Commentary

Introduction

This Commentary is concerned mainly with events during the three months from February to April. At the end of February renewed fears about possible changes in U.S. gold policy stimulated a heavy demand for gold. During the next two weeks speculation in gold increased alarmingly. By the middle of March sterling had come under heavy pressure, there were signs of a flight from currencies into gold, and there was much talk of a breakdown in the international monetary system.

The London gold market was closed on 15th March, and central bank governors, meeting in Washington during the next two days, agreed to restrict the use of officially-held gold to transactions between monetary authorities. Foreign exchange markets then became calmer. The improvement in sentiment was helped by the U.K. Budget on 19th March – which was severe and generally acclaimed as appropriate – and by agreement in Stockholm at the end of the month by nine of the Group of Ten countries[1] to the scheme for Special Drawing Rights within the framework of the International Monetary Fund.[2]

Sterling improved after the Budget, and Bank rate was reduced from 8% to $7\frac{1}{2}$% on 21st March. For a short time there seemed a prospect that interest rates might go lower. However, the balance of payments and fiscal problems of the United States again claimed attention. Credit conditions there became tighter and Federal Reserve discount rates were raised with effect from 19th April. Meanwhile the feeling grew that the problems of the international monetary system were still pressing, and that the outlook for world trade remained uncertain. Sterling fell back after the first week of April and the price of gold in London and in other free markets began to rise again.

Lending by the clearing banks continued to rise; on 23rd May the measures of credit restriction that had been introduced on 18th November 1967 were modified so as to bring about a greater reduction in bank lending to non-priority borrowers than had so far taken place, while leaving sufficient room for lending for exports.

The Budget

It was noted in the last Commentary that the measures of 18th November and the cuts in the growth of public expenditure announced on 16th January would contribute only part of the reduction in domestic spending that was needed to free resources for improving the balance of payments; and that the Chancellor had made it clear that personal consumption in particular would be restrained further in the Budget. In the weeks before the Budget, consumer spending – prompted by the fear of price increases as well as of official restraints – continued to grow; while in the first

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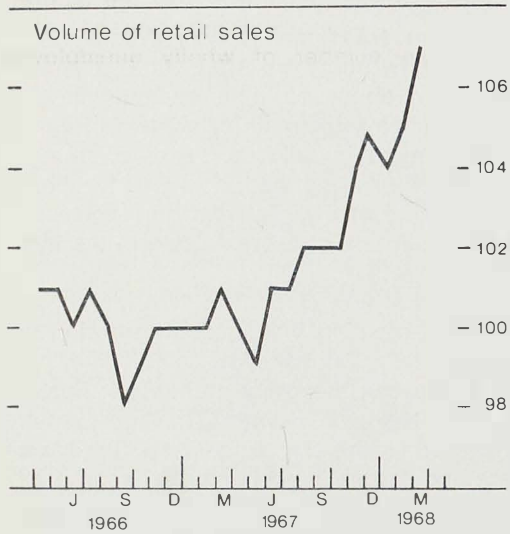
1 Belgium, Canada, France, Italy, Japan, the Netherlands, Sweden, the United Kingdom, the United States and Western Germany.

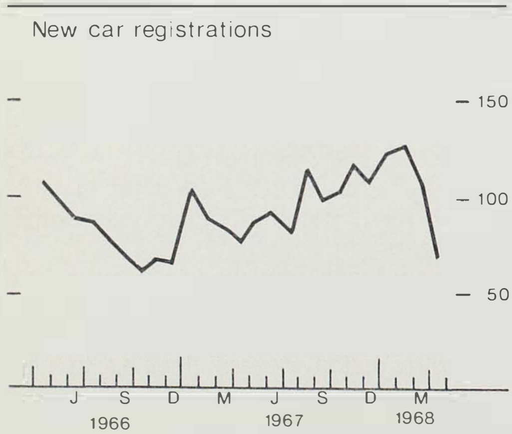
2 An article on Special Drawing Rights appears on page 146.

Seasonally adjusted Average 1966=100



Retail sales continued to rise in the first quarter . . .

Seasonally adjusted
latest month provisional Thousands



. . . and car registration reached a peak in February before falling back in March and April.

half of March, the events noted above in the foreign exchange and gold markets further weakened confidence in sterling. Much depended, therefore, on the strength and realism of the Budget proposals.

The Budget was introduced on 19th March. The Chancellor proposed heavy additional taxation, mainly indirect: he announced higher rates of purchase tax; increased duties on tobacco, wines and spirits, road fuels, and betting and gaming; a rise in motor vehicle duties; and an increase of 50% in selective employment tax (but with some concessions on refunds). There was also to be a special progressive charge, for one year only, on individuals' investment income in excess of £3,000.

These proposals, together with two announced previously – an increase in corporation tax from 40% to 42½% and a reduction in income tax personal allowances to offset an increase in family allowances – were estimated to yield an extra £775 million in revenue in 1968/69, and £923 million in a full year.

The expected increase in revenue reduced the Government's estimate of their borrowing requirement in 1968/69 to just under one third of the previous forecast: the revised estimate given in the Budget speech was £364 million. It will be recalled that the Government had stated their intention to the I.M.F., when the standby facility was granted in November 1967, of holding down the borrowing requirement this year to not more than £1,000 million.

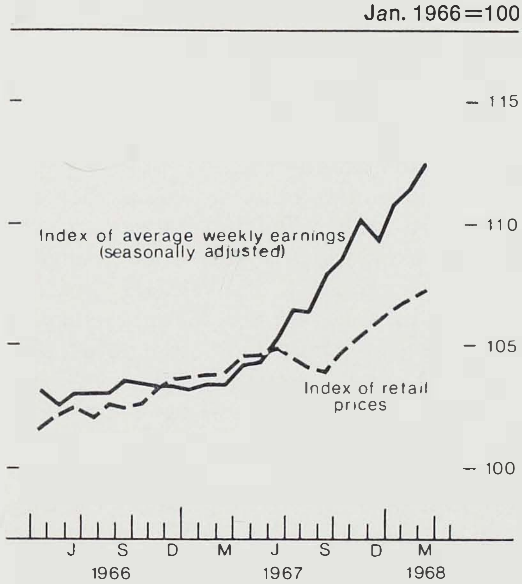
It has been estimated that the Budget measures, directly and indirectly, will withdraw about £500 million of purchasing power from the economy during 1968 and the first half of 1969; and according to the forecast published with the Budget, gross domestic product should grow at an annual rate of not much more than 3% during this period – roughly in line with the estimated average growth of productive potential.

Of the various components of demand, personal consumption is affected most by the Budget proposals, and is forecast to fall by almost 2%, in real terms, in the course of this year. In consequence, imports should grow more slowly than they would otherwise have done. And the reduced pressure of home demand on domestic resources should make room for exports to increase substantially – provided that world demand expands at an adequate rate. The volume of exports of goods and services is, in fact, forecast to rise at an annual rate of nearly 11% during 1968 and the first half of 1969 (or at 7½% if allowance is made for shipments in 1968 of goods delayed by the docks strikes at the end of last year).

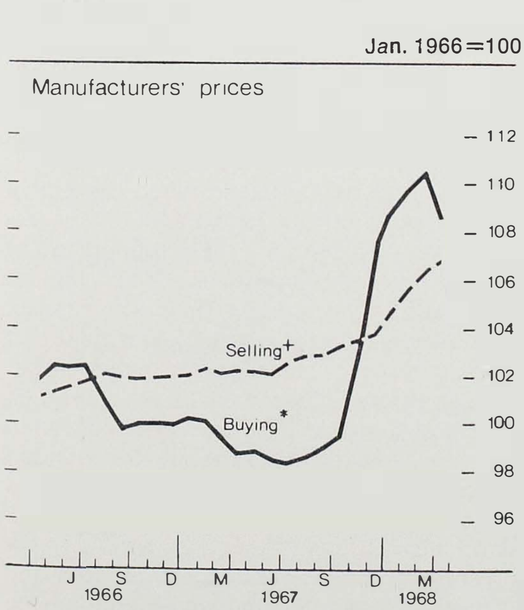
The Chancellor also proposed to increase the attractions of national savings. He announced the introduction of a weekly prize (in addition to the monthly ones) on premium savings bonds; a 6% British Savings Bond to replace the 5½% National Development Bond; and an increase from £750 to £1,000 in the maximum holding of national savings certificates of the current issue.

Domestic economy

Total demand probably rose in the first quarter of 1968,



Earnings continued to rise rapidly and by considerably more than retail prices.



Manufacturers' home selling prices have begun to show the effects of devaluation. Their buying prices have risen very sharply.

* Buying prices for basic materials and fuels.

\+ Home market selling prices for all manufactured products.

mainly owing to the strength of consumers' expenditure. Some, perhaps a substantial part, of the increase was met by a rise in imports, but domestic output also seems to have expanded – seasonally adjusted, the index of industrial production rose by just over 1%. However, activity may have been growing less quickly towards the end of the quarter. Certainly the fall in unemployment was reversed; after seasonal adjustment the number of wholly unemployed increased a little in March and continued to rise during the next two months – by May it totalled 544,000 (2·3% of all employees) compared with 503,000 (2·2%) in February. Notified vacancies for adults had ceased to rise at the beginning of the year.

Consumer spending continued strongly up to the time of the Budget. In the first quarter, the volume of retail sales, seasonally adjusted, was over $1\frac{1}{2}$% higher than in the fourth, and new car registrations reached a peak in February. However, spending seems to have fallen back since the Budget. Car registrations dropped quite strikingly, and the evidence on hand about the index of retail sales in April suggests a sharp fall in volume.

Other forms of domestic demand grew less vigorously in the first quarter or else declined. Fixed investment by the distributive and service industries increased; housebuilding for private ownership seems to have risen; and public investment probably continued to grow. On the other hand, investment by private manufacturing industry fell back further – particularly expenditure on plant and machinery; and there was apparently a sharp fall in stocks, concentrated in manufacturers' stocks of finished goods.

Wages and earnings have continued to rise by considerably more than retail prices. Between December and March hourly wage rates rose by over $2\frac{3}{4}$%, and the index of average weekly earnings, after seasonal adjustment, by about 3%. Retail prices, however, had still to reflect most of the effects of devaluation and the increases in indirect taxes imposed in the Budget; they rose by about $1\frac{1}{4}$% during the same period, and a significant part of the movement was due to seasonal increases in food prices.

As might be expected, the prices at which manufacturers sell their goods in the home market began to show the effects of devaluation rather earlier: in March, prices were more than 3% higher than in October. Manufacturers' buying prices for basic materials and fuels, moreover, had risen by nearly 11% during the same period.

In April, H.M. Government published a White Paper dealing with productivity, prices and incomes in 1968 and 1969. Existing criteria for increases in incomes would continue in force; a new feature, however, would be a limit, applied at an annual rate of $3\frac{1}{2}$%, to increases in pay – except in the case of genuine productivity bargains – and to dividend increases. The Government recognised that prices would rise because of devaluation and the Budget; but they hoped nevertheless, that increases would be kept to a minimum and every effort made to absorb higher costs through improved efficiency. They proposed to take statutory powers to delay price and pay increases for twelve months (through the process of reference to the National Board for Prices and Incomes), to require notification of dividend increases – and to prevent excessive increases – and to moderate and phase increases in housing rents. These powers would be held in reserve and used only if the existing voluntary arrangements were not being properly observed. A Prices and Incomes Bill was published in the first half of May.

Foreign exchange and gold markets

Until the end of February markets were fairly quiet. Demand for gold was moderate, though producers' sales were well below normal and the fixing price in the London market remained high – between \$35·19$\frac{1}{8}$ and \$35·19$\frac{7}{8}$ per fine ounce. In the foreign exchange market, maturing forward sales of sterling that had been contracted before devaluation were heavy, particularly in the first half of the month; and the demand for sterling to close out these contracts generally kept the spot rate for the U.S. dollar at just over \$2·41. Sterling weakened following the publication, on 22nd February, of the Vote on Account for 1968/69; the figures were wrongly interpreted as undermining the cuts in the growth of public expenditure announced in January, and the spot rate fell below \$2·40$\frac{1}{2}$.

At the very end of February demand for gold increased – and the pound came under some pressure. In the next two weeks the belief gained ground that the official price of gold could not be held; demand for gold in London and in other markets grew extremely heavy, as many moved out of currencies. Pressure on the U.S. dollar became severe, and sterling also was sold heavily. On 4th March the spot rate fell below the official parity of \$2·40, for the first time.

The scramble to buy gold barely eased when the active members of the gold pool[1], on 10th March at Basle, reaffirmed their determination to continue their support to the pool based on the fixed price of \$35 per fine ounce – though for a few days the pressure on sterling was less intense. By 14th March the movement out of currency into gold had become disturbingly large and sterling was again under heavy pressure – the spot rate falling to \$2·39. A conference of the active members of the gold pool was then convened in Washington over the week-end. Meanwhile the London gold market was closed and a bank holiday was declared in the United Kingdom for Friday, 15th March (and subsequently for 16th March also).

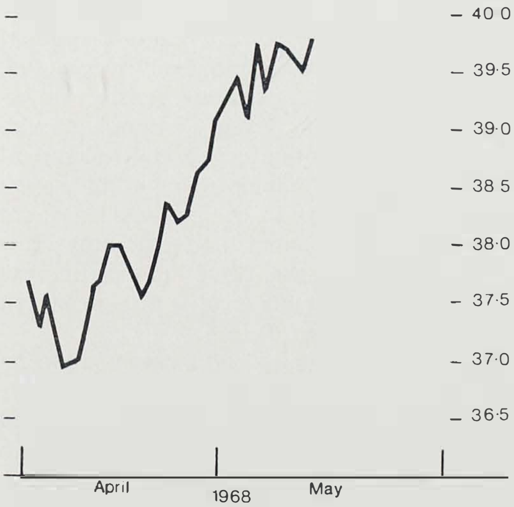
The central bankers who met in Washington on 16th and 17th March noted that the United States would continue to buy and sell gold at the existing price of \$35 per fine ounce with monetary authorities; and they expressed their resolve that all gold in their hands should be used for monetary purposes only. Consequently, they would no longer sell gold in the market, nor did they feel it necessary to buy it; nor would they sell to monetary authorities to replace gold sold in the market; and they invited the co-operation of other monetary authorities in making these policies effective. The response to this invitation was prompt and encouraging.

The Washington conference brought to an end the gold

1 The central banks of Belgium, Italy, the Netherlands, Switzerland, the United Kingdom, the United States and Western Germany.

$ per fine ounce

Fixing price* for gold in the London market from 1 April



When the London market reopened on 1 April the price of gold soon fell to below $37 per fine ounce: but by the end of the month it had advanced to over $39, and was still rising.

* Daily, afternoon fixing.

pool arrangements which had been in existence since 1961.[1] It effectively re-established a system of free gold markets in which central banks would not deal, and in which prices would be determined by supply and demand. The London gold market remained closed until 1st April in deference to the strongly held views of some signatories of the Washington agreement that the inauguration of the two-tier gold system would otherwise be prejudiced; in other markets attempts to start the price on a basis of $42-$45 per fine ounce brought out many sellers – mainly those who had financed short-term speculative positions with dollars borrowed at high rates of interest – and before long prices settled down in the range of $37-$39 while turnover returned to fairly normal proportions. The members of the pool had sold over $3,000 million of gold between the devaluation of the pound on 18th November and the Washington conference. The fact that the greater part of this had passed into private hands seemed likely to be a restraining influence on the market for some while to come.

When the London gold market reopened, the initial fixing price[2] was $38 per fine ounce; turnover was brisk and the price fell within a few days to below $37. However, the price began to edge up again following a statement on 8th April by the South African Government that they did not intend to sell gold for the time being. And it rose further after warnings by U.S. officials that the tax surcharges and cuts in Federal Government expenditure which were under discussion in Congress must be implemented without delay. By the end of April the price had reached $39·10 per fine ounce and was still rising; turnover was normal, however.

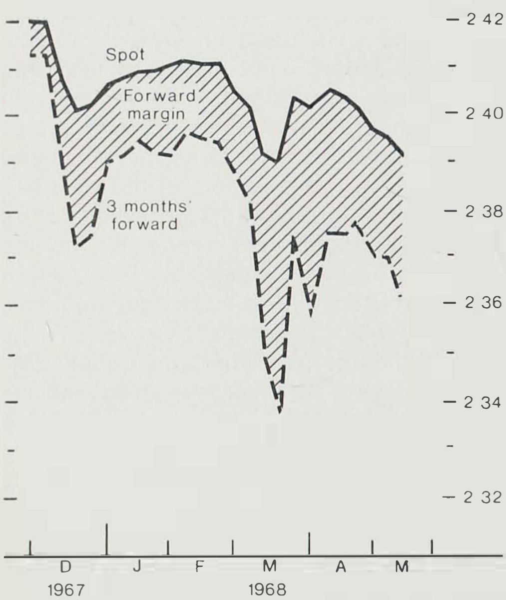
Some changes of procedure were adopted by the London market from 1st April. There are now two fixings daily, at 10.30 a.m. and 3 p.m., instead of the morning fixing only; and prices are fixed in U.S. dollars and not, as before, in sterling.

The U.S. dollar strengthened after the Washington conference. Sterling also improved a little, but the market remained cautious ahead of the Budget. The Chancellor's proposals were received with approval, however, and after touching $2·40¾ on the day after the Budget the spot rate steadied for a time at over $2·40¼. Towards the end of March the approach of the Group of Ten meeting in Stockholm – with rumours of divided opinions – unsettled markets; but when agreement was announced on the scheme for Special Drawing Rights in the I.M.F., both sterling and the dollar recovered the ground that they had lost – sterling moving up to around $2·40½, where it settled for a while. Nevertheless, buying of sterling was never heavy, and it did not require much bad news to depress the rate again; there was in fact a good deal of discouraging news before very long – the trade figures for March, the raising of Federal Reserve discount rates, and the warnings by U.S. officials noted earlier – and the spot rate moved downwards, falling below $2·40 on 22nd April, and to a shade below $2·39¾ by the end of the month.

Discounts on forward sterling narrowed a little early in February, but by the end of the month, when confidence had

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

Spot and 3 months' forward rates for U.S. dollars in London * since devaluation



The spot rate weakened in the first half of March and the forward margin widened very sharply. Confidence improved after the Washington conference and the Budget, but in April the spot rate drifted downwards and the forward margin widened.

* Middle closing rates; weekly, Fridays.

begun to weaken, the cost of three months' cover had risen again to the equivalent of almost $2\frac{3}{4}$% a year. During the first two weeks in March the margins against sterling widened strikingly – the cost of three months' cover was at one time in excess of 10% – but they narrowed again as the Washington conference, the Budget and the fall in Bank rate restored a measure of confidence. They continued to narrow for a time in April – the three months' margin came back to $3\frac{3}{4}$% on the 17th – but widened again as markets became more unsettled.

Balance of payments

It is clear that the current and long-term capital account remained in substantial deficit in the first quarter of 1968 – full details will be published shortly – though the deficit was probably not as large as the £356 million in the previous quarter. On the other hand, the net total of monetary movements[1] seems to have been more unfavourable than in the fourth quarter, so the presumption is that the positive balancing item was reduced or gave way to a negative one.

The deficit on visible trade, after seasonal adjustment and excluding payments to the United States for military aircraft, was in the region of £200 million. The c.i.f. value of imports, as recorded in the trade accounts and seasonally adjusted, was about $13\frac{1}{2}$% higher than in the previous quarter. Devaluation continued to add to prices (though without, as yet, curbing demand for imported goods); and the volume of imports rose sharply, nearly all the main commodity groups showing increases. Part of the rise in volume was no doubt accounted for by the consumer boom, and part may have been due to the rebuilding of stocks. Nevertheless, imports have continued to run at a very high level – though March (and April) showed no further increase.

The value of exports, after seasonal adjustment, rose by over 30% in the first quarter, though this was largely because arrears of shipments delayed by the docks strikes were being made good; there was also some increase in sterling prices. There were nevertheless signs (becoming slightly stronger in April) of an underlying rise in exports – thanks in part to slightly faster growth in world trade. However, the main increase in volume expected as a result of devaluation has still to come.

The invisibles account is likely to have been more favourable than in the fourth quarter, probably moving into surplus again. The improvement will have been partly seasonal, partly because freight costs, which had been inflated by the closure of the Suez Canal, were lower, and partly because devaluation has raised the value of net overseas earnings in sterling terms. On the other hand, it is probable that the long-term capital account moved further into deficit, mainly because of a larger net outflow of private capital.

Movements of short-term funds

The net outflow of short-term funds was resumed during the three months between February and April and was parti-

1 Among monetary movements there was another large 'exchange adjustment' in the first quarter. The adjustment is occasioned mainly by maturing forward sales of sterling entered into before devaluation; and is necessary because foreign exchange was provided by the reserves at the old parity to meet the maturing contracts, whereas the fall in the reserves is recorded in the accounts at the new parity.

cularly heavy in the early part of March.

Over the three months as a whole, the sterling balances of countries outside the sterling area, excluding the counterpart of drawings on central bank facilities, declined quite markedly; in February they continued the recovery which had been under way since the end of November, but they fell abruptly in March and declined a little further in April. The balances of overseas sterling area countries, which had recovered in January, fell moderately between February and April.

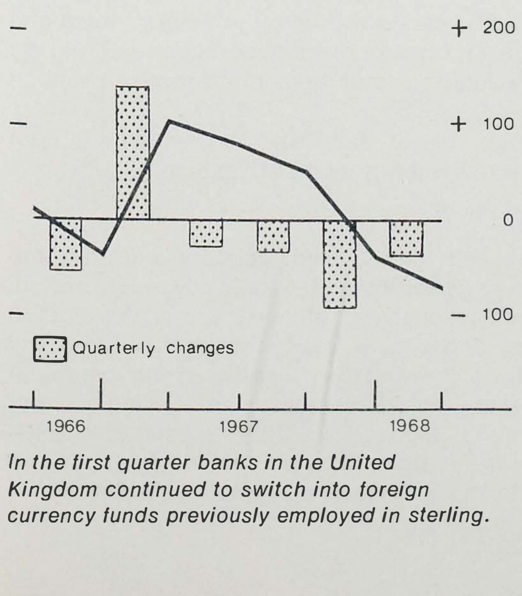
Mainly because of the widening of forward discounts against sterling, noted earlier, the normal arbitrage comparisons became still more unfavourable to investment in sterling. During most of February the margin by which the return on three months' euro-dollar deposits exceeded that on three months' loans to U.K. local authorities, after allowing for the cost of forward cover, was usually not much above $\frac{1}{8}$%. But euro-dollar rates, which had been steady early in the month, began to rise towards the end, and then increased rapidly in March as deposits were withdrawn, or dollars borrowed, to purchase gold. By the middle of March the return on three months' euro-dollar deposits had risen to $7\frac{5}{16}$%, despite central bank operations to put dollars back into the market. At the same time, forward discounts against sterling widened sharply so that the margin in favour of investment in euro-dollar deposits reached a peak of almost $8\frac{3}{4}$%.

Euro-dollar rates eased somewhat after the Washington conference, helped by further central bank action, and, as noted above, because some speculators who had borrowed dollars were selling gold. But in April continuing pressures on interest rates within the United States helped to push euro-dollar rates up again, and by the end of the month the three months' rate was still about $1\frac{1}{4}$% higher than at the end of January. This, together with the continuing high cost of forward cover, kept the margin in favour of euro-dollar investment abnormally large; at the end of April it was still above $2\frac{3}{4}$%.

Banks in the United Kingdom continued to expand their operations in the euro-currency market. During the first quarter their external liabilities in non-sterling currencies rose by £641 million and their external claims by £676 million, indicating that on balance they switched into foreign currency £35 million previously employed in sterling; at the end of March they had net external claims in foreign currencies of £73 million. In April banks appear to have switched a small amount of foreign currency into sterling.

£ millions

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

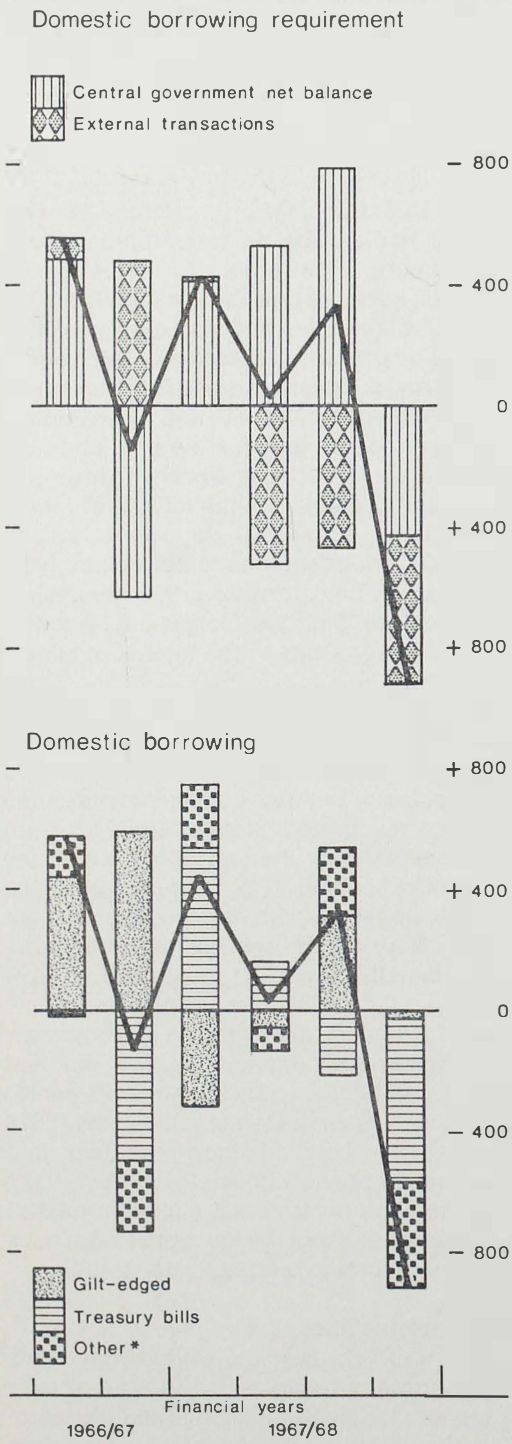


In the first quarter banks in the United Kingdom continued to switch into foreign currency funds previously employed in sterling.

Reserves and central bank facilities

After rising in January and February, the United Kingdom's gold and convertible currency reserves fell in March; over the quarter, the reserves rose by £11 million. The balance of payments deficit in the quarter and the sales of sterling during the first half of March led to a considerable loss of foreign exchange, and the United Kingdom made substantial drawings on central bank facilities, including the equivalent of £20 million under the Federal Reserve reciprocal swap arrangement.

Exchequer finance £ millions



In the first quarter the central government's surplus (net balance) was augmented by external transactions, and a large amount of domestic debt was repaid.

* Net indebtedness to Bank of England, Banking Department; notes and coin in circulation; non-marketable debt.

At the Washington conference central banks agreed to increase the amount of short-term assistance available for the support of sterling: additional credit facilities were placed at the disposal of the United Kingdom, so as to bring the total of credits immediately usable (including the I.M.F. standby facility) to approximately $4,000 million. The additional credits included an increase from $1,500 million to $2,000 million in the swap facility with the Federal Reserve; this formed part of a further enlargement (to a total of $9,355 million) of the Federal's swap arrangements with other central banks.

Exchequer finance

Though the Exchequer's surplus of revenue over expenditure was seasonally large in the first quarter (£898 million) it was less than a year earlier. Expenditure was higher, because of three items in particular – investment grants, regional employment premiums, and compensation for the epidemic of foot-and-mouth disease – none of which was being paid in the first quarter of 1967.

Loans from the Consolidated Fund, at £541 million, were a good deal larger than in the same quarter last year, because of bigger drawings by the nationalised industries – particularly by the British Steel Corporation, which repaid other borrowing, and by the Transport Holding Company, which bought out British Electric Traction's bus interests. Local authority borrowing was much the same in size as a year earlier; authorities borrowed relatively little during the first two months of the quarter – relying instead on temporary borrowing and bank advances – but increased their borrowing sharply in March; this enabled them to make greater use of their quotas with the Public Works Loan Board before the end of the financial year.

The central government's surplus (net balance) was £430 million, compared with £627 million in the first quarter of 1967. Because of the outflow of foreign exchange, however, receipts of sterling from external transactions were large, and £913 million was available to the Exchequer to repay domestic holdings of debt. Though national savings rose slightly during the quarter, holdings of gilt-edged declined on balance and there were seasonal reductions in notes and coin in circulation and in tax reserve certificates. Treasury bills held by the banking sector were run down by as much as £520 million.

In aggregate, the banks' holdings of government debt were reduced during the quarter by £862 million.

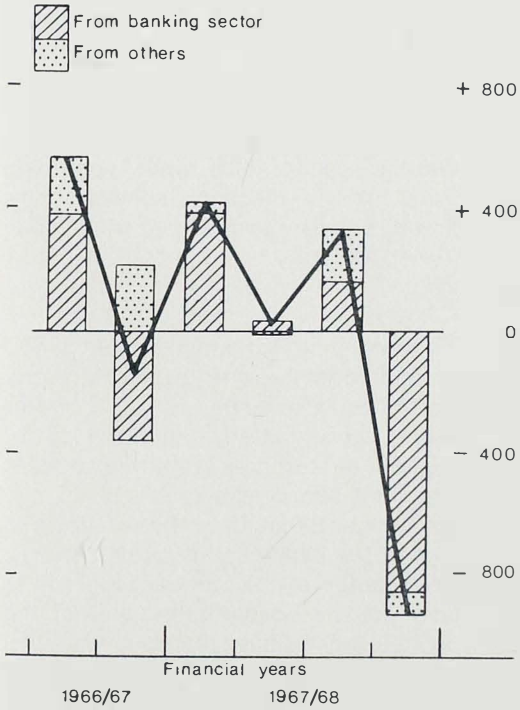
The banking sector

Between their make-up dates in mid-January and mid-April the *London clearing banks* increased their advances, excluding those to the nationalised industries, by about £170 million more than might have been expected on seasonal grounds – mostly in the first two months of the period. A considerable part of the increase was in lending exempt from the restrictions imposed on 18th November 1967 – when all banks were asked to hold down most of their sterling lending to the level then current.[1] Local authorities

1 December 1967 *Bulletin*, page 348.

Exchequer finance £ millions

Domestic borrowing



The repayment of government debt was mainly to the banking sector, whose Treasury bill holdings fell by £520 million.

in particular made unusually heavy use of their clearing bank facilities, because of the high cost of both long-term finance and temporary money. Nevertheless, advances subject to restriction seem also to have increased, notably in the first two months under review; and in April the clearing banks' holdings of commercial bills rose sharply, most of the increase, it would seem, being associated with restricted lending.

In the month to mid-May the clearing banks' advances, excluding those to the nationalised industries, continued to rise by more than the seasonal expectation. The figures implied that, after seasonal adjustment, total lending in sterling to the private sector and to borrowers abroad stood at about 104% of the level reached in November 1967.

On 23rd May restrictions were modified so as to accommodate all sterling lending to the private sector and overseas, including the export lending and finance for shipbuilding hitherto exempt, within a new overall ceiling: the clearing banks were asked not to let this lending exceed 104% of the level reached in November 1967; and all other banks were asked to restrict lending in this category to the same percentage increase over November 1967 as the clearing banks. Within the new ceiling banks were asked to make sufficient room for lending for exports and for activities directly related to improving the balance of payments. This would have to be achieved by a greater reduction in lending to non-priority borrowers than had so far taken place. The banks were asked especially to intensify restrictions on the granting of credit associated with imports of manufactured goods for home consumption or imports for stock accumulation. The full text of the notice to the banks is published elsewhere in this *Bulletin*.[1]

In the three months to mid-April, net deposits with the clearing banks increased, after seasonal adjustment, by some £130 million. Until mid-March deposits rose by considerably more than the seasonal expectation; the rise was mainly associated with the increase in advances. In the following month, however, deposits fell sharply, because of substantial gilt-edged purchases after the Budget by the banks' customers. The clearing banks' own contribution to government financing fell markedly: their Treasury bill holdings were run down and they withdrew call money from the discount market.

During the first calendar quarter the holdings of government debt of *the accepting houses, overseas banks and other banks* fell moderately. Among their other sterling assets, advances to U.K. residents (excluding other banks) rose slightly, while those to overseas residents declined. There was a large increase in the banks' lending to local authorities, which seems to have been matched in part by a withdrawal of call money from the discount market. Sterling deposits with these banks (excluding those by other banks) rose on balance: deposits by overseas residents declined – presumably because, in March, currencies were being converted into gold – but those of their domestic customers increased. Domestic deposits usually fall during the first quarter – partly because it is the main Exchequer revenue

1 Page 120.

season – but early in March this year the local authority temporary money market and sterling inter-bank market[1] were both very active, and some banks seem to have been bidding for deposits from U.K. companies to place there.

Activity in the inter-bank market was quite marked in February also; shortages were caused by withdrawals of funds to meet the maturing forward sales of sterling contracted before devaluation.

The *discount market's* total assets fell during the first quarter by £288 million, wholly because of a sharp drop in Treasury bills – reflecting low offerings at the tenders, and keen outside competition to secure bills while very high interest rates lasted. As for the discount houses' other assets, holdings of gilt-edged rose somewhat, while commercial bills declined.

Bill markets

Money continued to be very short for most of the period under review though conditions became easier in April. The effects of the seasonal flow of revenue to the Exchequer in February and March were accentuated, in the first half of February and the second half of March by large official sales of gilt-edged, and in the first two weeks of March by the heavy loss of foreign exchange. Because of the run-down in the Treasury bill holdings of the banks and discount houses, noted earlier, and the reluctance of the market generally to part with the bills that it had, a considerable part of the shortages could not be relieved by outright bill purchases; and the Bank became an increasingly frequent lender of large amounts at market rates – generally for one or two days but sometimes for longer – so that shortages were transferred from day to day or from one week to the next. On occasions – particularly in March – assistance was exceptionally large.

The market encountered particularly difficult conditions when it reopened on 18th March after the two emergency bank holidays. Among the factors making for an exceptionally large shortage were repayments to the Bank of sizable loans extended on three days of the previous week. The turnover in funds was very heavy and the Bank lent large amounts overnight at market rates. During that week shortages were reduced to the extent that the market did not have to pay for new bills, because the tender for 15th March had been cancelled.

Shortages continued into April and the houses were regularly obliged to borrow large amounts from the Bank at market rates. However, during the month the houses lightened their bond portfolios, conditions became easier, and the Bank were able to reduce the scale of their lending. Towards the end of April the Bank sold bills on occasion to absorb temporary surpluses.

With relatively few Treasury bills on offer, and a widespread belief during much of the period that interest rates would come down, outside competition at the Treasury bill tenders was generally strong. Apart from one reduction on tactical grounds, the houses raised their bid each week until early in April. Consequently the tender rate declined from

1 The sterling inter-bank market is discussed on page 159-160.

just under $7\frac{9}{16}$% at the beginning of February to $7\frac{3}{8}$% at the last tender before the reduction in Bank rate on 21st March. After the cut in Bank rate the houses raised their bid sharply, though not to the extent of reducing the tender rate by a full $\frac{1}{2}$%. By early April the rate had declined to $7\frac{1}{16}$%. Thereafter, the expectation of another cut in Bank rate diminished and the Treasury bill rate edged up again.

The average cost of the houses' borrowed funds remained at $7\frac{1}{4}$%-$7\frac{5}{16}$% until the fall in Bank rate, when it eased to $6\frac{15}{16}$%; it remained at about that level throughout April. The houses' buying rates for three months' prime bank bills moved for the most part in line with the Treasury bill rate. After the reduction in Bank rate the buying rate fell to $7\frac{3}{8}$%-$7\frac{7}{16}$%, where it remained for the next few weeks, despite the fall in the Treasury bill rate. The houses feared that any reduction in their buying rates would encourage the banks to unload bills on them, and the houses' holdings were already high in relation to their credit ceilings.

Other short-term rates

Local authority temporary money rates rose quite sharply during February and the first half of March, along with interest rates in other markets. There was a general shortage of funds; as already noted, a strong demand developed in the euro-dollar market towards the end of February, and in the sterling inter-bank market during the first half of March; in the inter-bank market, rates of over 10% were conceded for money at very short-term. Local authorities themselves were keen bidders because revenue was seasonally low, and high interest rates dissuaded them from borrowing at longer term. At one point early in March the rate for seven days' local authority money exceeded $9\frac{1}{2}$%, compared with 8% at the beginning of February; and by the middle of March the rate for three months' money reached almost $8\frac{1}{2}$% – over $\frac{1}{2}$% more than at the beginning of the period.

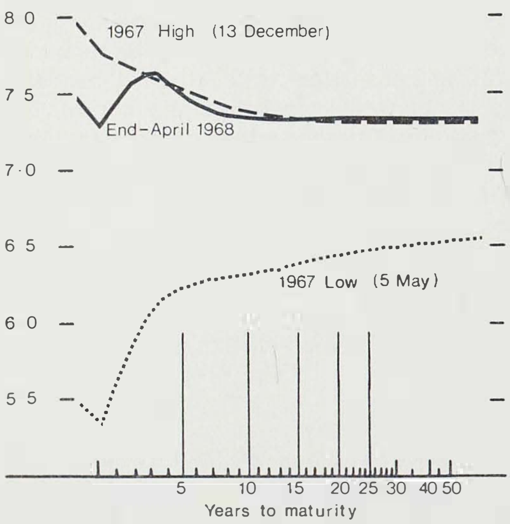
Rates then eased a little and were subsequently adjusted to the $\frac{1}{2}$% cut in Bank rate. Late in March and at the beginning of April the trend was again upwards, reflecting rising interest rates abroad and a continued shortage of funds in the United Kingdom; but by the end of April most local authority rates had fallen back again – the rate for three months' money ending the period at $8\frac{1}{8}$%-$8\frac{1}{4}$%.

Because of the strong demand for consumer durables, *hire purchase finance houses* continued to bid keenly for funds in February and the early part of March, and the rate for three months' deposits moved up slightly faster than the equivalent local authority rate. By the middle of March the finance houses' rate was between $8\frac{1}{2}$% and $8\frac{3}{4}$%, compared with just over 8% at the beginning of February. After easing slightly in the second half of March it began to harden again – in line with most other short-term rates. By the end of April the rate was again in the range of $8\frac{1}{2}$%-$8\frac{3}{4}$%.

At the end of February the total of outstanding hire purchase debt owed to finance houses had brought them in aggregate above the ceiling that they had been asked to observe in November 1967,[1] and they were reminded by the Bank of the need for restraint. In May, when as noted

1 March *Bulletin*, page 15.

Time/yield curves of British government securities *

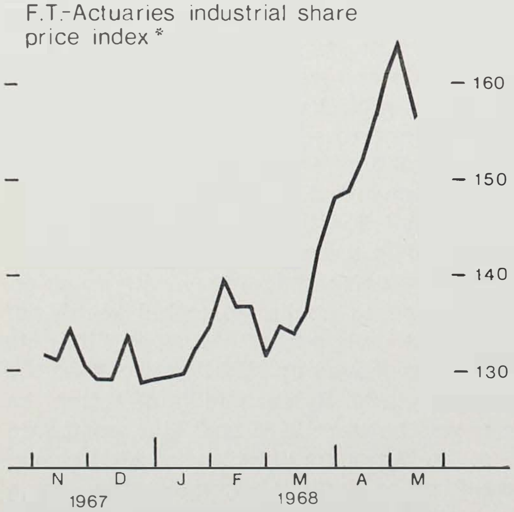


Between December and the end of April yields declined at the shorter end of the range but were otherwise little changed.

* The lines begin at Bank rate and continue through the yield on 91-day Treasury bills to those on British government stocks.

10.4.62=100

F.T.-Actuaries industrial share price index *



Share prices climbed steeply between the middle of March and the first few days of May.

* Weekly, Fridays.

earlier, restrictions on bank lending were modified, the finance houses were informed that the November ceiling would continue to apply to their business; and that those houses which were over the limit should reduce their lending without delay.

Gilt-edged market

The market was fairly buoyant at the beginning of the period, thanks mainly to the slightly better tone of sterling; hopes of a firm Budget and of an early cut in Bank rate encouraged buyers. Towards the end of February, however, the renewed weakness of sterling unsettled the market and demand fell away; nevertheless, the undertone remained quite firm until shortly before the middle of March, when the heavy demand for gold and mounting pressure on sterling led to widespread selling, particularly at the shorter end. Prices fell sharply, despite official purchases.

The successful outcome of the Washington conference brought a steadier tone, but the market did not fully recover its poise until after the Budget, when the Chancellor's proposals, followed closely by the cut in Bank rate, stimulated heavy buying. The improvement continued into April, encouraged for a time by hopes of an early end to the fighting in Vietnam – and consequently of easier credit conditions and lower interest rates in the United States. With the rise in Federal Reserve discount rates, and reminders of the continuing difficulties facing the U.S. economy, however, hopes of a further cut in Bank rate receded. Prices fell back, and the authorities took in some stock.

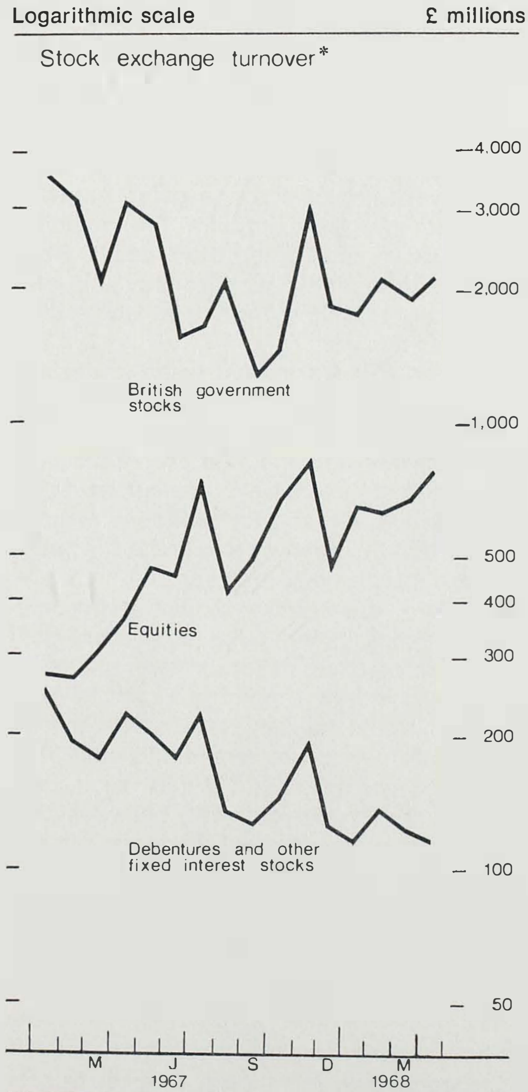
During these three months, turnover was lower than in the previous three – which had included the heavy dealings after devaluation. Yields at the end of April were a little lower than three months earlier, except on longer-dated stocks.

Official supplies of the existing short-dated tap stock and of the steel compensation stock[1] were exhausted early in February and £700 million of a new short-dated tap, 6¾% Exchequer Stock 1973, was issued. 4% Exchequer Loan 1968 was redeemed for cash on 18th March.[2] As with other recent maturities, a substantial part of the outstanding stock was still in the hands of the market at the redemption date. This was because the stock had re-entered its 'neutral (tax-free) zone'[3] when it went ex-dividend, making it attractive to surtax payers and tax-paying financial institutions. There is a clause in the 1968 Finance Bill withdrawing from individuals and companies the exemption from tax on short-term gains in respect of stocks in the neutral zone.

Other medium and long-term rates

As noted earlier, high interest rates continued to restrain local authorities' medium and longer-term borrowing. Authorities took very little from the P.W.L.B. in February or in April though, as noted above, they drew much more in March. During this period P.W.L.B. lending rates, which had been raised at the time of devaluation, generally remained unchanged.

1 6½% Treasury Stock 1971.
2 The redemption date was 15th March but, as noted earlier, 15th and 16th March were bank holidays.
3 The band, between the lowest price of issue and the redemption price, in which a stock may appreciate without attracting the taxes on capital gains.



Turnover in equities remained high throughout the period.

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

The proceeds of new issues of stocks and marketable bonds exceeded maturities by £27 million – in the previous three months repayments had been slightly larger than new issues. Towards the end of March the Greater London Council issued £40 million $7\frac{1}{4}$% Stock 1977, by tender, of which 40% was called before the end of April. Borrowing on mortgage, however, was still rather low. Mortgage rates rose slightly over the period, and by the end of April they were in the range $7\frac{5}{8}$%-8%, compared with $7\frac{1}{2}$%-$7\frac{11}{16}$% at the end of January.

There was little activity in the debenture market. According to the F.T.-Actuaries calculation,[1] the redemption yield on 20-year debentures and company loan stocks rose from $7\frac{7}{8}$% at the beginning of February to just over 8% before the cut in Bank rate: it then fell very gradually over subsequent weeks, to $7\frac{15}{16}$% at the end of April. The margin over the calculated yield on a 20-year government stock remained at about $\frac{5}{8}$% during the period. Companies generally were not in much need of funds, and high interest rates continued to make fixed interest borrowing unattractive.

Equities

Throughout much of February and early March the market remained rather quiet, with prices at first drifting downwards – as fears of a harsh Budget grew – and then steadying as Budget day approached.

The Budget proposals were taken as helpful to the recovery of the U.K. economy, and so to equities. Also, equities seemed to offer some protection against the prospect of further increases in domestic prices. Demand from the financial institutions – which had not been much in evidence while the market drifted – now strengthened, and prices moved sharply upwards. During the rest of March, and in April, the market continued to move ahead, encouraged by some good company results, and later by Wall Street's buoyant response to a new initiative for peace in Vietnam. The F.T.-Actuaries industrial share price index, which stood at 136·4 on Budget day, had reached 159·0 by the end of April. Turnover remained high during the period.

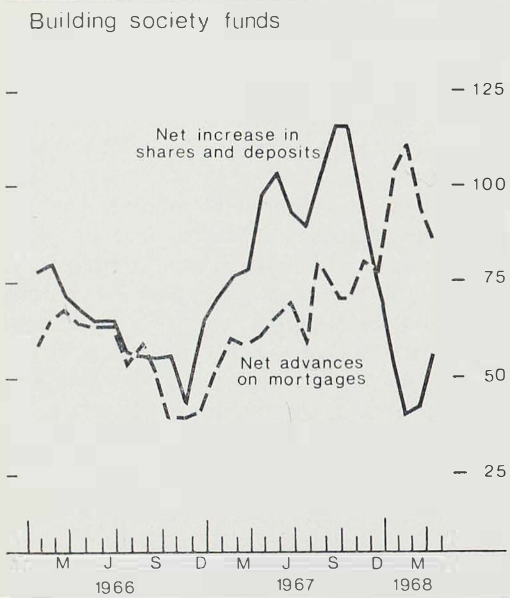
New equity issues, at £35 million, were higher than for some while, though still much lower than before corporation tax was introduced. The lack of new equities, combined with heavy take-over activity, continued to keep the market short of stock, contributing in no small measure to its underlying strength. There was also a reluctance on the part of many holders to sell and thus incur a liability to capital gains tax. A notable feature of the period was the very large sales of units by unit trusts.

Building societies

The net inflow of funds into the building societies, which had been large during the summer and autumn of 1967, fell sharply towards the end of the year. New funds became scarcer, for the societies had not raised their borrowing rates in November when Bank rate went up to 8%, and other forms of investment offered more attractive returns

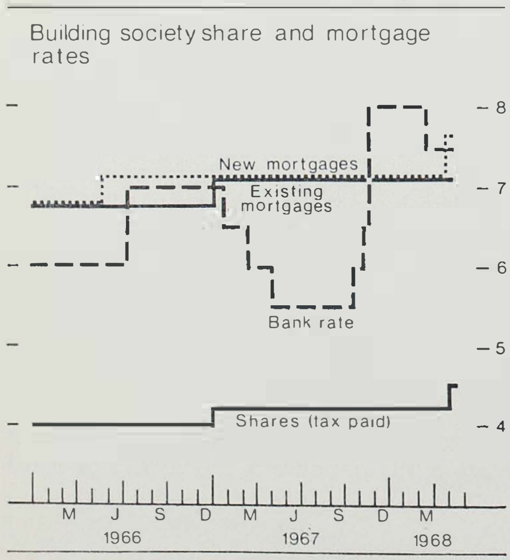
1 This calculation is based on representative stocks bearing various coupons, but giving a yield that was somewhat above that obtainable on high coupon stocks issued recently.

Seasonally adjusted £ millions



The inflow of funds fell sharply during the winter but the societies' lending remained high, reaching a peak in February.

Per cent per annum



Consequently the societies increased their rates paid to investors from 1 May, and, in order to maintain working margins, they raised their rates on mortgages.

or, like unit trusts, an apparent hedge against a fall in the value of money. At the same time withdrawals increased, partly no doubt because some savings were encashed to buy consumer goods. Meanwhile, the societies' lending and their new commitments remained high, and they were compelled to run down their liquid resources – which, however, had been built up considerably in 1967.

Early in 1968 some societies found it necessary to ration mortgages; and there was soon discussion of an increase in borrowing and mortgage rates, though the societies decided to postpone action until after the Budget. They change their rates as infrequently as possible, and only when there are clear signs that they are more than temporarily out of line with other rates.

The cut in Bank rate on 21st March and some slackening in consumer spending after the Budget brought a little relief. But by this time the societies were becoming anxious, for between the end of October and the end of March their combined liquidity ratio had fallen from just under $18\frac{1}{2}$% to just under 16%; while the demand for advances seemed likely to be swollen by the Government's scheme for 100% mortgages, which came into force on 1st April.

On 19th April, therefore, the Building Societies Association recommended increases in the rates of interest paid to investors and in the rates charged to borrowers – to the extent needed to maintain working margins. From 1st May the rate paid on shares would be $4\frac{1}{2}$% (tax paid) instead of $4\frac{1}{4}$%; and mortgages to new borrowers would cost $7\frac{5}{8}$% instead of $7\frac{1}{8}$% – existing borrowers would start paying the new rate later in the year. The Government, believing that higher rates for mortgages would hold dangers for the prices and incomes policy, expressed the hope that the societies would "keep the position under review, so that the high level of interest rates lasts no longer than is absolutely necessary".

Conclusion

The Government have taken vigorous budgetary action towards creating the conditions in which a transfer of real resources from home demand to the improvement of the balance of payments could take place. The Budget, moreover, has been accepted, at home and abroad, as a symbol of the United Kingdom's determination to seize the competitive advantage offered by devaluation.

Much now turns on the rate of increase in world trade, and on how well demand in the other major trading nations holds up while the United Kingdom and the United States seek urgently to improve their balance of payments positions. It is heartening, therefore, to see signs of some quickening in the growth of trade in the first quarter; and to note that European countries have lately given evidence of more expansionary intentions. However, the direction in which European trade will be influenced by developments in France is at present unclear.

The difficulties of the reserve currencies (and the consequent weakness of the international monetary system) have recently diverted attention from the development of world trade. Yet the two are interdependent; an improvement in the external positions of the United Kingdom and the United States might have damaging consequences for trade if the measures taken by either country were of a kind that invited retaliation, or if those countries which now attain ample surpluses and have built up their reserves were not prepared to ease the process of adjustment by encouraging domestic demand to grow faster.

Nevertheless, consequences no less grave – and more immediate – would attend any failure of confidence in sterling and the dollar. Though the agreements reached on gold in Washington and on Special Drawing Rights in Stockholm have allayed the widespread fear that the international monetary system might suddenly collapse, faith in the system is unlikely to become stronger until the dollar's difficulties are resolved and some successes are achieved by the United Kingdom.

There has been some progress in the United States towards the implementation of fiscal proposals; meanwhile, monetary action has been taken there to reduce the growth of domestic demand. In the longer term, the prospects for the U.S. balance of payments might be considerably improved by an end to the war in Vietnam; while the adoption by the major trading nations of the scheme for Special Drawing Rights holds out real hopes of achieving an improved basis of world liquidity.

It is in this context that the progress of the United Kingdom's balance of payments needs to be assessed. As yet, it is too soon for most of the potential benefit of devaluation to appear. However, exports have begun to show signs of an underlying rise; so, for the moment, it is the continuing high level of imports which gives cause for concern. Until the trading position improves significantly, it is the more important that the productivity, prices and incomes policy should make – and should be seen to make – a real contribution to the achievement of genuine gains in productivity and to the containment of costs.