Commentary

Introduction

Most of this Commentary is concerned with the three months from August to October when, after an unsettled beginning, foreign exchange markets became generally quiet and sterling developed a stronger tone. Confidence was encouraged at this time by the conclusion of arrangements at Basle early in September for a medium-term facility of $2,000 million to counter fluctuations in the sterling balances of sterling area countries;[1] and, shortly afterwards, by the trade figures for August which showed another good rise in exports. These developments made it possible to reduce Bank rate from 7½% to 7% on 19th September. Short-term interest rates in the United Kingdom fell sharply – from their high levels – with the reduction in Bank rate, and mostly continued to decline afterwards. However, the trend in dollar interest rates in October was upwards.

The trade figures for September published in the middle of October confirmed that exports were still rising strongly. But by the end of October, fresh doubts were emerging about the pace of the United Kingdom's economic recovery. Despite the prospect of further improvement in the third quarter, the balance of payments would clearly remain in substantial deficit this year; and the prospect for 1969 had become more clouded, for imports remained stubbornly high. Equally serious was the fact that consumer spending had not fallen back to the level predicted at the time of the Budget – partly because price rises had come through more slowly than increases in earnings. Indeed, the renewed growth of personal spending was as much responsible as the rise in exports for a faster growth of domestic activity in the third quarter. Meanwhile, on the supply side, skilled labour was becoming scarcer, pressures for wage increases were building up and shortages of capacity began to appear here and there; together with frequent industrial stoppages, these developments threatened industry's ability to offer and to keep to competitive delivery dates and to control costs.

There seemed little doubt that corrective action was required and that it needed to be directed primarily towards consumer spending. From 2nd November, therefore, terms control was tightened on hire purchase contracts covering a wide range of goods. Some two weeks later trade figures for October were issued; these showed deterioration, though not so severe as clearly to reverse the favourable trend indicated by recent months' figures. Then the re-emergence, very soon afterwards, of widespread rumours that certain European exchange rates would be altered, which led to the meeting in Bonn of Finance Ministers from 20th to 22nd November, made it urgent to make clear that the parity of

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1 The facility and the accompanying agreements between the United Kingdom and overseas sterling area countries are described in a White Paper "The Basle Facility and the Sterling Area" (Cmnd. 3787). The texts of the agreements between H.M. Government and other governments in the sterling area are set out in two later White Papers (Cmnd. 3834 and Cmnd. 3835).

sterling would be maintained. Thus, on 22nd November, the Chancellor of the Exchequer announced that H.M. Government were taking further measures to hasten the recovery of the balance of payments.

Action to overcome the respective pressures upon their exchanges was taken at this time by Western Germany, and by France in conjunction with an international stand-by credit operated through the Bank for International Settlements and designed to stabilise the French franc after the speculation to which it had been exposed. The period of instability in exchange markets that preceded these actions again demonstrated the great dangers of continued unbalance in external payments and of exchange speculation.

The measures of 22nd November

The measures announced by the Chancellor comprised increases in indirect taxation – through the use of the tax regulator – and greater restraint on lending by the banks and finance houses accompanied by the introduction of an import deposit scheme.

Through the maximum permitted use of the regulator, existing rates of purchase tax and the duties on alcohol, tobacco, petrol and oil were surcharged by 10%. The surcharge is estimated to yield about £250 million in additional revenue in a full year, and is expected to cause an initial increase in consumer prices of about 1%. Its effect in restraining consumer demand is likely to be quick and to build up in the course of next year.

The Bank of England's notice about changes in credit restrictions is reproduced after this Commentary.[1] Briefly, the London clearing banks, the Scottish banks and the other banks were asked to bring or to keep their lending in sterling to domestic private borrowers and to overseas borrowers within new, lower ceilings, which would no longer include their lending at a fixed rate ($5\frac{1}{2}$%) under the special schemes for export and shipbuilding finance. Observance of the new ceilings would oblige the banks to restrain their low-priority lending more severely than before; and, to the extent that they lent to finance import deposits, would entail still greater restriction of their lending in other categories. Moreover, the clearing banks and the Scottish banks were asked to ensure a substantial reduction in their lending, whether direct or indirect, for the finance of personal consumption; and the other banks to ensure that the curtailment of their low-priority lending fell particularly on the finance of personal consumption.

Finance houses, which had been reminded on 6th November of the need to reduce their outstanding lending within the existing credit ceiling without delay, were asked on 22nd November to observe new restraints on their lending roughly comparable with those which the banks had been asked to observe.

The notice to the banks explaining the import deposit scheme is also reproduced after this Commentary.[2] Importers are required to deposit with H.M. Customs 50% of the value of all imports covered by the scheme – which are about two

1 Page 358.
2 Page 359.

fifths of total U.K. imports. Deposits, bearing no interest, are to be made at the time the goods arrive in this country and will be repaid to importers 180 days later. The scheme should reduce imports in two ways: by raising their cost because of the interest forgone on the deposit; and, during the first six months of the scheme, by draining off some of the liquidity that importers need to pay for goods. The banks will clearly have to be very restrictive about lending for import deposits – except where it can be shown that the imports in question make an essential contribution to exports or to other activities having a high national priority.

Apart from its effects in helping to tighten bank credit and to reduce the liquidity of the private sector, the import deposit scheme will diminish the central government's borrowing requirement. Depending on how far imports are in fact reduced as a result of the scheme and the higher rates of indirect taxes imposed by the regulator, deposits will perhaps build up at a rate of roughly £100 million a month.

Domestic economy

In the third quarter domestic output seems to have risen quite strongly; indeed, the rate of increase was probably now faster than that at which productive potential is estimated to be growing.

Allowing for seasonal movements, the index of industrial production rose by a little over 1%, compared with an increase of just under $\frac{3}{4}$% in the second quarter. Meanwhile the growth of productivity seems to have slowed down. In the six months ended in March 1968 output per head in manufacturing industry probably increased at an annual rate of as much as 9% (manufacturing output, seasonally adjusted, rose by nearly 4% while numbers in employment are estimated to have fallen by $\frac{1}{2}$%).[1] However, productivity generally rises quite fast when output begins to spurt and capacity has been idle; more recently, with employment rising, the rate of growth of productivity in manufacturing seems to have been nearer 4%.

Unemployment has turned down. After seasonal adjustment, the number of wholly unemployed fell by 56,000 between August and November, to 2·3% of the estimated total of employees – suggesting that the number out of work in the winter months may be appreciably less than was predicted during the summer. The number of notified vacancies for adult workers increased during the same three months by about 32,000. Skilled labour was reported to be short in some areas and this was said to be adding to pressures for increased earnings. Meanwhile the average number of hours worked in manufacturing industry has been rising.

As for domestic demand, consumer spending rose appreciably in the third quarter, following the decline in the second after the Budget measures. After seasonal adjustment the volume of retail sales (representing about half of all consumer spending) increased by about 1%. There was also a steep rise, after seasonal adjustment, in the number of new cars registered – new cars account for about 5% of

1 Comparing the first quarter of 1968 with the third quarter of 1967.

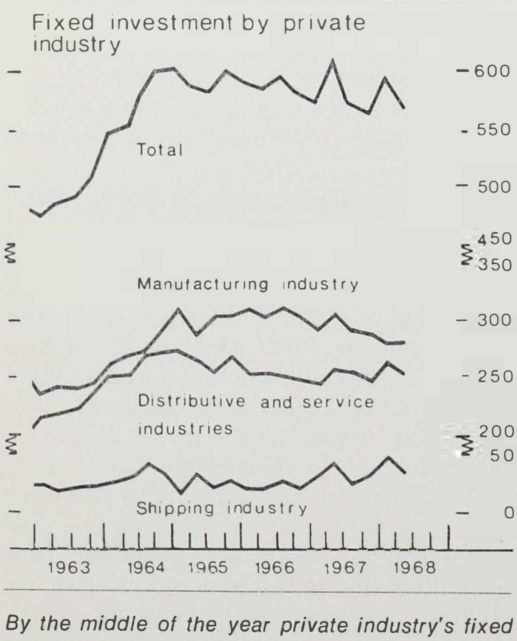
consumer spending. Though the extent of the rise (over one fifth) may be overstated – because the seasonal adjustment does not fully reflect the fact that the vehicle registration letter now changes in August and not in January[1] – there is no doubt that there was a sizable increase; nor that motor car production for the home market rose in the third quarter more sharply than production for export. Furthermore, registrations remained high in October. Spending in the shops too continued buoyant.

Indeed, before hire purchase restrictions were tightened and the other measures taken, it appeared that consumers' expenditure in the last six months of this year would be as high as in the second half of 1967, or higher, whereas at the time of the Budget expenditure in real terms was expected to fall by almost 2%. The recovery in personal spending has owed much to the fact that prices have risen rather slowly since the Budget – though the belief that they will continue to rise has certainly not diminished – while earnings have risen less slowly and have been supplemented by increases in family allowances. But it is also possible that consumers have reduced their rate of saving, or have drawn upon their stock of savings – indicating a strong determination to maintain living standards.

By October consumer prices had probably experienced most of the immediate effects of devaluation and of the Budget, though the increase in September in rates of selective employment tax had still to work through fully into prices. Between November 1967 and September 1968 the index of retail prices had increased by $4\frac{1}{2}$%, while, after seasonal adjustment, the index of average weekly earnings had risen by $5\frac{1}{4}$%. Higher wage rates accounted for most of the increase in earnings.

By the middle of this year private industry had not apparently begun to increase its spending on fixed assets. In the first six months, spending by manufacturers was at its lowest for nearly four years; yet smaller investment grants will be paid for expenditure on plant and machinery after 31st December. Partly because there was some recovery in profits, it is improbable that an increase in investment has been held back by a shortage of immediately available finance. It seems more likely that the interval between a rise in activity and an upturn in investment has been longer than usual because industry's confidence has been so badly shaken over the last year or so. The latest survey of investment intentions carried out by the Board of Trade in August and September suggests that fixed investment by manufacturing industry may be no higher in 1968 as a whole than in 1967. But in 1969 manufacturers are expected to invest some 10% to 15% more than this year – markedly increasing their expenditures on plant and machinery and on vehicles. These views are broadly endorsed by the enquiry into industrial trends carried out by the Confederation of British Industry in the last two weeks of September, which also found that shortages of plant capacity were becoming a serious impediment to increased output.

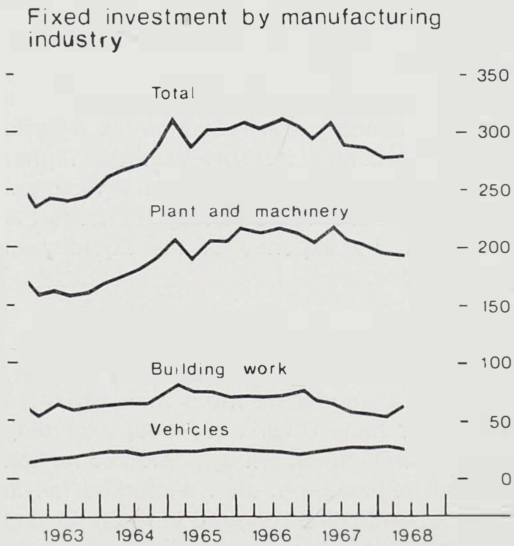
Seasonally adjusted £ millions at 1958 prices



By the middle of the year private industry's fixed investment was still not rising.

1 The arrangements changed in 1967, when a new registration letter was introduced in August as well as in January. Registration letters indicate the age of a car and therefore influence its marketable value; prospective buyers tend to delay purchases over the end of a registration year.

Seasonally adjusted £ millions at 1958 prices



Manufacturers spent less on fixed assets in the first half of 1968 than for nearly four years.

Little is known yet of the recent course of other forms of domestic demand. In the second quarter stocks were built up – mostly finished goods held by manufacturers – and they probably continued to rise in the third quarter. Housebuilding for private ownership increased in the second quarter, and it may well have continued to rise since, along with housebuilding for the public sector – which had levelled out in the second quarter. Expenditure on other fixed assets by the public sector declined, and current spending on public account was little changed in the second quarter. Indeed, the evidence suggests that public expenditure as a whole is responding to the curbs imposed since devaluation.

Central government finance

The central government's borrowing requirement (net balance) in the third calendar quarter was £359 million, £183 million less than a year earlier. The improvement was in the balance between revenue and expenditure – now shown under the item "Consolidated Fund (net)".[1] Revenue rose more quickly than expenditure because of larger yields from customs and excise duties – particularly purchase tax – after rates were increased in the Budget, and also from income tax. The net amount lent by the Government was not very different from that in the third quarter of 1967 – if allowance is made for borrowers' unused balances (included within "other central government funds and accounts").[1] Though local authorities borrowed rather more (their borrowing in 1967 was abnormally low) the nationalised industries took less.

Because some foreign exchange was coming in, however, external transactions added £66 million to the financing requirement, whereas a year earlier external transactions had contributed £512 million of finance. In sum, therefore, the Government's domestic borrowing requirement was £425 million, compared with only £30 million in the third quarter of 1967.

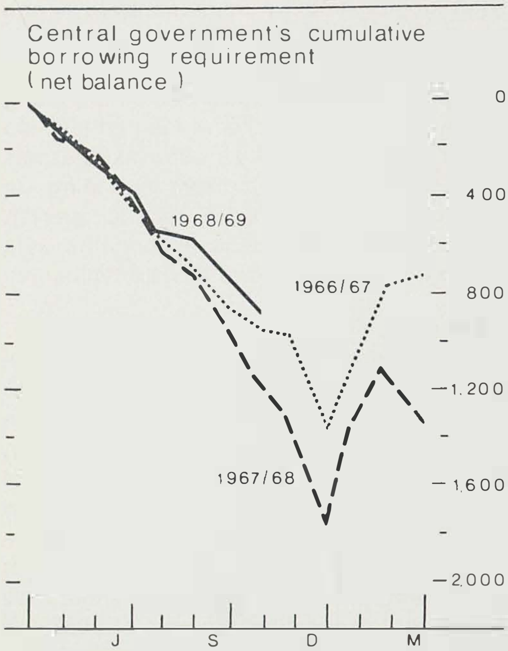
Holdings of government debt by investors outside the banking sector were little changed in aggregate. They bought over £70 million of gilt-edged – mainly towards the end of July and early in August – and continued to take up a modest amount of tax reserve certificates; but they also continued to run down their national savings, and there was a large fall (over £100 million) in their holdings of notes and coin – matched, however, by an increase in the banks' till money.

It seemed that the encouragement given to national savings in the Budget was still outweighed by the desire to turn money into goods or equity investments; unit trust units, for example, were still selling well. Nevertheless, national savings have improved a little since the third quarter; in particular, sales of premium bonds – which alone continue to make a net contribution, month in and month out – seem to have been further stimulated by the introduction from September of the new weekly prize of £25,000.

The banks and discount houses bought a large amount (around £300 million) of gilt-edged, and, as already noted, there was a sizable increase in the banks' holdings of notes

1 Table 1 of the annex.

£ millions



In the last quarter of the current fiscal year the 1968 Budget measures should powerfully reinforce the seasonal reduction in the borrowing requirement.

and coin. So, despite the fact that the banking sector met the whole of the Government's domestic borrowing requirement, its Treasury bill holdings were little changed.

In the first half of the current financial year the central government's borrowing requirement was £753 million – £212 million less than last year. This is well in line with expectations of a much smaller borrowing requirement during the whole of 1968/69. The cumulative borrowing requirement is always reduced between January and March, when a large proportion of tax revenue comes in. This year the higher rate of corporation tax and the special charge on investment income levied in the Budget should powerfully reinforce the seasonal movement – at the expense of the liquidity of companies and persons.

The banks and discount houses

In the three months to mid-October the *London clearing banks'* net deposits rose a good deal more than expected seasonally. On the other hand, their advances, excluding those to the nationalised industries, fell by some £65 million more than the seasonal expectation: after a marked fall in the month to mid-August and some rebound in the following month – which again brought these banks collectively up to the 104% ceiling – lending fell once more in October. Within the total, lending to companies other than for export business was rather sluggish, which suggests that companies as a whole were still fairly liquid and tends to confirm that spending on fixed assets was going rather slowly. Some lending to which the banks are asked to give low priority – such as to property companies – was reduced; but lending to persons (which had risen earlier in the year) probably did no more than level off. Lending to local authorities continued to fall.

The clearing banks bought nearly £100 million of gilt-edged, but were still left to take up, direct or through call money with the discount houses, more short-term government debt than usual: their Treasury bill holdings rose by £113 million, and they increased their lending to the discount market by £150 million. Despite a sharp fall in their commercial bill holdings, their liquid assets in total rose by £220 million over the three months; this brought their combined liquidity ratio to 32% of gross deposits – a little more than a year earlier, and a comfortable enough position but for the prospect that liquidity would be unusually strained in the first few months of 1969.

During the third calendar quarter sterling advances by the *accepting houses, overseas banks and other banks* to private customers in the United Kingdom fell a little, and those to residents overseas appreciably. As the banks' holdings of commercial bills were little changed, their sterling lending in aggregate remained below the ceiling. Meanwhile sterling acceptances, which had risen quite markedly earlier in the year, fell a little below the (separate) ceiling to which they are subject.[1] However, the banks substantially increased their lending to local authorities, presumably because the latter were anxious to keep their borrowing as short as

1 September *Bulletin*, page 238.

possible while interest rates were falling. As for the banks' other sterling assets, their purchases of gilt-edged (early in the quarter) were partly offset by a fall in their Treasury bill holdings; otherwise there were few changes.

Their sterling deposits from overseas increased sharply at the beginning of the period, but later fell a little; by contrast, a rise in deposits from U.K. residents other than banks took place largely at the end of the period. After the sharp increase in activity in the sterling inter-bank market at the half year business eased, and the market was generally quiet until towards the end of September.

The *discount market's* total assets rose by £180 million in the third quarter; a little over £140 million of the increase was in the houses' gilt-edged portfolios. Their Treasury bill holdings fell and their other bill holdings declined slightly. Even so, the houses were still running larger bill portfolios than usual because many of the banks had cut their bill purchases – lending to the houses the funds that in other circumstances they might have used to buy bills from them. The increase in the houses' borrowed funds came from the London clearing banks and the Scottish banks, which together provided about £300 million more. The rise was partly seasonal as the banks reduced their cash balances after the end of the half year. The houses were thus able to repay £130 million borrowed from the Bank of England.

The market in sterling certificates of deposit, which had been in preparation for some time, opened on 28th October. A certificate bears witness that a deposit of a round amount – the minimum is £50,000 and the maximum £250,000 – has been made at the London office of the issuing bank and will be repaid to bearer, with interest, on a specified date. The life of certificates seems likely to be between three months and five years, though the maximum is unlikely to exceed two years at first. Holders wishing to realise their certificates before maturity will be able to find buyers in a secondary market, provided in the first instance largely by the members of the London Discount Market Association. Sterling certificates may provide companies and others with a useful additional outlet for the investment of liquid funds. From the point of view of individual banks a growth in deposits at longer term may – credit restrictions apart – increase the scope for longer-term lending. As mentioned in the last Commentary,[1] certificates held by 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.

In October, the exchange control authority for the use of sterling usance credits to finance trade between countries outside the sterling area was withdrawn. This action was taken in order to safeguard the United Kingdom's official gold and dollar reserves.

Whenever a non-resident discounts a sterling usance bill on London, either there is an outflow of foreign currency or the non-resident uses the sterling so acquired instead of having to buy sterling in the market. Until funds are provided

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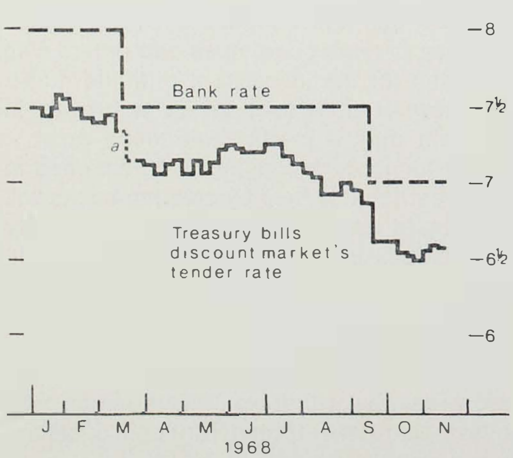
1 September *Bulletin*, page 239.

to meet the bill at maturity, directly or indirectly the reserves suffer. Although the U.K. balance of payments undoubtedly benefits from the invisible earnings on the provision of credits, in present circumstances the benefit is partly neutralised by the cost of additional official borrowing to support the reserves. Throughout this year there have been strong indications that increasing use was being made of the type of facility which has now been withdrawn, particularly while forward sterling stood at a substantial discount – thus reducing the net cost of a credit to a non-resident. While the attraction of such facilities has diminished with the narrowing of the discount in recent months, their use has continued to a greater extent than the United Kingdom can currently afford. Their withdrawal will result in a useful once-for-all benefit to the reserves.

There are no changes in the arrangements for the use of sterling facilities for financing trade in which a sterling area resident is either the importer or the exporter, or in which a merchant in the sterling area is concerned; nor does the restriction apply to any facilities where sight credits only are involved.

Moreover, the authority to finance trade between countries outside the sterling area by the use of currencies other than sterling continues.

Per cent per annum



The discount houses reduced their tender rate until 18 October; thereafter, a further cut in Bank rate seemed less likely and the tender rate hardened.

a There was no tender on 15 March.

Bill market

Conditions were more difficult for the discount houses between August and October than in the previous three months. Money was short, particularly during most of August. At the beginning of that month, and again just after the middle of September, large sales of gilt-edged by the authorities made shortages more acute. As a result, the scale of the Bank's assistance to the market was generally quite large; in August and the second half of September it was most frequently by lending at market rates. At no time, however, did the houses' indebtedness to the Bank become nearly as large as in the early months of this year. There was no lending at Bank rate.

In October the Bank felt able to relieve more of the daily shortages by purchasing Treasury bills and less by overnight lending, so that shortages were not generally rolled forward from day to day. Furthermore, the shortages themselves were more modest than in previous months, and there were a few days on which the Bank were able to sell bills to absorb temporary surpluses.

The average cost of the houses' borrowed funds fell from just under 7% at the beginning of August to below $6\frac{9}{16}$% after the reduction in Bank rate; it subsequently declined a little more, as money taken at higher rates ran off, and was just over $6\frac{7}{16}$% at the end of October.

The discount market's tender rate had declined during July. By the beginning of August expectations of a cut in Bank rate had become quite strong, and outside competition at the tenders keen; so, on 9th August, the houses reduced the rate sharply, from just under $7\frac{1}{16}$% to below $6\frac{15}{16}$%. Disappointing trade figures for July, announced just before the middle of August, had a dampening effect, but the news shortly afterwards of a reduction in Federal Reserve discount rates easily offset this and the houses left the tender rate unchanged on 16th August. The invasion of Czechoslovakia then caused nervousness in the markets generally, and as a precaution the discount houses raised the tender rate; but the increase was temporary and the confirmation in early September of the Basle agreement, followed by the improved trade figures for August, revived hopes of a reduction in Bank rate.

Though the cut of $\frac{1}{2}$% in Bank rate on 19th September caused little surprise, the houses assumed that the authorities did not wish to see bill rates fall too sharply, and they reduced the rate at the tender on the following day by little more than $\frac{1}{4}$% – to just under $6\frac{5}{8}$%. In the face of keen competition, they then continued to raise their bids until by 18th October the rate had fallen to little more than $6\frac{1}{2}$%. By the next tender, however, reports of industrial disputes were affecting the markets and the houses had become more cautious; accordingly they raised their rate to a little over $6\frac{9}{16}$%.

As noted earlier, the clearing banks were running down their holdings of commercial bills and so were less ready than usual to purchase bills from the discount houses. The houses therefore kept their buying rates for prime bank bills relatively high throughout the three months reviewed here. Early in August they cut their rates by $\frac{1}{8}$%, but this was the first reduction since 12th July and the Treasury bill tender rate had meanwhile fallen by as much as $\frac{1}{4}$%. After the cut in Bank rate, the houses reduced their rates for prime bank bills, but by no more than $\frac{7}{16}$%, thus moving them nearer Bank rate than before. They then kept their buying rate for three months' bills at $6\frac{15}{16}$%.

Local authorities

With interest rates still high but expected to go lower, local authorities remained reluctant to borrow from the Public Works Loan Board; they took only £40 million or so (net) compared with about £150 million between May and July. P.W.L.B. lending rates for loans up to 10 years were reduced twice during the period, and those for loans between 10 and 25 years once; at the end of October rates were between $\frac{1}{8}$% and $\frac{3}{8}$% less than at the end of July. By contrast authorities seem to have more or less doubled their borrowing on mortgage compared with the previous three months; as usual, however, most mortgages were for periods of five years or under – shorter than the normal term of P.W.L.B. lending. Despite the heavier demand, mortgage rates also declined over the three months – by between $\frac{1}{4}$% and $\frac{1}{2}$%; at the end of October rates ranged from $7\frac{5}{8}$% to $7\frac{7}{8}$%.

New money raised through stock issues, at £19 million, was also more than in the previous three months – though £14 million of it was by way of calls on the £25 million $7\frac{3}{4}$% Birmingham Corporation Loan 1980/82 issued in July. A similar amount was raised through issues of marketable bonds.

Though local authorities continued to rely mainly on temporary money – as noted earlier they increased their borrowing in the third quarter from the accepting houses, overseas banks and other banks – interest rates tended to decline except for a brief reaction around the end of August when the demand for funds was particularly heavy. Early in September the shorter rates moved slightly above longer ones, but after the Bank rate change a more normal pattern was restored. As the gilt-edged market became less active, funds became freely available at short term, and rates fell accordingly. By the end of October the cost of three months' money, at 7%, was $\frac{7}{8}$% less than three months earlier; over the same period seven-day money had fallen by $1\frac{1}{8}$%.

Yields on new issues of marketable bonds fell from around 8% at the beginning of August to slightly above $7\frac{1}{2}$% at the end of October.

Hire purchase finance houses

The total of outstanding debt owed to finance houses, which, after seasonal adjustment, had fallen since the Budget, began to rise again during the third quarter. By the end of September the houses collectively were about 2% above their ceiling and the position worsened during October. However, the tightening of terms control from 2nd November was expected to help the houses bring down their outstanding lending within the ceiling.

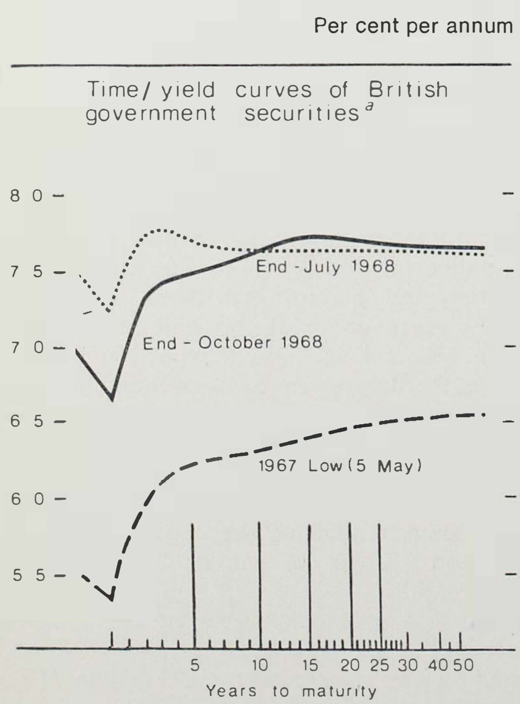
The changes in terms control represent a return to broadly the same degree of restraint as in July 1966. For cars the minimum deposit was raised from $33\frac{1}{3}$% to 40%, and the maximum repayment period shortened from 27 to 24 months; for most other consumer durables the new minimum deposit is $33\frac{1}{3}$% (formerly 25%) and the maximum repayment period 24 months (formerly 30 months).

During the three months under review the houses were not keen bidders for deposits; and though the rates offered fluctuated a little, they continued on balance to decline, along with other short-term interest rates. By the end of October three months' deposits yielded $7\frac{3}{8}$%-$7\frac{1}{2}$% compared with $7\frac{3}{4}$%-$8\frac{1}{8}$% at the end of July. The rate for six months' deposits generally remained $\frac{1}{8}$% above the three months' rate.

Gilt-edged

The gilt-edged market showed considerable resilience during the three months. Despite some set-backs, the authorities were able to sell on balance quite a large amount of stock, and turnover was higher than in the previous three months. The market seemed more encouraged by U.K. balance of payments prospects and there was a general belief that interest rates would continue to fall. Yields on short-dated stocks fell by between $\frac{1}{8}$% and $\frac{9}{16}$% over the period, while those on other maturities were little changed.

During the early part of August the authorities continued to sell stock. Hopes of a cut in Bank rate were still high, especially after the sharp reduction in the Treasury bill rate on 9th August, and some investors switched into gilts from equities, while others switched from short-dated stocks into longer-dated. The disappointing trade figures for July brought profit-taking and a temporary fall in prices; but this came to an end when Federal Reserve discount rates were



Yields on shorter dated stocks fell by between $\frac{1}{8}$% and $\frac{9}{16}$% during the period.

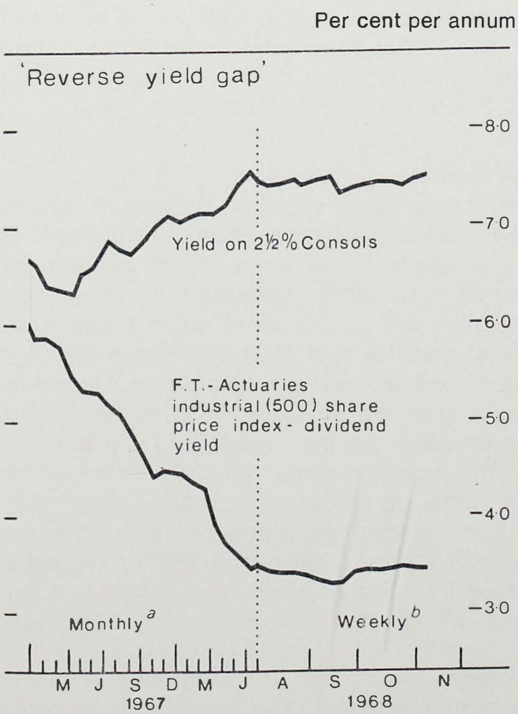
a The lines begin at Bank rate and continue through the yield on 91-day Treasury bills to those on British government stocks.

reduced, and there was some revival of demand at the end of the month.

The market remained firm, though quiet, until the next set of trade figures – which were good enough to revive hopes of a cut in Bank rate – stimulated demand for both shorter and longer-dated maturities. Demand for the latter arose in part from switching into the appropriate tap stock, $6\frac{3}{4}$% Treasury Loan 1995/98, and since this seemed to be largely a speculative movement, the authorities tried to avoid facilitating it. The cut in Bank rate – smaller than some had anticipated – and profit-taking brought buying to an abrupt halt.

Activity remained low until the middle of October when there was a little buying ahead of the trade figures for September. Though the figures themselves were much better than many had expected and raised some hopes of a further cut in Bank rate – despite the tendency for short-term interest rates abroad to rise – fears of a national strike in the engineering industry put an end to buying and kept the market fairly subdued during the rest of October.

3% Funding Stock 1966/68 was redeemed for cash on 1st August. Much of the outstanding stock was in official hands before the redemption date.



The gap narrowed a little in September.

a Average of working days.
b Wednesdays.

Equities and debentures

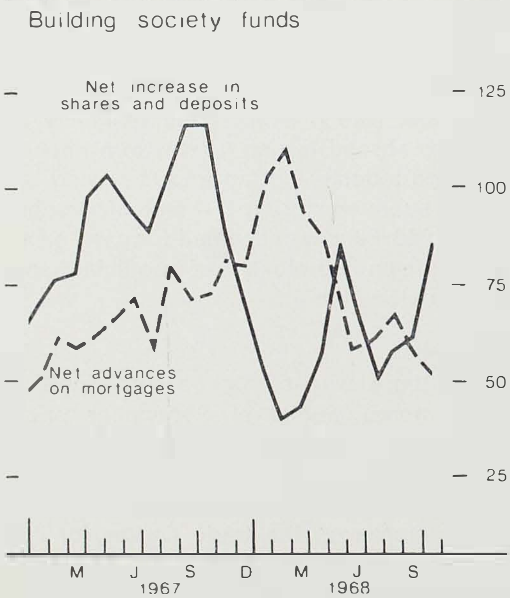
In the *equity market* there was a marked turn-round. In August and the first three weeks of September prices advanced, albeit irregularly, in response to some vigorous take-over activity – notably the proposals to merge G.E.C. and English Electric – and a number of generally satisfactory company results; moreover, the trade figures for July threw fresh doubts on the recovery of sterling and underlined the attractions of equities for those who had anxieties about inflation. The market hesitated only momentarily during the crisis in Czechoslovakia and by the end of August the F.T.-Actuaries industrial share price index was above 180 for the first time. Soon, the better trade figures for August and the cut in Bank rate stimulated further buying, and on 19th September the index reached a peak of 183·6.

The next day, however, some extensive profit-taking set off a reaction, and the collapse of the previously strong demand for Australian mining shares soon depressed the market further. From then on prices generally retreated, assisted, as October progressed, by reports of industrial disputes. Towards the end of the month, moreover, further restraints on consumer spending seemed imminent. By the end of October the price index had fallen to 176·2. During this time the 'reverse yield gap', which until the middle of September had continued to widen, narrowed a little.

The weaker tone reflected a larger supply of stock – new issues in the third quarter were the largest for some years – as well as lack of buying interest; buying by the institutions was less apparent, and other investors also seemed to have become more selective. Moreover, a pause for reassessment and readjustment was not unnatural after the broad advance that had lasted so long.

Though turnover in equities between August and October was somewhat lower than in the previous three months, that in *debenture and loan stocks* was slightly higher. Yields on fixed interest stocks barely changed; the F.T.-Actuaries calculated 20-year redemption yield fluctuated narrowly around 8⅜% during the period while the margin over the calculated yield on gilt-edged stock of comparable term remained at a little below ¾%. New issues of debenture and loan stocks also were substantially larger than for some time.

Seasonally adjusted £ millions



The reduction in Bank rate in September and the more uncertain course of equities have improved the position of the building societies.

Building societies

For much of this year the building societies have found it difficult to attract and hold sufficient funds to cover their lending. There was some improvement after they raised the rates of interest paid to investors (and also the rates charged to borrowers) on 1st May, but by July net receipts had again fallen below net advances, with a consequent fall in the societies' liquid assets; by the end of September their combined liquidity ratio was down to slightly over 15% – lower than in April. There seems little doubt that building society shares and deposits, like national savings, have suffered this year from high consumer spending and the search for investments offering some protection against inflation.

However, there was a strong improvement in the societies' net receipts (and in their liquidity ratios) in October. Evidently the reduction in Bank rate in September has brought some relief, and the more uncertain course of equities afterwards may have helped. Also it was announced on 16th October that the Inland Revenue had agreed that the limit on individual investment in any one society should be raised from £5,000 to £10,000. This may help the societies attract more local money, and will allow them to reinvest interest where shareholders had reached the former upper limit.

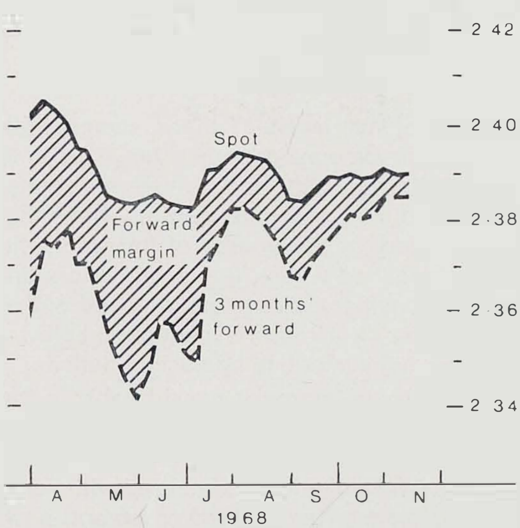
Foreign exchange market

The stronger demand for sterling which developed in July persisted into early August, and the authorities were able to take in moderate amounts of exchange. From mid-August, however, the market suffered a series of jolts to its confidence. First, U.K. imports in July were much higher than had been expected, and the spot U.S. dollar rate declined from \$2·39$\frac{7}{16}$ to \$2·39¼ while the discount on forward sterling widened. A week later the invasion of Czechoslovakia brought renewed pressure on the pound, and the rate fell below \$2·39 – for the first time since 12th July. Towards the end of the month rumours, entirely unfounded though they were, that the U.K. authorities were pressing Western Germany to revalue produced a heavy demand for deutschemarks accompanied by sales of sterling; the spot rate fell sharply and by 6th September was standing at little more than \$2·38¼.

As in July, recovery began with the monthly meeting of central bank Governors at Basle. The Governors, as noted earlier, confirmed that they would extend a \$2,000 million medium-term credit to the United Kingdom – they had indicated in July that they would be willing to do so, subject to the satisfactory outcome of consultations between the

$ to £

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

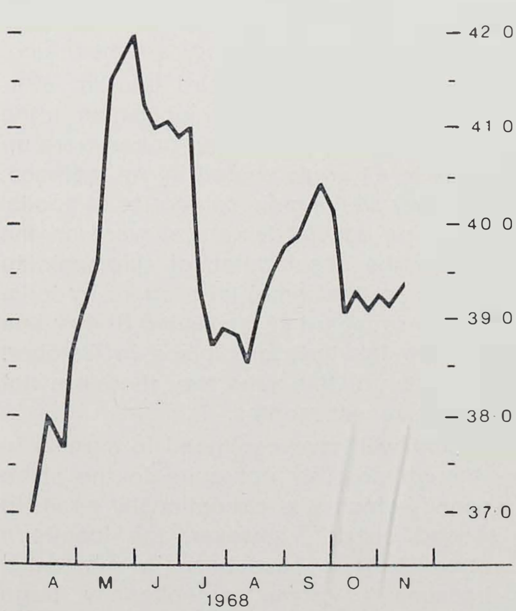


Sterling improved after August; the forward discount narrowed markedly in September and continued to narrow in October.

a Middle closing rates; weekly, Fridays.

$ per fine ounce

Fixing price[a] for gold in London.



Uncertainty about the future disposal of South African gold contributed most to the marked rise in price in August and September and to the subsequent reaction.

a Weekly, Friday afternoons.

United Kingdom and other countries in the sterling area. The spot rate moved up to $2·38\frac{3}{4}$ and improved further with the publication a week later of the trade figures for August. The reduction in Bank rate, though fully discounted in advance by the market, was then well received and sterling continued firm for the rest of September, with the rate moving narrowly around $2·39. Indeed, the approach of the end of the quarter – which as usual produced a demand for dollars to replace deposits withdrawn from the euro-dollar market for balance sheet purposes – brought no great problems for sterling; and the market was also unusually quiet before the annual meeting in Washington of the Board of Governors of the International Monetary Fund at the beginning of October.

The firmer tone continued into October, and indeed for much of the month there was a steady though modest demand for sterling. After a good start, however, the market grew more cautious as industrial disputes became more prominent. There was also some disappointment that an agreement with Rhodesia had not been reached, and the next trade figures were awaited with some anxiety. By 14th October the spot rate had declined to $2·38\frac{13}{16}$, and the trade figures for September announced the next day, good though export performance was, were overshadowed by the strike threat to the engineering industry. When the threat receded, however, the rate climbed above $2·39, where it remained during the rest of the month.

In the forward market there was a fairly marked recovery after August, suggesting that confidence in the United Kingdom's prospects had improved. At the end of October the cost of three months' forward cover, expressed as an annual rate, stood at a little over $\frac{3}{4}$% – the lowest for a year – compared with $2\frac{1}{8}$% three months earlier. By the end of October the Exchange Equalisation Account's outstanding forward commitments to take sterling from the market had been reduced to about one fifth of the peak reached before devaluation.

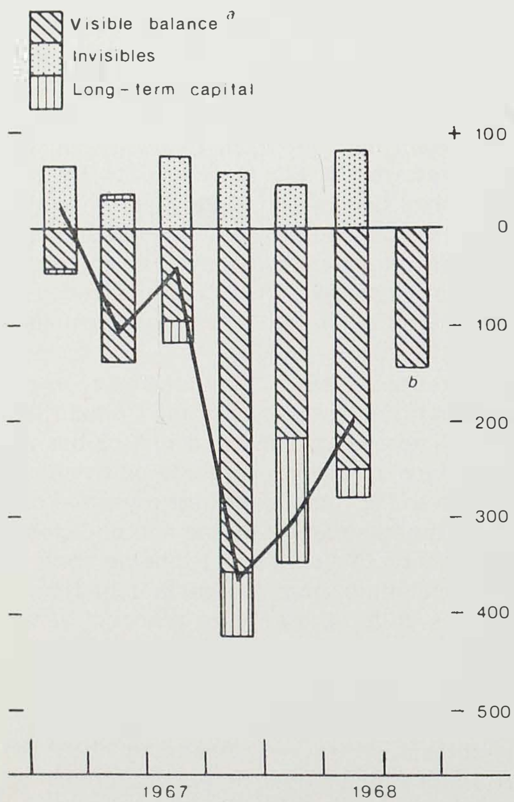
Gold market

During the three months under review, uncertainty about the future disposal of South Africa's gold production continued to influence free gold markets. Prices in London did not fluctuate quite as much as in the previous three months. Towards the end of August the crisis in Czechoslovakia brought the fixing price above $40, and early in September the ending of the control over movements of gold into and out of France also stimulated demand. By the third week in September the price had edged up to around $40·50.

Before the annual meeting of the I.M.F. Governors the price tended to fall, because the market believed that, whatever the outcome in Washington, South Africa must soon resume selling gold. Reports of agreement that she would sell most of her production on free markets, with the Fund standing ready to buy when the market price fell below $35 per fine ounce, caused the London price to fall as low as $38·30 at the morning fixing on Wednesday, 2nd October, though it rebounded when South Africa refused to accept the formula.

Seasonally adjusted £ millions

U.K. balance of payments



a Including, except for the third quarter of 1968, payments to the United States for military aircraft and missiles.
b Figures for the visible balance in the third quarter are provisional; figures for invisibles and long-term capital are not yet available.

Subsequently, the price drifted downwards again, and it generally remained between $39 and $39·50 over the rest of the period. The market still seemed to favour the view that South African sales would begin before long, though uncertainties about the outcome of the U.S. Presidential election may have been a factor pulling in the direction of higher prices.

Balance of payments

Although full details are still awaited, there seems little doubt that with the help of some exceptionally large receipts of investment capital the current and long-term capital account was in surplus during the third quarter. Nevertheless, despite some recovery in the course of this year, the point has not yet been reached where, if special factors are ignored, the balance of payments has clearly moved out of deficit. In the fourth quarter – for reasons mentioned below – it is likely, after seasonal adjustment, to be back in deficit.

The balance of visible trade improved considerably in the third quarter: the deficit, after seasonal adjustment and excluding payments to the United States for military aircraft and missiles, was about £145 million, as compared with some £220 million in the second quarter. The improvement, however, was entirely in exports; imports remained high.

Indeed, as recorded in the trade accounts and seasonally adjusted, imports were almost 3½% higher by value than in the second quarter. It would appear, however, that the increase was partly due to temporary factors – mainly shipments held back until after 1st July to take advantage of the 'Kennedy round' of tariff reductions, and goods delayed in France by the disturbances during May and June – and had it not been for these, imports would have been much the same in both quarters. Nevertheless, the high level of imports and the increase in October (largely in food) are disturbing.

Exports did particularly well in the third quarter: after seasonal adjustment their value was 8½% higher than in the second; 6½% of the rise was in volume, and prices were up by only 2%. Shipments to all areas shared in the increase, and it was well spread over all the main categories of goods. However, there were some special factors at work on the export side too, notably the acceleration of shipments to anticipate the likelihood (at that time) of a strike by longshoremen on the eastern seaboard of the United States; and this was reflected in the fall that took place in October. Exports in the last quarter of this year may therefore not increase as rapidly as in recent months.

The invisibles account will have continued in surplus in the third quarter, though possibly not quite to the same extent as in the second, which was exceptionally good. In contrast to the second quarter, however, the long-term capital account seems likely to have been in substantial surplus, mainly because of some exceptionally large receipts. These were largely of American money to buy out shareholders in British firms such as Gallaher Limited – control of which had been acquired by the American Tobacco Company. There also seems to have been some reduction in the outflow of U.K. portfolio investment in Australian companies. It is likely that the capital account will show a marked deterioration in the fourth quarter, because, for example, the large receipts of the third quarter have given way to at least one large payment to the United States – consequent upon the sale by General Telephone to U.K. residents of its shares in Thorn Electrical.

The change on current and long-term capital account in the third quarter was probably nearly matched by the change in the net total of monetary movements, so the balancing item is likely to have been small.

Movements of short-term funds

The strengthening of confidence between August and October had a noticeable effect on the movement of short-term funds: a net outflow in both August and September gave way to a sizable inflow in October – into the sterling balances of sterling area countries.

Taking the three months together, the United Kingdom's net external liabilities in sterling, and in currencies of other sterling area countries, increased – after their rapid fall in the earlier part of the year. Net liabilities to countries outside the sterling area, excluding the counterpart of drawings on central bank facilities, fell somewhat; but there was a large increase in net liabilities to sterling area countries, due no doubt in part to the conclusion of the agreements between the United Kingdom and other members of the sterling area in connection with the new Basle medium-term facility.

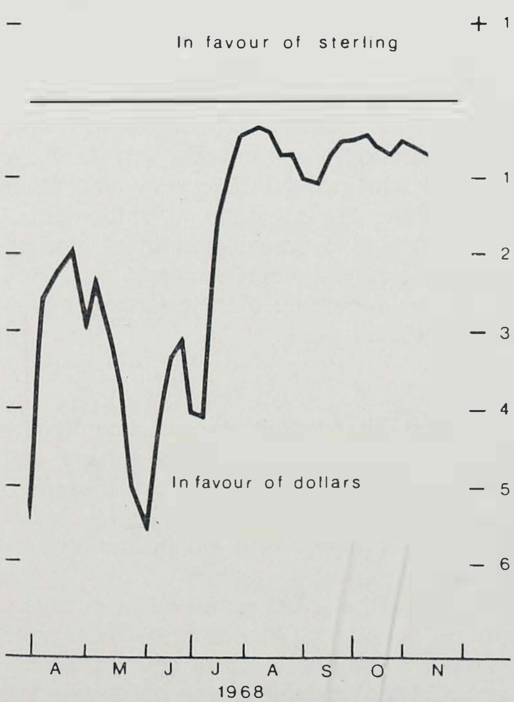
The arrangement of 1st June which enabled the Hong Kong Government to purchase, for sterling, British government bonds denominated in Hong Kong dollars was superseded in September by a new agreement, similar to those with other sterling area countries. Accordingly the dollar bonds which had been purchased by Hong Kong were redeemed for sterling.

Month by month, switching of short-term funds by banks in the United Kingdom between employment in sterling and in the euro-currency market was not significant except in October, when they switched a moderate amount out of sterling. The usual arbitrage margins generally remained unfavourable to sterling – though less so than at any time since last February. In August euro-dollar rates declined on balance; they fell sharply early in the month, and this led American banks to borrow heavily through their London offices; but rates increased again towards the end of August as funds were withdrawn from the market to purchase deutschemarks. Meanwhile the cost of covering investment in sterling forward increased during August, and covered margins in favour of investment in euro-dollars consequently widened.

During September rates of return on euro-dollar deposits generally declined, though at the end of the month the rate on three months' deposits hardened because of a demand for funds for terms extending over the end of the year. However, the covered margin in favour of investment in three months' euro-dollars narrowed quite markedly – despite a fall during the month in U.K. local authority interest rates – for there was a sharp reduction in the cost

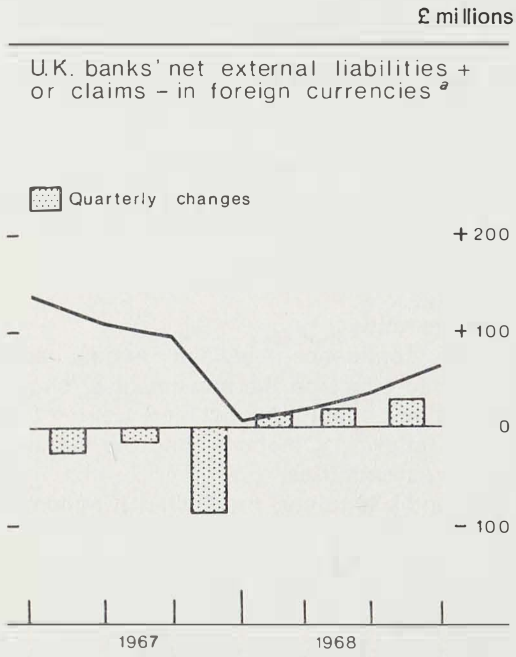
Per cent per annum

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



Arbitrage comparisons, though still unfavourable to sterling, reflected the much narrower forward discount.

a Weekly, Fridays.



At the end of September banks in the United Kingdom had net external liabilities in foreign currencies of £63 million, compared with £37 million at the end of June.

a Series revised to include previously unallocated items.

of forward cover. An increased demand for funds in the first half of October – American banks were bidding strongly – caused euro-dollar rates to rise, while rates in the United Kingdom edged downwards. Nevertheless, the cost of forward cover continued to decline in October, and the covered margin in favour of euro-dollars was further reduced; by the end of the month it was a little smaller than three months earlier, at about $\frac{3}{8}$%.

In July banks in the United Kingdom had switched foreign currency deposits into sterling; as already indicated, there was little or no net movement in August and September. In the third calendar quarter the banks' gross external claims in foreign currencies increased by £397 million and their gross external liabilities by £423 million, so that they switched £26 million into sterling; as a result their net external liabilities rose to £63 million.[1]

Reserves and special facilities

In the third quarter the United Kingdom's gold and currency reserves increased by the equivalent of £14 million; this was after loan repayments equivalent to £77 million, including £35 million ($85 million) to the International Monetary Fund in August – the first of eight instalments in respect of the United Kingdom's drawing in May 1965.

During the quarter a net amount of $400 million (£167 million) was drawn under the Federal Reserve reciprocal swap facility of $2,000 million – which had been wholly reconstituted from the proceeds of the United Kingdom's drawing on the I.M.F. in June; there was a net repayment of assistance under other short-term facilities; and the first drawing was made under the medium-term facility of $2,000 million established at Basle in September.

When the arrangements at Basle were completed it was disclosed that the earlier, short-term facility which the Bank of England had entered into in June 1966 with nine other central banks and the Bank for International Settlements,[2] and related to fluctuations in overseas countries' sterling balances, would be progressively liquidated and ended by 1971. $600 million will be repaid in eight quarterly instalments from September 1969.

Conclusion

It is to be hoped that the action taken recently by the United Kingdom, France and Western Germany will strengthen confidence. Even so, some of the measures taken in the interests of stability may lead to a slower growth in world demand – prospects for which had already become less favourable.

For the United Kingdom, the latest upheaval in currency markets has shown that confidence abroad in her economic recovery remains fragile. The weakness of sterling is only in part a consequence of the strength of the deutschemark and the state of the franc; more directly it reflects the slow pace of recovery in the United Kingdom's balance of pay-

1 Figures for earlier periods have been revised; see page 420.
2 The facility was renewed for a year in March 1967 and again in March 1968. It formed part of total facilities of $1,000 million related to fluctuations in the sterling balances. See March *Bulletin*, page 8.

ments since devaluation and the recent divergence of the domestic economy from the path laid down at the time of the Budget.

The import deposit scheme, which is aimed at securing a reduction in imports, may also encourage domestic industry to replace some imported goods. But the scheme is temporary in nature, and to bring about a sustained improvement in the balance of payments, the United Kingdom will need to surpass her recent export performance – perhaps under substantially less favourable conditions of world demand. The containment of consumer spending should help to reduce both import demand, and the demand for home-produced goods – so providing further scope for increasing exports.

Consumer spending has again borne the brunt of restrictive policies. The growth of public spending is being held down, in terms of volume, to the rates predicted at the time of the Budget. However, room must be made for the increase – which is now overdue – in investment by private industry needed to support more import saving and to accelerate exports.

Domestic resources must be made available to meet more of the demands, in home and export markets, that are at present being satisfied by foreign producers; and the competitive advantage gained by devaluation must be held. The measures taken recently should ensure that home demand is kept within bounds. The prices and incomes policy is the necessary means of relating increases in industrial costs to increases in productivity.