Commentary

Introduction

Sterling fared reasonably well in the three months May to July, with which this Commentary is mainly concerned. It came under sharp pressure early in May, as speculation developed on a revaluation of the Deutschemark; but, after the West German Government had announced their determination not to revalue, markets calmed down and sterling strengthened. Though it did not quickly regain all the ground which had been lost, the rate was rarely under $2·38\frac{3}{4}$ during the remainder of the period. Indeed, sufficient foreign exchange was taken in over the rest of the three months to make good the losses of early May and to continue repaying short and medium-term borrowing – a substantial amount of which had been repaid before May. On 18th July, the Chancellor of the Exchequer told the House of Commons that net repayments of external debt since the beginning of the calendar year had amounted to very nearly $1,000 million. In addition, there was some conversion from short to longer-term debt, because $500 million drawn in June on a new stand-by credit from the International Monetary Fund was used to repay debt of shorter term.

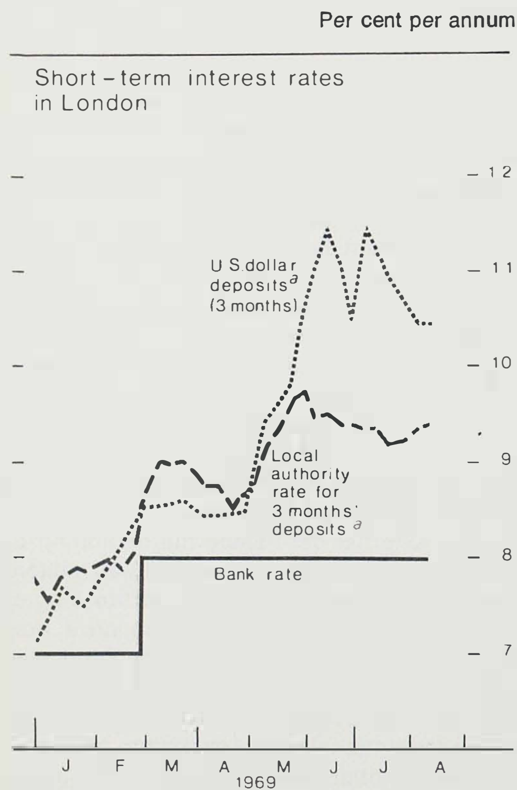
Early in August, the devaluation of the French franc caused inevitable uncertainties in the exchange markets, and there was some substantial selling of sterling for a few days. This selling did not persist, but markets remained nervous and subdued.

In a Letter of Intent to the I.M.F. on 22nd May, the Chancellor stated that the Government's objective was to obtain a surplus of at least £300 million on the current and long-term capital account of the balance of payments in the financial year ending in March 1970. He also stated that the Government's objectives and policies implied a domestic credit expansion for the private and public sectors during the same period of not more than £400 million, compared with some £1,225 million[1] in 1968/69. It was the Government's policy to ensure that the course, quarter by quarter, of domestic credit expansion as a whole and of the central government borrowing requirement within it, was consistent with the intended result for the year, and to take any appropriate action to secure this result. In the June quarter, both measurements proved to be consistent with the expectations for the financial year as a whole.

With credit becoming increasingly scarce elsewhere, companies and others have made greater use of existing facilities with the clearing banks. As a result, the banks' restricted lending has increased, and a particularly sharp rise in August brought them collectively some $4\frac{1}{2}$% above their lending ceiling. The Governor at once stressed to the banks' chairmen the urgent need to correct the position, and asked them to carry out a detailed review of the reasons for the increase in preparation for a discussion with the Chancellor later in September.

1 The figure for 1968/69 has since been revised to £1,175 million.

Per cent per annum



Market rates, both international and domestic, rose to record levels during the currency speculation in May, and then remained high.

a Weekly, Fridays.

The balance of payments improved further in the second quarter, mainly, it seems, in the long-term capital account. It was announced in June that exports have been under-recorded in the official trade statistics for several years; corrective action is being taken for the future. The error – which will have been reflected in the balancing item in the balance of payments accounts – may recently have been of the order of 2% (some £10 million a month) or more.

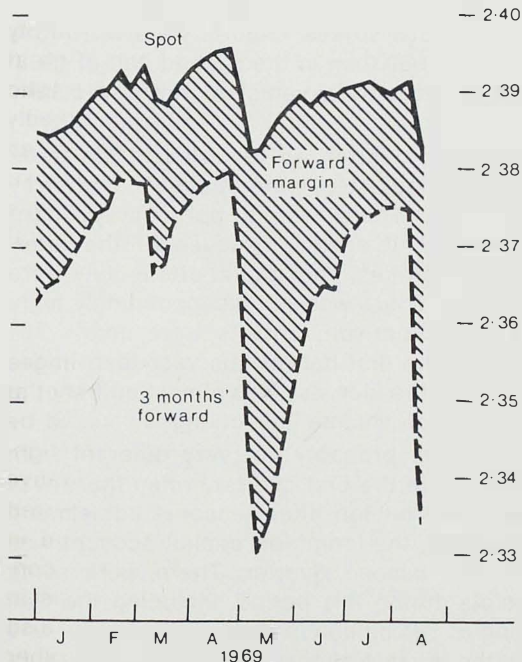
Some short-term domestic interest rates rose very sharply in May and, though they later eased, were still very high at the end of July. International rates rose faster than domestic rates, and the usual arbitrage comparisons became markedly unfavourable to the United Kingdom, often even on an uncovered basis. However, this situation did not provoke any substantial movement out of sterling, and Bank rate was kept unchanged, even though a number of other central banks raised their discount rates.

Foreign exchange and gold markets

Towards the end of April the likelihood of political changes in France revived doubts about the stability of the franc; at the same time suggestions that the Deutschemark would be revalued – if only within the framework of a wider realignment of leading currencies – gave rise to heavy speculative buying of that currency. In large part the funds transferred to Western Germany were withdrawn from or borrowed in the euro-dollar market, and there was, in addition, a considerable outflow of short-term funds from corporations in the United States. But sterling and the French franc also came under pressure as, to a lesser extent, did most other European currencies. The spot rate for sterling against the U.S. dollar, which had fallen from $2·39\frac{5}{8}$ in mid-April to $2·38\frac{1}{2}$ at the end of the month, declined to $2·38\frac{1}{4}$ early in May, and a considerable amount of support was necessary.

On 9th May the West German Cabinet announced their decision not to revalue the Deutschemark and this put an end to the speculative buying. Some of the funds which had flowed into Western Germany moved out again – albeit rather slowly at first – and the strain on sterling was eased; after the week-end the spot rate opened at $2·38\frac{9}{16}$. However, the market took the view that the measures subsequently announced by Western Germany to reduce its balance of payments surplus were not likely to be sufficient; and, as the U.K. trade figures published in mid-May showed no improvement in export performance, the pound recovered only sluggishly in quieter markets – by the end of May the spot rate was still no higher than $2·38\frac{15}{16}$. A large part of the reflux of speculative funds from Western Germany was reinvested in the euro-dollar market, where U.S. banks were bidding particularly strongly for funds to meet the needs of their head offices; so that sterling and other currencies probably did not make good what they had earlier lost.

Early in June the spot rate for sterling eased a little, partly because international interest rates were still rising strongly, and partly because of a critical assessment of the U.K. economy in the *Annual Report of the Bank for International Settlements*. However, the publication in the middle of June of more encouraging trade figures for May, and a small



Spot and forward rates recovered after the May currency disturbances, but weakened sharply early in August following the French franc devaluation.

a Middle closing rates: weekly, Fridays.

decline in euro-dollar rates from earlier peaks, brought a modest demand for sterling: the spot rate improved to about $2·39 where, although sensitive to any adverse news, it mostly remained until early in August. In the wake of the devaluation of the French franc, the spot rate for sterling was allowed to fall steeply, to about $2·38⅛; this demonstrated that the authorities will, on occasion, make full use of the room for manoeuvre within the Bank of England's published buying and selling rates for dollars. The spot rate remained low following the announcement of the July trade figures.

Forward rates reacted nervously to the events of early May – at one point the cost of three months' forward cover, expressed at an annual rate, went over 15%. Though the margin subsequently narrowed, it was not until July that it had fallen back to the levels prevailing before the outbreak of speculation – around 2¾% per annum for three months' cover. The cost fell a little further over the remainder of that month, bringing the three months' margin to about 2⅝% per annum; but towards the middle of August, margins widened very sharply.

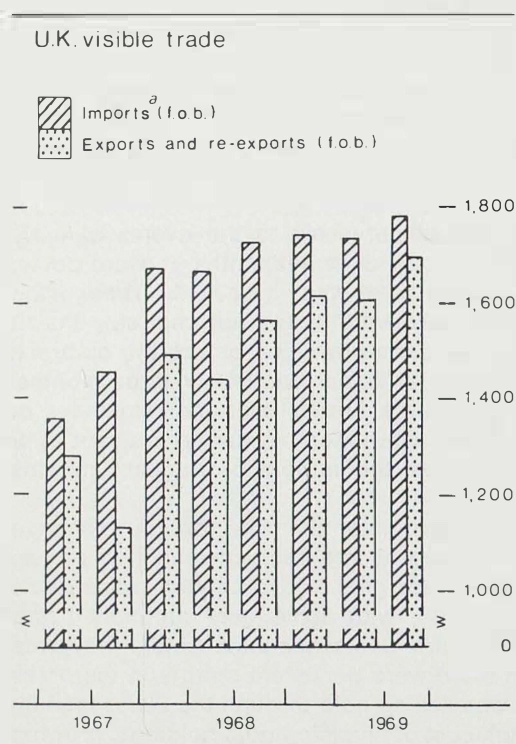
The gold market was quieter than the foreign exchange market. When the movement into deutschemarks was at its height, the fixing price for gold in the London market was steady at around $43·60, with some gold probably being sold in order to acquire deutschemarks. Later, the price tended to fall and there were persistent reports in the press that South Africa was selling gold through the Swiss market. Meanwhile, the high cost of financing gold holdings, growing expectations that the scheme for Special Drawing Rights will be activated, and reports of differences of view between the three banks mainly involved in the Swiss gold market, have probably discouraged buying and have led some speculators to liquidate their positions.

Balance of payments

Although full details were not available when this Commentary was written, it seems clear that there was a definite improvement in the balance of payments in the second quarter. After seasonal adjustment, the current and long-term capital account may have been in surplus by some £75 million-£100 million, compared with a deficit of the same order of magnitude in the first quarter; these estimates include an allowance for the under-recording of exports already referred to, which the Board of Trade tentatively put at some £10 million a month. By far the greater part of the improvement seems to have been in the capital account, although, even before allowing for under-recorded exports, the current account probably moved into surplus for the first time for over two years.

The published deficit on visible trade, not adjusted for under-recorded exports, was about £100 million, after seasonal adjustment, compared with some £130 million in the first quarter; and there was a marked improvement in the course of the quarter, thanks to a strong recovery in exports to new record levels in May and June. During the second quarter the value of exports was more than 5% greater than in the first and it now seems clear that the disappointing

Seasonally adjusted £ millions



Growth of exports was resumed after the U.S. dock strikes and, though imports were also higher, the trade gap has narrowed.

a Excluding military aircraft and missiles purchased from the United States.

performance during the early months of 1969 was mainly caused by the strikes in United States east coast ports. In May and June exports were still benefiting to some extent from the clearance of goods after these strikes. However, the rise in June was mainly in deliveries to other areas, notably to Western Europe; and another satisfactory figure for July confirms that exports are still on a strongly rising trend. Using a six-monthly comparison to reduce the distorting effects of the U.S. dock strikes, exports were worth 3% more in the first half of 1969 than in the second half of 1968; deliveries of cars and commercial vehicles grew particularly strongly.

Imports in the second quarter, as recorded in the trade accounts and seasonally adjusted, were about 3% higher by value than in the first. There was a particularly sharp increase in June, partly, it seems, because of the after-effects of the U.S. dock strikes. Though imports in July were smaller than in June, the figure was still disappointingly high. Using a six-monthly comparison, arrivals were nearly 2% higher in value during the first half of this year than in the second half of 1968, but the increase was almost entirely the result of higher prices, with volume little changed.

Invisible earnings were probably not very different from the high figure reached in the first quarter, when there was a surplus of about £140 million after seasonal adjustment. So far as can be judged, the long-term capital account was also in surplus in the second quarter. There were some large special receipts during this period, including the Gas Council's borrowing of £31 million in Western Germany[1] and the purchase by the First National City Bank of a substantial stake in National and Grindlays Bank.

Movements of short-term funds

In contrast to the earlier part of the year, the three months to July saw an appreciable net outflow of short-term funds. Over the period as a whole, the chief reason for the outflow was a reduction, probably mainly seasonal, in the sterling holdings of overseas sterling area countries. Even so, these countries' holdings remain very substantially higher than at the time of the sterling area agreements of last September.

Early in May, when funds were moving into deutschemarks, there were large withdrawals from the sterling holdings of countries outside the sterling area (leaving aside the counterpart of drawings on central bank facilities). But these withdrawals were very quickly reversed, and holdings thereafter began to rise slowly to show some increase over the three months – for the first time for about a year. The level of holdings at the end of July was, however, still quite low by past standards. At the same time, U.K. sterling claims on these countries continued to increase because of the granting of export credit. As a result, net sterling holdings were not greatly changed over the period; and, for holders

1 It was noted in the June *Bulletin* that H.M. Government have decided that the nationalised industries, and in certain cases local authorities, should be encouraged to raise medium and long-term finance in overseas capital markets. Such borrowing will be co-ordinated by the Bank in the light of conditions in the markets concerned. In March the Gas Council announced the issue of bearer bonds in Western Germany totalling DM 300 million – two thirds through a public issue, the rest by private placing; the issue affected the balance of payments in the second quarter.

other than central monetary institutions, U.K. claims remained very considerably in excess of liabilities.

During the three months to July, the euro-dollar market was again dominated by the heavy demand from the U.S. banking system. Because of the tightness of credit in the United States, the banks there were faced with a vigorous call for domestic advances at a time of falling domestic deposits. They therefore continued to bid very strongly for funds through their branches in London. As before, a large proportion of the funds on-lent to U.S. banks came from West European countries, despite the steps which a number of these countries have taken to restrict short-term outflows. Besides the demand from the United States, there was substantial borrowing of euro-dollars in May by speculators wishing to switch into deutschemarks, as already mentioned. In the result, there was an unprecedented increase of some £2,300 million in U.K. banks' external liabilities and claims in foreign currencies in the second quarter[1] – though the net foreign currency position for all the banks taken together showed little change over the quarter. By the end of June, the size of the market in London, as measured by deposits taken from overseas residents, totalled over $25 billion – an increase of about 50% since the beginning of the year. The Federal Reserve Board have recently introduced measures, including new reserve requirements, which will add to the effective costs incurred by U.S. banks in borrowing euro-dollars.

Euro-dollar rates reflected these various demands for funds. After remaining fairly steady in April, rates increased very sharply in May and early June, generally to around 10½%. A further sharp increase towards the middle of June took them to new heights – approaching 13% for three months' funds – after a rise in the U.S. banks' prime lending rate to a record level of 8½%. Some easing in euro-dollar rates over the remainder of the month left those for very short-term loans lower at the end of June than they had been at the beginning, and those for longer terms not greatly changed. On balance rates were little changed in July. The increases in May had brought euro-dollar rates significantly above those for U.K. local authority deposits and, except for very short-term funds, this remained so at the end of July. Interest differentials had therefore become distinctly unfavourable to the United Kingdom even before allowing for the cost of forward cover.

Reserves and special facilities

The official gold and convertible currency reserves rose in April and June, in total by the equivalent of £22 million, but fell by £33 million in May as a result of the general disturbance of markets during that month. As noted earlier, the policy of using accruals to the reserves for the repayment of debt continued.

Medium-term borrowing repaid included the equivalent of £82 million in May to the I.M.F. – the fourth of eight instalments due under the May 1965 drawing; £4 million to Switzerland as the final instalment on a credit arranged at the same time; and £17 million to the Bank for International

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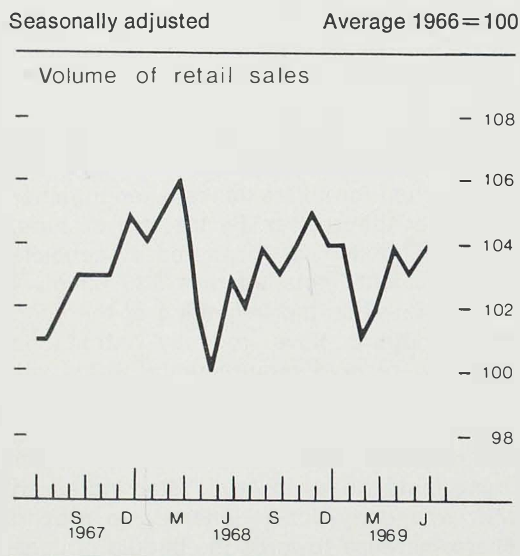
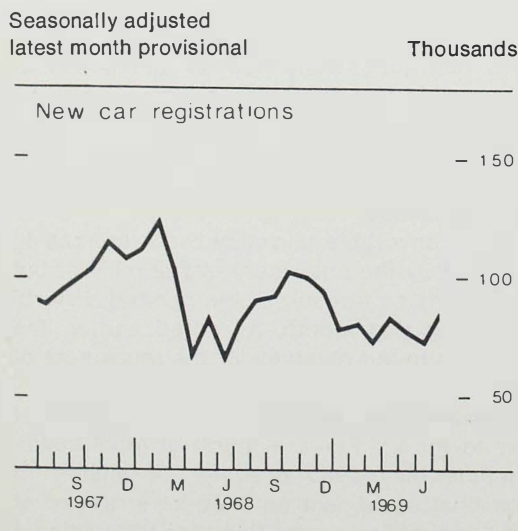
1 See Table 18 of the annex.



After recovering in April the volume of retail sales in the second quarter was almost back to the level of the fourth quarter. . .



. . . but registrations of new cars remained low.

Settlements in respect of the two remaining instalments of the November 1967 credit.[1]

The $500 million (£208 million) drawn from the I.M.F. in June under the newly arranged standby facility was used to reduce outstanding borrowing from overseas monetary authorities under special facilities. Taking this drawing and the May repayment together, the net use of I.M.F. resources during the second quarter was thus equivalent to £126 million; but this was considerably exceeded by the net amount repaid on short-term credits and other special facilities during the quarter, despite some recourse to central bank assistance during the May disturbance. The facilities used at that time included a recycling arrangement between the Bundesbank and the Bank of England designed to neutralise part of the movement of speculative funds from the United Kingdom into Western Germany. Repayments during the quarter included a net amount of $75 million (£31 million) under the $2,000 million Federal Reserve reciprocal swap arrangement – which left $1,025 million still outstanding on this facility – and, as a result of the continued rebuilding of the sterling balances of sterling area countries during the early months of 1969, almost the whole of what remained outstanding under the medium-term facility agreed at Basle in September 1968.

Domestic economy

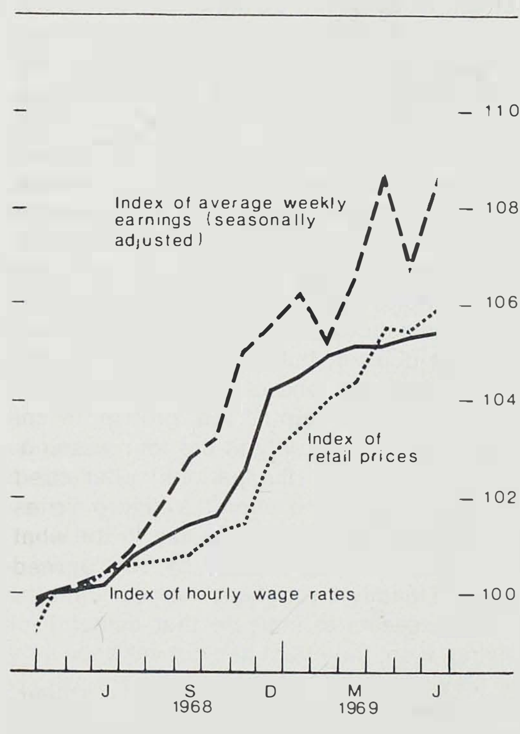
Total demand contracted in the first quarter of this year. Consumer spending, which is easily the largest component, was lower following the restraining measures taken the previous November.[2] Some of the other elements of demand were subject to special influences. The volume of exports of goods and services, affected by the strikes in U.S. east coast ports, was more or less the same as in the previous quarter. At the same time, a fall in fixed investment occurred mainly because of a reduction in private industry's investment expenditure, which had accelerated very sharply in the fourth quarter of 1968 to take advantage of the higher rates of investment grants ruling until the end of the year.

Developments in the second quarter are still not wholly clear, but demand seems to have started to rise again, and may have expanded quite briskly. How far this was simply a rebound after the earlier fall remains to be seen. As already noted, exports rose strongly, and not wholly because of the clearance of goods which had been held up by the U.S. dock strikes. In addition, fixed investment by private industry probably recovered from the low figure recorded in the first quarter; and consumer spending rose, on preliminary estimates, by about 1%.

The rise in consumers' expenditure included an increase of nearly $1\frac{1}{4}$% in the volume of retail sales, mainly concentrated in April; these sales, which account for about half of personal spending, appear to have then been broadly unchanged in May and June. The number of new cars registered in the second quarter – representing perhaps

1 This credit, for the equivalent of some $250 million, was extended by a number of central banks, through the B.I.S., to finance the final repayment to the I.M.F. of the United Kingdom's 1964 drawing – see the March 1968 *Bulletin*, page 8.

2 December 1968 *Bulletin*, pages 342 and 358.



The rise in real earnings appears to have moderated in the first half of 1969.

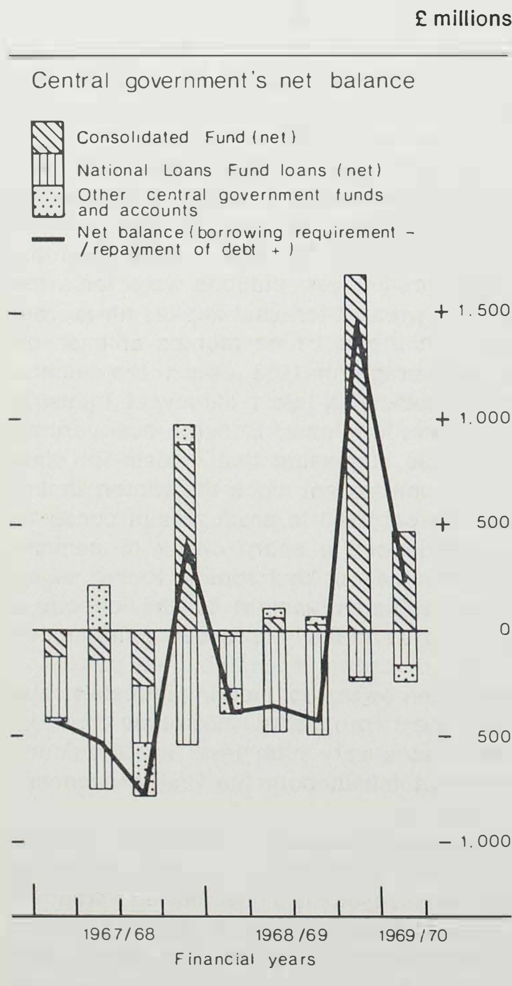
another 4% of personal spending – remained at the low level of the previous three months. Although new car registrations increased in July, the distortions affecting the seasonal pattern in July and August are such that the significance to be attached to the figures for one of these months alone is still uncertain. Apart from that, there are few recent indications of the course of consumer spending, but reports do not suggest that it has been unduly buoyant. Future developments will very much depend on the course of real earnings and savings. Though real earnings probably began to rise again in the second quarter, after a fall in the first, the recent increase is unlikely to have been as fast as at the end of last year: average weekly earnings, seasonally adjusted, were almost 2% higher than in the first quarter, but retail prices went up by over 1½%, though partly for seasonal reasons.

Within the total of private industry's investment expenditure on fixed assets, investment by manufacturing industry fell by nearly 16% in the first quarter; but taking this quarter and the preceding one together (so as to reduce the effect of the withdrawal of higher rates of investment grant), manufacturing investment was nearly 11% higher than at the beginning of 1968. There is as yet no later information on such expenditure. The survey of industry's investment intentions carried out by the Board of Trade in May suggested that the volume of manufacturing investment in 1969 as a whole might be some 7%-8% higher than in 1968. If roughly adjusted for the distortions in recorded expenditure between the fourth quarter of 1968 and the first quarter of 1969, the Board of Trade's forecast represents an increase in 1969 of about 10%; earlier expectations were for a rise of some 10%-15%. The present forecast implies an average quarterly expenditure in the last nine months of this year some 11% above the average for 1968 – much the same as the recent rate of growth. The latest survey of industrial trends taken by the Confederation of British Industry in late May and early June also suggested that investment plans had been reduced to some extent since the winter, though the revision was mostly confined to producers of consumer goods, who had experienced a sharp check to demand. However, the C.B.I. pointed out that replies to the survey may not have given sufficient weight to the effects of stringent monetary policy, and they expressed some anxiety about the future level of capital spending. The pattern of home market orders taken by the engineering industries also suggests that investment prospects may now be less buoyant; orders were at a very high level in the fourth quarter of last year, but fell in both the first and second quarters.

Other forms of demand do not seem to have been particularly strong. Output in the construction industry fell in the first quarter, partly because of the unusually bad weather. There were reductions in housebuilding, both for the public sector and for private purchase, and also in other public works; but new building for private industry increased to a modest extent. Building output may perhaps have recovered a little in the second quarter, but is likely to continue at a fairly depressed level, to judge from new orders placed for

construction work. Stocks of finished goods and the volume of work in progress increased quite sharply in the first quarter; some of this was presumably an involuntary build-up following the check to domestic demand, but some may have been in response to the acceleration in the growth of orders for the engineering industry at the end of last year. The increase in stocks during the second quarter is likely to have been smaller.

The resumed growth in total demand in the second quarter was accompanied by quite a sharp increase in domestic output. The index of industrial production, recently recalculated, was some 1½% higher than in the first quarter, and the output of manufacturing industry (which represents three quarters of the whole) went up by nearly 2½%. This suggests that total domestic output not only recovered from the fall in the first quarter, but was probably running somewhat above the level at the end of 1968. Perhaps as a reflection of this recovery in output, the growth in the numbers unemployed slowed markedly in the four weeks to mid-August (allowing for seasonal fluctuations) after sharp increases in June and July. One month's figure is an uncertain guide, though an accompanying rise in the number of vacancies for adult workers notified by employers – which had been falling steadily throughout the year until the upturn in August – also seems to indicate that demand for labour may be reviving. If so, the effect has not yet been very marked; between May and August, the numbers wholly unemployed rose by some 67,000 to 585,000 (2½% of total employees). However, reports of shortages of both labour and capacity continue to be received from parts of the engineering industry and from some chemical manufacturers. The shortage of credit is also imposing a constraint; according to the C.B.I. survey of industrial trends, the smaller firms in particular are becoming increasingly aware of this problem.



For the first time for many years, the central government was in surplus in a June quarter.

Central government finance

The central government's net balance in the second calendar quarter was a surplus of some £15 million even before including receipts from import deposits, and some £235 million including such receipts, compared with a deficit of nearly £400 million a year earlier. It was in fact the first time for many years that the Government had repaid debt in any but the March quarter, which is the main revenue season. Expenditure was above the previous year's level but there was a much greater rise in revenue, reflecting higher rates of selective employment tax and other indirect taxes as well as receipts from import deposits. (As deposits began to fall due for repayment from the end of May, however, net receipts on this account were not as large as in the first quarter.) Meanwhile, the net amount lent by the central government, at £163 million, was the lowest quarterly figure for some years, and nearly £100 million less than a year earlier. Drawings by the nationalised industries were considerably smaller – partly as a result of the Gas Council's borrowing in Western Germany already referred to – and local authorities also took less.

External transactions required sterling financing to the

extent of some £90 million during the second quarter, reflecting the better performance of the pound despite the currency pressures in May. Even so, the Government were able to repay some £145 million of debt to domestic holders. Domestic holders outside the banks took up about £25 million, so that roughly £170 million of debt held by the banking sector was repaid.

In more detail, investors other than the banks bought £108 million of gilt-edged on balance, mostly in the second half of June as described later. However, their holdings of national savings fell by £92 million – the run-down continued in July – and it seems likely that some funds which might otherwise have gone into national savings were diverted into short-dated gilts, which offered a better return. Holdings of tax reserve certificates increased seasonally.

The banking sector as a whole sold gilt-edged, and the Banking Department of the Bank of England's net claims on the Government fell by £43 million. Treasury bills held by the banks and discount houses fell by about £110 million, an unusual event outside the revenue season.

Banks and discount houses

Over the three months to mid-July, advances by the *London clearing banks* other than to the nationalised industries rose by £100 million, seasonally adjusted. There were, however, large swings from month to month. In the month to mid-May advances rose by almost £160 million and, though a large part of the increase was in categories of lending exempt from restriction (particularly loans to local authorities), lending subject to the 98% ceiling also rose substantially, to more than 2% over the limit. As noted in the June *Bulletin*, the Bank therefore decided to halve, with effect from 2nd June, the rate of interest payable on the Special Deposits made by the clearing banks, until lending was brought down to the ceiling. By mid-June, the total of advances had fallen almost to the mid-April level; exempt lending fell as a result of sizable repayments by local authorities, and a very substantial fall in restricted lending brought the banks fairly close to their collective ceiling. However, the pressure of demand for loans was considerable, and lending rose again in the following month. About half the seasonally adjusted increase of £80 million was in restricted lending which, at mid-July, was about 1½% above the ceiling.

As already noted, the clearing banks' advances rose again, and very sharply, in the month to mid-August. Excluding lending to the nationalised industries, the seasonally adjusted increase was £185 million. As in July, borrowing by local authorities was comparatively heavy. But the bulk of the increase was in lending subject to restriction, so that this group of banks was, collectively, some 4½% above the lending ceiling at mid-August. The emphasis which the authorities have placed upon the urgent need to correct this position has been referred to earlier. The banks' combined liquidity ratio fell further, to 28·4%, in August – an unusually low figure for this month.

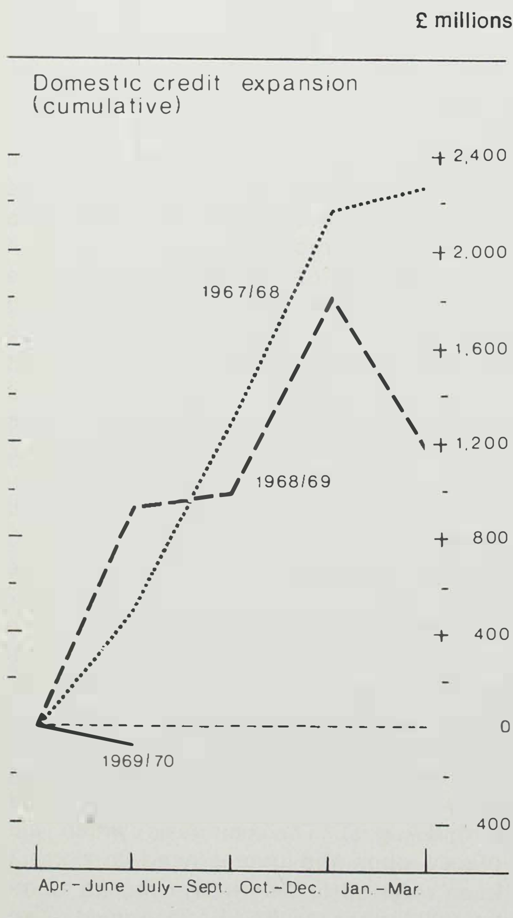
Between mid-April and mid-July the clearing banks sold some £65 million of gilt-edged, largely to restore their

liquidity. Their Treasury bill holdings were almost halved – to about £190 million, the lowest for over twenty years – but they lent a further £30 million of call money to the discount houses. Reflecting the Government's surplus, and sales of gilt-edged stocks to investors other than the banks, net deposits with the clearing banks during these same three months fell by some £140 million, after seasonal adjustment, despite the rise in their advances. Deposits were then lower, on a seasonally adjusted basis, than at the end of last year.

During the second calendar quarter there was little change in the sterling advances of the *accepting houses, overseas banks and other banks* to the U.K. private sector or to overseas residents. Their restricted lending in aggregate remained comfortably below the ceiling (102% of the total at the time of devaluation) which they had been asked to observe. Their lending to local authorities increased sharply in April and then declined equally sharply in May when, because of a steep rise in temporary money rates, local authorities seem to have turned to the clearing banks to meet their needs. As for the banks' other sterling assets, money at call increased early in the quarter, but then declined; Treasury bill holdings were somewhat reduced; and holdings of gilt-edged remained low.

The rise in sterling deposits with these banks slowed down. Domestic deposits from outside the banking sector and sterling certificates of deposit each rose less than in the first quarter, but there was also a small rise in deposits by overseas residents, which had fallen in the two preceding quarters. Activity in the inter-bank market continued at the higher level evident at the end of the previous quarter.

The *discount market's* borrowed funds rose on balance by some £60 million during the second quarter, largely money lent at call by the clearing banks. Most of the increase in the houses' assets was in Treasury and other public sector bills; their holdings of gilt-edged were little changed.



The contraction in domestic credit in the June quarter reflects increasing monetary stringency.

Domestic credit expansion[1]

Mention has already been made of the Chancellor's statement, in the Letter of Intent which he sent to the I.M.F. in May, that policy objectives implied that domestic credit expansion for the private and public sectors in the current financial year would not exceed £400 million.

During the quarter ended 30th June, domestic credit is estimated to have contracted by some £75 million. This result for the first quarter of the financial year is fully consistent with the Government's expectations for the year as a whole, and reflects monetary conditions which are likely to become increasingly severe. Movements in the various components of domestic credit are described in the analysis of financial statistics, which follows as a supplement to this issue.

1 An article describing the concept of domestic credit expansion and outlining various alternative methods of measurement follows as a supplement to this issue.

Bill markets

Early in May, the large foreign exchange outflow served to keep the discount houses acutely short of funds. The Bank relieved these shortages by extensive bill purchases; and because the houses' Treasury bill portfolios were unusually low, following very small allocations at the tenders, the authorities decided that part of their support would again take the form of purchases of both commercial and local authority bills, a method of assistance which had been used for a time in February and March. However, once the pressures in the foreign exchange market had abated towards the middle of May, conditions became easier for the houses, and remained so until the end of June. The Bank's intervention during this period, to absorb surpluses or to relieve such shortages as occurred, was confined to operations in Treasury bills. At the half year the Bank gave a greater amount of help, for the market had to contend not only with the usual half-year influences, but also with shortages arising from revenue transfers to the Exchequer and settlements for large official sales of gilt-edged stocks. Most of this help was again in the form of Treasury bill purchases but, recognising the very temporary nature of some of the mid-year shortages that had arisen, the Bank also lent a comparatively small amount of overnight money at market rates. After the turn of the half year, conditions became easier again for a time, but gilt-edged settlements caused further shortages, particularly between 23rd and 25th July when there was a good public response to the issue on 23rd July of 9% Treasury Loan 1994. In considering how they should alleviate the shortage on 24th July, the Bank were influenced by the expectation that the maturity of two issues on 11th August ($6\frac{1}{2}$% Exchequer Stock 1969 and $4\frac{1}{2}$% British Electricity Stock 1967/69) would leave surplus funds in the market at that time. Their normal response would have been to purchase Treasury bills of the appropriate maturity from the market, but there were not sufficient bills available. In the circumstances the Bank bought some bills and lent the remainder of the amount required, at market rates, for repayment on 11th August – an unusually long term of eighteen days. The average cost of the discount houses' borrowed funds moved narrowly around $7\frac{1}{2}$% throughout the three months.

At the beginning of May, the discount market's tender rate for Treasury bills remained a little below $7\frac{13}{16}$%. The houses reduced their bids in the face of the disturbances in the foreign exchange markets. Outside competition was, however, strong and comparatively few bills were on offer; as a result, the houses received only very small allotments and, at the second tender of the month, no bills at all. Thereafter, the rate moved up fairly steadily, to nearly $7\frac{15}{16}$% in mid-June, in line with the upward trend of interest rates generally. With an increase in Bank rate widely expected, outside competition fell away, and allotments to the houses enabled them to replenish their depleted Treasury bill holdings. The better tone in the gilt-edged market in the second half of June encouraged a reduction in the bill rate to $7\frac{7}{8}$%, and it had fallen a little further by the end of July.

The houses raised their buying rate for three-month prime

bank bills on two occasions – by $\frac{1}{8}$% following the tender on 23rd May, and by a further $\frac{1}{4}$%, to $8\frac{3}{4}$%, on 13th June. Collectively, they succeeded in bringing their commercial bills down to the limits imposed by the credit restrictions. Nevertheless, the offtake by the clearing banks remained low; the banks' own credit ceilings include commercial bills, and they preferred not to increase their purchases from the houses at a time when they were having to restrict lending to their own customers.

Hire purchase finance houses

After adjustment for seasonal influences, there was another reduction in the amount of new credit extended by the finance houses during the second quarter – perhaps partly because new borrowers were discouraged when certain interest payments no longer qualified for tax relief after the Budget. At the end of June, the total of hire purchase debt outstanding to the houses was £23 million less than at the end of March; and the finance houses in aggregate were only fractionally above the ceiling they had been asked to observe on their lending (98% of their hire purchase debt and other lending at the end of October 1967).

Though the houses had no need to compete strongly for new funds during this period, the general tightness of credit obliged them to raise the rates which they offered on deposits in line with the increase in other short-term interest rates. At times in May and June the houses were obliged to offer over 10% for three-month deposits, and though rates had eased somewhat by the end of June, the range was still around $9\frac{1}{2}$%-$9\frac{3}{4}$% at the end of July, compared with $8\frac{3}{4}$%-$8\frac{7}{8}$% at the end of April.

Local authorities

With interest rates so high, local authorities sought to keep their new borrowing as short as possible, and they borrowed relatively little at long-term between May and July. Borrowing from the Public Works Loan Board picked up during the period but only apparently to make good a reduced inflow from market mortgages – which had generally been high since the early part of the year. Reflecting the pattern of gilt-edged yields, P.W.L.B. rates for quota loans were raised on three occasions during May and June, but were reduced on 5th July and, after further changes on 26th July, stood at 9%-$9\frac{1}{2}$%, or about $\frac{1}{2}$% higher than three months earlier. Rates on market mortgages also eased towards the end of the period but, at $9\frac{7}{8}$%-$10\frac{1}{4}$%, were nevertheless rather more than 1% higher than at the end of April.

During the three months under review, no more than £2·3 million was raised by means of stock issues. This was the total paid up during the period on two new issues totalling £7 million. An issue of £4 million $9\frac{1}{2}$% stock by Dunbarton County Council in May was the first by a local authority since the previous October; and in July, Sunderland Corporation made an issue of £3 million $9\frac{1}{2}$% redeemable stock. Little was raised through marketable bonds either – in June, when one-year bonds were yielding as much as 10%, new borrowing was more than matched by redemptions.

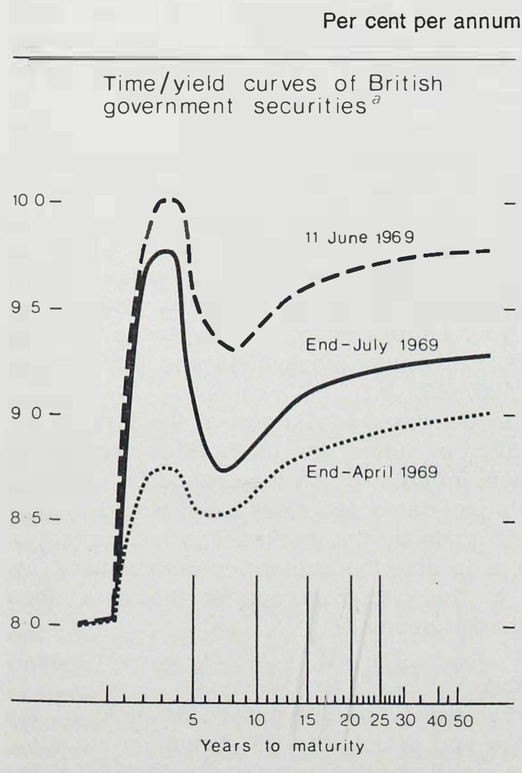
At the beginning of May temporary money rates began to

rise steeply, influenced by the increase in international interest rates as speculative funds moved into Western Germany. As noted earlier, local authorities sharply reduced their borrowing from the accepting houses, overseas and other banks through the temporary money market in May, and drew only quite a small amount from this source in June. Large drawings on clearing bank facilities up to mid-May were reversed the following month, though further quite sizable amounts were drawn in the month to mid-July. Taking the three months as a whole, however, local authorities do not seem to have borrowed large amounts from the banks,[7] perhaps because rate income increases at this time of the year. This was no doubt one reason why temporary money rates began to fall a little early in June. The fall was most marked for shorter-dated money – the rate for two-day money fell at the beginning of the month by $\frac{7}{8}$%, although this fall was partly reversed by increases at the end of the half year and on occasion in July. Rates for three months' deposits also eased a little between the end of May and late July, but the decline was checked at the end of that month, when rates were in the region of 9$\frac{3}{8}$% compared with around 8$\frac{3}{4}$% at the end of April.

Gilt-edged

The renewed disturbance in the foreign exchange markets, fears of still higher interest rates at home and abroad, and disappointment with the trade figures for April, caused continued weakness in the gilt-edged market in May and early June. However, conditions improved markedly over the remainder of that month. One reason for the recovery was a strengthening of sterling and the better trade figures for May. Another was a growing realisation of the attractions of gilts compared with equities – particularly since the Budget had relieved gilts from long-term capital gains tax (and also from corporation tax when companies held them for more than twelve months). The upsurge in demand seems to have come at first from individuals, perhaps partly at the expense of national savings; later, demand spread to include the institutions and other categories of investor. The activity generally continued throughout July and into early August. But the market became subdued in mid-August, following the devaluation of the French franc and the publication of the trade figures for July.

The authorities allowed yields to rise very sharply at the beginning of the three months, reflecting market conditions. From the end of April until the middle of June yields on short-dated issues rose on balance by nearly 1%, and at one point touched a new peak of 10%; those on medium and long-dated stocks rose on average by about $\frac{3}{4}$%. Over the remainder of June, however, most yields fell by between $\frac{3}{8}$% and $\frac{1}{2}$%, and in July there were further falls of around $\frac{1}{8}$%. The falls were, however, less pronounced on short-dated stocks, yields on which exceeded longer-term yields by $\frac{1}{4}$% to $\frac{3}{8}$% at the end of July. This reflected a demand for longer-term stocks from investors wishing to obtain the present high yields for as long as possible, but also, in part, demand from short-term investors who judged that



By the end of July yields were generally about $\frac{1}{2}$% below the peak reached in mid-June.

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

[7] As already noted, however, local authorities drew further on their clearing bank facilities in the month to mid-August.

over the period immediately ahead, yields on longer-dated stocks were likely to fall more than those on shorter-dated issues. Towards the middle of August, there was some general rise in yields as a result of the developments noted above.

The change in conditions enabled the authorities to sell appreciable amounts of stock in June, after some further purchases in April and May. On balance over the calendar quarter, redemption payments on 3% Funding Loan 1959/69 amounted to £55 million, but net official sales of other stocks totalled £150 million. Within this total, the authorities bought £59 million of stocks due to mature within one year, but sold £121 million of other short-dated stocks and £88 million of medium and long-dated issues.[1] They were able to make further very substantial sales in July.

On 23rd July, £400 million of 9% Treasury Loan 1994 was issued at a price of £96 : 10 : – per £100 nominal. The new issue took over the rôle of long-dated tap stock from 6¾% Treasury Loan 1995/98, because the amounts of this stock held by the authorities for dealing purposes had become small. It came as a surprise to the market, when the issue was announced, that the earlier demand for gilts had been large enough to absorb most of what remained of the long tap; and the realisation encouraged further buying and sharp rises in prices of existing stocks. Applications for the new stock at the time of issue were unusually heavy, and further demand was seen after dealings began.

The authorities have recently made two changes of practice in their market dealings. In May, they informed the market that the official buying price for stocks within ninety-one days of redemption would no longer necessarily be tied to the Treasury bill rate, but that the Government Broker remained ready to receive offers of such stock. Previously the official buying price had been kept at a point which allowed the seller to reinvest the proceeds of the sale in Treasury bills of comparable life and secure a slightly larger income. The change gives the authorities firmer control over the timing of purchases of maturing stock, and was adopted for a time in respect of the two stocks maturing in August – 6½% Exchequer Stock 1969 and 4½% British Electricity Stock 1967/69.

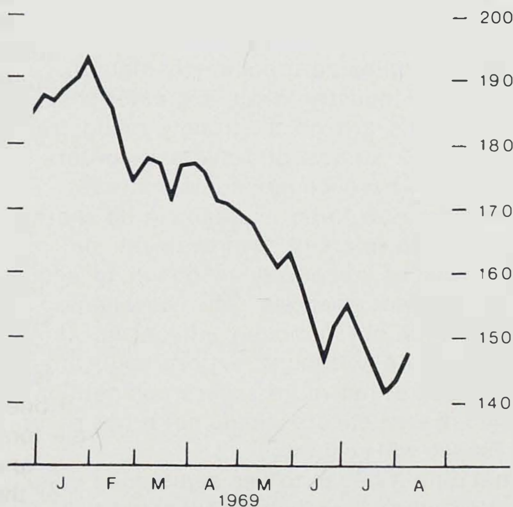
The second change was made known at the time of the new issue in July: in future the authorities would not announce an official price at which they would be prepared to sell short or longer-dated tap stocks, but would instead consider any bids made by the market. The main effect of this change, too, is to give the authorities greater flexibility in determining, in the circumstances at the time, their response to the market demand.

Company securities

The *equity market* was very depressed for most of the period, and by the end of July the F.T.-Actuaries industrial share price index stood at 142·1 compared with 168·0 at the end of April. There were signs of a recovery towards the end of June, when some investors appeared to take the view that earlier falls had been exaggerated, but prices fell

1 See Table 3 (1) of the annex.

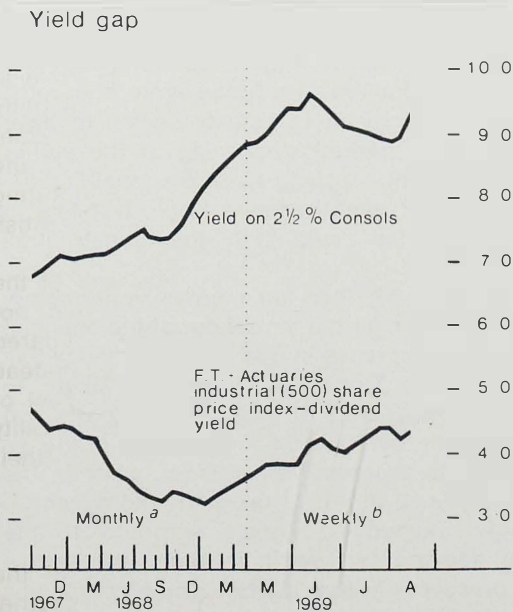
10 April 1962=100



By the end of July the index was 27% below the January peak . . .

a Weekly, Fridays.

Per cent per annum



. . . even so, yields on gilt-edged (despite the fall after mid-June) remained more than 4½% above those on equities.

a Average of working days.
b Wednesdays.

heavily again early in July. By the end of that month, the index was 27% below the peak reached in January. Turnover on the London stock exchange became very low on occasions during July.

Throughout the period, the market was feeling the effects of the severe credit squeeze and the continuing upward trend in interest rates both at home and abroad, and was depressed by the longer-term implications of possibly slower economic growth. It was also expected that some shares bought on borrowed funds would be sold, and the scope for further buying in this way reduced, because of the operation, from the mid-year, of the Budget proposal to discontinue the allowance against tax of interest on certain forms of personal borrowing. Other discouraging factors were the growing awareness of the favourable opportunities for investment in gilt-edged stocks and other fixed interest securities; the virtual absence, until late July, of take-over activity – which had contributed markedly to the market's advance in 1968; and the falls experienced on the New York market during much of the period. In these circumstances, the market failed to find much encouragement even from some good company results; and, unusually, there was no strong demand for equities at the time of the pressure on sterling in May.

Yields on *company fixed interest securities* followed a pattern broadly similar to those on gilt-edged stocks, rising very sharply until the middle of June, but falling a little thereafter. As measured by the F.T.-Actuaries calculation,[1] the redemption yield on twenty-year debenture and loan stocks rose on balance by ⅜% to just over 10½% over the three months to the end of July. By the end of the period company securities were yielding about 1½% more than similarly dated government stocks – about ¼% more than three months earlier. The differential was, however, rather narrower on a comparison between stocks of longer terms or issues with high coupons.[1]

There was a further reduction in the new issues of ordinary shares announced during the three months, and announcements of fixed interest stocks were also lower because of a marked fall in convertible issues. The market's response was still very hesitant, however, even though yields offered on fixed interest stocks were unusually high in relation to those obtainable in the gilt-edged market; and, as had happened in February and March, substantial amounts were left with underwriters. Under these conditions, the flow of new company issues virtually dried up and, by the end of July, very few were impending. Despite these difficulties, the amount raised during the three months was again substantial, because of calls on earlier issues.

Trading by unit trusts was naturally affected by the conditions which depressed the stock markets. Gross sales of units fell to £63 million in the second quarter, which was about half the record figure for the first quarter, and compared with an average of about £82 million a quarter in 1968. However, the number of units which the trusts were obliged

1 The F.T.-Actuaries calculation is based on representative stocks bearing various coupons, but giving a yield somewhat above that obtainable on high coupon stocks issued recently.

to repurchase from investors also fell a little. Sales remained very low in July, but repurchases continued to fall.

Conclusion

The continuing improvement in the balance of payments is encouraging. Allowing for unrecorded exports, the current account was probably in sizable surplus in the second quarter. But imports were still running some way ahead of exports; and this trading deficit needs to be further reduced. The volume of imports remains disappointingly high; there is plenty of scope for home industry to win a greater share of domestic demand. Exports are on a strongly rising trend, allowing for the U.S. dock strikes, and overseas orders for the engineering industry have continued to increase. The United Kingdom appears now to be maintaining its share of world trade, which is a marked improvement on past performance; but it will be necessary to go on to secure a larger share of overseas markets. The devaluation of the French franc should not seriously affect the United Kingdom's trading balance. Although exports will, after a time, be exposed to somewhat more severe competition in certain markets, the adverse effects should not prove severe; and imports from France will cost less.

The signs are that output began to rise again quite quickly in the second quarter, when it probably recovered to somewhat above the level at the end of 1968. Although consumption increased, it is encouraging that the resumption of growth seems to have been generated rather more by export and, perhaps, investment demand. However, such an upturn in most of the main elements of demand, would, if continued, lead to a rate of growth faster than can be sustained for very long. There are already reports of shortages of productive capacity in some important industries, and the possibility that further supply constraints might develop cannot be overlooked. To judge from the most recent indications, the increase in activity seems to have been accompanied by a marked slackening of the earlier sharp rise in unemployment – leaving aside seasonal fluctuations. The number out of work remains large, but this in part reflects relatively low output in the construction industry.

It remains to be seen whether the increasing monetary stringency to be expected over the remainder of the financial year will keep the future increase in domestic demand within manageable proportions. Tight conditions are likely to persist. Indeed, given the needs of finance for exports and other top priority claims, bank credit for all other purposes will continue to become progressively scarcer, while in the first quarter of next year – the main tax-gathering season – another very large Exchequer surplus will add to the pressures on the demand for credit. In order to avoid a concentration of pressures in that quarter, some companies may need to take steps in advance to spread the impact. The banking system is also likely to feel the effects of the squeeze to an increasing degree, and the constraints on lending imposed by the credit ceilings will be reinforced by pressures on bank liquidity, which could become severe as the transfer of tax revenue reaches its peak.

The prospects for a continued growth of world trade will be improved if, as seems likely, members of the I.M.F. decide, at their annual meeting at the end of September, to activate the scheme for Special Drawing Rights. Any such major step to increase world liquidity should lessen the risk that the movement into balance of payments surplus by the United States and the United Kingdom might induce other countries to pursue restrictive economic policies in order to protect their reserves. This further measure of international monetary co-operation – following hard upon the use of recycling arrangements after the May disturbance – can be expected to have a stabilising effect in the exchange markets in the longer run.