount of loan debt that

1 September *Bulletin*, page 228.



Turnover in government and other fixed interest stocks fell on balance from August to October. Equity turnover fell in August but picked up again in September and October.

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

the authority had outstanding. At the same time, the procedures under which the Bank of England are notified of the requirements of local authorities were modified to enable the Bank, in marshalling the queue of borrowers, to take greater account of readiness to proceed with issues. Though some authorities took advantage of their new limits to make bond issues, the net amount raised by local authorities as a whole through the issue of bonds and stocks between August and October was only £43 million – £56 million less than in the previous three months.

On the other hand, borrowing by local authorities on mortgages may have been heavier than in May to July; it was probably concentrated in September and October. Most mortgage rates fell slightly in mid-August; but they increased a little in the second half of September and rose sharply in October, particularly the rate for one-year mortgages – which tends to move broadly in line with rates for temporary money. At the end of October rates ranged from $7\frac{1}{8}$% to $7\frac{3}{8}$%, compared with $6\frac{3}{8}$%-7% at the end of July.

At the beginning of the period local authority securities were freed from stamp duty on both issue and transfer;[1] previously only temporary loans were exempt, though they were subject to a small flat rate duty – which remains in force.

The market for company fixed interest securities was fairly quiet between August and October. After the heavy dealings in July (associated with the transactions in steel company securities) turnover fell sharply in August and was little changed in September or October. Yields declined a little; according to the F.T.-Actuaries calculation,[2] the yield on 20-year debentures and company loan stocks fell from around $7\frac{3}{4}$% at the end of July to about $7\frac{5}{8}$% at the end of October. As gilt-edged yields rose a little during the period, the margin over the calculated yield on a 20-year government stock narrowed to about $\frac{5}{8}$%. New issues of fixed interest securities were very small in August; but they rose sharply in September, to the highest figure since February, and were almost as high in October. During the three months companies raised just over £80 million – a little more than in the previous three.

Equities

Between August and October equity prices continued to rise strongly, to reach new peaks – continuing an advance that, with short interruptions, had persisted since the previous autumn. Turnover during the period, however, was smaller than in May to July.

The underlying strength of the market owed a good deal to a lack of new issues and a considerable amount of take-over activity, which together reduced the amount of stock in the hands of the market. In the first nine months of 1967 new issues of ordinary shares by U.K. quoted public companies totalled some £58 million[3] – much lower than in most recent years. During the same period, up to £190 million of ordinary shares of quoted public companies was absorbed in take-over deals for cash.[4] In addition, an appreciable amount of equities was taken over in exchange for the issue of fixed interest stocks. And some £350 million of marketable equities disappeared into official hands when steel was re-nationalised.

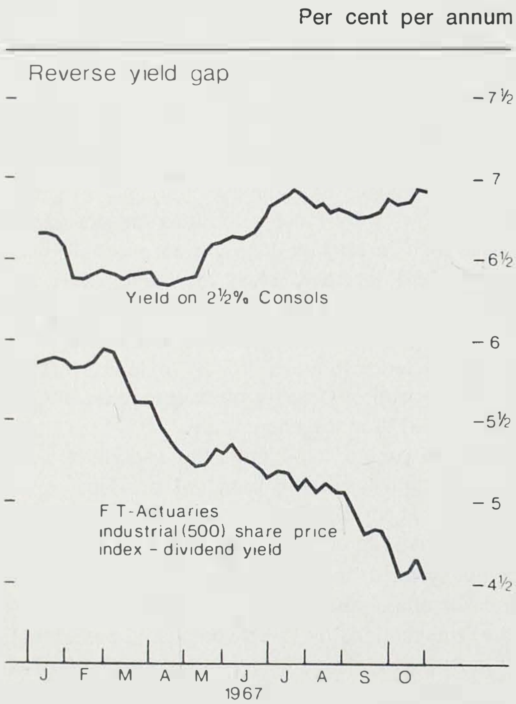
During the three months under review, however, the strong rise

1 Previously, duty on transfer of stocks and marketable bonds was, in most cases, either compounded or paid by the borrowing body.

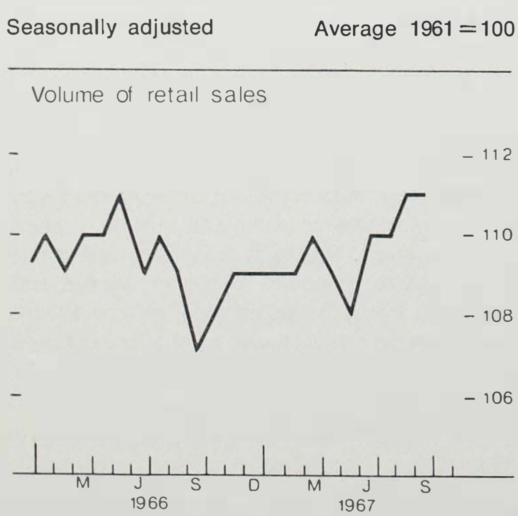
2 This calculation is based on representative stocks bearing various coupons but all issued before April 1964—giving a yield which was somewhat higher than that on stocks issued more recently.

3 Table 14 of the annex.

4 Table 15 of the annex.



Share prices rose strongly from August to October, reducing the dividend yield. The yield on undated government stocks rose slightly, so that the reverse yield gap grew wider.



Retail sales were 2% higher in the third quarter than in the second.

in equities also reflected the view taken by investors that the economy had by then experienced the worst effects of the period of restraint, and that the reflationary measures would soon lead to renewed growth. Some recovery in profits, and a number of better than expected company results, added to the market's buoyancy, as also did precautionary buying of equities as a hedge against devaluation – a possibility that continued to be discussed.

The market weakened a little in the early part of August, but the better trade figures for July soon brought about an improvement and, at the end of the month, the further relaxations in hire purchase restrictions caused prices to move ahead sharply. The market continued to advance during the greater part of September and was checked only temporarily by some profit-taking towards the end of the month. Early in October there was some hesitation, mainly because of the poor trade figures for September; but the undertone remained firm and, after the rise in Bank rate on 19th October, prices rallied strongly.

At the end of October the F.T.-Actuaries index of industrial share prices stood at 131·5, some 14% higher than three months earlier and about 40% above the low point of November 1966. The rise in prices was accompanied by an almost corresponding drop in dividend yields. The "reverse yield gap" – the amount by which the yield on 2½% Consols exceeds the average dividend yield on shares included in the F.T.-Actuaries industrial share price index – had widened to almost 2½%.

New issues rose sharply in September and, during the period as a whole, totalled some £33 million – a good deal higher than in May to July, though still low by historical standards.

Domestic economy

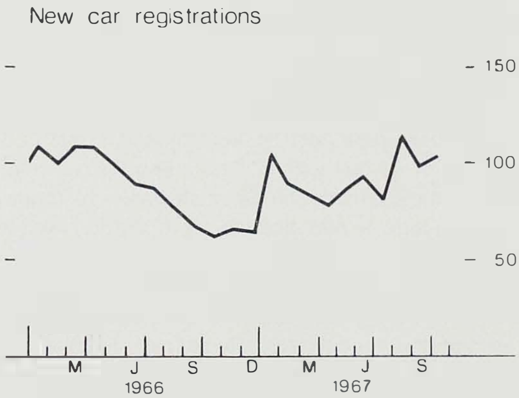
Contrary to earlier impressions, output and domestic demand did not fall in the second quarter. Since then it seems that output by manufacturing industry has increased a little, and there is stronger evidence of a rise in demand. The latest survey carried out by the Confederation of British Industry reported that industrialists were feeling slightly more confident in September than in May.

After allowing for seasonal factors, industrial production as a whole was no higher in the third quarter than in the second, though there was some increase in production by manufacturing industry. However, the underlying rise in unemployment may have come to an end; after seasonal adjustment, the number of wholly unemployed (excluding school-leavers) fell between August and November, while the number of vacancies for adults increased, after having declined over the previous twelve months.

The growth of domestic demand was due primarily to a rise in consumer spending assisted by the relaxations of hire purchase restrictions in June and at the end of August, by an increase in personal borrowing from the banks and, most of all, by a rise in incomes after the period of severe restraint ended in June. Wage rates rose sharply in July and more slowly between August and October. And earnings were over 2½% higher in the third quarter than in the second. Retail prices, however, remained fairly steady until October, when they moved up quite sharply, only in part for seasonal reasons.

Seasonally adjusted, the volume of retail sales (accounting for roughly one half of consumers' expenditure) rose sharply in August; though there was little or no further change in September, sales were about 2% greater in the third quarter than in the second. There

Seasonally adjusted
latest month provisional Thousands



And the upward trend in car registrations continued. Both retail sales and registrations were helped by the relaxations in hire purchase restrictions, by an increase in personal borrowing from the banks and by a rise in incomes.

was an increase also in the number of new cars registered; after seasonal adjustment, registrations rose sharply in August, in part because of the introduction of the new registration letter; nevertheless, the underlying trend was upwards, reflecting the easing of hire purchase restrictions.

Housebuilding too has contributed to the rise in demand. In the second quarter expenditure on new housing by the public sector was nearly 3% higher than in the first; and there was an even bigger rise (6½%) in housebuilding for private ownership. More recently, lending by the building societies increased quite substantially in the third quarter, while their commitments to lend also continued to rise. There has been a parallel increase in bank lending for house purchase.

Other fixed investment by the public sector has continued to grow quickly. In the second quarter expenditure was just over 7% higher than in the first, and it seems likely to have risen further since then. To help employment in the development areas during the winter months, some projects are being brought forward by the public sector for completion before the end of April.

The volume of fixed investment by private industry, after seasonal adjustment, rose a little in the second quarter. The distributive and service industries spent more – heavier progress payments on ships were in part responsible – while expenditure by manufacturing industry continued to decline slowly, because less was spent on buildings and construction. However, the Board of Trade's survey of investment intentions, published in October, indicated that manufacturers would spend only about 6% less this year than in 1966 – a much smaller drop than was forecast in the spring. And the indications were that their spending would begin to rise next year. Investment by the distributive and service industries too is likely to have been more buoyant than was forecast earlier. Expenditure on plant and machinery – which accounts for just under half of all private industry's fixed investment – seems generally to have held up well.

In other fields demand has been less strong. As noted above, exports declined further: in the third quarter, their volume, after seasonal adjustment, was about 4% lower than in the second. During the same period, manufacturers and distributors ran down their stocks.