Commentary

Introduction

The last Commentary outlined the events leading up to the devaluation of the pound on 18th November. This one covers briefly some of the same ground, and then describes developments, in more detail, up to the end of January.

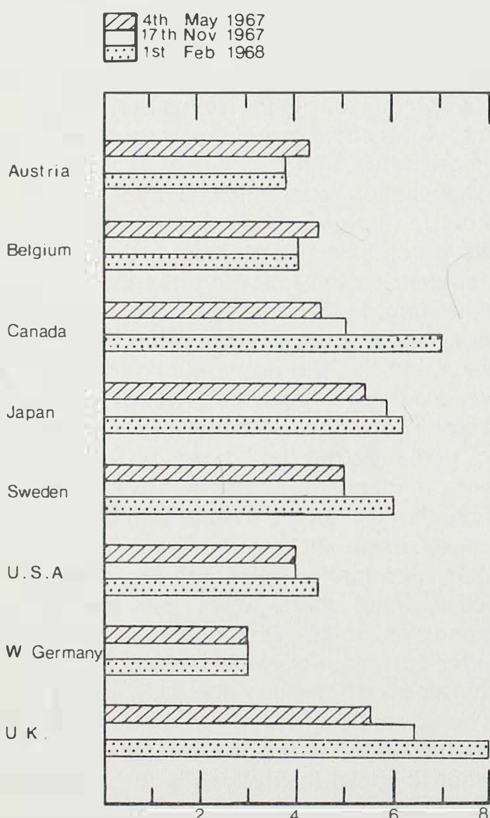
The shock of devaluation was followed by a period of upheaval and rumour in foreign exchange and gold markets. In London, markets were closed on Monday 20th November, and when they reopened on the following day there was an acute shortage of sterling. In the next few days a good deal of foreign exchange flowed back to the United Kingdom to cover short positions, but this did not continue for long and there was a renewed outflow of short-term funds in December. The market soon took the view that the measures to restrain domestic demand that had been announced on 18th November were inadequate, and it then waited for the further steps which the Government had said they stood ready to take to make devaluation work.

Immediately after devaluation pressure on the dollar became very heavy, and there were periods of unprecedented demand for gold. Confidence in the dollar began to return after 1st January, when President Johnson announced a programme to reduce the U.S. balance of payments deficit by $3 billion in 1968; new direct investment abroad is to be limited,[1] and the foreign lending of U.S. banks and other financial institutions is to be reduced, particularly lending to continental Western Europe. Proposals have also been made to tax travel by U.S. residents to countries outside the western hemisphere.

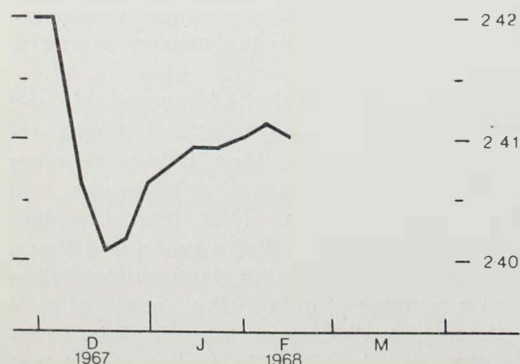
In other U.K. markets the period just after devaluation was hectic. Official sales of gilt-edged were very large for a week or so, as investors seized the opportunity of obtaining yields associated with an 8% Bank rate; and in the equity market there was a heavy demand for shares that seemed likely to benefit from devaluation. The money market experienced an extreme shortage of funds for three days after devaluation, followed by two days of large surpluses – a reflection of the intense activity in the foreign exchange and gilt-edged markets.

By early December security markets had become thin and volatile. Confidence remained very brittle, and it was not until after the middle of the month, when it became clear that the Government were preparing further measures, that sentiment began to improve a little. Even then, investors were clearly suspending judgment until the extent and shape of the measures were known. On 16th January the Prime Minister announced a number of cuts in the growth of public expenditure; these are discussed later in this Commentary. And, on the next day, the Chancellor stated that the Budget would be brought forward to 19th March, and would contain further measures to restrain the growth of

1 The limits will vary from one group of countries to another; in the group that includes the United Kingdom, investment by corporations in 1968 will be limited to 65% of the average amount invested in 1965-66.



After Bank rate was increased to 8%, discount rates were raised in a number of other countries.



The spot rate weakened soon after devaluation; from mid-December onwards, however, it improved gradually.

* Weekly, Fridays.

consumer spending. The initial reaction of the markets was unfavourable – gilt-edged prices fell sharply and equities made record gains – mainly because they had expected immediate steps to restrain consumer spending, which seemed to have been rising unusually fast since devaluation. Later, markets became more settled.

Interest rates abroad generally continued to rise during the three months under review. After Bank rate was increased to 8%, official discount rates were raised in a number of countries, including the United States. Late in December the Federal Reserve System took a modest step towards tightening its credit policy, and a further rise in interest rates in the United States seemed in prospect. However, U.S. Treasury bill rates eased temporarily towards the end of January; and in the euro-dollar market, too, rates fell back – by rather more than was to be expected from the reversal of end-year pressures.

Foreign exchange market

Sterling was under heavy pressure throughout the first two weeks of November, and there was much talk of devaluation; apprehension fed on anything that seemed to point to a change in the parity. In the third week confidence at first recovered slightly: on Tuesday 14th November it was announced that a loan equivalent to some $250 million had been extended to the United Kingdom, through the Bank for International Settlements, to finance the final repayment to the International Monetary Fund of the 1964 drawing; and it was widely believed that further substantial assistance for sterling was being discussed. However, towards the end of the week the market became convinced that devaluation was imminent. The pound was then sold, both spot and forward, on a massive scale.

When the market reopened after devaluation, there was an immediate shortage of sterling, as those who had entered into commitments before the week-end to deliver sterling which they did not have, now scrambled to buy pounds at the new rate of exchange, or to borrow them. Covering of short positions continued during the next few days and kept the spot rate very close to the new official upper limit of $2·42. Nevertheless, the reflux of foreign exchange fell a good way short of the very large outflow before devaluation. Nor was there much sign at this time (or, indeed, later in the period) that investment funds were returning, despite the 8% Bank rate; or that forward sales of sterling were being reversed before maturity.

The inflow of foreign exchange fell away around the turn of the month, and the spot rate for U.S. dollars dropped back from $2·42. In the early part of December the rate moved downwards in an extremely thin market. Very heavy demand for gold shortly before the middle of December further depressed sterling, and the rate fell almost to the new parity of $2·40. However, a firmer tone developed just before Christmas, thanks in part to reports that there would soon be further cuts in domestic spending, but also because gold buying had diminished and commercial demand for sterling had developed. By the end of the year the spot rate had recovered to almost $2·40¾.

The announcement of the measures to reduce the U.S. balance of payments deficit caused the dollar to strengthen immediately against all other currencies, including sterling. But the pound suffered only temporarily, for there was soon a renewal of commercial demand, while dollars became more plentiful as end-year window dressing operations by continental banks were reversed.

Hope that the impending cuts in U.K. domestic spending would re-establish confidence, and the belief that the U.S. measures would restore stability to the international monetary system, produced some improvement in the spot rate; by the middle of January it had recovered to just over $2·41. The actual announcement of the cuts in public expenditure disappointed the market; but later the spot rate resumed its upward movement and reached almost $2·41¼ by the end of the month. Its main support came from purchases of sterling to close out the forward contracts entered into before devaluation, many of which were now beginning to mature.

The discount on forward sterling had widened in the first half of November, in spite of continued official support. After devaluation, when the Bank ceased to play an active part in the forward market, rates remained highly sensitive, reflecting the continued weakness of confidence. At one point, in mid-December, the cost of three months' cover reached the equivalent of almost 5% a year. Later in the month, however, margins narrowed, and they were generally smaller in January, reflecting some improvement in sentiment.

Gold market

Demand for gold grew heavy early in November, for there was much uneasiness about the stability of both reserve currencies. In the week after the devaluation of the pound, speculative pressure against the dollar intensified – apart from the disturbance in the markets the prospects for the U.S. balance of payments were disquieting – and it took the form of a much heavier demand for gold. Indeed, this reached new records on each successive day from the Wednesday to the Friday. On 26th November, the members of the central bank gold pool[1] (except France, which had ceased to take an active part in the pool in July) met in Frankfurt and expressed their confidence in their ability to maintain the existing gold price and exchange parities. This calmed the market, which remained much quieter until the middle of December.

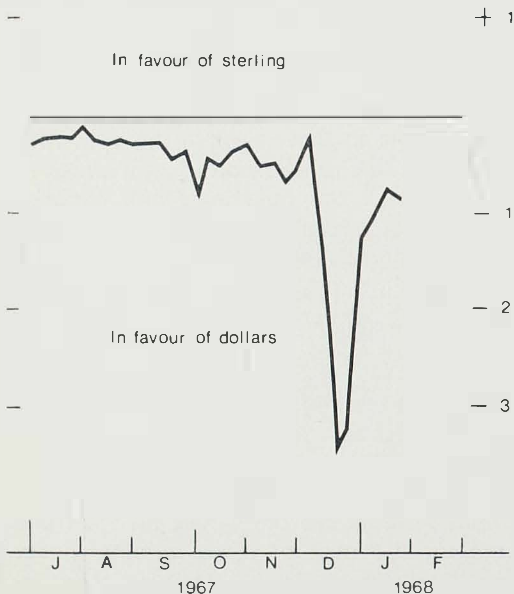
Heavy buying of gold was resumed when there were rumours that freedom of access to the London gold market might be restricted. Pressure eased again after a joint declaration by the Secretary of the U.S. Treasury and the Chairman of the Federal Reserve Board that the existing gold price would be maintained, and that market arrangements would remain unchanged; and early in January demand returned to normal after the announcement of the U.S. balance of payments measures.

In the middle of January there was a brief resumption of heavy buying before President Johnson's State of the

1 The origin and purpose of the gold pool are described in the March 1964 *Bulletin*, page 18.

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 *

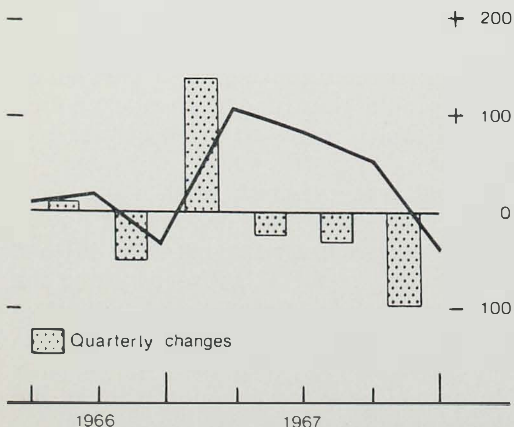


The covered margin in favour of investment in euro-dollars moved erratically during the period November to January; at one point in mid-December it reached almost 3½%.

* Weekly, Fridays.

£ millions

U.K. banks' net external liabilities(+) or claims (–) in foreign currencies



At the end of December banks in the United Kingdom had net external claims in foreign currencies of £38 million, compared with net external liabilities of £54 million three months earlier.

Union message, but it fell away after the President had said that he would ask Congress to abolish the statutory 25% gold backing of the Federal Reserve note issue.

The dollar equivalent of the daily fixing price remained between \$35·19¼ and \$35·20 throughout most of November and December; early in January it fell back temporarily to \$35·13¾, but it had recovered to above \$35·19 by the end of the month.

The central bank gold pool continued to operate throughout 1967. The pool was a net supplier of gold over the year, the outflow being heaviest in November and December.

Movements of short-term funds

There was a large net outflow of short-term funds during the three months under review, and it was concentrated in November and December. In January there was a net inflow, mainly in the form of a rise in the sterling balances of overseas sterling area countries. Confidence remained weak, particularly in December, and after taking into consideration the cost of forward cover, there was no interest incentive for funds to move to London.

The United Kingdom's net external liabilities in sterling fell sharply in November and December but recovered to some extent in January. Over the three months taken together, and excluding the counterpart of drawings on central bank facilities, the sterling balances of countries outside the sterling area showed little change; they declined in November – more was withdrawn from London before devaluation than returned immediately afterwards – but were built up again in December and January. The balances of overseas sterling area countries fell in November and December but showed some recovery in January. Interpretation of these movements is more difficult than usual, however, because of the disturbed nature of the period under review.

Although short-term interest rates in the United Kingdom were high, the normal arbitrage comparisons during the period were generally unfavourable to sterling. Indeed, at one point in mid-December the increased cost of forward cover raised the margin by which the return on three months' euro-dollar deposits exceeded that on three months' loans to local authorities to almost 3½%. In November banks in the United Kingdom continued to switch back into foreign currency funds previously employed in sterling. They seem, however, to have switched a small amount into sterling in December and January. Compared with their net external liabilities in foreign currencies of £54 million at the end of September, the banks had net external claims of £38 million at the end of December.[1]

Euro-dollar rates rose sharply after devaluation, influenced by the rise in U.K. and U.S. short-term interest rates and by a heavy demand for dollars to purchase gold. By the end of November they had fallen somewhat; gold buying had temporarily abated and, to ease the expected end-year shortage, some central banks made dollars available for redeposit in the market. In December rates declined

1 As noted in the article "U.K. banks' external liabilities and claims in foreign currencies", in the June 1964 *Bulletin*, the banks have an underlying net assets position because they hold minimum balances with their correspondents abroad, as well as certain balances for U.K. residents who have exchange control authority to retain foreign currency.

on balance – despite the resumption of gold buying towards the middle of the month and the usual demand for dollars at the end of the year – and they fell back quite markedly in January. Some decline was to be expected after the end of the year, but the fall in rates may have been associated to some extent also with the temporary employment of funds raised in the euro-bond market.

Balance of payments

The balance of payments estimates for the fourth quarter of 1967 will be published shortly. Meanwhile, it is clear that there was a very much larger deficit on current and long-term capital account than in the third quarter. The deterioration was due mainly to the effects of the strikes in the Liverpool and London docks, though the extra costs to the United Kingdom of the closure of the Suez Canal (which reached their peak in the fourth quarter) and the initial rise in import prices after devaluation were also important.

The deficit on visible trade, after seasonal adjustment, was about £335 million, compared with £80 million in the third quarter. The c.i.f. value of imports, as recorded in the trade accounts and seasonally adjusted, was 10% higher – in part because the volume of oil imports was larger and freight on oil more expensive, in part because of the generally higher value of imports, in sterling terms, following devaluation. The much greater sterling cost of the United Kingdom's imports will worsen the deficit in the early part of this year, whereas the potential benefits of devaluation, in terms of increased exports, will take longer to materialise.

Exports fell abruptly in the fourth quarter. After seasonal adjustment, they were about 10% lower in value than in the third quarter, mainly because of the delays in shipments caused by the strikes. However, December was much better than November, as the arrears at Liverpool began to be cleared; and there was a very large rise in January, as a start was made on the back-log at London.

The invisible account will have worsened in the fourth quarter, partly for seasonal reasons – there were annual payments of interest in December on the U.S. and Canadian government loans, and royalty and tax payments by the oil companies were larger. The long-term capital account also will have been more unfavourable, mainly because of the repayments of principal on the North American loans.

In 1967 as a whole the deficit on current and long-term capital account may well have been in the region of £550 million – over four times as large as in 1966 and considerably greater than in 1965. The size of the reverse owed much to the docks strikes in the fourth quarter and to other exceptional factors during the year. The closure of the Suez Canal, the displacement of imports from 1966 (caused by the advance warning of the removal of the import surcharge) and the docks strikes, taken together, may have accounted for half or more of the deficit. Nevertheless, exports were disappointingly low; and imports were high for most of the year. It is clear that the underlying trend in the balance of payments remained unsatisfactory, and that the earlier recovery was not sufficiently well-founded.

Reserves and central bank facilities

In the fourth quarter of 1967, the United Kingdom's gold and convertible currency reserves fell by $38 million.[1] In January they rose by $53 million.

Month by month there were some fairly large swings in the reserves during the fourth quarter. In October there was an increase of $75 million. In November there was a larger increase ($127 million), but only after taking into account the transfer to the reserves of the remaining assets ($490 million) in the Government's portfolio of dollar investments. In December there was a fall of $240 million, but this time after $220 million had been repaid by way of principal and interest on the North American loans.

The reserves benefited in October from a loan of 450 million Swiss francs ($103 million) offered to H.M. Government by a consortium of three Swiss commercial banks. As noted earlier, a loan in November, equivalent to some $250 million, from a number of central banks[2] was used to make the final repayment to the I.M.F. of the United Kingdom's 1964 drawing – so that the reserves suffered no net loss on this account. Following devaluation, some $1,500 million of credit facilities were placed at the disposal of the United Kingdom by central banks, and a one-year standby facility of $1,400 million was provided by the I.M.F.[3]

During the quarter, a net amount of $400 million was drawn under the Federal Reserve reciprocal swap arrangement. By mid-November the whole amount then available under this facility ($1,350 million) had been drawn, but some was repaid later in the month as foreign exchange returned to London after devaluation. At the end of November the facility was increased to $1,500 million, as part of a general enlargement of the reciprocal arrangements that exist between the Federal Reserve System and other central banks. At the end of December outstanding drawings under the increased facility totalled $1,050 million. During the quarter other facilities also were drawn upon.

It was announced on 12th February that the arrangements – related to fluctuations in overseas countries' sterling balances – which were originally entered into in June 1966 with nine central banks, and with the B.I.S., had been extended for a further year from March 1968. The facilities arranged in September 1965 with the U.S. authorities – which are additional to the standing reciprocal swap arrangement with the Federal Reserve System for $1,500 million, noted above – continue alongside these arrangements, as does the renewable three months' swap facility with the Bank of France. The total of these facilities remains at $1,000 million.

Commodity markets

The devaluation of sterling involved losses for a number of U.K. merchants – particularly commodity traders, whose losses arose in two ways. International trade in many commodities is conducted extensively in sterling, so that on

1 Figures in this section are quoted in U.S. dollars to avoid problems of conversion into pounds sterling arising from the change in the exchange rate during the quarter.

2 The loan was in various currencies; it is due for repayment in twelve equal instalments, spread over a period from seven to eighteen months after the drawing.

3 December 1967 *Bulletin*, page 336.

18th November a number of traders had forward contracts open in sterling, both to buy and to sell. Shippers in exporting countries that had not devalued found the sterling they had contracted to receive worth less in terms of their own currencies, and some demanded that contract prices should be revised upwards before the goods were supplied. U.K. merchants, unable or unwilling to break their own sales contracts, strenuously resisted such demands, and in certain cases H.M. Government took up the matter, through their posts abroad. Many cases have now been resolved by agreement between supplier and merchant; some are still subject to arbitration.

Other merchants, because of trade practices or local official requirements, had contracted to purchase goods from certain sterling area countries in local currencies, for which they were unable to obtain forward cover and which, in the event, were not devalued. The question of cover had been discussed from time to time, both with the selling countries mainly concerned and with the U.K. authorities. It had not proved possible for the selling countries to set up adequate forward markets in their currencies, and the U.K. authorities were not willing to see sterling area trade covered in London in dollars. After devaluation representatives of commodity market associations in London and Liverpool approached the authorities to seek compensation for those of their members who faced losses. Neither the Government nor the Bank accepted that they had a responsibility for making good losses which had arisen as a result of commercial decisions taken in the knowledge of the risks involved.

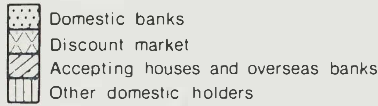
However, to assist traders over their difficulties – which might well have endangered the future of these commodity markets in the United Kingdom – the Bank offered loans up to a total of £5 million, subject to a maximum of 80% of losses incurred. Firms' initial estimates of their losses had totalled £6½ million; but, partly because some losses proved on re-examination not to be eligible, and partly because a number of firms decided to meet theirs from their own resources, applications were finally received by the Bank in respect of losses totalling only £4½ million, and the Bank expect to advance just over £3½ million. The loans are unsecured, and subordinate to claims of other creditors. They are repayable by half-yearly instalments over five years, with interest at 5%.

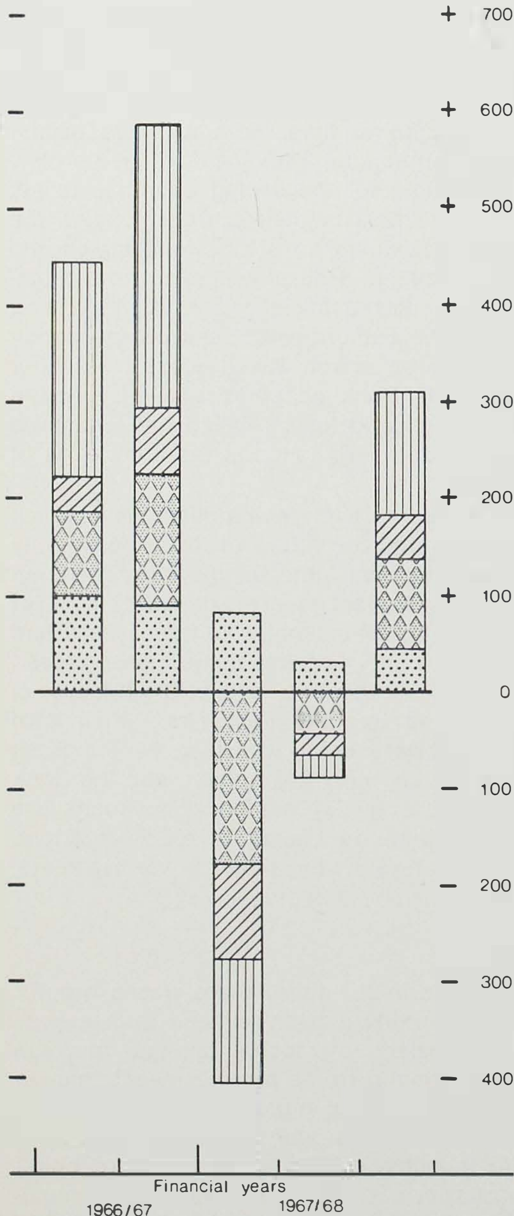
Exchequer finance

In the fourth quarter, as in the third, there was a greater excess of ordinary expenditure over revenue than a year earlier. Receipts, particularly of income tax and customs and excise duties, continued to be more buoyant than in 1966. But expenditure rose even more, mainly because of payments of investment grants and refunds of selective employment tax to industry, neither of which were being paid in the fourth quarter of 1966. Loans from the Consolidated Fund, on the other hand, were smaller: though the nationalised industries took much the same as a year earlier, local authorities borrowed considerably less.

The central government's deficit (net balance), at about

£ millions





Official sales of gilt-edged improved markedly in the fourth quarter because of the heavy demand just after devaluation.

£800 million, was a good deal larger than in the fourth quarter of 1966. But receipts of sterling from external transactions were large, so that the domestic borrowing requirement was limited to about £335 million – much less than a year earlier.

The domestic borrowing requirement was more than covered by sales of gilt-edged (which were particularly large just after devaluation), and by the seasonal increase in notes and coin held by the public. As other forms of non-marketable government debt were on balance little changed – small savings declined (also seasonally) but the public built up its tax reserve certificates – there was a reduction of about £215 million in Treasury bills outstanding.

The banking sector

In aggregate, the banking sector ran down slightly in the fourth quarter its holdings of marketable government debt. Its net gilt-edged purchases were large – over £180 million – but its holdings of Treasury bills fell by about £195 million.

The *discount market's* assets rose in total by about £160 million. There was a substantial increase in the houses' holdings of short-dated bonds, which they bought heavily after Bank rate rose to 8%. However, their Treasury bill holdings fell a little during the quarter: before the rise in Bank rate their portfolios grew considerably, because the banks were reluctant to acquire bills; but afterwards they obtained smaller allotments, in face of keen outside competition at the tenders. The houses' commercial bill holdings followed a similar pattern, but rose substantially over the quarter.

The increase in their borrowed funds was in call money from the London clearing banks and advances from the Bank. The accepting houses and overseas banks withdrew funds from the market.

The call money withdrawn by the *accepting houses and overseas banks* appears to have been switched into gilt-edged, of which these institutions also made large purchases after the rise in Bank rate. Among their other sterling assets, advances to U.K. residents (excluding other banks) and lending to U.K. local authorities each fell appreciably; and there was only a small increase in sterling lending to overseas residents.

Sterling deposits by U.K. residents, excluding other banks, increased, but deposits in sterling by overseas residents again fell substantially – a reflection of the continued lack of confidence.

The figures for the *London clearing banks* relate to the period between their make-up dates in mid-October and mid-January. Before devaluation, they ran down their holdings of Treasury bills, anticipating a further rise in interest rates, and preferred instead to lend substantial amounts on call to the discount houses. After the rise in Bank rate they rebuilt their bill holdings and reduced their lending to the houses. On balance during the three months their Treasury bill holdings declined and their call money increased. The clearing banks, too, bought gilt-edged, but their purchases were not large compared with the other banks'.

Net deposits, after seasonal adjustment, rose only moderately, and by less than the banks' lending to customers. The small increase in deposits reflected the Exchequer's comparatively low domestic borrowing requirement, and the extent to which it was met by sales of gilt-edged to investors other than the banks.

The clearing banks' advances, excluding those to the nationalised industries, rose during these three months by about £85 million more than might have been expected on seasonal grounds. Most of the increase, however, occurred during the early part of the period, and advances then levelled out. One factor was the effect of the restrictions imposed on 18th November[1] in restraining personal advances – which had gone ahead strongly in the summer and autumn. But demand from industry for bank advances also seemed to have fallen away, possibly because of the general atmosphere of uncertainty after devaluation and the high cost of bank borrowing after Bank rate was raised to 8%.

In the month to mid-February, however, advances rose by about £65 million, after seasonal adjustment. One reason seems to have been that local authorities were borrowing on overdraft more heavily than usual; as noted below, they have tended recently to borrow as short as possible because of current high interest rates. Part of the balance will no doubt reflect increases in other forms of lending exempt from the restrictions; but a detailed analysis is not yet available.

Bill markets

During most of the three months from November to January, money continued to be very short. Though the pressure on sterling abated after devaluation, the ensuing turmoil in foreign exchange markets, and the tendency towards still higher interest rates abroad, required the authorities to maintain the conditions of stringency that had been a feature of the money market since the summer.

In the three weeks before devaluation, however, the Bank only once required the market to borrow at Bank rate. At other times they relieved the fairly large shortages by purchases of Treasury bills and by lending for one or two days at market rates. It was a difficult period for the houses, because the trend in interest rates was clearly upwards. Bank rate had been increased from 5½% to 6% on 19th October, and it was raised to 6½% on 9th November; yet it was widely expected that rates would go higher still, and the houses were reluctant to acquire bills. However, with little outside competition at the tenders, they were obliged to take up a substantial proportion of the bills on offer. Meanwhile, the average cost of their borrowed funds was rising, and they were running at a loss the bills that they had acquired at lower rates.

In the week after devaluation, the supply of money in the market fluctuated very widely. On Tuesday, 21st November, there was an acute shortage because the banks were withdrawing funds, on an altogether exceptional scale, to meet the sales of sterling that had been contracted just

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1 December 1967 *Bulletin*, page 348.

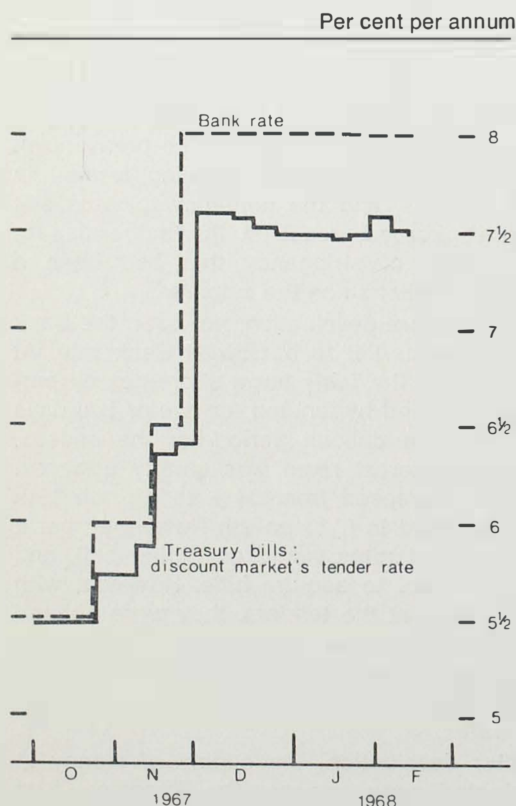
before devaluation. And shortages continued on the next two days as money was called in to meet very large gilt-edged purchases undertaken on the Tuesday and Wednesday respectively. By the end of the week, however, shortages had given way to conditions of surplus, because the Exchange Equalisation Account was paying out large amounts of sterling for the foreign exchange that it acquired immediately after devaluation. During the first part of the week the Bank assisted the market to an unprecedented extent, largely through purchases of Treasury bills; and towards the end of the week they sold bills to absorb the very large surpluses. Their net assistance to the market in the week totalled over £700 million.

The difficulties experienced by the houses in the first half of November, noted above, were greatly aggravated by the rise in Bank rate to 8%. The consequent increase in overnight borrowing rates raised the average cost of the houses' borrowed funds sharply, so that they were having to run their portfolios at a much bigger loss than before. By early December the average cost was about $7\frac{1}{4}$%, compared with about $5\frac{1}{2}$% at the end of October, and it remained fairly steady over the rest of the period.

The market continued to experience shortages in December, but they were not severe until after Christmas, when the banks were calling in funds to meet end-year needs. In January, the start of the heavy seasonal flow of revenue to the Exchequer brought fresh shortages, which the Bank continued to relieve by lending and by bill purchases – on a large scale on successive Tuesdays (the main day for revenue transfers), and to a smaller extent on other days.

After the increase in Bank rate to 8% the houses lowered their bid sharply at the tender, raising the rate by about $1\frac{3}{16}$% to a little over $7\frac{9}{16}$%. Outside competition then revived strongly; with the next move in interest rates likely to be downwards, bills had again become very attractive. The discount houses were anxious to obtain reasonable allotments but were well aware that any move to drop the rate sharply, in order to improve their share of the tenders, would be resisted by the authorities. So they increased their bids in only small stages over the next four tenders. Early in January they made a further small increase in their bid because, with the arrival of the main revenue season, bills were expected to become scarce; but the rate then became firmer, for it seemed less likely that Bank rate would be reduced quickly.

The houses progressively raised their buying rates for prime bank bills during the first half of November, both to keep them in line with the increases in the tender rate, and to damp the flow of commercial paper that they were obliged to take from increasingly unwilling holders among the banks. Having risen to about $7\frac{3}{4}$% after 18th November, the buying rate for three months' bills remained unchanged over the rest of the period.



During December and early January the discount houses reduced the tender rate in small stages. The rate became firmer when an early fall in Bank rate seemed less likely.

Gilt-edged

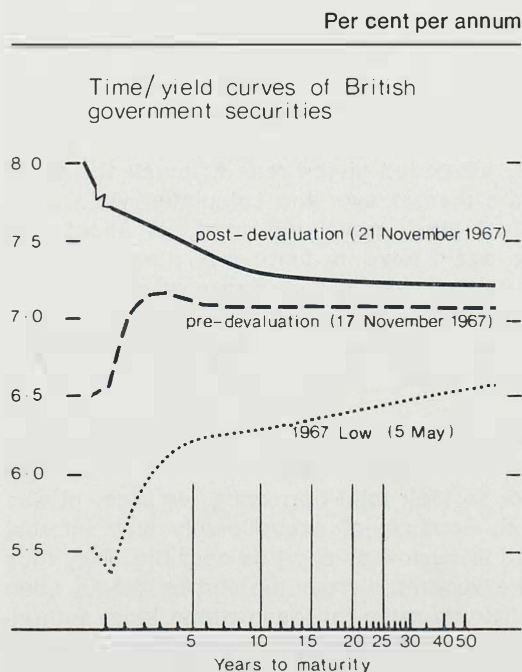
In the first half of November the market remained uneasy; the external situation was plainly deteriorating and, des-

pite the increase in Bank rate to $6\frac{1}{2}$% on 9th November, there was a general expectation that interest rates would go higher still. But selling was never really heavy, though prices, particularly of the shorter-dated stocks, tended to fall. Shortly before devaluation the market had steadied and the authorities managed to sell a sizable amount of stock.

In the week after devaluation net official sales were extremely large, and they continued to be quite heavy in the following week. Supplies of the long tap stock were almost exhausted (a further tranche of £600 million $6\frac{3}{4}$% Treasury Loan 1995/98 was issued on 24th November) and sales of the short-dated tap stock and of the steel compensation stock[1] were also large. Yields were lifted after the rise in Bank rate to 8%, and there was a marked change in the pattern, which brought short-dated yields well above the longer-dated. Subsequently yields fell steadily.

The market's exuberance had died away by the beginning of December and speculative holders took their profit. More important than the technical reaction, however, was the fear that the Government might be slow to take the further measures needed to ensure the success of devaluation; and an early reduction in interest rates seemed less certain. However, selling was seldom large, and towards the end of the month the expectation of further measures brought a better tone. By and large, conditions were quiet but firm up to the middle of January, and the authorities were again able to sell some stock. But the gilt-edged market, like others, was disappointed by the announcement of cuts affecting only public expenditure, and prices fell sharply. Though sentiment later improved a little, investors were now clearly waiting for the Budget.

Over the three months, gilt-edged yields rose appreciably: on short-dated stocks by almost $\frac{3}{4}$%, and on longer-dated by about $\frac{1}{4}$%. Mainly because of the heavy dealings in the wake of devaluation, turnover was considerably higher than in August to October.[2]



Short-term yields rose very sharply after devaluation, thus changing the pattern of the yield curve.

Equities and debentures

The equity market remained fairly buoyant during the early part of November, though it moved erratically just before devaluation. When the market reopened on 21st November it went ahead strongly, as investors sought out shares of companies with a large (or potentially large) export business, or with substantial overseas assets. The F.T.-Actuaries industrial share price index rose from 134·1 on 17th November to a new peak of 136·6 on the 22nd. There was soon a sharp reaction, however, as the full implications of devaluation and the associated measures began to be appreciated; and it was not long before the market was looking to further measures to reduce domestic demand. During the greater part of December the mood fluctuated; investors were uncertain about the domestic economy, still apprehensive about sterling, and nervous about the dollar's difficulties.

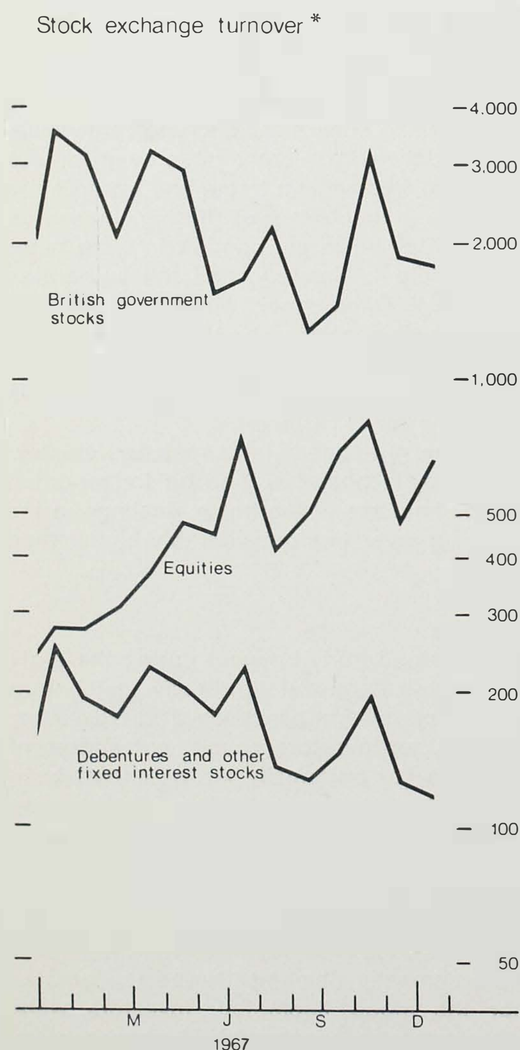
Early in January sentiment improved a little, partly because industry seemed slightly more cheerful about post-

1 $6\frac{1}{2}$% Treasury Stock 1971.
2 An article about turnover in British government stocks up to the end of September appears on page 48.

devaluation prospects but also, perhaps, because investors were beginning to hedge against a renewal of inflationary pressures – though further measures to reduce demand seemed imminent. As the cuts in public expenditure were announced shares were bought heavily, for the market saw the absence of restraints on consumer spending as confirmation of its suspicions; and by the close of business on 16th January the F.T.-Actuaries index had risen by a record 3·5 points. Prices fell back the next day, following the forecast of a strongly deflationary Budget, but the market continued mainly firm throughout the rest of the month.

Turnover in equities was exceptionally heavy in November and considerably higher over the three months taken together than in the previous three. New issues, at about £27 million, were slightly lower than in August to October.

Activity in company fixed interest securities remained small; turnover was only slightly higher than in August to October. Yields rose on balance; according to the F.T.-Actuaries calculation,[1] the yield on 20-year debenture and loan stocks increased from around 7⅝% at the beginning of November to around 7⅞% at the end of January. During the same period, gilt-edged yields rose to much the same extent, so that the margin over the calculated yield on a 20-year government stock remained steady at about ⅝%. New issues were again few; no doubt a number of would-be borrowers were deterred by the high cost of long-term finance, while companies in general seem to have been very liquid. It seems clear, nevertheless, that industry's need for finance was still rather low.



Devaluation was followed by heavy dealings. December was quieter, but turnover in equities increased in January.

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

Local authorities

Local authorities' income from rates was seasonally high during the period, so their total borrowing requirement was probably reduced. Because of exceptionally high interest rates, they tended to borrow as short as possible. They thus continued to take very little from the Public Works Loan Board. P.W.L.B. lending rates for loans within local authorities' quotas had risen fairly sharply since the end of May – when they began (for the first time since 1964) to reflect the full cost of the Exchequer's own borrowing; and they were raised after devaluation, from 7% to 7½% for shorter-term borrowing, and to 7⅜% for most longer-term.

Repayments on maturing stocks and marketable bonds slightly exceeded new issues, while borrowing on mortgages tended to fall away. Most mortgage rates rose throughout the period, apart from a short-lived decline early in December. By the end of January rates generally were around 7½%-7⅝%, compared with 7⅛%-7⅜% at the end of October.

Temporary borrowing, on the other hand, may well have been higher than in August to October, and was concentrated at the shorter end. Local authorities now have longer – until the end of March 1969 – in which to reduce their temporary debt to not more than 20% of their total outstanding debt, and it is possible that some of those who had reduced to near or below the minimum expanded their

[1] This calculation is based on representative stocks bearing various coupons, but giving a yield that was somewhat above that obtainable on high coupon stocks issued recently.

short-term borrowing in November to January.

Temporary money rates rose quite sharply early in the period – money for up to seven days more sharply than the rest. After the increase in Bank rate to 8%, a heavy demand for funds to replace those drawn into the gilt-edged market pushed rates higher, and they continued in the main to rise in December, as the banks called in funds to meet end-year demands. By the end of December the rate for three months' money was just over 1½% higher than at the end of October; there was little change in January.

Hire purchase finance companies

Having fallen since August 1966, the total of outstanding hire purchase debt owed to finance houses began to rise after terms control on cars was eased last June. Helped by other relaxations applying to a wide range of goods at the end of August, it continued to rise over the next few months – very sharply in October and November.

Hire purchase terms for cars were tightened again on 18th November, though terms remained rather easier than they had been before June. At the same time, the Bank requested finance houses to hold down their total lending – after allowing for seasonal fluctuations – to the level of end-October 1967 until further notice. As with the banks,[1] lending to the public sector, or specifically identified with the finance of export transactions, is exempt from the ceiling.

Until the sharp rise in their business in October the houses had little need to bid for funds; and the rates that they offered on three-month deposits did little more, during the summer and autumn, than keep pace with the rise in competitive rates. When Bank rate was increased to 8% the houses reacted in different ways; a number, believing that high interest rates would not last, began to quote rates varying with Bank rate for three-months' and six-months' deposits. By the end of December, however, when an early reduction in Bank rate seemed less likely, all the houses were again offering fixed rates for three-month money, and a few offered them for longer periods. By the end of January, rates for three-months' deposits were around 8%, compared with around 6½% at the end of October.

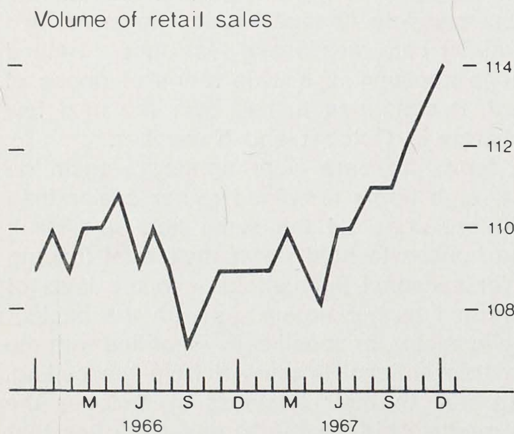
Domestic economy

The most significant feature of recent months has been a sharp rise in consumer spending. Other components of demand, with the probable exception of public expenditure, seem to have risen more slowly or to have declined. Demand as a whole may have increased, however, simply because consumer spending – which is by far the largest component – has risen rapidly. On the supply side industrial output – which had changed little since the end of 1966 – rose in the fourth quarter. The volume of imports was also greater.

After allowing for seasonal factors, industrial production increased appreciably (by over 1%) in the fourth quarter. And there are signs that activity has continued to pick up, largely, no doubt, because of the consumer boom but also, perhaps, because of some increase in export demand since

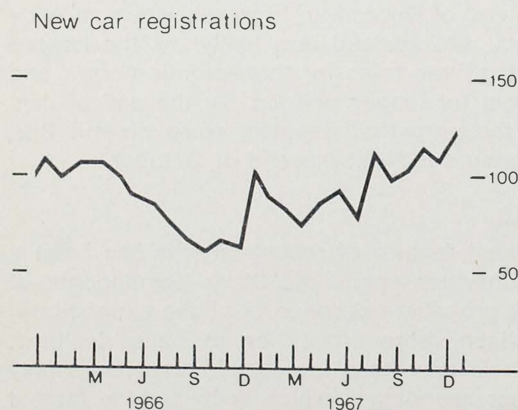
1 December 1967 *Bulletin*, page 348.

Seasonally adjusted Average 1961 = 100



The volume of retail sales increased sharply during the period November to January . . .

Seasonally adjusted
latest month provisional Thousands



. . . and the trend in new car registrations continued upwards.

devaluation. An enquiry in December by the National Institute of Economic and Social Research showed that firms engaged in engineering, and vehicle and chemical production, were forecasting large increases in both output and exports in 1968. More recently, a survey carried out by the Confederation of British Industry in early February revealed a big rise in the number of firms forecasting an increase in exports, compared with four months earlier.

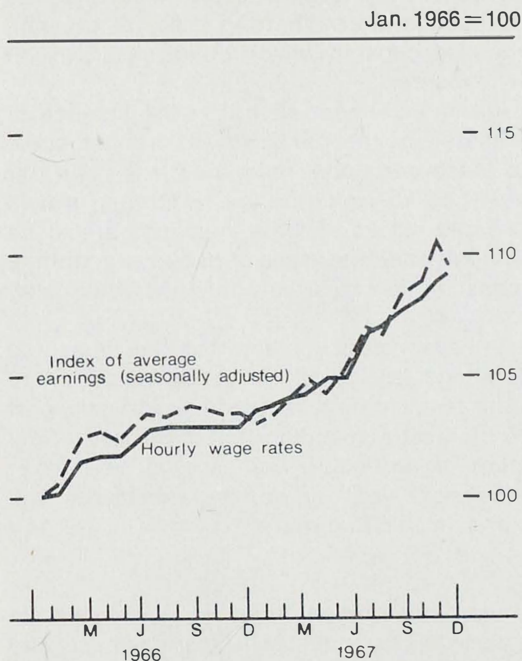
Unemployment has continued to decline. In mid-February the number of wholly unemployed, seasonally adjusted and excluding school-leavers, was 503,000 (2·1% of the total labour force) compared with 536,000 (2·3%) in mid-November. During the same period the number of adult vacancies rose slowly.

Consumer spending, which had been growing since the early months of 1967, increased strongly in the third quarter, and also – judging by the volume of retail sales and the number of new cars registered – in the fourth. There are reports that spending in the shops since the end of the year has been heavier than usual, while car registrations rose steeply in January. It seems clear that the surge in buying – much of it concentrated on durable goods – has been prompted by the fear of price increases and of further restraints on consumers' expenditure. Despite the tightening of terms control and the new restrictions on personal borrowing in November, purchasing power has remained high, largely because incomes have been rising much faster than prices. However, spending may have been boosted also by a reduced rate of personal saving.

Average weekly earnings continued to rise in the fourth quarter; after seasonal adjustment, the index was 4% higher in December than in June, when the period of severe restraint came to an end. Part of the increase was due to more overtime in the motor industry and – following the end of the strikes – in the docks. But basic wage rates also continued to rise quickly; between September and December the index of hourly wage rates increased by about $1\frac{1}{2}$%; and in January it rose more sharply still (by 2%). The rise looked like continuing; at the end of January pay claims were outstanding for well over 4 million wage and salary earners, about one fifth of the total labour force.

Though consumer prices have not, as yet, increased much as a result of devaluation, the prices of raw materials have risen sharply. The Board of Trade's index of manufacturers' buying prices for basic materials and fuels went up by as much as 9% between October and January. This had not worked its way through into industry's home selling prices, which rose by less than 1% during the same period.

As noted above, most forms of demand other than consumer spending seem either to have risen more slowly in recent months or to have fallen. Expenditure on new housing, by the public sector and for private ownership, taken together, probably rose less in the fourth quarter than in the third. Fixed investment by private manufacturing industry fell back in the third quarter and dropped further in the fourth; spending on plant and machinery, which had previously held up well, fell sharply. Investment by the distributive and service trades (apart from the shipping



In the fourth quarter, both wage rates and earnings continued to rise.

industry) was unchanged in the third quarter, but it too fell back in the fourth. However, the latest survey of investment intentions carried out by the Board of Trade indicated that investment by manufacturing industry may rise by about 5% this year, with a similar increase for the distributive and service trades. And the survey by the Confederation of British Industry, mentioned earlier, suggests that in February companies in general were planning to invest rather more this year than four months earlier.

According to provisional figures, manufacturers' and distributors' stocks, which had fallen in the third quarter, continued to decline in the fourth.

Public expenditure: domestic demand

On 16th January the Prime Minister announced a number of cuts in the growth of public expenditure. Some of these will begin to take effect in the financial year 1968/69, but the full savings will not be realised until 1970/71, or even later. It is estimated that in 1968/69 the cuts will save about £300 million of civil expenditure; and in 1969/70 total expenditure is expected to be reduced by £415 million, large economies falling on defence.

The cuts will bring a slower rate of growth in public expenditure than would otherwise have taken place, but not an absolute reduction. Expenditure is still likely to rise in 1968/69 by about 3¾% in real terms;[1] though the rise in 1969/70 is estimated to be no more than 1%. These measures reinforce, and are additional to, those announced at the time of devaluation.[2] They are designed to contribute to the diversion from home demand to the balance of payments of the considerable real resources that are required to take up the competitive advantage offered by devaluation.

The Government have stated that the United Kingdom needs to achieve a balance of payments surplus of the order of £500 million a year, and to maintain this while the massive amount of external short and medium-term debt that has been incurred in the last few years is repaid, the reserves are rebuilt, and the basis of sound domestic growth is laid. The size of the task may be judged by comparing the balance of payments target with the substantial underlying deficit experienced in 1967. Nevertheless, the objective is by no means beyond reach; in recent years a number of countries – Western Germany, France and Italy – have achieved very large improvements on current account quite quickly, albeit under differing circumstances.

The achievement of a surplus of £500 million will require the diversion of at least £1,000 million of resources from meeting domestic demand to improving the balance of payments. Part of the resources thus diverted will be needed to produce more exports, part to save imports – by competing more effectively with goods and services hitherto imported – and a smaller part to meet the worsening in the terms of trade which devaluation inevitably entails.

The growth of productive capacity – estimated to average about 3% a year at present – should provide most of the

1 Payments to industry of investment grants, selective employment tax refunds and regional employment premiums are excluded, so that the comparison between 1967/68 and 1968/69 is not distorted.

2 December 1967 *Bulletin*, page 336.

additional resources required; reckoned in terms of gross domestic product at 1967 prices, it could contribute as much as £1,000 million a year. There is also, at present, some margin of unused capacity which could be drawn on to provide further resources.

It is plain that the improvement sought in the balance of payments in the course of the next two years must make deep inroads into these additional resources; and a further substantial share will be absorbed by the necessary growth of fixed investment and stocks. If these demands are to be met, the claims on additional resources of public expenditure and of personal consumption must be contained within very narrow limits.

The Government have made it clear that the measures of 18th November and the cuts in public expenditure announced on 16th January have accounted for only part of the reduction in domestic spending that is needed. Consumers' expenditure in particular will have to be further restrained over the next year or so, and measures will be taken to this end in the Budget.

Conclusion

In the months ahead, the nation faces a severe test of tenacity and purpose. For industry – management and labour – the necessary effort to increase overseas sales will, in many cases, entail a major reorganisation. Though inducements are strong and the rewards of success large – whether looked at from the private or the national standpoint – it does industry no service to underrate the difficulties, or the length of time needed to achieve so radical a realignment of its production and marketing effort. The task will be less difficult if national self-confidence can be re-established quickly; and if, in the longer term, policy changes could be more gradual and their purpose understood better by those whom they affect.

Foreign confidence in the U.K. economy will need to be restored further if the reserves are to be augmented by a return of overseas funds. It was noted earlier in this Commentary that there has been little sign, so far, that high interest rates of themselves are attracting substantial funds to the United Kingdom – though funds have not moved out of London recently in response to high interest rates in other important centres. It was also noted that there was an easier tendency, towards the end of the period, in certain rates abroad. However, the future trend of interest rates is far from clear. The measures taken by the United States to improve its balance of payments may, for instance – by adding to the demand for dollars outside the United States, or by reducing their supply – contribute to the pressures that are keeping rates up.

In the longer term, the prospects for world trade and payments are likely to be improved by the reduction of the external deficit of the United States and the achievement of an external surplus by the United Kingdom. However, the conditions governing world trade in 1968 have been changed by the measures taken by the United States and the United Kingdom, and a recovery in the rate of growth may not be easily achieved. In that other countries are now called on

to run smaller surpluses than they would otherwise have done, it is important for trade prospects that policies of restriction or retaliation are eschewed. It is encouraging to note, therefore, that the other member nations of O.E.C.D. have indicated that they will try to accommodate the U.K. and U.S. measures without recourse to restriction.

Although the speed of the United Kingdom's recovery clearly depends in part on the progress of world trade, it is just as important that the competitive edge that devaluation has established for many British goods in home and overseas markets is maintained. It is urgent, therefore, that firm control be re-established over incomes, because demands for general wage increases are likely to grow stronger as prices rise in consequence of devaluation, while the likelihood of wage drift becomes greater as employment increases. A continued rise in incomes at anything like the recent rate (even if later neutralised by additional taxation) would add severely to industry's already growing costs.

The consumer will need to play his part in making room for an export-led expansion. To the extent that the present surge in consumer spending is anticipatory, it should have largely exhausted itself by the Budget; and be followed by slower growth, as savings are in some degree rebuilt. But the continuing rise in incomes adds to the danger that consumer spending may remain higher than can be safely tolerated at a time when exports and productive investment are expected to claim a much larger share of resources.

The management of demand will require particular care in the months ahead, if resources are not again to become overstretched and costs to rise out of hand. There will be strong pressures, of all kinds, to allow consumer spending and public expenditure to claim a larger share of resources than the needs of the balance of payments will permit. These pressures will need to be withstood until a lasting recovery in the external balance is seen to be achieved.