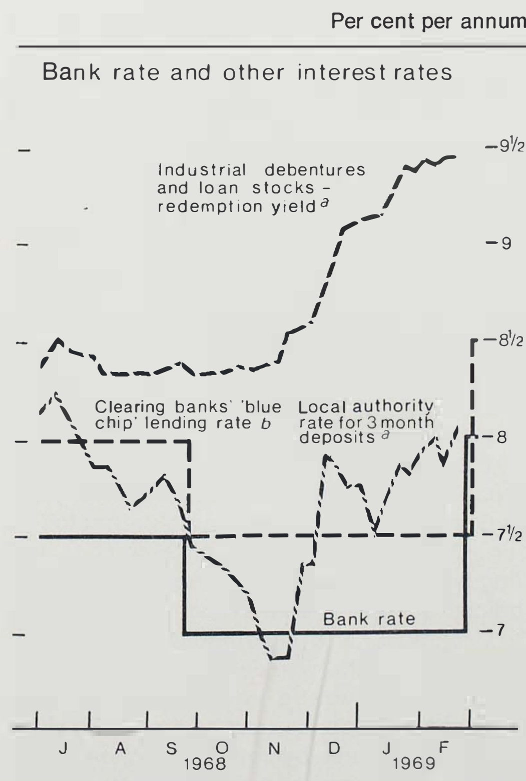
Commentary

Per cent per annum

Bank rate and other interest rates



The cost of most forms of borrowing had risen well above the lowest rate of interest ordinarily charged by the clearing banks for advances – which is directly linked with Bank rate. Bank rate was raised from 7% to 8% on 27th February.

a Weekly, Fridays.

b London clearing banks' minimum lending rate for advances to first class industrial and commercial borrowers.

Introduction

The last Commentary contained a brief account of the upheaval in foreign exchange markets in the middle of November, and described the measures announced on 22nd November to hasten the recovery of the United Kingdom's balance of payments.[1] Measures were also announced at that time by Western Germany and by France to reduce the pressures affecting their currencies.[2]

Afterwards, markets became more orderly, and a substantial part of the short-term funds that had entered Western Germany flowed out again. Nevertheless, confidence in sterling remained brittle, and because euro-dollars were much in demand there was little or no reflux of funds to the United Kingdom by the end of the year. In January, however, moderate but steady demand for sterling helped to improve the spot rate and the reserves. The visible trade deficit in the fourth quarter was a little smaller than in the third, but the balance of payments as a whole moved (as expected) back into deficit because the long-term capital account was less favourable.

Short-term interest rates in international markets, particularly the key dollar rates, moved strongly upwards between November and January. Euro-dollar rates increased in November, notably during the currency crisis, and early in December tighter credit conditions led banks in the United States to raise their prime lending rates. U.S. Treasury bill rates were also rising, and most Federal Reserve Banks raised their discount rates from $5\frac{1}{4}$% to $5\frac{1}{2}$% with effect from 18th December.[3] At the same time the Federal added to the pressures on the banks' liquidity by maintaining existing ceilings on the rates offered for time and savings deposits; the banks responded by again raising their prime lending rates, and they raised them for a third time early in the New Year; euro-dollar rates continued to increase in January. Meanwhile, several other central banks had raised their discount rates.

In the United Kingdom most short-term interest rates have risen fairly rapidly in recent months, and yields on gilt-edged and on company fixed interest securities have climbed to new peaks. By late February the lowest rate of interest ordinarily charged by the clearing banks for advances to commercial borrowers was well below yields then obtainable on short-term investment in the parallel money markets. Meanwhile, the clearing banks' lending to the private sector had moved further away from the target set last November,[4] and by mid-February they were collectively between $3\frac{1}{2}$% and 4% above the limit. It was therefore

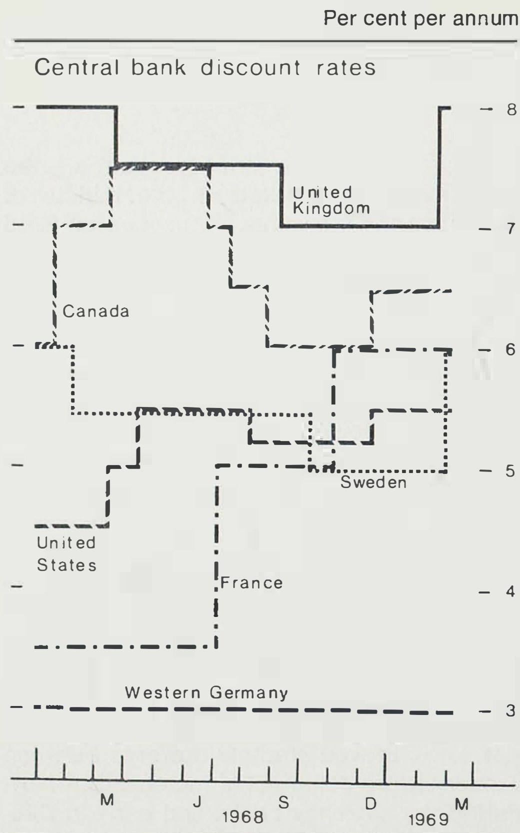
1 December 1968 *Bulletin*, page 342.

2 On 19th November the West German Government (which had reaffirmed that the Deutschemark would not be revalued) announced legislation to amend border taxes, so as effectively to reduce the cost of most imports and increase the cost of exports; and, together with the Bundesbank, they took steps to deter the heavy inflow of short-term funds. The French Government declared on 23rd November that they would not devalue the franc, and later announced a programme of austerity, including budgetary restraint and the reintroduction of exchange control.

3 The remaining Federal Reserve Banks raised their rates from 20th December.

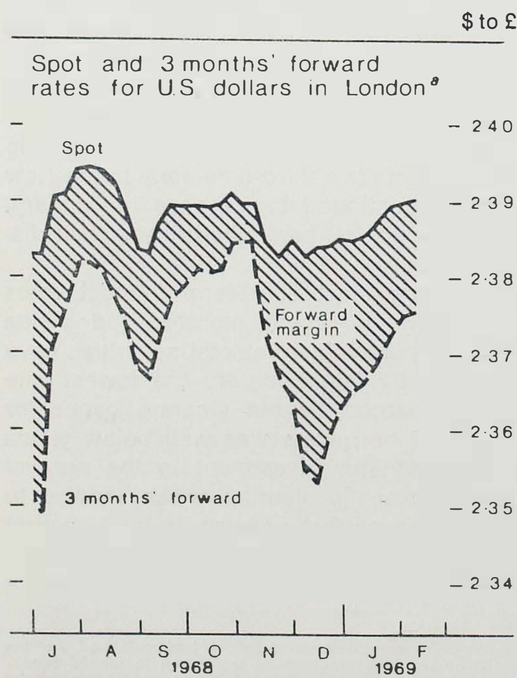
4 December 1968 *Bulletin*, page 358.

Per cent per annum



The rise in Bank rate followed increases in a number of other central bank discount rates.

$ to £



From the middle of December commercial demand for sterling improved the spot rate; the forward rate also recovered.

a Middle closing rates: weekly, Fridays.

decided that the official policy of severe credit restraint, which it was essential to maintain, should be supported by an increase in Bank rate and in those interest rates directly linked with it; Bank rate was raised on 27th February from 7% to 8%. At the same time the banks were reminded by the Chancellor of the Exchequer of the great importance that the Government attached to the achievement as soon as possible of the required reduction in lending.

The U.K. domestic economy continued to expand strongly in the fourth quarter, though growth may have been less rapid by the end of the year. There was probably little spare capacity in some key industries, and labour was almost certainly more in demand than the monthly unemployment totals indicated. Fixed investment by private manufacturing industry had turned upwards by the end of the year, though not apparently very strongly.

Foreign exchange market

The early part of November was quiet. The spot rate for the U.S. dollar remained close to $2·39, and even the announcement on 13th November of disappointing trade figures for October did not at first provoke much selling of sterling. However, rumours were spreading of imminent changes in currency parities – notably of the French franc and the Deutschemark – and sterling came under severe pressure as speculative funds moved into Western Germany. On Friday, 15th November sterling required substantial support, and after the week-end, when the flight into the Deutschemark from the French franc and the pound was resumed, the rate fell to $2·38¼; on 19th November there was again heavy official intervention.

The London market was closed from 20th to 22nd November,[1] along with foreign exchange markets in France and Western Germany; other continental markets meanwhile suspended quotations in sterling, francs and deutschemarks. During this time spot sterling was held in the New York market – which remained open – at $2·38. After the other markets reopened, the rate recovered somewhat – it touched $2·38¾ on 27th November – but though funds were now flowing out of Western Germany they were not much attracted at this time to London. During the early part of December, the weakness of sterling was aggravated by a strong demand for dollars; despite official support the rate declined to $2·38¼ on Thursday, 5th December, and substantial support was also necessary either side of the week-end.

On 11th December there was a reaction; many who needed to deliver pounds had gone short of them and were conceding high rates to borrow by means of short-dated swaps. Anticipating that the trade figures for November (which were due to be announced the next day) would be better than those for the previous month, those who were oversold scrambled to cover their commitments, and the spot rate touched $2·38⅞. But though the trade figures were even better than expected, most of the benefit had accrued beforehand and the rate fell back to $2·38⅜.

Despite some modest commercial demand later in the month, sterling was restrained by the rise in U.S. interest

1 While Finance Ministers of the Group of Ten countries met at Bonn.

rates and the shortage of dollars, and the rate had not quite regained $2·38½ by the end of the year. In the early part of the New Year dollars were (unusually) still in demand, and in thin exchange markets sterling declined to just over $2·38⅜. But as conditions in the euro-dollar market eased a little towards the middle of the month, sterling improved on steady commercial demand – much of it seasonal. By 22nd January the rate had climbed above $2·39 for the first time since early November, and it remained around this point for the rest of the month. As the rate moved up some dollars were taken into the reserves.

The heavy pressures on sterling in the second half of November brought about a sharp increase in the cost of covering forward in dollars: hedging by foreign holders of sterling assets affected the longer dates, and borrowing of sterling through swaps affected the shorter. By the end of November three months' cover, expressed as an annual rate, cost about 3⅝%, compared with a little over ¾% at the end of October. Forward margins continued to widen early in December, and they recovered only part of the ground later in the month. Despite some improvement in January the cost of three months' cover was still over 2½% per annum at the end of the month.

The steady rise from December onwards in the free market price of gold was due mainly to a lack of sellers. Turnover remained moderate.

a Weekly, Friday afternoons.

Gold market

Though the price of gold in free markets increased during November it was affected comparatively little by the instability in currency markets – apparently because a ready supply was forthcoming (through Switzerland) whenever the market price reached $40 per fine ounce; it was widely supposed that South Africa was the source. The fixing price in London, which had been about $39 at the beginning of November, went to $40·75 on 20th November, but had fallen below $40 by the end of that month. Demand declined partly because the French measures announced after 23rd November included fresh restrictions on movements of gold into and out of France.

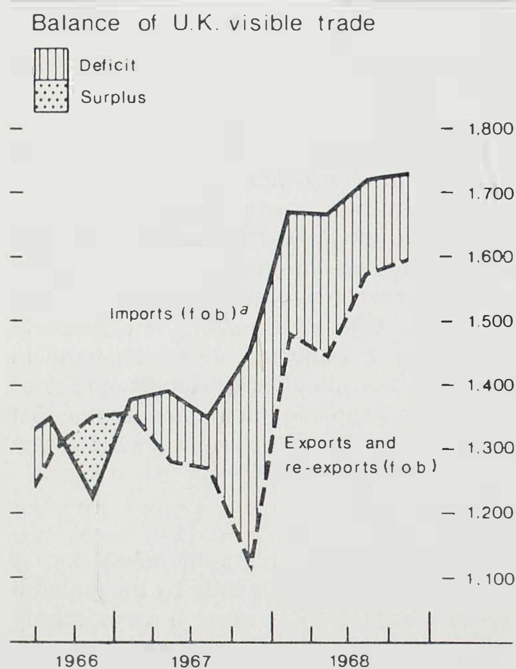
In December the price climbed fairly steadily, partly because tension had risen in the Middle East, but mainly because of a lack of sellers; and it went higher in the New Year when for a time renewed fighting in the Middle East was feared. On 15th January the (morning) fixing price of $42·75 in London was the highest since the 'two-tier' system of gold markets was instituted in March 1968;[1] and the price remained for the most part well above $42 for the rest of January, finishing the month at a little over $42·50. Nevertheless, turnover remained moderate. On 22nd January the newly appointed Secretary of the U.S. Treasury stated that the United States would not seek an answer to its problems by changing the price of monetary gold.

Balance of payments

The seasonally adjusted surplus of over £100 million on current and long-term capital account in the third quarter of 1968 gave way, as expected, to a substantial deficit in the fourth; full details will be published very shortly, but in the meantime it seems clear that by far the greater part of

1 June 1968 *Bulletin*, page 109.

Seasonally adjusted
latest quarter provisional £ millions



The visible trade deficit in the fourth quarter was slightly smaller than in the third. Exports rose faster than imports.

a Excluding deliveries of, and payments for, military aircraft and missiles from the United States.

the change was in the capital account, which had been particularly favourable in the third quarter. The deficit on visible trade,[1] after seasonal adjustment, was just under £130 million, compared with about £150 million in the third.

The value of exports fluctuated considerably month by month, but during the quarter as a whole was not quite 2% higher than in the third. On the face of it this was a somewhat disappointing performance after the strong rise earlier in the year; however, deliveries to countries in the European Economic Community increased encouragingly, and a fall in those to the United States was from a high point in the third quarter when shipments had been accelerated to arrive before strikes began in United States east coast ports.[2] Moreover, exports rose impressively in January.

Imports, as recorded in the trade accounts and seasonally adjusted, reached a peak in October and then declined. Their value in the fourth quarter was much the same as in the third – confirming earlier impressions that the rising trend had at last levelled out.

The import deposit scheme which came into force on 27th November is unlikely to have had any appreciable effect on imports in the fourth quarter. The scheme was reinforced on 18th December when it was announced that U.K. importers would no longer be allowed to borrow foreign currency, or sterling owned by overseas residents outside the sterling area, in order to pay deposits. During the first few weeks of the scheme permission to borrow was given quite freely but soon the prospect of heavy use of such facilities threatened to cut across one of its main objects – the reduction of U.K. imports. Nevertheless, the burden for U.K. importers is probably eased through the provision of increased credit by their overseas suppliers.

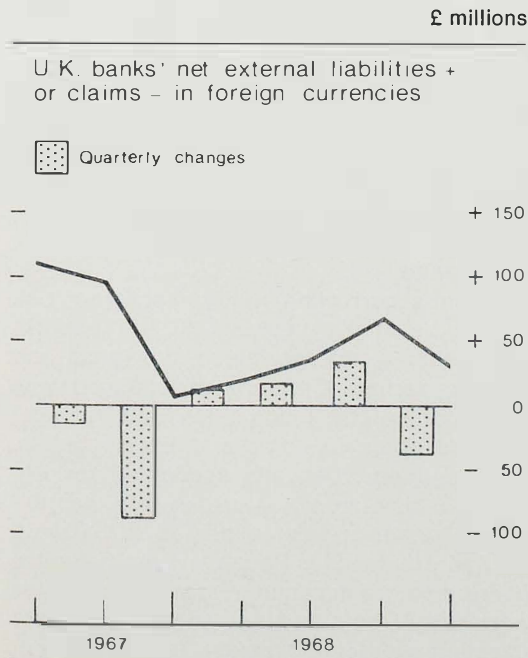
Over the whole of 1968, there was a notable although slow improvement in the trade balance, after seasonal adjustment. The initial effect of devaluation in worsening the terms of trade against the United Kingdom was accentuated in the first quarter by a rise in the volume of imports – associated with sharply increased consumer spending and the growth of industrial output. Thereafter imports remained high; but as the year wore on, the effect of this was progressively countered by a rise in export earnings – the volume of exports grew strongly and exporters increased their prices. By the fourth quarter the value of exports was about 28% greater in sterling terms than in the two middle quarters of 1967 (a better pre-devaluation period for purposes of comparison than the fourth quarter of 1967, when trade was distorted by the strikes in the London and Liverpool docks); that is 10% in dollar terms.[3] On the same comparison, the value of imports increased by as much as 26% in sterling terms and 8% in dollar terms.

The invisible account was probably in smaller surplus in the fourth quarter of 1968 than in either the second or third. The long-term capital account, however, was markedly more unfavourable, for there was nothing equivalent to the large

1 Excluding payments made to the United States for military aircraft and missiles.
2 However, a 'cooling-off' period was ordered, and the strikes began not in early October but on 20th December.
3 Values expressed in sterling represent 14·3% less in terms of the U.S. dollar than before the pound was devalued.

receipts in the third quarter which had stemmed from the acquisition of British firms by American interests; indeed there was at least one large payment to the United States.

The deficit on current and long-term capital account in the fourth quarter was probably roughly equal to the net total of monetary movements, so the balancing item is likely to have been small.



During the fourth quarter banks in the United Kingdom added £39 million more to their claims in foreign currencies than to their liabilities.

Movements of short-term funds

November saw a considerable outflow of funds from London; in particular, the sterling balances of countries outside the sterling area were run down rapidly. And a moderate outflow persisted in December when the weakness of sterling and a demand for euro-dollars provided little incentive for short-term funds to return to the United Kingdom. However, there was a net inflow in January, mainly in the form of a seasonal rise in the sterling balances of overseas sterling area countries.

Over the three months taken together, the sterling balances of countries outside the sterling area, excluding the counterpart of drawings on central bank facilities, fell substantially. On the other hand, the United Kingdom's net external liabilities in sterling to sterling area countries were little changed on balance, thanks to the rise in January.

In the fourth quarter banks in the United Kingdom expanded their operations in euro-dollars rather faster than in the previous one – though not quite as rapidly as in the second quarter. Their gross external liabilities in foreign currencies rose by £600 million, and their gross claims by £639 million, reflecting a net switch out of sterling during the quarter of £39 million. In November, the banks were switching funds out of sterling into foreign currency, as they had also done in October. Over the next two months, however, foreign currency was switched into sterling, even though the normal interest arbitrage comparisons became markedly unfavourable to the employment of short-term funds in the United Kingdom owing to the high cost of covering investment in sterling forward. By the end of January the margin in favour of investment in three months' euro-dollar deposits, rather than in three months' loans to U.K. local authorities covered forward, stood at $2\frac{5}{16}$%, expressed as an annual rate of return, compared with $\frac{7}{16}$% three months earlier.

Euro-dollar interest rates increased in the second half of November partly because U.S. banks were borrowing through their London offices but mainly because funds were withdrawn for conversion into deutschemarks. The usual demand for dollars to carry over the end of the year kept rates up at first in December (absorbing most of the funds that were then moving out of Western Germany), and later in the month deposits by overseas subsidiaries of U.S. corporations were withdrawn for repatriation to the United States; U.S. banks, which had continued to borrow heavily through their branches in London in the early part of the month, repaid them later so that these withdrawals could be met. With the passing of end-year pressures, however, the U.S. banks returned to the market as borrowers; because of the increased tightness of funds in the United States their requirements were very large, particularly during the early part of January.

Reserves and special facilities

In the fourth quarter the United Kingdom's gold and currency reserves fell by the equivalent of £123 million, after repayment of various forms of medium-term borrowing totalling £115 million. Repayments comprised £43 million to the three Swiss commercial banks who, in October 1967, lent 450 million Swiss francs to H.M. Government; £45 million to the International Monetary Fund and to the Swiss National Bank;[1] and £27 million (three instalments) to the Bank for International Settlements in respect of the central bank credit of $250 million arranged in November 1967. However, the reserves were saved about £72 million through the deferment of debt repayment on the North American loans.[2]

The United Kingdom drew a net amount of $750 million (£313 million) during the quarter under the Federal Reserve $2,000 million reciprocal swap facility, bringing the total outstanding to $1,150 million. There was a net repayment under other short-term arrangements – including the whole of what was outstanding under the swap facility with the Bank of France – but this was more than matched by the completion in October of the United Kingdom's initial drawing under the $2,000 million medium-term facility which was agreed at Basle in September; this drawing was to finance reductions which had occurred earlier in the year in the sterling balances of sterling area countries.

In the coming months a considerable amount of short-term debt falls due for repayment, and the need to meet these obligations must come first. Thus, it is intended to use a substantial part of any foreign currencies that may be taken in by the Exchange Equalisation Account to repay debt, rather than to add to the published total of reserves.

Central government finance

The central government's borrowing requirement (net balance) has continued to be smaller than in 1967; in the fourth quarter it was £426 million – not very much more than half the figure for a year earlier. Ordinary expenditure was larger, but revenue, particularly income tax and receipts from purchase tax and other Customs and Excise duties, was very much larger. Import deposits accounted for £77 million of the rise in Customs receipts – rather less than the monthly rate at which deposits were expected to build up when the scheme was announced. Receipts from selective employment tax were also greater than a year earlier (rates of contribution were raised from 2nd September) but there was some compensating additional expenditure in the way of refunds. The net amount lent by the Government was only a little larger than a year earlier, when allowance is made for funds that were drawn and re-lent to the central government until required.[3]

Over the first three quarters of the current financial year the balance between revenue and expenditure improved by as much as £580 million compared with the corresponding

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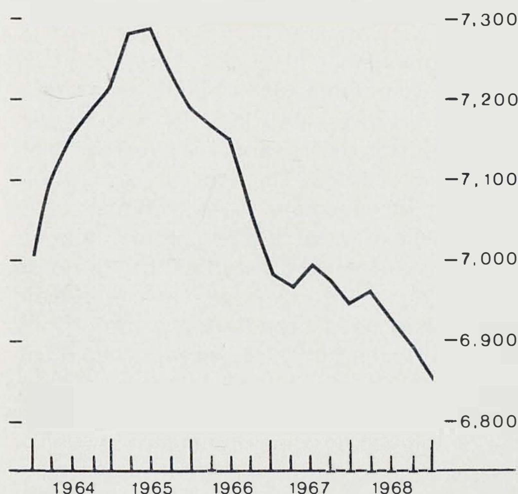
1 £42 million was paid to the I.M.F. and £3 million to Switzerland, being the second of eight repayments of the United Kingdom's drawing from the I.M.F. (and the drawing on the parallel Swiss credit) in May 1965.

2 The deferment provisions in the financial agreements of March 1957 with the U.S. and Canadian Governments have now been invoked four times, out of a possible maximum of seven.

3 Such funds are included within "other central government funds and accounts" in Table 1 of the annex.

£ millions

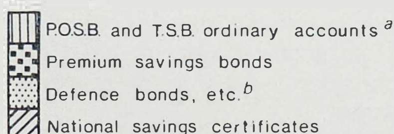
National savings, total outstanding

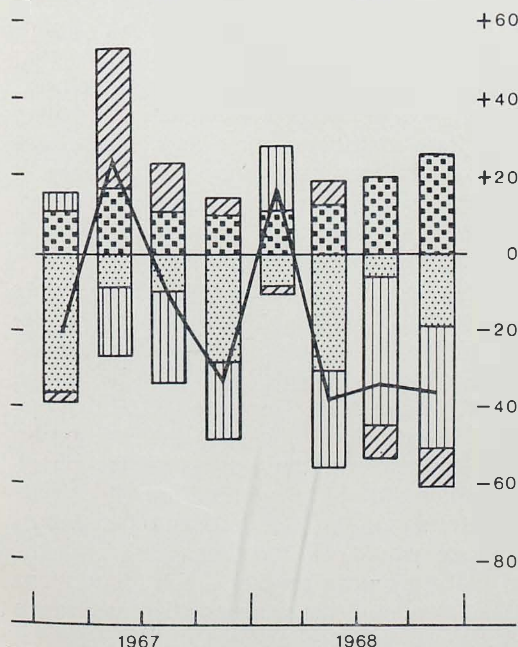


Investors continued to run down their national savings in the fourth quarter.

£ millions

National savings, changes in totals outstanding





Recently only holdings of premium savings bonds have consistently increased.

a Deposits in investment accounts with the P.O.S.B. and in the special investment departments of the T.S.B.s are excluded (see the note on page 121).

b Including national development bonds and British savings bonds.

period of 1967/68 – in part admittedly because revenue from indirect taxes had been swollen by larger than expected consumer spending. Meanwhile lending by the Government was much the same as a year earlier. In consequence the expectation of a very substantial reduction in the central government's borrowing requirement in the current financial year was well on the way to fulfilment. Indeed, taking into account additional receipts stemming from the November measures, it is possible that a small positive net balance may emerge.

Because £337 million of sterling accrued from external transactions in the fourth quarter – a reflection of the large outflow of foreign exchange in November – the domestic borrowing requirement was £89 million. Investors other than the banks reduced their holdings of government debt in aggregate by £120 million, so that the banking sector was left to take up £209 million of debt. The banks' holdings of notes rose seasonally by over £150 million, and net government indebtedness to the Banking Department of the Bank of England increased by nearly £70 million; however, the banks and discount houses – particularly the latter – sold over £230 million of gilt-edged, and consequently took up £220 million of Treasury bills.

Both individuals and companies made larger net additions to their holdings of tax reserve certificates than in any quarter during the previous eighteen months; this probably owed something to the increased rate of interest paid on company certificates since August (there was another increase on 21st December) and, for persons, to the liability for the special charge on investment income levied in the last Budget and falling due on 1st January 1969. There was also a more than seasonal rise in notes in the hands of the public. However, investors outside the banking sector sold £193 million of gilt-edged and continued to run down their national savings at much the same rate as in the two previous quarters.

It seems unlikely that as much of the fall in national savings in the fourth quarter was of a seasonal nature as in the third; withdrawals at Christmas are normally provided for in part by extra savings in October and November, whereas holiday spending has a marked effect on savings throughout a third quarter. Of the main types of asset, national savings certificates were run down further in the fourth quarter; and ordinary deposits with savings banks continued to fall partly because of switching into higher-yielding investment accounts (which are not counted as national savings in this context). Aggregate holdings of defence bonds, national development bonds and British savings bonds also continued to fall; their decline in recent years has owed much to a failure to reinvest or convert as securities mature. However, premium savings bonds improved on their already good performance, thanks in part to the extra inducement of the weekly prize of £25,000.

It is possible that other forms of personal saving benefited in the fourth quarter at the expense of national savings; certainly sales of unit trust units reached new peaks. The importance at the present time of attracting a larger part of disposable incomes into savings can hardly be overstressed, and the Government are examining methods by

which this might be brought about. A number of unofficial schemes for increasing the volume of savings have also been canvassed recently.

The banks and discount houses

As was noted in the last Commentary, the banks were asked on 22nd November to bring or to keep their lending in sterling to domestic private borrowers and to overseas borrowers within new, lower, ceilings. The new ceilings would no longer include the banks' fixed rate (5½%) lending under the special schemes for export and shipbuilding finance.

Allowing for the exclusion of fixed rate finance, the sterling lending of the *London clearing banks* to the private sector and to overseas had been broadly the same at mid-October 1968 as in mid-November 1967, and in their case the new ceiling was set at 98% of this level. In bringing down their advances they were asked to reduce substantially their lending for the finance of personal consumption.

The tighter credit restrictions were discussed by the Bank of England with the clearing banks beforehand. It was recognised that bank customers whose borrowing was not of the highest national priority must expect to be asked to reduce it. Soon afterwards, the Chairman of the Committee of London Clearing Bankers wrote to the Governor of the Bank of England assuring him that the clearing banks would do their best in the national interest to comply with the official request, but pointing out that further contraction of the credit base of the private sector might not be possible without the risk of some considerable disruption of markets, including the gilt-edged market.

In the period up to mid-January the total advances of the clearing banks, excluding those to the nationalised industries, continued to rise after seasonal adjustment – particularly sharply between mid-November and mid-December. Though a substantial part of the increase was in lending for purposes exempt from restriction, restricted lending was still well in excess of the new ceiling by mid-January. It seemed that the continued strength of advances was mainly due to the greater use of existing facilities and that demand for new accommodation was not particularly heavy.

On 31st January the Deputy Governor of the Bank wrote to the Chairman of the C.L.C.B. pointing out that in order to achieve the required target the clearing banks would need to reduce their lending to the private sector, after normal seasonal adjustment, by about 3% (or some £150 million) before the middle of March.[1] He concluded that the banks would need sharply to increase their pressure for repayments of borrowing which did not fall within the high priority categories. The Chairman of the C.L.C.B. and his deputy replied that the banks would do their best to meet the revised target and that they were sending fresh instructions to their branches; but they could give no positive assurance that they would succeed in meeting it.

In the month to mid-February there was a further increase in the clearing banks' advances, after seasonal adjustment, of about £60 million. Although the rise seemed in part to have been in the exempt categories of lending, details of

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1 The text of the Deputy Governor's letter is reproduced on page 21.

which are not immediately available, it was clear that there had also been some further expansion of lending subject to the 98% ceiling. On 27th February, therefore, the Chancellor of the Exchequer, together with the Governor of the Bank, met representatives of certain London clearing banks and of the Scottish banks and reaffirmed the importance that the authorities attached to the achievement as soon as possible of the reduction in lending required to bring the banks within the 98% ceiling. The banks, while emphasising the difficulties involved, agreed to intensify their efforts to this end.

As for the clearing banks' other assets, there was little change between mid-October and mid-January in their aggregate holdings of gilt-edged. Their Treasury bills rose by some £65 million, despite a marked drop in the month to mid-December when interest rates were rising strongly; they also increased their call money with the discount market – notably when they were running down their Treasury bills. Their combined liquidity ratio fell until mid-December, but had been restored to about 32% – the mid-October figure – by the middle of January; it then fell sharply.

Over the three months net deposits of the clearing banks rose by more than the seasonal expectation, reflecting in part the increase in the banks' lending to the private sector and the fact that investors were selling gilt-edged.

The accepting houses, overseas banks and other banks, who were affected much less than the clearing banks by the exclusion of fixed rate lending from the new ceilings, were asked on 22nd November to ensure that their restricted lending at the end of March 1969 did not exceed 102% of the figure immediately before sterling was devalued (18th November 1967). At the end of November 1968 their restricted sterling lending was in aggregate already within the new ceiling, though their sterling acceptances – which were subject to a separate ceiling of 102% – were slightly above.

During the fourth calendar quarter the banks' sterling advances to U.K. private customers increased, as did those to overseas residents. On the other hand, their lending to U.K. local authorities through the temporary money market rose strongly at the beginning of the quarter, but then dropped below the end-September figure as local authorities drew on the Public Works Loan Board. The banks' money at call increased on balance, the rise coming at the beginning of the quarter, but they ran down their gilt-edged by about £70 million, reducing their holdings to the lowest recorded total since the present series of statistics began in 1962.[1]

By the end of December these banks had raised about £165 million by way of sterling certificates of deposit – the market in which opened on 28th October; about half of these deposits came from U.K. residents outside the banking sector. The banks' ordinary sterling deposits, excluding those made by other banks, declined on balance by about £70 million during the fourth quarter. This was more than accounted for by deposits from overseas which rose sharply early in the period – as sterling area countries rebuilt their balances – but fell even more sharply as non-sterling coun-

[1] Table 10 of the annex.

tries withdrew their funds from London during and after the currency crisis.

Activity in the inter-bank sterling market was high in October and still more so towards the end of the year.

The *discount market's* total assets increased by just over £100 million in the fourth quarter. Though the houses substantially reduced their portfolio of short-dated gilt-edged, their Treasury bill holdings increased by over £200 million and there was a rise of about £40 million in their commercial bills, probably because they were still finding it difficult to rediscount bills with the banks. When the credit restrictions of 22nd November were announced the houses' commercial bill figures were significantly above the new ceiling of 102% which they were asked to achieve by mid-March, but by the middle of January the excess had to some extent been reduced.

The increase in the houses' borrowed funds during the fourth quarter was in call money from the banks – nearly £90 million from the clearing banks and over £50 million from the rest. Some £30 million of borrowing from the Bank of England was outstanding at the beginning of the quarter, and none at the end.

The secondary market in sterling certificates of deposit, which is largely provided by the discount houses, had not had time to develop an active two-way business by the end of the quarter. The houses were able to sell some of the certificates which they had bought for their own portfolios from the issuing banks, but few holders had sought to discount their certificates.

In October the *National Giro* operated by the Post Office began business.[1] By the end of December deposits with the Giro amounted to £10 million. Up to that point the Giro had chiefly employed its funds in short-term assets – in particular, loans at call with the discount market and temporary loans to local authorities. However, it is authorised to invest also in other forms of public sector debt.

Bill markets

Except when sterling was under heavy pressure in November, and for a short time early in December, the discount houses generally found conditions easier in the three months ended in January than in the previous three. When shortages did occur, they were usually relieved by the Bank through purchases of Treasury bills. In contrast to the earlier part of 1968 the Bank greatly restricted their lending at market rates; they lent very small amounts on only four occasions in November and nothing thereafter. And they lent nothing at Bank rate. Because assistance was given through purchases of bills rather than by lending, market shortages were not continually transferred from day to day, or from one week to the next. The relatively small (and diminishing) number of bills offered at the weekly tenders also served to reduce the scale of market shortages.

In the middle of November official purchases of gilt-edged made funds available to the money market, and the Bank sold bills to absorb surpluses. The discount houses were

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1 Table 8 of the annex shows the main assets and liabilities of the Giro outside the banking sector.

among the sellers of gilts, substantially reducing their portfolios and so improving their liquidity. Shortly afterwards, however, the withdrawal of funds from London left money very short and the Bank gave help on a large scale, nearly all of it by buying Treasury bills. Funds became more plentiful towards the end of the month when the gilt-edged market weakened, and on several days there were surpluses which the Bank absorbed by selling bills.

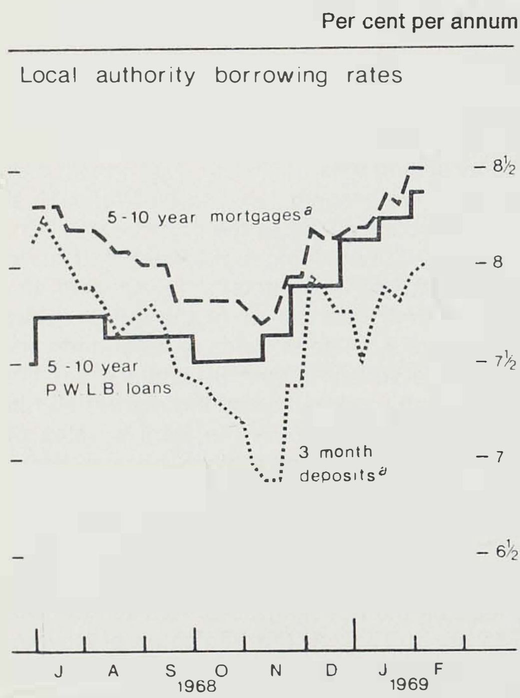
Although the houses were again left short of funds just before the middle of December – when the pound came temporarily under pressure – the settlement of foreign exchange transactions soon turned in the market's favour and the easier conditions persisted for the rest of the month, save very briefly when the banks called in funds to meet end-year needs. The main revenue season began in January, but the first few days of the month generally saw the market still in comfortable surplus and on occasion the Bank's sales of bills were quite large. Thereafter conditions became more difficult, though shortages were eased as a result of continuing official purchases in the gilt-edged market and by maturities of the Treasury bills which the authorities had sold to the houses earlier.

Over the three months the houses raised their tender rate by just over $\frac{1}{8}$%, to about $6\frac{3}{4}$%. At the beginning of November the fresh restrictions applied to consumers' expenditure made an increase in interest rates seem likely, so the houses let the rate rise by $\frac{1}{32}$%. They made further reductions in their bid during the crisis in currency markets, but outside competition was weak and they generally obtained a reasonable proportion of their applications. Even so, the quantity of bills that they secured was not large because of the smallness of amounts offered for tender. After the early part of December the houses reduced the tender rate a little – despite the continued rise in dollar interest rates – because they wanted more bills and because outside competition had become stronger. By early January, however, the houses' holdings had been substantially increased by the authorities' market operations and they had little reason to make a further increase in their bid at the tender. On the other hand, they did not want to see the rate rise, for funds might soon become scarce and the houses obliged to sell bills back to the authorities; so there was little change in the rate during that month.

The average cost of the houses' borrowed funds increased on balance in November and rose a little more, to just over $6\frac{9}{16}$%, in the first half of December. It eased only a little as funds became more plentiful later in that month, and it remained at just over $6\frac{1}{2}$% during most of January.

As noted earlier, the houses' commercial bill holdings, already large, continued to grow. After the tender on 22nd November they adopted $7\frac{1}{8}$% as their minimum buying rate for prime bank bills (it was previously $6\frac{15}{16}$%, though some houses, for a day or two, had been quoting higher rates) but were nevertheless still obliged to ration their purchases severely; a further rise of $\frac{1}{8}$% early in December brought little relief. In early January they raised their minimum buying rate for six months' bills to $7\frac{3}{8}$%, but kept the rate for shorter bills unchanged at $7\frac{1}{4}$%.

Per cent per annum



From November increases in P.W.L.B. lending rates contributed to a sharp rise in the cost of local authority borrowing.

a Weekly, Fridays.

Local authorities

Local authorities stepped up their borrowing from the P.W.L.B. between November and January even though the Board raised its lending rates for quota loans on four occasions, bringing them well above 8%. Local authorities borrowed more heavily from this source partly no doubt because they feared that other funds would become scarce – owing to the very large central government surplus expected in the first quarter and to possible difficulties in borrowing from the banks; partly because of a new rule under which authorities must apply for up to 75% of their P.W.L.B. quotas for the financial year by the end of December or forfeit the shortfall;[1] and partly because of the need to fund temporary debt. By the end of March 1969 authorities are required to have reduced their borrowing for periods of up to one year to not more than 20% of their total outstanding loan debt. Collectively they have always been well below this limit, and many individual authorities who were above it seem to have reduced their temporary borrowing by the end of December – which was possibly one reason for the net repayment in the fourth quarter, noted earlier, of borrowing from the accepting houses, overseas banks and other banks. However, at the beginning of January a number of authorities still had funding to do.

During and after the disturbance in foreign exchange markets, lenders of temporary money were unwilling to lay out funds for more than one month; rising euro-dollar rates soon accentuated the shortage of funds. The rate for three months' money rose by $\frac{1}{2}$% in the second half of November, and by a further $\frac{1}{2}$% early in December. After easing, it recovered in January to $7\frac{7}{8}$%-$7\frac{15}{16}$% – a rise of nearly 1% since the end of October. Meanwhile the rate for seven-day money increased by little more than $\frac{1}{2}$%.

Borrowing on mortgage had built up throughout the late summer and autumn, and by early November local authorities were probably raising over £30 million a week (net) from this source. Mortgage rates did not rise until funds became scarce in the second half of November, but between then and the end of January they increased by as much as $\frac{7}{8}$%-1%.

Because of the weakness of the gilt-edged market there were no local authority stock issues during the period. However, the net amount raised on new issues of marketable bonds was £23 million – compared with £19 million in the previous three months. Bond yields rose from slightly over $7\frac{1}{2}$%, to $8\frac{3}{8}$%.

On 1st February the Bank announced that they had reviewed the conditions under which they are prepared to discount local authority bills – or to accept them as security for advances to the discount market – and had decided that the requirement that there must be at least sixty days in each financial year during which the local authority concerned has no bills outstanding was no longer necessary. Other conditions were unaltered, and it was emphasised that

1 The rule specifies that where a local authority has not applied for 75% of its quota by the end of December, the shortfall may be reallocated among all authorities for use during the last quarter of the financial year. It enables local authorities who wish to take full advantage of P.W.L.B. lending to benefit from quotas not required by others.

the change did not mean a departure from the principle that bills should be issued for revenue purposes only; future issues of bills would still be subject to the provisions of the Control of Borrowing Order 1958.

Hire purchase finance houses

Following the changes in November in terms control on hire purchase contracts,[1] the Bank wrote to finance houses asking them to reduce their lending by March 1969 to 98% of the figure at the end of October 1967. (Previously the ceiling had been 100% of that figure.) During November the total of outstanding debt owed to the houses continued to rise, after seasonal adjustment, and in December it remained unchanged; in both months, however, new credit extended fell. By the end of December the houses collectively were about 5% above the new ceiling. Subsequently the Bank wrote to those houses which were most out of line, reminding them of the need to reduce their lending without delay.

Although their business was not expanding strongly at this time the houses had to pay more for deposits in order to remain competitive with the local authorities. Interest rates for three months' deposits rose quite sharply in late November, and again towards the end of January, when they stood $\frac{1}{2}$%-$\frac{7}{8}$% higher than three months earlier.

Gilt-edged market

Long-term interest rates were on an upward trend through much of the period and the gilt-edged market was unsettled and depressed. There were expectations of continuing inflation and of exchange rate weakness and, later, of capital market pressures arising from credit restriction. The upward trend in interest rates abroad and doubts about the future of the international monetary system were further depressive influences.

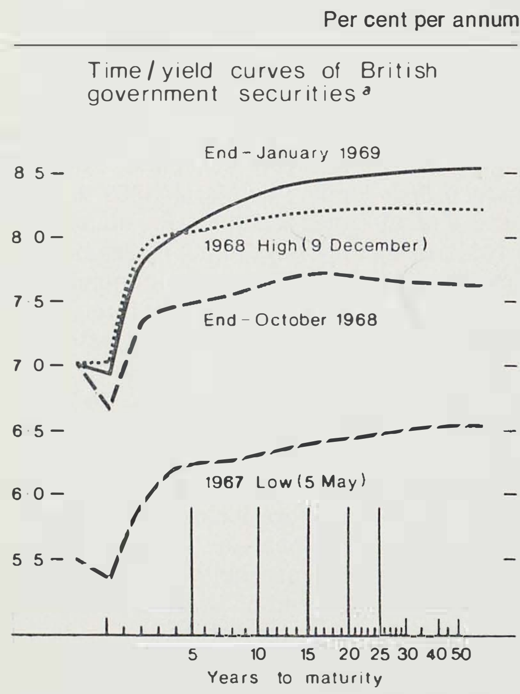
Throughout, the authorities were, as always, prepared to deal in response to market offers, at prices judged by them both to conform with the underlying trend of interest rates and to be consistent with the underlying long-term objective of preserving market conditions favourable to maximum official sales of government debt – particularly sales to investors outside the banking sector. During the period changes in the surrounding circumstances led to adjustments in the authorities' tactics regarding the prices at which they were prepared to deal.

The market was fairly quiet in the first half of November; there was some selling of medium and longer-dated stocks and the authorities readily allowed this to have its effect on yields. They continued to do so when sales became sizable following the disappointing trade figures for October, announced on 13th November.

In the following week further selling – mostly of short-dated stocks by the banks and discount houses – was provoked by the international currency crisis; and the market became more unsettled during the conference of Finance Ministers in Bonn. The authorities therefore modified their tactics in order to steady the market until the outlook was a little clearer. When the foreign exchange markets had calmed

1 December 1968 *Bulletin*, page 350.

Per cent per annum



Gilt-edged yields reached new peaks early in December and yields on medium and longer-dated stocks rose further in January.

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

down after the meeting, a rise in U.K. interest rates other than the very shortest was seen as an appropriate accompaniment to the measures which had been taken to restrain domestic demand; and the authorities reverted to a policy of allowing any weakness to be fully reflected in prices. Thus, during the first ten days of December yields on most short-dated stocks rose from under 7¾% to almost 8% and those on long-dated from just under 8% to over 8⅛%; so that, since the end of October, yields on most stocks other than the very short-dated issues had risen by about ½%.

Though the market then strengthened for a time in the expectation, soon confirmed, of improved trade figures for November, the rising trend in dollar interest rates – acknowledged by the increase of Federal Reserve discount rates – soon brought further selling and the market became very unsettled. It seemed that against this background a further very sharp fall in prices could well cause an increase in selling pressure. In their response to offers of stock the authorities therefore sought to exert a steadying influence, by lowering relatively slowly the prices at which they were prepared to deal; and in the event their purchases of medium and longer-dated stocks were minimal.

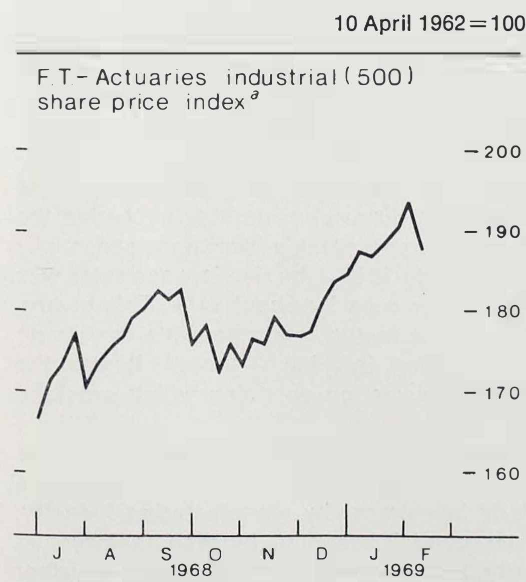
Despite the marked weakness of the market for much of the time, the authorities' net purchases of medium and long-dated stocks during the fourth calendar quarter totalled no more than £69 million;[1] an amount which, on past experience, can be resold very quickly once a new level of yields has been consolidated. On the other hand, their purchases of short-dated stocks, at £336 million, were substantial – though the bulk of these reflected sales by the discount market and by holders outside the banking system of stocks maturing in 1969. In the conditions prevailing during November and December it was to be expected that advantage would be taken of the near liquid character of early maturing stocks, and that little or no reinvestment demand would emerge. However, though selling by the market of early maturities continued, a good reinvestment demand for the longer short-dated stocks built up early in the New Year.

Just before the middle of January the publication of poor trade figures for December – adding to some existing expectations of a rise in Bank rate – provoked renewed pressure at the longer end, which the authorities did little to resist; and yields rose to nearly 8½%. Soon afterwards the improved tone of sterling and a fall in U.S. Treasury bill rates led to a brief rally; but selling reappeared towards the end of January when the market became unsettled by industrial disputes and expectations of a further rise in interest rates abroad. Once again the authorities did not resist a tendency for yields to rise and their purchases were largely confined to the 1969 maturities. By mid-February yields on longer-term stocks had risen to about 8⅝%, nearly 1% above their level in October 1968, and there began to be signs of new buying.

In December the Government Broker began, experimentally, to offer the long dated tap stock[2] for sale on the basis of a specified yield rather than a specified price. Previously the Government Broker's price was adjusted, in

1 Table 3 of the annex.
2 Currently 6¾% Treasury Stock 1995/98.

times of active demand, either to alter, in conformity with official tactics in the market, the yield basis on which he was willing to sell it, or to reflect accruing interest – leaving the yield largely unaffected. The latter adjustment will now be made daily irrespective of the state of demand, whereas previously it had been made only at longer intervals. Response to demand for the tap stock will now take the form of alterations in the yield specified by the Government Broker. The previous practice on accrued interest meant that the market price of tap stocks failed to reflect accruing interest and the changes should add to the flexibility of the market in these stocks at times when demand is active.



In December and January share prices moved up to new record levels.

a Weekly, Fridays.

Equities and debentures

In November the *equity market* made a hesitant recovery, which was broken towards the end of the month by the announcement of the new measures to curb domestic demand. Early in December the expectation of better trade figures for November strengthened prices, and when this was more than fulfilled, the F.T.-Actuaries industrial share price index soon passed the peak that it had reached in September. Thereafter, the market remained very firm, with periods of heavy buying notably around the middle of January. By the end of January the price index had reached a new peak of 193·7, compared with the low point of 172·4 in October. Turnover throughout the three months was very high, with a new monthly record in January.

Though some good company results contributed to the improvement, and though equities were still keenly sought as a hedge against a fall in the value of money, there seems little doubt that buying was greatly stimulated by an exceptionally large number of take-over bids and the anticipation of future bids. Underpinning the strength of the market was a continuing shortage of stock, for though the volume of new issues in 1968 totalled more than in the previous three years put together, existing stock continued to disappear rapidly as companies took over other firms for cash or for fixed interest securities.

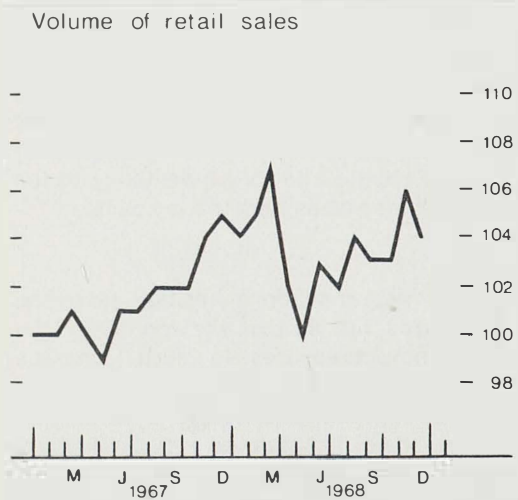
The high, and rising, yields in the gilt-edged market were reflected in those for *debenture and loan stocks.* According to the F.T.-Actuaries calculation (which is based on representative stocks bearing various coupons, but giving a yield somewhat higher than that on stocks issued recently), the redemption yield on such 20-year stocks rose during the period from just over $8\frac{3}{8}\%$ to $9\frac{7}{16}\%$. The margin over the yield on gilt-edged stocks of comparable term widened from just under $\frac{3}{4}\%$ to almost 1%. Moreover, in January two debenture issues bearing 9% coupons were made at par by large public companies.

Turnover in company fixed interest securities was somewhat higher than of late. New borrowing declined; in 1968 new debenture issues were smaller than in any of the three previous years.

Domestic economy

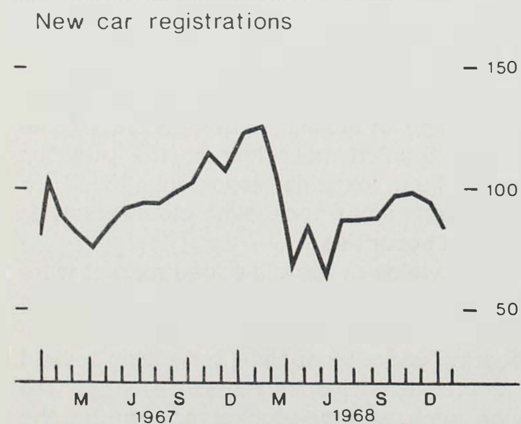
Demand in total expanded strongly in the third quarter of 1968, thanks mainly to the continued growth of exports and to a sharp upturn in consumer spending. The preliminary

Seasonally adjusted Average 1966=100



Until December retail sales rose rapidly.

Seasonally adjusted
latest month provisional Thousands



Registrations of new cars fell back in December and more sharply in January.

evidence suggests slightly less rapid growth in the fourth quarter, with exports, and seemingly consumer spending too, rising more slowly towards the end of the year.

Information about consumer spending in the fourth quarter is still incomplete. Retail sales in November, after seasonal adjustment, showed a particularly sharp rise due, to some extent, to anticipatory buying when further restraints on spending seemed likely, but more to the rush to buy goods before the increases in indirect taxation announced on 22nd November were reflected in prices. Nevertheless, though buying to clear existing stocks carried over into the period covered by the December figures,[1] the index fell quite markedly (by almost 2%) in that month; no doubt the higher taxes and the tighter hire purchase terms announced earlier were having some effect. Another important component of consumer spending – purchases of new cars – continued to rise in the fourth quarter though not as rapidly as in the third. Indeed, the numbers of new cars registered fell a little in December, after seasonal adjustment, and they dropped sharply in January.

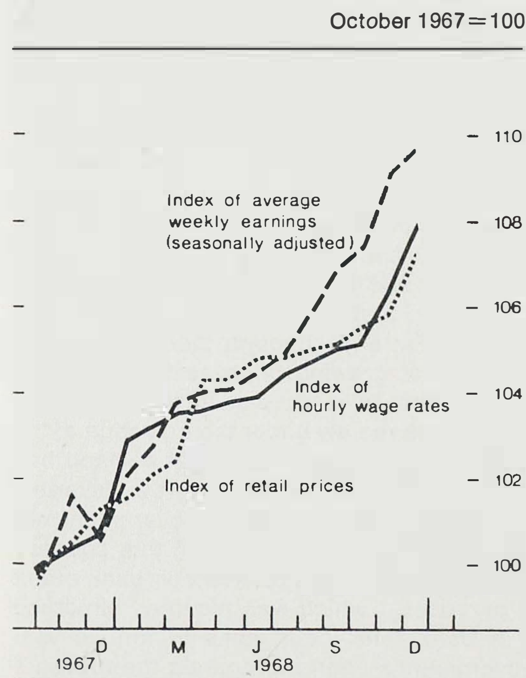
However, even if consumer spending was easing at the end of 1968, it was not because real earnings had stopped rising. Though retail prices increased by about 2% between September and December, hourly wage rates rose by almost $2\frac{3}{4}$% – largely because of pay awards affecting engineering workers – and average weekly earnings, seasonally adjusted, increased by over $2\frac{1}{2}$%.

During the period from just before devaluation up to the end of 1968 the rise in earnings considerably exceeded the rise in retail prices; average weekly earnings, seasonally adjusted, were up by nearly 10% – the rise in wage rates was roughly 8% – while prices rose by about $7\frac{1}{4}$%. This divergence, more than any other factor, made possible the strong rise in consumer spending in 1968 – though it was the expectation that prices would go on rising which provided the spur.

One of the more worrying features of the economy remains the relatively slow rate of fixed investment by private industry, particularly investment by manufacturing industry. In the third quarter capital spending by manufacturers at last turned upwards, and there has probably been a further rise since then. However, though expenditure was rising, the pace and strength of the upturn still remained in doubt. For new investment by manufacturers in 1968 to have even equalled that in 1967, a rise of about $6\frac{1}{2}$%, after seasonal adjustment, will have been necessary in the fourth quarter. Meanwhile, new fixed investment by the distributive and service industries was still apparently on the decline.

The latest Board of Trade survey of private industry's investment intentions, carried out in November and December, indicated that manufacturers expected to increase their capital expenditure in 1969 by as much as 15% and that the upward trend was likely to continue strongly into 1970. As this largely reflected intentions before the measures of 22nd November had been fully assessed by companies, the rise in capital spending may not be as strong as the replies

1 The index relates to the period 24th November – 28th December.



Since devaluation earnings have risen considerably more than retail prices.

indicated. It could indeed be a lot weaker; it is difficult to forecast with precision, and a good deal hangs on the intentions of firms which look first to the home market – where prospects have become more uncertain since the November measures. However, the likelihood of a more or less substantial rise in capital spending this year is confirmed by the latest enquiry of the Confederation of British Industry into industrial trends (which related to views expressed at the end of January and the beginning of February) and by other economic indicators.

With total demand still increasing in the fourth quarter but with little change in the volume of imports, domestic output continued to rise quite fast; the index of industrial production, after seasonal adjustment, showed an increase of just over 1%, compared with about 1½% in the third quarter. By the end of January there still seemed a danger that the main constraint on further growth would be shortages of capacity. According to the C.B.I. enquiry, the number of firms working to capacity was the highest for four years. On the other hand, though shortages of manpower continued to be an important limiting factor on expansion of output so far as smaller firms were concerned, it was, according to the enquiry, no longer the main constraint for larger firms.

Nevertheless, between November and February the number of wholly unemployed, seasonally adjusted, fell by a further 42,000 to 487,000 – just over 2% of total employees. And though the number of notified vacancies for adult workers had fallen quite sharply, it still totalled 208,000. Moreover, the shortage of labour – especially in the skilled categories – was probably greater than the figures of unemployment indicated. In the past, reported unfilled vacancies equal to those in mid-February have usually been associated with unemployment of between 1½% and 1¾%, rather than of over 2%. There are probably several reasons why unemployment is apparently higher now for a given level of industrial activity than in the past; one perhaps is the effects of the Redundancy Fund, which has made it possible for those whose jobs disappear to be more selective in finding new work, and employers more willing to stream-line their labour forces. The fund, which is intended to be self-financing, has been increasingly in deficit for most of its existence, and the Government have decided that, rather than again increase the rates of contribution paid by all employers (or reduce the benefits received by individual redundant workers) they will pay smaller rebates to employers who make terminal payments. It is possible that employers will now be slightly less ready to dismiss redundant workers.

Conclusion

The favourable effects of devaluation on the current account of the balance of payments were slow to appear, but by the fourth quarter of 1968 exports were 28% greater in terms of sterling values and 15% higher by volume than in the summer of 1967. In spite of persistently high imports the current account as a whole improved appreciably from the spring of 1968 onwards. In the second half of the year, moreover, imports seemed to have levelled out, and with some

restraining effect still possibly to come from devaluation – added to the temporary effect of import deposits – it could be that they will increase little further in 1969. Although world demand seems unlikely to expand as rapidly in 1969 as in 1968, the competitive advantages to be gained from devaluation by U.K. goods abroad have by no means all been realised and a further good rise in exports should be attainable.

However, the satisfactory development of the current account of the balance of payments will depend crucially on containment of the pressure of demand and industrial costs. It was clear by the end of 1968 that the pressure on resources was distinctly higher than that associated in the past with unemployment of over 2%; and although there were signs that total demand was not growing quite as fast as in the previous six months, and in particular that consumers' expenditure was rising less rapidly under the influence of the November measures, it was not clear that total demand had yet fallen back to a sustainable rate of growth. Nevertheless, in the first quarter of 1969 the central government will have been in unprecedentedly large surplus; this squeeze on liquidity, and the policy of severe restraint on bank credit for less essential purposes – which was recently reinforced by the increase in Bank rate – continues to form a vital element in the Government's efforts to contain the pressure of demand.

In the longer term, a satisfactory current account surplus, combined with a reasonable rate of increase in home demand, can be sustained only if productivity rises fast enough. Better industrial relations and an incomes policy properly related to gains in efficiency can contribute much to this process, but the maintenance of an adequate level of industrial fixed investment is also vital. If, in the short run, the desirable objective of a rapid rise in industrial investment is to be attained, then room will have to be made for it by a slower rate of increase in other elements of demand. Otherwise, the achievement of a substantial and sustained surplus on the current account – which remains essential to national recovery – will be put in danger.