Commentary

Introduction

In July, the latest of the three months reviewed by this Commentary, sterling became a little stronger as the United Kingdom's prospects appeared to improve; and foreign exchange markets – which earlier had been beset by fresh anxieties about the stability of the international monetary system – grew calmer as the economic and political disturbances in France died away.

The first encouraging news came towards the end of June, when the U.S. Congress finally approved the surcharge on income taxes, combined with substantial cuts in Federal expenditure; the belief was that this would ease pressures in the U.S. domestic economy, leading to lower interest rates and a smaller U.S. balance of payments deficit. Soon afterwards, balance of payments and other measures were taken in France which seemed to rule out any immediate devaluation of the franc. On 8th July it was disclosed that central bankers, meeting in Basle, had agreed in principle to a medium-term credit facility for the United Kingdom to offset fluctuations in the sterling balances of sterling area countries. The U.K. trade figures for June which were announced a few days later – though still showing a large deficit – were better than for some months past. By the end of July sterling, both spot and forward, had become appreciably stronger and there was some evidence that very short-term funds were moving to London.

Short-term interest rates abroad tended to rise at the beginning of the second quarter, and with credit in the United States tight, and American banks borrowing dollars heavily through their London offices, euro-dollar and U.S. Treasury bill rates reached peaks towards the end of May. Some short-term interest rates eased in June and in July they, including those in the United Kingdom, generally began to fall.

Domestic activity in the United Kingdom seems to have risen rather less in the second quarter than in the first, mainly because personal spending was not as high as it had been before the Budget.

Foreign exchange market

May and June were disturbed months, and sterling came under heavy pressure at times, particularly before week-ends. Early in May, rumours (quickly denied) that the deutschemark might be revalued brought selling of the dollar and the pound, and the continued lack of evidence that the U.K. economy had begun to reap the potential benefits of devaluation added to the strain on sterling. By the middle of May, the spot rate for sterling against the U.S. dollar, which had been almost $2·39\frac{3}{4}$ at the beginning of the month, had fallen below $2·39. The market's nervousness was not helped by continued delays in implementing the proposals for a surcharge on income taxes in the United States, and was soon intensified by the disturbances in France and the subsequent weakening of the franc. The withdrawal of official support for the franc on 30th May encouraged the belief that France might devalue – followed, possibly, by sterling and other leading currencies. Before the Whitsun week-end, therefore, the dollar and sterling came under very heavy pressure and the spot rate for sterling fell below \$2·38$\frac{3}{8}$.

Sentiment improved at first in June, thanks in part to signs that France was returning to normal and in part to reports – after the annual meeting of Governors of the Bank for International Settlements – that a new scheme for countering fluctuations in the sterling balances was under active discussion. Sterling did not come under any pressure before the two week-ends after Whitsun, and the spot rate had risen to about \$2·38$\frac{5}{8}$ by the middle of the month. But it weakened when the trade figures for May were announced; these showed no reduction in the trade deficit, and were badly received by the market which had expected an improvement. Soon, industrial disputes over wage claims caused fresh uneasiness. Towards the end of June, rumours again became rife that the franc would be devalued – probably before 1st July, when the remaining tariffs inside the Common Market were due to be removed. Sterling came under some pressure and the spot rate dropped to \$2·38$\frac{1}{4}$. The pound was awkwardly placed, therefore, to weather the approach of the half year, bringing, as it normally does, a demand for European currencies for balance sheet purposes. In the event, the consequent shortage of dollars was largely relieved through co-operative action by the B.I.S. and central banks, which channelled back into the euro-dollar market some of the funds that had been withdrawn.

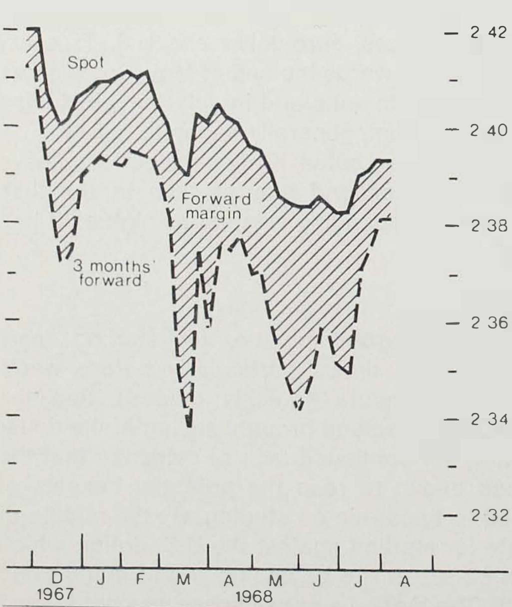
At the beginning of July the market's depression lifted a little as the likelihood of an early devaluation of the franc again receded. And the tone was soon much improved by the announcement of the credit facility arranged at Basle noted earlier – though demand for sterling was only moderate, the spot rate rose above \$2·38$\frac{7}{8}$. The trade figures for June a few days later were greeted with a sense of relief; buying of sterling increased, and by the middle of the month the spot rate had risen to about \$2·39$\frac{1}{8}$. During the rest of the month sterling remained in fairly good demand and the rate rose to \$2·39$\frac{1}{2}$.

During May and June, discounts on forward sterling remained wide; the cost of three months' forward cover reached the equivalent of 7% a year at the end of May, and was still as high as 5$\frac{1}{4}$% at the end of June. Margins narrowed sharply, however, in the second week of July and continued to improve during the rest of the month; by the end of July the cost of three months' forward cover had fallen to the equivalent of 2$\frac{1}{8}$% a year. Margins for periods longer than three months improved less than those for shorter dates, but even so contracted quite markedly, particularly towards the end of July – indicating that confidence in the longer-term prospects for sterling was gradually returning.

During these three months the Exchange Equalisation Account's outstanding commitments with the banks to buy sterling forward were further reduced.

\$ to £

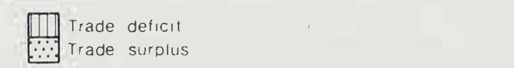
Spot and 3 months' forward rates for U.S. dollars in London[a] since devaluation



In July sterling, both spot and forward, strengthened appreciably.

a Middle closing rate: weekly, Fridays.

Seasonally adjusted
latest quarter provisional £ millions



In the second quarter the underlying trend in exports was still upwards, for much of the sharp rise in the preceding quarter had been due to the clearance of goods delayed by the strikes in the docks. Imports declined.

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

Gold market

In the last Commentary[1] it was explained that the central bank gold pool arrangements came to an end in the middle of March, and that a system of 'free' gold markets, in which a number of leading central banks had declared that they would not deal, and in which prices would be determined by other supply and demand, was effectively established. As a result, turnover in the London gold market – which reopened on 1st April – though still substantial, was a good deal less than when the gold pool had operated; and prices fluctuated much more. In May gold was in steady demand, and the fixing price, influenced mainly by the lack of progress on the U.S. tax proposals and by the reports of unrest from France, increased from a little above $39 per fine ounce at the beginning of the month to a peak of $42·60 at the morning fixing on 21st May. Later, however, the enforced closure of French banks, followed by official restrictions at the end of May on movements of gold into and out of France, helped to restrain the demand for gold, so that the market remained fairly calm; indeed, the fixing price had fallen below $42 by the end of May, and it generally remained between $41 and $42 during June.

The price fell sharply after the Basle meeting in early July, and it continued to decline quite rapidly over the next two weeks. After falling below $38 on 17th July, it rebounded the next day when the South African Finance Minister stated that his country did not intend to sell more gold for some time.[2] By the end of the month, however, the price had settled down at around $39.

Balance of payments

Balance of payments estimates for the second quarter have not yet been published. The indications are, however, that the deficit on current and long-term capital account was a good deal smaller than in the first quarter, though some of the improvement will have been for seasonal reasons.

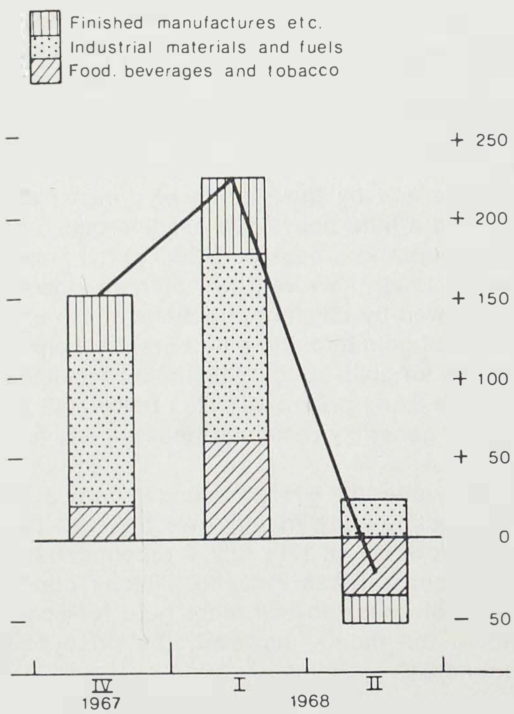
The deficit on visible trade, after seasonal adjustment and excluding payments to the United States for military aircraft and missiles, was about £220 million. This was slightly larger than in the 1st quarter,[3] when, however, there was a considerable benefit – amounting perhaps to over £100 million – from the clearance of exports after the strikes in the docks.

Imports, as recorded in the trade accounts and seasonally adjusted, fell in the second quarter by no more than 1% in value; they remained, therefore, uncomfortably high. Nevertheless, the trend gave some encouragement: there was a substantial fall in imports in June, and though July saw a sharp reaction – partly because shipments held back until after the general round of tariff reductions on 1st July were made up, while trade with France revived – imports were distinctly lower in June and July taken together than in the earlier months of this year. Moreover, the composition of the import bill changed for the better; in the second quarter there were fewer imports of food and finished goods – no

1 June *Bulletin*, page 108.
2 He also stated that South Africa had sold some gold in May and June to test the capacity of free markets.
3 The unadjusted trade deficit was smaller in the second quarter than in the first.

Seasonally adjusted £ millions

Changes in U.K. imports [a]



The fall in imports was concentrated in finished goods and food; industrial materials and fuels increased.

a Quarter on quarter; imports c.i.f., excluding deliveries of military aircraft and missiles purchased from the United States.

doubt partly because of the decline in consumer spending – and more of raw materials and fuels.

A feature of the first six months of the year was that imports of silver bullion were very high – amounting in all to £61 million, as compared with £17 million in the previous six months. Nervousness about currency values at a time when the strong demand for silver seemed likely to continue led to heavy buying of the metal through London and to a consequent increase in stocks of silver in the United Kingdom. Some 80% of these stocks at the end of June were held either directly or indirectly by overseas residents, and, while in their hands, will not involve an overall charge on the U.K. balance of payments – whether or not the silver is physically re-exported at a later date.

Exports continued to do well in the second quarter; after seasonal adjustment and discounting the clearance in the first quarter of goods delayed by the strikes in the docks, the value of shipments rose by about 5%. More than half of the increase was accounted for by a greater volume of goods; this probably owed something to the stimulus of devaluation, though the continuing rapid growth of world trade undoubtedly played a major part. In July the strong rise in exports continued.

The surplus on the invisible account may have been of about the same very favourable order in the second quarter as in the first and the long-term capital account is certain to have improved quite strikingly because, for example, the net outflow of private capital will have been smaller; though purchases of Australian company securities by U.K. residents seem again to have been substantial, there was no single transaction to compare with the £80 million or so subscribed in the first quarter by the Royal Dutch/Shell group to a rights issue by their U.S. subsidiary.

The improvement in the balance on current and long-term capital account in the second quarter was probably not as large as that in the net total of monetary movements; so the balancing item may have become positive.

Movements of short-term funds

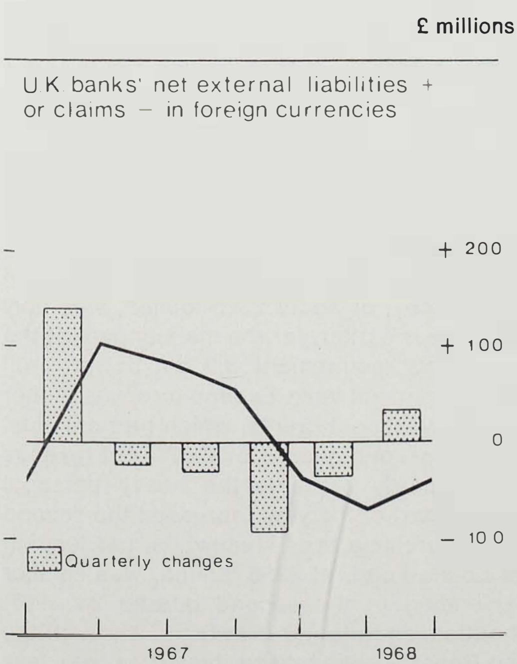
Between May and July there was a substantial net outflow of short-term funds, most of it in May when, as noted earlier, there were renewed fears about sterling. The outflow in June was much smaller, and during July some funds began to return to London.

Net liabilities in sterling to countries outside the sterling area, excluding the counterpart of drawings on central bank facilities, fell moderately; a sharp drop in May and a smaller one in July were partly offset by some increase in June. And there was a substantial fall in May and June in sterling liabilities to sterling area countries, with little or no net movement in July.

During the three months covered by this Commentary the normal arbitrage margins continued to be unfavourable to sterling, though they narrowed considerably in July. Euro-dollar rates rose sharply in the middle of May, for credit conditions in the main continental centres had become somewhat tighter, American banks were bidding keenly for funds through their London offices to counteract the tightness of money in the United States, and some funds were already being withdrawn from the market before the half year. Meanwhile, short-term interest rates in the United Kingdom had risen less than euro-dollar rates, and the cost of forward cover had also increased, so margins in favour of investment in euro-dollars became larger; by the end of May the annual rate of 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, by as much as $5\frac{3}{4}$%.

Euro-dollar rates began to ease in June – despite a continued heavy demand from the American banks – for central banks took steps, as noted earlier, to replace dollars withdrawn from the market before the half year, and there was a substantial outflow of funds from France. After the end of the half year the normally easier supply position was soon helped by a fall in demand from the American banks as money became less tight in the United States. While euro-dollar rates continued to decline, the cost of covering investment in sterling forward was also reduced, so that the margin in favour of euro-dollar investment fell sharply – to 1% by the middle of July, and to no more than $\frac{1}{2}$% by the end of the month.

In May banks in the United Kingdom switched into foreign currency a small amount of funds previously employed in sterling, but over the next two months they switched foreign currency deposits into sterling. During the second calendar quarter their net external claims in foreign currencies fell by £34 million, to £39 million; their gross claims increased by £1,029 million but their liabilities rose by £1,063 million.



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Reserves and special facilities

On 19th June the United Kingdom drew from the International Monetary Fund the equivalent of £583 million, in various currencies, under the terms of the standby facility arranged last November. The I.M.F. financed the drawing partly by recourse to the General Arrangements to Borrow, under which the Group of Ten countries[1] agree to lend their own currencies to the Fund over and above the amounts that they have provided by way of subscription. The drawing from the Fund was used to repay part of the United Kingdom's outstanding indebtedness under special short-term facilities, including the whole of what had then been drawn under the reciprocal swap arrangement of $2,000 million with the Federal Reserve System. The I.M.F. drawing thus effectively lengthened to three years the period during which this part of the United Kingdom's indebtedness will have to be repaid, while the reconstitution of short-term borrowing facilities left them available for further use, if required.

As a result of the I.M.F. drawing the United Kingdom's short-term indebtedness was considerably reduced in the second quarter – despite substantial recourse to special facilities, particularly in May when the outflow of short-term funds was large. Nevertheless, a heavy burden of short-term debt was still outstanding at the end of June. The United

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

Kingdom's gold and convertible currency reserves fell by the equivalent of £16 million during the quarter; they rose in April and declined over the next two months.

Sterling area developments

Following the devaluation of sterling last November and throughout the early months of the year, when there was widespread nervousness about the future of both major international currencies, members of the sterling area would have had the disposition of their external reserves very much in mind. For the United Kingdom it was important to provide reassurance to sterling area countries and thus discourage withdrawals of sterling, the effects of which might be damaging to confidence. Two significant developments were announced in June and July. First, discussions took place between the Government of Hong Kong and H.M. Government, to see whether the Colony's desire for some change in the composition of its external assets could be met in a way which recognised its special circumstances, but did not lead to major problems for sterling or for other countries in the sterling area. On 1st June H.M. Government announced that they had agreed to a new reserve asset for Hong Kong – in the form of British government bonds denominated in Hong Kong dollars – to enable it to replace part of its sterling reserves up to a limit of £150 million. The bonds are not transferable but are encashable in sterling on need.

Second, the new medium-term credit facility arranged at Basle and announced on 8th July will place some $2,000 million at the disposal of the United Kingdom to offset fluctuations in the sterling balances of sterling area countries. The central banks of twelve countries,[1] speaking where appropriate with the authority of their governments, have agreed in principle to participate – through the B.I.S. – in these new arrangements, which are to be completed as soon as satisfactory consultations have taken place between the United Kingdom and other sterling area countries.

Central government finance[2]

In the second quarter the central government's borrowing requirement (net balance), at about £395 million, was only a little smaller than a year earlier, for the main impact of the Budget measures on this requirement will not be felt until the second half of the financial year. Expenditure was higher – notably because of investment grants, which had only just begun to be paid in the second quarter of 1967 – but revenue increased still more, partly because the heavy personal spending in the earlier part of the year increased the second quarter's receipts of purchase tax.[3] Meanwhile, net lending from the National Loans Fund, at £256 million, was smaller than comparable lending in the second quarter of 1967: though local authorities made larger drawings – through the Public Works Loan Board – nationalised industries took less than a year earlier.

1 Austria, Belgium, Canada, Denmark, the Netherlands, Italy, Japan, Norway, Sweden, Switzerland, the United States and Western Germany.
2 A note on page 280 introduces some recent changes in government accounting.
3 Purchase tax is paid over to the Government's account quarterly, in the middle of the quarter after the one to which it relates.

Because of the continued loss of foreign exchange during the quarter, external transactions contributed £400 million of sterling;[1] so that there was little net change in the Government's total domestic borrowing. (A year earlier external transactions were broadly in balance and there was a substantial domestic borrowing requirement.) Within the total, however, there was a repayment of debt to domestic holders outside the banking sector. Their holdings of gilt-edged stocks fell appreciably, their Treasury bills were run down, and national savings also declined – partly because of a redemption of defence bonds. Altogether, these outweighed an increase in their holdings of other types of government debt: tax reserve certificates provided some finance, though not as much as a year earlier – possibly because companies were unwilling to commit liquid resources up to a year ahead at a time when interest rates might still rise – and there was an appreciable increase in the note circulation.

The banking sector increased its holdings of government debt, in aggregate, by just over £70 million. There was a sharp increase in net government indebtedness to the Bank of England – which largely reflected the usual rise before the end of the half year in bankers' balances with the Bank; and the banks and discount houses took up a substantial amount of Treasury bills. On the other hand, they sold gilt-edged heavily – much more so than other domestic holders.

The banks and discount houses

It was noted in the June *Bulletin* that restrictions on bank lending were intensified on 23rd May.[2] The banks were asked not to let their total sterling lending to the private sector and overseas exceed 104% of the level reached in November 1967, and to make sufficient room within this new ceiling for the needs of priority borrowers by curtailing lending to persons and for other less essential purposes.

When the new restrictions were imposed the London clearing banks were not well placed – they were particularly anxious lest they might be unable to meet outstanding commitments without exceeding the 104% ceiling. It was subsequently made clear to them that the authorities were aware of these difficulties and, while expecting them to bring their lending within the new ceiling as soon as they could, would make some allowances during the period of adjustment.

In the month to mid-May their advances, excluding those to the nationalised industries, had continued to rise by more than the seasonal expectation. In the following month advances fell by about £60 million, and in the month to mid-July they rose by some £115 million. Because half-yearly influences such as the debiting of interest charges to overdrawn accounts distort the seasonal pattern in June and July, it is more satisfactory to take the two months together, and considered thus, there was probably not much change

1 However, the balance of payments deficit on current and long-term capital account was certainly a good deal smaller than the total of external transactions. Though there is a broad relationship between the two, the total of external transactions (changes in the reserves and in overseas holdings of British government debt) will not reflect balance of payments transactions that give rise to a change in the net overseas liabilities of U.K. banks, local authorities or the private sector – for example, a rise in sterling claims on overseas by U.K. banks which may have financed part of the increase in U.K. exports.

2 The text of the notice to banks was published on page 120 of the June *Bulletin*.

in advances after seasonal adjustment. Within the total, however, there was a fall in lending to local authorities – which the banks had been asked in May to reduce to normal levels – so that other lending increased. Whereas, in mid-May, restricted lending was probably a little below the 104% ceiling, the rise up to mid-July brought the clearing banks collectively fully up to the limit.

Over the three months, taken together, their advances, other than to the nationalised industries, rose by about £20 million more than the seasonal expectation. Their net deposits, after seasonal adjustment, increased by about £35 million. Among their liquid assets, commercial bill holdings were little changed, but their Treasury bills increased, as did, to a lesser extent, their lending at call to the discount market. On balance, they ran down their holdings of gilt-edged.

In the month to mid-August, the clearing banks' advances, other than to the nationalised industries, fell by £112 million or about £70 million more than the seasonal expectation, suggesting that restricted lending had been reduced to a level a little below the ceiling. Their portfolios of commercial bills also fell but their other liquid assets, including Treasury bills, increased sharply and, for the first time since December 1967, they added to their holdings of gilt-edged. After seasonal adjustment, their net deposits rose substantially.

In noting with appreciation the fall in the clearing banks' advances in August to within the 104% ceiling, the Bank of England have stressed the importance of continuing to enforce the current restrictions on credit and the clearing banks have assured the Bank that they will continue to adjust their lending policies accordingly.[1] The substance of this message was also drawn to the attention of the Scottish banks and of the main associations of other banks.

The sterling lending of the *accepting houses, overseas banks and other banks* had fallen on balance between November and May, so that when the revised credit restrictions were announced in May these banks in general were not uncomfortably placed with regard to the new limits that they were asked to observe. On the other hand, their sterling acceptances – which are subject to a separate limit from that on advances and commercial bills – were somewhat above the new ceiling, and a number of banks found that they had to curtail such business rather sharply. (The separate ceiling applied to acceptances is intended to restrict the supply of bills entering the market and to avoid excessive pressure on the discount houses – who are themselves required to observe the 104% ceiling.)

During the second calendar quarter these banks' advances to U.K. residents, excluding other banks, rose appreciably, and so did their sterling lending to overseas residents. Lending to U.K. local authorities also rose quite sharply – largely making good the fall in the latter's borrowing from the clearing and other deposit banks. As for the banks' other sterling assets, there was a fall in their holdings of gilt-edged and a smaller decline in their Treasury bills. On the other hand their lending at call, other than to the

1 The text of the announcement to the Press appears on page 288.

discount market, increased moderately.

Deposits from U.K. residents other than banks increased very sharply, more than making good a decline in sterling deposits from overseas – which in May fell to their lowest point since April 1963. In the sterling inter-bank market, a decline in activity in April was partly reversed in May, and as the end of the half year approached the banks' business increased sharply; by the end of the quarter their outstanding commitments were appreciably larger than three months earlier.

The *discount market's* total assets fell by £76 million in the second quarter; their holdings of gilt-edged dropped sharply but they increased their Treasury bills a little and their commercial bills appreciably. When credit restrictions were revised in May the discount houses held substantially more export bills – exempt from restriction under the previous ceiling – than they had done in November. As a result they found themselves above the new ceiling, and obliged to curtail the amount of commercial paper that they took from the banks. Though they raised their buying rates for prime bank bills on three occasions it did not fully relieve the pressure on them to take bills.

The corresponding fall in the houses' borrowed funds reflected in part the withdrawal of call money by the clearing banks, and in part a decline, after the middle of April, in the scale of the Bank's lending to the market.

In May those houses which have no financial interests in firms of foreign exchange and currency deposit brokers were given exchange control permissions to run books in bills denominated in foreign currencies; some commenced to deal in such bills during the quarter. The houses are likely to approach this new business with caution; by the end of June holdings of foreign currency bills amounted to a negligible percentage of the market's total assets.

With the passage, in July, of the 1968 Finance Act, certificates of deposit are now defined, for exchange control purposes, as securities and it is envisaged that a market in sterling certificates of deposit will develop in London as soon as the necessary preliminaries are completed. In anticipation of this development, the Bank's wishes in regard to banking arrangements and reporting procedures were made known in May to those banks to whom exchange control permission is likely to be given for the issue of such paper. Certificates are likely to be denominated in multiples of £10,000, with a minimum of £50,000 and a maximum of £250,000; they will probably have a term to maturity of between three months and five years – though at first the market may confine itself to paper with a life of less than one year. Certificates will not be eligible at the Bank as security for advances to the discount market, nor will the Bank themselves discount or purchase them. Certificates held by the clearing banks will not be regarded as liquid assets for purposes of liquidity ratios, and banks' liabilities in the form of certificates will be treated as ordinary deposit liabilities for the purposes of the Special Deposits and Cash Deposits schemes.

Bill markets

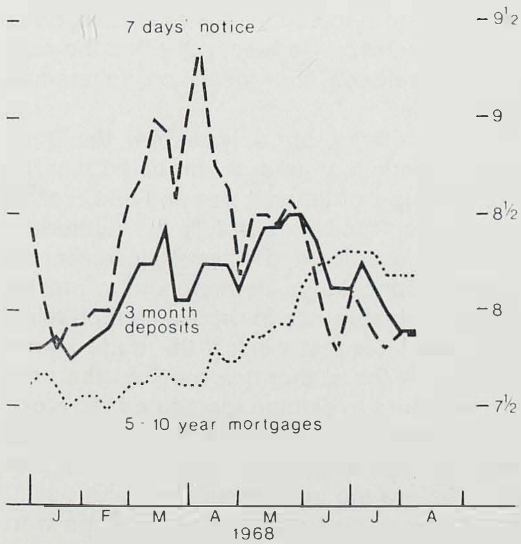
It was a quieter time for the discount houses. In May and June money generally continued short, but the assistance given by the Bank was seldom heavy. Though more of it took the form of bill purchases, these were distinctly smaller than in preceding months, and lending to the houses, all at market rates, never attained the very large proportions that had been an outstanding feature of the period up to mid-April. At times, such as just before Whitsun, when the balance of government revenue and expenditure was in the market's favour, there were temporary surpluses which the Bank absorbed by selling bills. At the end of June money became tight, as funds were called in by the banks to meet half-yearly balance sheet requirements; and the Bank increased the scale of their assistance both by purchasing Treasury bills and by lending for up to three days at market rates. In the early part of July heavy purchases by investors in the gilt-edged market led to a shortage of funds in the money market, and there were similar shortages at the end of the month. The average cost of the houses' borrowed funds was around $6\frac{15}{16}\%$ for most of the period, edging up to 7% during June.

During the three months under review there were slightly larger offerings of Treasury bills than in the previous three, and the houses were generally able to secure satisfactory allotments. Expectations of a fall in interest rates had diminished – indeed for much of the period, still higher rates seemed in prospect – and outside competition at the tenders was not particularly strong. For the most part, the discount market's tender rate moved fairly narrowly. In May the houses reduced their bids at each tender save one, and the rate rose from just over $7\frac{1}{8}\%$ at the beginning of the month to $7\frac{1}{4}\%$ by the end. Outside competition was a little keener in the first half of June; but towards the end of the month the rate again hardened to $7\frac{1}{4}\%$ in face of what seemed a more uncertain outlook for the international monetary system and for the domestic economy. In July the market's reaction to the improved tone of sterling and to the downward trend of interest rates was cautious, but tempered by the need to obtain bills in face of increased competition. The houses raised their bids gradually, and their tender rate had fallen to little more than $7\frac{1}{16}\%$ by the end of the month.

Even before the change in credit restrictions on 23rd May, the houses were experiencing difficulty in keeping their holdings of commercial bills within required limits. As noted earlier, the inclusion of export paper within ceilings after that date took a number of houses above the limits, and they decided to discourage sales of bills by the banks (and to keep in line with the rise in the Treasury bill rate) by raising their rates for prime bank bills. Rates were increased on 24th May – the first change since 22nd March – by $\frac{1}{16}\%$; and a week later by another $\frac{1}{16}\%$. At the end of June, the rise in the Treasury bill rate and the need for a further defensive move led the houses to raise their rates for bills generally by $\frac{1}{8}\%$, and to widen the range of buying rates for six months' bills from $\frac{1}{16}\%$ to $\frac{1}{8}\%$. But in July, with other rates falling, the houses brought their buying rates down again by $\frac{1}{8}\%$.

Per cent per annum

Local authority mortgage and temporary money rates[a]



By July local authority interest rates had resumed a more normal pattern, with rates for shorter term borrowing below those for longer term.

a Weekly, Fridays.

Local authorities

Local authorities' borrowing through the P.W.L.B., at £150 million, was less than in the previous three months, which included the end of the financial year. It was, however, much higher than the year before – when borrowing declined – following a change in the formula for P.W.L.B. loans under quota and a rise in interest rates.[1] In May the Government informed local authorities – who were already required to spread their quota borrowing over the financial year – that they would no longer be allowed to apply for more than 25% of their annual entitlement in the March quarter; any excess at the end of December would be forfeited. P.W.L.B. lending rates, which stood in the range $7\frac{3}{8}\%$–$7\frac{5}{8}\%$ at the beginning of the period, were raised twice before the end of July, to $7\frac{3}{4}\%$–8%, to keep them in line with the rates that the Government were paying on their own borrowing; but they were generally reduced by $\frac{1}{8}\%$ early in August.

With interest rates still very high, local authorities were reluctant to raise much long-term finance in the market. Only one new stock was issued – £25 million $7\frac{3}{4}\%$ Birmingham Corporation Stock 1980/82 – though there were calls on earlier issues. Yields on marketable bonds continued to rise at first, and there were no new issues, other than in replacement of maturities, until the middle of June, when rates of $8\frac{1}{2}\%$ were conceded for a time on one-year bonds. Thereafter yields declined somewhat. Nevertheless, the proceeds of new issues of stocks and marketable bonds exceeded maturities by £34 million – rather more than in the previous three months. Borrowing on mortgages was probably also heavier than between February and April. Mortgage rates rose slightly over the period – from $7\frac{3}{4}\%$–$8\frac{1}{4}\%$ to $7\frac{7}{8}\%$–$8\frac{3}{8}\%$.

Local authorities continued to rely more on short-term borrowing. Rates for temporary money hardened in the first half of May, as funds were withdrawn to meet the maturing forward exchange contracts noted earlier, and to keep pace with rates elsewhere.

In June, however, funds became more plentiful – partly because domestic investors were selling gilt-edged – and rates declined, especially at the shorter end; this restored a more normal pattern, with short-term money costing less than that for longer term. Funds temporarily became a little dearer at the end of the half year, particularly for the shorter periods, but July saw rates fall further. At the end of the period the cost of three months' money was about $7\frac{7}{8}\%$, some $\frac{5}{16}\%$ less than three months earlier.

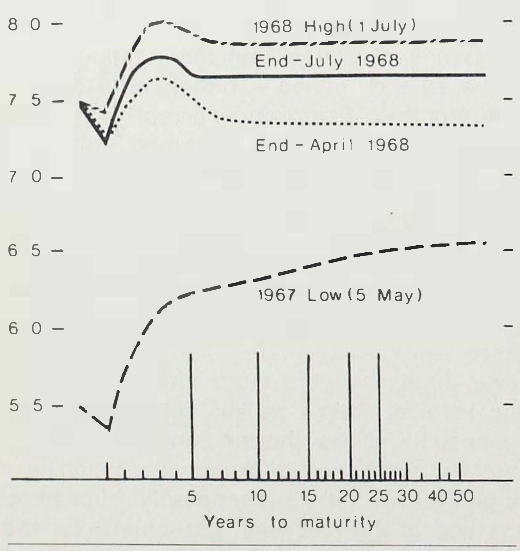
Hire purchase finance houses

After seasonal adjustment, the total of outstanding debt owed to finance houses which had risen sharply in the early months of the year – bringing the houses' lending in aggregate appreciably above the ceiling that they had been asked in November to observe – fell back in April; and it continued to decline in May and June, as consumer spending in total was reduced. It was noted in the last Commentary[2] that the houses were reminded in May that those which were over

1 June 1967 *Bulletin*, page 116, and September 1967 *Bulletin*, page 228.
2 June *Bulletin*, page 115.

Per cent per annum

Time/ yield curves of British government securities[a]



Yields rose sharply to a peak at the beginning of July: later the market made a strong recovery.

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

their limits should reduce their lending without delay. The decline in consumer demand which took place at this time helped to ease individual positions.

The houses' need for funds diminished as their business contracted; they reduced the scale of their bank borrowing and bid less keenly for deposits. Their deposit rates rose a little in May and early June, so that they were not uncompetitive, but then conformed with the downward trend in other short-term rates; by the end of July three months' deposits were yielding 7¾%–8⅛%, compared with 8½%–8¾% at the end of April. The rate for six months' deposits, which had generally been below the three months' rate after February, was about ⅛% above it by the end of July.

Gilt-edged

For most of the three months the gilt-edged market was depressed. In May uncertainty as to the direction in which the U.K. economy was moving, the new threats to the international monetary system, and the rising trend of short-term interest rates abroad brought a sharp fall in prices. In June, industrial disputes in the United Kingdom, coming on top of the trade deficit for May, added to the market's apprehension. During these two months and in the first few days of July the authorities bought a fair amount of stock, while the calculated yield on a 20-year stock had risen from a little under 7⅜% at the end of April to about 7⅞% at the beginning of July. Not for very many years – indeed, not since the early eighteenth century – have such high yields on government securities been obtainable.

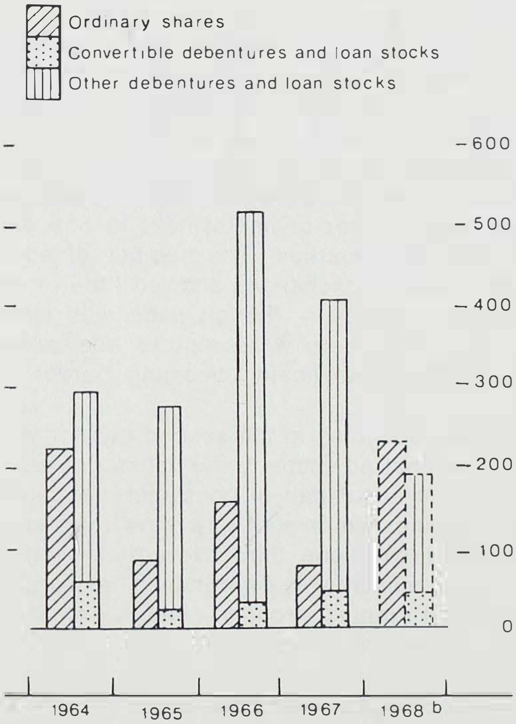
The market rallied on Friday, 5th July, before the Basle arrangements were announced, and it improved sharply after the week-end. Pent-up institutional demand had created a strong technical position, and on 9th July the authorities were able to sell a large amount of stock. However, the buying also contained a speculative element, and to prevent an excessive and unsustainable rise in prices – which might well have been reversed later that week if the trade figures for June had been poor – the authorities reduced the price at which they were prepared to sell the long-dated tap stock, 6¾% Treasury Stock 1995/98, to the market level, which it had stood well above since early April. This led to a temporary fall in prices, before the market steadied and buying was resumed. In the event, the trade figures for June were better and helped to sustain the stronger tone of the market; official sales, particularly of the longer-dated stocks, continued and there was also a good deal of switching out of short-dated stocks. The decline in short-term interest rates abroad was another helpful influence and prices generally continued to move ahead during the rest of July; by the end of the month the calculated yield on a 20-year stock had fallen to 7⅝%. Turnover, which had been low in May and June, became heavy in July.

Equities and debentures

For much of the period the performance of equities was somewhat hesitant. This may have owed something to a sharp rise in new issues of ordinary shares, while in May

£ millions

Capital issues by quoted U.K. public companies [a]



New issues of ordinary shares in the first half of the year were running at a higher rate than for several years past, while company fixed interest issues were down.

a Issues on U.K. market excluding preference shares. Debenture and loan stock issues are net of redemptions, convertibles net of cash redemptions only.
b First half year expressed as an annual rate.

and June the far from reassuring prospects at home and abroad kept buying at modest levels.

In May, prices declined on balance in face of discouraging reports of U.K. economic progress, while turnover increased quite sharply. The market was only a little firmer in June because more cheerful reports of industry's prospects later this year and next vied with news of labour disputes in the car industry and on the railways. Early in July, however, the announcement of the Basle arrangements and the better trade figures for June brought a rise in prices and an increase in turnover. Later the market fell back, to some extent in sympathy with a sharp break in prices on Wall Street (which in turn anticipated some slowing down in the pace of the U.S. economy); but prices in London may have weakened also in the belief that the market's long advance had been too fast and too indiscriminate. Possibly, too, the desire to hedge against a fall in the value of money was becoming less dominant.

The F.T.-Actuaries industrial share price index attained a new peak of 177·4 on 19th July, compared with 159·0 at the end of April; by the end of the month, however, it had fallen to 172·0. As dividend yields were falling the 'reverse yield gap'[1] continued to widen until early July when it was slightly over $4\frac{1}{4}$%. It then narrowed.

New issues of ordinary shares, at £125 million, were considerably larger than for some time past. Companies seemed in greater need of finance – fixed industrial investment is forecast to rise this year – and to be viewing equity issues with slightly more favour. It might have been that some companies were approaching the point where the proportion of fixed interest debt to equity capital was rather high; also, the very wide differential that exists between yields on fixed interest issues and on equities has reduced the substantial cost advantage of debenture issues brought about by corporation tax.

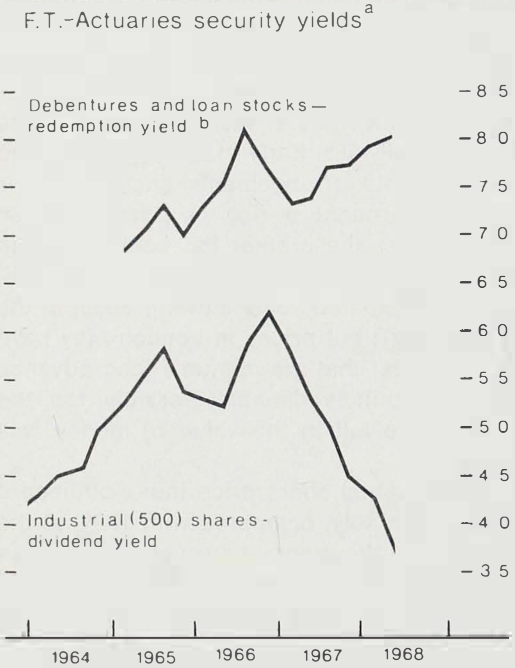
The market in debenture and loan stocks remained fairly quiet over the three months. Turnover was a little larger than in the previous three and yields increased; according to the F.T.-Actuaries calculation,[2] the redemption yield on 20-year stocks of this kind rose by almost $\frac{1}{2}$% over the period, to $8\frac{3}{8}$%. The margin over the calculated yield on gilt-edged stock of comparable term was $\frac{3}{4}$% at end-July, compared with $\frac{5}{8}$% three months earlier. There were rather more new issues than in the preceding three months.

Domestic economy

It is now clear that the rapid growth of personal spending and the underlying rise in exports in the first quarter was reflected in a fairly sharp increase in domestic output, coupled with a bigger increase still in imports and a decline in manufacturers' stocks, particularly of finished goods. Incomplete evidence suggests that activity may not have grown at quite such a high rate in the second quarter;

1 The amount by which the yield on $2\frac{1}{2}$% Consols exceeds the average dividend yield on shares included in the F.T.-Actuaries industrial share price index.
2 This calculation is based on representative stocks bearing various coupons, but giving a yield somewhat above that obtainable on high coupon stocks issued recently.

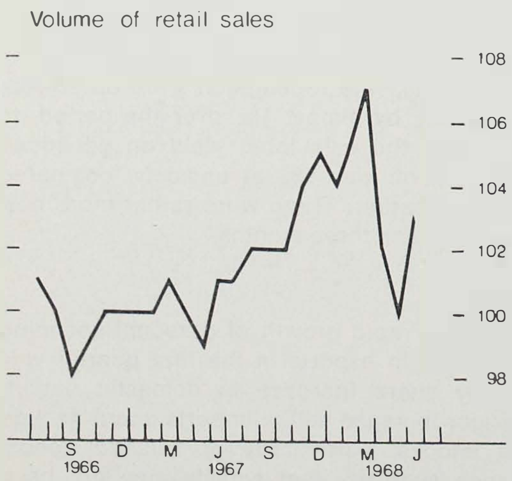
Per cent per annum



The differential between the yields on company fixed interest securities and those on ordinary shares has become very wide.

a Quarterly, average of working days.
b This series was begun in January 1965.

Seasonally adjusted Average 1966 = 100



The volume of retail sales, which had been very high, fell sharply in the second quarter, though there was some recovery towards the end.

though exports continued to rise – discounting the benefit in the first quarter from the after-effects of the strikes in the docks – consumers' expenditure fell back.

Allowing for seasonal movements, the index of industrial production, which accounts for about half of national output, rose by a little under 1% in the second quarter – rather less than in the first. Unless productivity has continued to improve, however, it is not easy to explain why unemployment continued to edge up at the same time as output was rising. After seasonal adjustment, the number of wholly unemployed increased by about 40,000 between May and August to 2·5% of the estimated total labour force. Although the rate of increase was much the same as in the previous three months, the tendency for unemployment to rise has latterly become much less marked. The number of adult vacancies notified to labour exchanges showed little or no change over the same period – though vacancies were admittedly very low – and there were reports from some areas that skilled labour was again becoming harder to recruit.

The fall in consumer spending in the second quarter was quite sharp; after seasonal adjustment, the volume of retail sales – which represent about half of consumers' expenditure – fell by 3½%, while numbers of new cars registered apparently dropped by over one third. Nevertheless, personal spending was previously very high indeed, so despite the sharp drop it is still running strongly – and in excess of the estimates made at the time of the Budget.

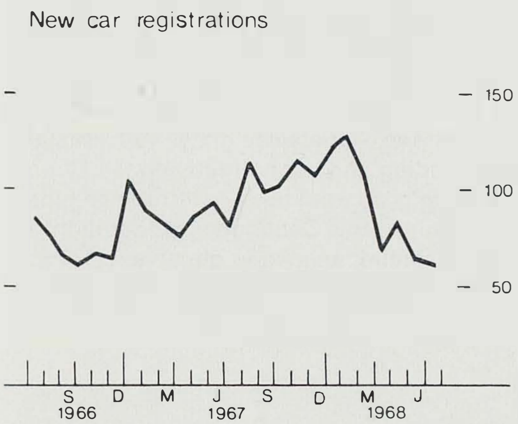
Earnings have not risen as quickly in recent months – there have been fewer wage settlements – and have probably inflated personal spending less than in the earlier part of the year when they were rising sharply; nevertheless, the pressure of wage claims remains strong and could threaten the containment of price increases as well as that of consumer demand. Some expectation of further increases in prices might still help to maintain spending. In the second quarter prices rose by about 2¼%, most of the increase coming in April after the Budget measures.

Information about other forms of domestic demand is not as up to date, and a complete picture of the second quarter is not yet available. In the first quarter, however, public sector investment, after seasonal adjustment, was much the same as in the preceding one – capital spending by public authorities continued to rise while the nationalised industries reduced theirs – and public consumption continued upwards. As noted earlier, there was a sharp fall in stocks of raw materials and finished goods; though distributors built up their stocks, manufacturers reduced theirs substantially, while goods that had been delayed by the strikes in the docks were cleared. But there may have been some restocking by manufacturers since then, to redress the seemingly very low ratio of stocks to industrial output.

The volume of fixed investment by private industry, after seasonal adjustment, rose quite sharply in the first quarter, but this was because the shipping industry – whose expenditure is irregular – and the distributive and service trades were spending more; investment by manufacturers fell back.

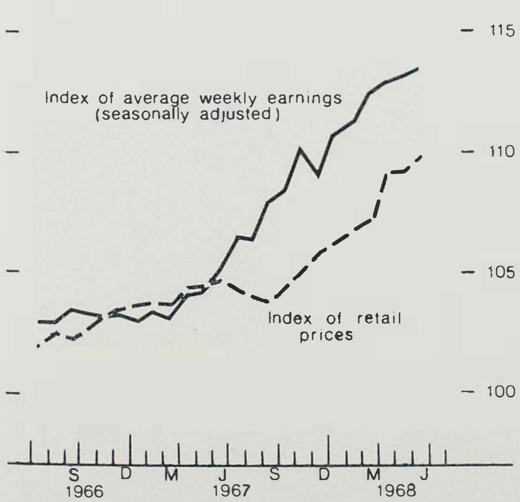
Seasonally adjusted
latest month provisional

Thousands



The fall in new car registrations was also sharp.

Jan. 1966 = 100



Earnings have been rising less steeply, while prices increased sharply after the Budget.

Looking ahead, however, the latest enquiry into the investment intentions of manufacturing industry, carried out by the Board of Trade in May, broadly confirms earlier forecasts that manufacturing investment should begin to rise this year, with the rise continuing into 1969. Other recent surveys suggest that intentions of expansion should soon be translated into an increase in orders for capital goods. Meanwhile approvals of industrial building development again rose substantially in the second quarter, mainly for manufacturing industry.

Housebuilding for private ownership, seasonally adjusted, maintained much the same high rate of activity in the first quarter as in the previous six months; but it may have fallen away a little in the second quarter, possibly because there was more difficulty in obtaining mortgages. Spending by the public sector on new housing was probably little changed in the second quarter.

Conclusion

The recent signs of improvement at home and abroad, though welcome, must be kept in perspective. At home, the trade balance is somewhat better, but what little effect devaluation has had so far on trade has been on exports rather than imports – whose continued strength is discouraging; exports have been materially helped also by buoyant conditions of world trade. The achievement of the Government's balance of payments objective of a sustained surplus of £500 million a year still requires a very large swing from the present position. Although it was not the only factor, high consumer spending – notably in the early months of the year – has contributed substantially to the resilience of imports since devaluation. As a consequence the economy has departed somewhat from the path foreseen at the time of the Budget, and this will have delayed until later in 1969 the expected move into surplus of the balance of payments.

Externally, circumstances are not unfavourable to the achievement by the United Kingdom of a balance of payments surplus. The international monetary system now seems less vulnerable than for some months past – though it will remain fragile until sterling and the dollar give further proof of being over the worst of their difficulties – and there has been some progress towards greater stability, notably in the scheme for Special Drawing Rights in the International Monetary Fund and more recently in the medium-term arrangements for the sterling balances. World trade is still expanding quite fast; though from now on growth may be less rapid partly because the measures to improve their balance of payments positions taken by the United Kingdom and the United States will have a progressive effect, and partly because France has taken temporary measures to safeguard her reserves. The efforts required from British exporters to penetrate and retain overseas markets may accordingly become more strenuous.

However, the course of the United Kingdom's recovery rests crucially at the present time on certain elements of policy, notably on the observance of budgetary restraint and credit restraint. The Chancellor of the Exchequer has recently reaffirmed his determination to keep public expenditure closely under review, so that any corrective action which may be necessary to keep it within the levels already announced can be taken. At the same time he has made it clear that there can be no relaxation of restraints on consumer spending. It is equally important, if recovery is not to be impeded, that current policies of credit restraint – which are directed towards the containment of personal spending and less essential imports – are strictly enforced.

Increases in incomes too – because they both sustain growth in consumer spending and bear directly on the United Kingdom's ability to remain competitive – will require close scrutiny in the months ahead. Continued moderation in claims and awards is essential, as also is observance of the criterion that increases are justified in terms of increased productivity.