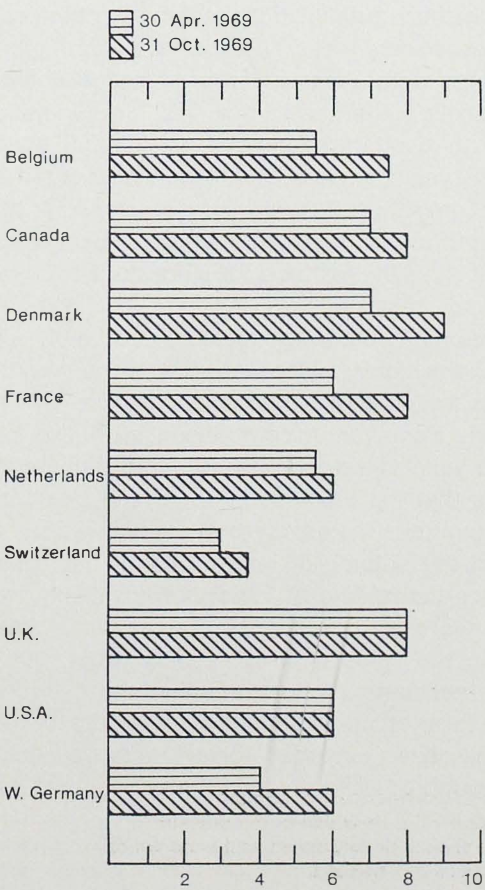
Commentary

Per cent per annum

Central bank discount rates



Many central banks overseas raised their discount rates in the six months to October.

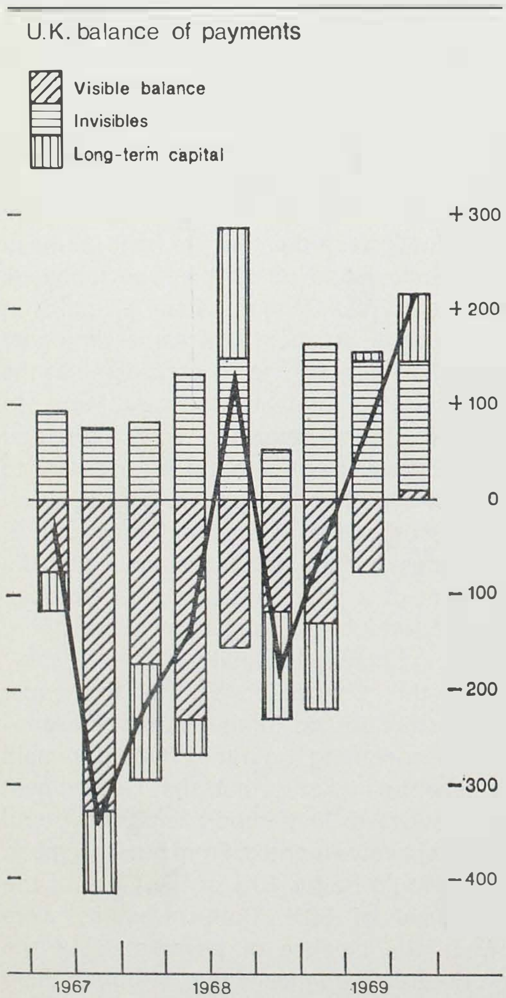
Introduction

Early in September, it became known that the balance of payments had moved into surplus in the second quarter of the year; and the trade figures released in September and October gave the first indications that the surplus had increased in the third quarter. In these circumstances, sterling stood up fairly well to testing conditions during the three months August to October, with which this Commentary is mainly concerned. The exchange markets were affected by the devaluation of the French franc early in August, by renewed speculation about the Deutschemark with the approach of the West German federal elections in September, and by reports at about the same time that greater exchange rate flexibility was to be considered at the annual meeting of the International Monetary Fund. In addition, interest rates abroad remained very high, and several central banks overseas again found it necessary to raise their discount rates during this period. The decision of the West German authorities to suspend their official buying and selling rates for the Deutschemark, and the eventual announcement of a new parity on 24th October, removed an uncertainty which had long been overhanging the markets, and sterling improved steadily.

On 21st October, the Chancellor of the Exchequer announced that the restrictions on foreign currency expenditure for travel in non-sterling countries would remain unaltered for the time being, and that the Government proposed that their powers to levy import deposits should be continued for a further twelve months. From 5th December, however, the deposit would be for 40% of the value of the affected imports, instead of 50%. Both measures were designed to reinforce the balance of payments, but the extension of import deposits also means that, although there will be small net repayments over the next few months, the company sector will not now receive the substantial sums which might otherwise have afforded some partial relief from liquidity pressures in the revenue quarter.

At their meeting at the end of September, the Governors of the International Monetary Fund approved the proposal to introduce Special Drawing Rights. A first allocation of \$3,500 million will be made next January, followed by issues of \$3,000 million in each of the years 1971 and 1972. Ordered additions to world reserves in this way should tend to offset the reduction in the supply of reserve currencies which would occur if an improvement in the balance of payments of the United States followed the movement into surplus by the United Kingdom. The creation of S.D.R.s provides a more rational system for expanding international liquidity when this is judged necessary to avoid impeding the growth of world trade.

Seasonally adjusted
latest quarter provisional £ millions



By the third quarter, the balance of payments had moved into substantial surplus . . .

Balance of payments[1]

In the September quarter, there was a seasonally adjusted surplus on current and long-term capital account which, at about £200 million, was considerably larger than in the preceding quarter. The largest single factor in the improvement was the emergence of a surplus on visible trade, but there was also a substantial net inflow of long-term capital, because of a number of special receipts.

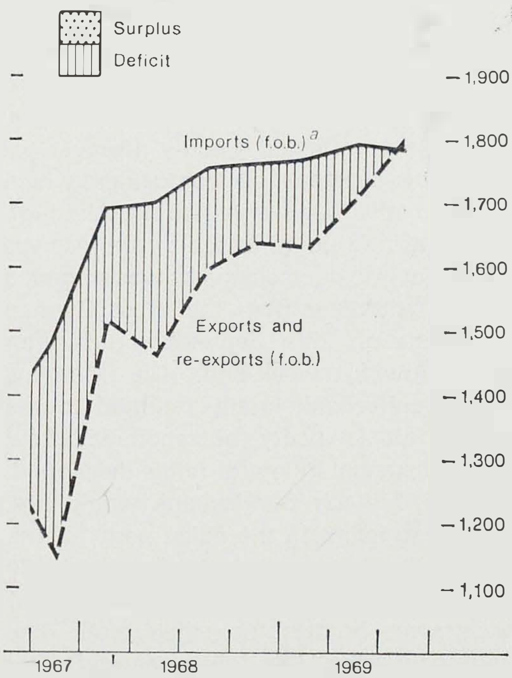
Visible trade moved into surplus for the first time in nearly three years. Exports rose sharply, and the official estimates are that, when various distortions in reporting are corrected as far as possible, the value of deliveries was nearly 5% higher than in the previous quarter. Shipments remained high in October. Most categories of goods contributed to the increase in the third quarter, but machinery, chemicals and metals did especially well. There was a particularly strong growth in sales to Western Europe, and deliveries to most other markets continued to rise. The large increase in exports in the third quarter followed a rise of 3½% in the first half of the year compared with the second half of 1968. Most of the growth in the value of exports so far this year has been attributable to a growing volume of shipments; prices have risen by less than 1% since the beginning of the year.

By contrast, imports in the third quarter were barely any higher than in the second (when arrivals were swollen because of goods which had earlier been delayed by the U.S. dock strikes). However, a comparison with the first six months of the year, taken together to avoid dock strike distortions, shows that the value of imports rose by nearly 2% in the third quarter. The increase was mainly due to higher prices, and the volume of imports has in fact risen scarcely at all since the middle of 1968, during which time domestic output has risen by over 2%. There was a small further increase in the value of arrivals in October, but it was well within the range of fluctuation in these figures from one month to another. As already noted, the import deposit scheme has been extended for a further year from 5th December, though at a slightly lower rate.

1 These estimates include the following adjustments to the recorded figures of exports:
- *a* a reduction for forms lodged in the period but relating to earlier shipments; and
- *b* a reduction for forms which are now being lodged more promptly than before; as well as
- *c* an addition for shipments thought to have been still unrecorded.

Seasonally adjusted
latest quarter provisional £ millions

Balance of U.K. visible trade[a]



. . . and visible trade was itself in surplus in the third quarter.

a Including payments for military aircraft and missiles purchased from the United States.

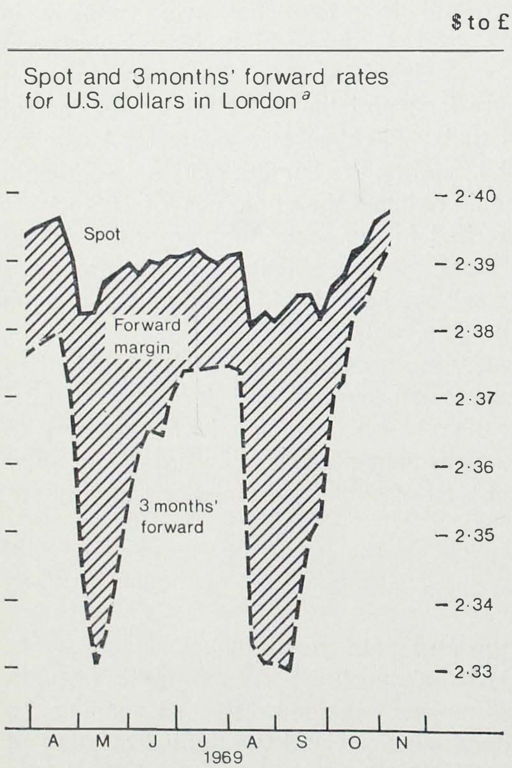
Net invisible earnings were again large in the third quarter although, with some reduction in oil companies' net receipts, the total was not quite up to the exceptional figures in the region of £150 million a quarter reached earlier in the year. The special capital receipts which contributed to another surplus on long-term capital transactions included a ten-year loan equivalent to £52 million (the loan is denominated in U.S. dollars) from the West German Government, as part of the agreement to offset the foreign exchange cost over the two years from April 1969 to March 1971 of stationing British forces in that country; medium and long-term borrowing, mainly in Western Germany, by U.K. public authorities, including a bond issue by the Electricity Council, which together brought in £33 million; and the redemption proceeds of £29 million paid to U.K. holders of a maturing Australian government stock issued on the London market. In addition, U.K. investors again reduced their holdings of U.S. dollar securities, as they had in the second quarter; the fall in prices on U.S. stock markets since the spring prompted some investors to sell stocks and hold their funds in a more liquid form for the time being.

Identified monetary movements were less favourable than the recorded surplus on current and long-term capital accounts, so that the adverse balancing item necessary to reconcile the two measurements was quite large. (This entry represents the net total of errors and omissions throughout the estimates.)

Foreign exchange and gold markets

Following the devaluation of the French franc early in August, exchange markets remained disturbed pending the West German federal elections and the annual meeting of the I.M.F. at the end of September. The uncertainties in the exchanges during these two months were reflected in, and sometimes heightened by, continued talk of changes in the international monetary system; and international interest rates remained high. As mentioned in the September issue, the spot rate for sterling against the U.S. dollar was allowed to fall from around \$2·39 to \$2·38⅛ after the French devaluation. With the likelihood of a difficult period ahead, it was judged useful to demonstrate that full use will be made when necessary of the range available between the Bank's published buying and selling rates for dollars. The trade figures for July, published on 13th August, were poorly received and, as the week-end approached, support was required to meet a substantial, but short-lived, run into deutschemarks. Thereafter, with sterling in very short supply, the rate recovered for a while, but there was again a certain amount of pressure at the end of the month, before the bank holiday week-end.

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



By early November spot sterling had moved to its highest rate against the dollar for eighteen months, and the forward discount was narrow.

a Middle closing rates: weekly, Fridays.

With the announcement early in September that the balance of payments had moved into surplus in the second quarter, followed a few days later by exceptionally good trade figures for August, sentiment towards sterling improved a little; though the market remained cautious, the spot rate briefly rose to about $2·38¾. Towards the end of September, before the West German elections, the flow of speculative funds into deutschemarks grew larger, and several European currencies came under pressure. The pound, however, was less affected – partly because of substantial purchases by overseas oil companies which had royalty and tax payments to make in sterling. Although the rate fell to $2·38⅛ at one point, losses to the reserves were small. The movement into deutschemarks was stemmed when the Bundesbank withdrew from the West German foreign exchange markets on 25th September until after the elections the following week-end. On Monday, 29th September, the Bundesbank briefly returned to the market to maintain the official parity, but soon withdrew again when a further substantial inflow of funds developed. It was then announced that the Bundesbank would not, for the time being, seek to maintain the dollar parity of the Deutschemark, which thereafter appreciated, eventually to a premium of some 8%; funds began to flow out of Western Germany as some holders took their profit. The spot rate for sterling against the U.S. dollar rose and, after another good set of trade figuers was released in mid-October, moved above $2·39. Following the formal revaluation of the Deutschemark announced on 24th October, the pound improved further, to around $2·39⅝ at the end of that month.

Forward margins against sterling widened very sharply in mid-August: the cost of three months' cover expressed as an annual rate rose after the French devaluation to over 8%, where it remained until mid-September. The margin then narrowed to around 5½% in response to the better balance of payments and trade figures, and to about 2½% soon after the parity of the Deutschemark had been suspended. The release of another set of good trade figures in mid-October caused a further narrowing and, after the formal revaluation of the Deutschemark, the margin contracted to below 1%.

The gold markets were quiet. The fixing price for gold in London touched $41·45 at one point in mid-August, but generally fell thereafter to $39·75 at the end of October. The fall continued more steeply in November.

Movements of short-term funds

There was, on balance, some outflow of short-term funds over the three months to the end of October. Large withdrawals at the beginning of the period were followed by a sizable inflow in October. The sterling holdings of overseas sterling area countries did not change much on balance during these three months; but in the year since the conclusion of the sterling area agreements in September 1968,[1] these holdings have risen by nearly £300 million, taking official and private holdings together. The holdings of non-sterling countries fell between August and October, most of the reduction occurring in the period immediately following the French devaluation. There was little change in the banks' net external claims in foreign currencies over the three months; their gross currency liabilities and claims continued to rise substantially, though by much less than earlier in the year.

The smaller increase in currency balances was a reflection of rather less hectic conditions in the euro-dollar market. Borrowing by American banks from their overseas branches was on balance little changed between August and October. The demand for credit in the United States, which had been particularly large over the middle of the year, eased a little thereafter. Some U.S. banks might also have looked elsewhere for funds after a 10% reserve requirement imposed by the Federal Reserve Board on euro-dollar borrowing took effect on 16th October; broadly, the requirement applied at the outset to the amount by which average borrowings in the four weeks ended 2nd October exceeded the average in May. Although U.S. banks were bidding less actively at this time, there was some demand for euro-dollars from speculators wishing to switch into deutschemarks, especially after the French devaluation. This speculative demand was smaller than it had been at the time of the earlier movement of funds into deutschemarks in May, but nevertheless caused a sharp increase in euro-dollar rates; the three months' rate rose from below 10½% at the beginning of August to nearly 11½% early in September – a figure surpassed only in June. Rates remained high in September, but conditions eased as dollars were returned to the market following the West German decision to abandon the official support of the Deutschemark parity. The three months' rate had fallen to 8¾% before the revaluation of the Deutschemark, but the fall proved to have been overdone, and there was then quite a sharp reaction. Soon afterwards, U.S. banks began to bid strongly for euro-dollars again, following an F.R.B. proposal to limit the interest payable on issues of commercial paper by the banks' holding companies. Under these influences, the rate had moved up to 10% by the end of October and continued to rise sharply until mid-November.

For most of the period, euro-dollar rates remained significantly above U.K. local authority rates, so that even uncovered interest differentials were adverse to investment in the United Kingdom – as they had been since May.[2] The drop in euro-dollar rates in October narrowed these differentials quite substantially and, for a short time just before the end of the month, local authority deposits offered a higher return than euro-dollars on an uncovered basis.

1 See the Bank's *Annual Report*, 1969, page 13.

2 See chart on page 398.

Reserves and special facilities

The gold and convertible currency reserves fell by £4 million in the third calendar quarter, to £1,014 million; small increases in July and September were rather more than offset by a fall in August. Annual servicing on debt to Western Germany and Portugal cost £15 million, and there was a net repayment of £10 million to the I.M.F. – most of the £83 million ($200 million) repaid as the fifth of eight instalments on the May 1965 drawing having been matched by a drawing of £73 million ($175 million) on the standby credit arranged last June. On the other hand, the reserves benefited by £52 million in August from a ten-year loan made available by the Federal German Government as part of the arrangements to offset the cost of British forces stationed in Western Germany over the two years from April 1969 to March 1971.

In July, further repayments were made on central bank and other special facilities, but some renewed drawings were necessary in the uncertain conditions in the exchange markets in August and September. The net amount drawn over the quarter was, however, small and has been much more than outweighed by subsequent repayments. Transactions during the quarter included a repayment of £31 million to the Bank for International Settlements as the first of eight instalments due on drawings under the Basle arrangements of June 1966 to counter fluctuations in the sterling balances; and the remainder of the initial amount drawn under the Basle arrangements of September 1968, to mitigate the effect of drawings on the sterling holdings of overseas sterling area countries, was also repaid during the quarter. But these repayments were accompanied by larger drawings on other facilities, including a net £31 million ($75 million) on the $2,000 million swap arrangement with the Federal Reserve system, which brought outstanding drawings on this facility to £458 million ($1,100 million).

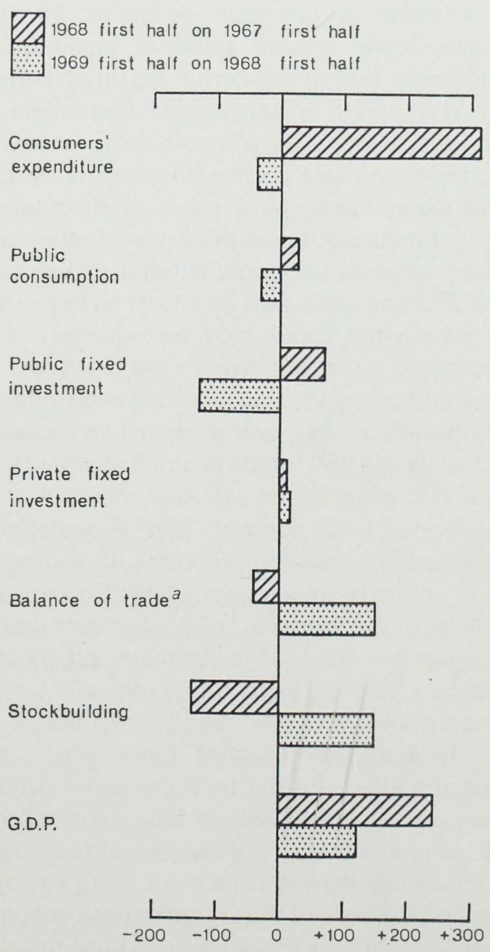
Domestic economy

Although the evidence is conflicting, it now appears that activity in the second quarter was only a little higher in total than in the first, after allowance for seasonal factors. The volume of exports of goods and services expanded sharply, and consumers' expenditure was also higher; but the increase in stocks and work in progress was much less than in the previous quarter. Fixed investment by private industry continued at roughly the average rate of the previous six months (which are taken together to avoid distortions caused by the reduction in investment grants after the end of 1968); within the total, manufacturing investment was probably still rising slowly. Public sector investment, however, was lower.

Information about the third quarter is still far from complete, and some of the main indicators for this period are proving more than usually difficult to interpret. So far as can be

£ millions
at 1963 factor cost

Changes in the pattern of demand



With the volume of consumer and government spending being held down, additional output has been diverted mainly to the balance of payments.

a In goods and services.

judged, output rose fairly sharply, and much of the increase went to satisfy export demand. The index of industrial production suggests an increase of only about ½%, seasonally adjusted, in these three months; but information about the engineering industries, which account for about one-third of the total production covered by the index, is far from complete as yet. The output of mechanical engineering companies has been rising quite sharply recently – by nearly 4% in the three months to August compared with the preceding three months, and by some 13% over the past year. Outstanding orders placed with the engineering industries as a whole suggest that the growth in their output could continue, unless it is impeded by the shortages of skilled labour and of productive capacity which are still being reported.

Perhaps as a result of the increase in output during the summer, the number of those wholly unemployed has recently started to fall (allowing for seasonal influences). Over the three months from mid-August to mid-November, the fall was sufficiently large, at 49,000, to reverse half the increase which had taken place between February and August, and it brought the total down to about 536,000 or some 2¼% of all employees. However, there was a similar apparent peak in the seasonally adjusted figures in mid-summer in 1967 and 1968, and it may be that the seasonal adjustments are at fault. Accompanying the fall in the numbers wholly unemployed, vacancies for adult workers began to rise in August and have continued upwards. In contrast, the numbers of workers temporarily stopped rose steadily from mid-July onwards to reach a comparatively large total in mid-October, before falling at the November count (no seasonal adjustments are available for these figures). The increase to October included workers laid off because of industrial disputes, as a result of which working days lost have been steeply higher in most months this year than last; indeed, the total of days lost so far this year is the largest for several years.

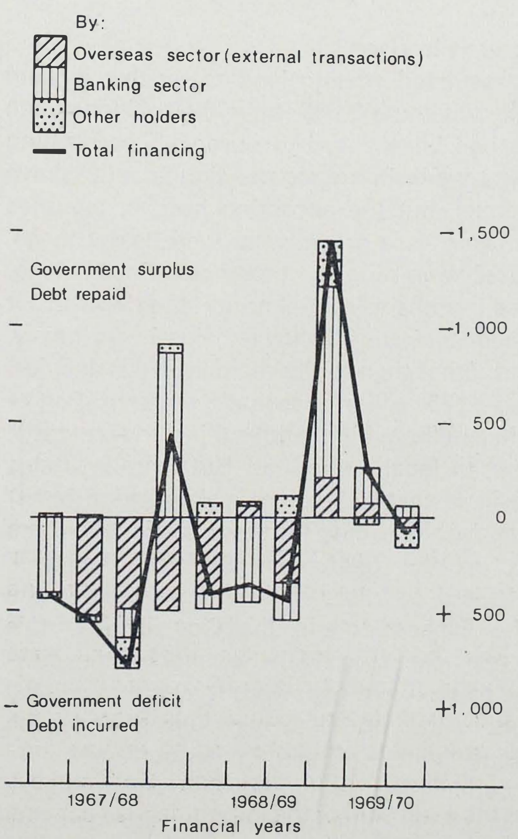
Apart from the strong growth of exports already noted, demand has probably been increasing only moderately. The volume of consumer spending seems to have risen only a little in the third quarter, and private industry's investment expenditure may have continued to increase; the addition to stocks and work in progress was probably larger than in the second quarter, but public expenditure does not seem to have changed much. Thus the pattern in recent months has probably been broadly in line with the Government's objectives, with additional resources going mainly into exports and, perhaps, industrial investment.

The rise in consumption in the third quarter was not reflected in retail sales, which were a little lower in volume than in the second quarter, and about the same as they had been a year ago. On the other hand, the number of new cars registered rose rapidly, and was 18% higher than in either of the first two quarters. Registrations remained quite high in October, and reports suggest that consumers' expenditure in general has probably continued to increase moderately. This perhaps reflects a further rise in real earnings; average weekly earnings rose by some 1 ¾%, after seasonal adjustment, in the third quarter, and the rise in retail prices on the same basis is likely to have been only about half as large. The prospects are for a steeper rise in earnings in the fourth quarter, partly because a number of settlements tend to be renewed at this time of the year, and partly because of some large awards recently – including those to mineworkers, local authority manual workers, farmworkers and those in the electricity supply industry.

As already mentioned, private manufacturing investment was probably still rising slowly up to the middle of the year, if rough allowance is made for the bunching which took place at the end of 1968 in order to qualify for investment grants at the higher rate effective until the end of that year. The increase was largely in building and construction work, but expenditure on plant and machinery also rose. To judge from an increase in domestic deliveries by the engineering industries, the upward trend of expenditure on plant and machinery may have continued in the third quarter. There was a sharp fall in new engineering orders in July; but the more recent figures have shown some recovery, and it is not yet clear what these figures foreshadow for the rate of investment expenditure. As a result of their latest survey of investment intentions, taken in August/September, the Board of Trade suggest that manufacturing investment of all kinds will be 5% higher this year than last; allowing for the distortions between the fourth and first quarters, the Board put the underlying increase between the two years at about 10%. This would be much the same adjusted rate of growth as was suggested in May, and it implies an increase between the two halves of 1969 which is much steeper than has probably been occurring in the last few months. This enquiry therefore appears to suggest that expectations continue high, despite the increasing pressures on company liquidity. A survey of industrial trends taken by the Confederation of British Industry in the latter part of September takes a somewhat more guarded view of investment prospects. Although a continued rise in expenditure on plant and machinery is foreseen over the next twelve months, it is expected to be only modest; and small firms, which are increasingly feeling the effects of the tight monetary conditions, are on balance expected to reduce their expenditure. In addition, more companies are expecting to reduce their capital outlays on buildings than to raise them. Both surveys were taken before the extension of the import deposit scheme was announced and, as this extension will reduce the net repayment which had been expected in the next few months, liquidity pressures might now be a more important factor in companies' investment decisions than the surveys suggest.

£ millions

Central government financing



The banks' holdings of government debt continued to fall as other holders bought gilt-edged and the government financial position remained strong.

Central government finance

In the September quarter, as in previous quarters, the central government were in a much stronger financial position than in any recent year. There was a borrowing requirement of only £85 million, compared with one of £360 million in the same quarter last year. Although expenditure was higher this year, there was a much greater increase in revenue, towards which higher rates of selective employment tax and other indirect taxes contributed. Import deposits hardly affected the position during this quarter; new deposits were broadly matched by the repayment of deposits made six months earlier. Apart from £215 million drawn by the electricity industry to redeem two government-guaranteed stocks (which did not affect the borrowing requirement),[1] the amount lent in the September quarter was again smaller, in total, than a year ago; more was drawn by local authorities, but much less by the nationalised industries.

The borrowing requirement was partly matched by receipts from external transactions because, as noted earlier, there was some relatively modest selling of sterling in the difficult conditions in the exchange markets in August and September. The net change in domestic holdings of government debt was thus quite small. Holders outside the banking sector took up nearly £120 million; despite maturities in August, they purchased a further £200 million net of gilt-edged stocks, including all except the shortest-dated issues. As in June, these purchases seem to have been partly at the expense of national savings, holdings of which were reduced by about another £70 million. Partly as a result of the exemption of gilt-edged stocks from long-term capital gains tax in the Budget, markedly higher yields can be obtained on these stocks than on most forms of national savings. The acquisition of government debt by domestic holders outside the banking sector enabled about £70 million of debt held by the banks and discount houses to be repaid; these institutions sold over £60 million of gilts, and their already depleted holdings of Treasury bills fell somewhat further.

Over the first half of the financial year, the central government had a quite unusual surplus approaching £150 million.[2] External transactions absorbed about £50 million of this, so that about £100 million was used to repay domestic debt. Holders outside the banking system took up almost £150 million of debt on balance, despite a substantial reduction in national savings, mainly because they bought very large amounts of gilt-edged stocks. As a result, nearly £250 million of debt held by the banking sector was repaid.

1 Because redemptions of government and government-guaranteed stocks are not treated as a charge on the central government, but rather as a change in the composition of its financing, this amount has been offset elsewhere in the accounts, and has no effect on the net balance. See Table 1 of the statistical annex.

2 Excluding import deposits, there would have been a deficit of about £60 million, but this is a very small figure in comparison with most other years, and compares, for example, with a deficit of some £750 million in the first half of 1968/69.

The December quarter is a period in which the central government's accounts will show a seasonal deficit, but this is expected to be followed by a very large surplus between January and March – the main revenue quarter. For the financial year as a whole, a surplus of well over £1,000 million now seems probable. At the time of the Budget last April, the surplus for the year was put at about £800 million, but the extension of the import deposit scheme is likely to increase the surplus substantially because net repayments of deposits over the remainder of the financial year will now be very much smaller than had been expected.

Public expenditure

Early in December, the Government published the first of a new annual series of White Papers on public expenditure. It deals with expenditure in 1969/70 and the four following years. Particular emphasis is given to the prospects up to 1971/72. Public expenditure in 1970/71 is expected to rise by about 3½% at constant prices. In 1971/72 a further increase of some 3¼% is forecast. The Government judge that both movements are compatible with the objective that the rate of growth of public sector expenditure should be consistent with the increase in total domestic resources.

Banks and discount houses

At mid-October, restricted sterling lending by the banking system as a whole was some 2½% above the ceilings which these institutions had been asked to observe. The clearing and Scottish banks were, in aggregate, significantly above their respective limits, but the accepting houses, overseas and other banks taken as a group were well below theirs. The discount houses were roughly at their combined ceiling.

During the three months to mid-October, the demand for loans from the *London clearing banks* remained very heavy, and their advances, other than to the nationalised industries, increased by some £175 million seasonally adjusted. Part of the increase was in lending which is not subject to restriction, including advances to local authorities. But there was also a very steep rise in restricted lending in August, to rather more than 4½% above the ceiling for these banks taken as a group. As noted in the September *Bulletin*, the bank chairmen were invited to discuss this increase with the Chancellor of the Exchequer and the Governor. At this meeting, which took place on 11th September, the difficulties facing the banks were reviewed. It was appreciated that the pressures in the month to mid-August had been exceptional – arising from a sizable Exchequer surplus (a most unusual occurrence at that time of the year) and from heavy official sales of gilt-edged stocks – but it was made clear that there was to be no relaxation of credit at that time. Part of the pressure for facilities from the clearing banks no doubt stemmed from the fact that the interest they charged on loans was below the rates charged elsewhere in the market. To lessen this anomaly, the banks later announced that, with the approval of the Bank of England, their lending rates were to be increased by ½% with effect from 1st October, except where this was not compatible with existing firm arrangements. Henceforth, the lowest rate charged to first class commercial borrowers would become 1% above Bank rate, with a minimum of 5%. However, the banks stated that the special 5½% rate charged for medium and long-term export and shipbuilding credits, and the arrangements for the provision of short-term export finance at Bank rate, would continue.[1]

Restricted lending was slightly reduced in the following two months, but was still nearly 4½% above the ceiling in mid-October. The banks remained under considerable pressure during these two months because a shortage of company liquidity was accentuated by the continued inactivity in the new issue market, and because official sales of gilt-edged stocks remained large. The existence of such pressure was acknowledged by the Bank at the time that the October figures were released; and it was recognised that the decision to continue the import deposit scheme was a new factor which would add to the pressures on the banking system over the coming months.

Even so, the banks succeeded in reducing their lending in the month to mid-November by some £80 million, after seasonal adjustment. There was a sharp fall in lending to local authorities, but restricted lending was also reduced by rather over 1%. It seems probable that local authorities and companies benefited from an inflow of overseas funds, and so were able to make less use of their bank facilities. This alleviation of the pressures on the banks was also reflected in a seasonally adjusted increase of about £85 million in their net deposits. The combined liquidity ratio rose by just over one percentage point to 31·0%, at which level the banks are somewhat better placed to meet the expected drain on their liquidity during the revenue season.

To provide themselves with more liquid assets, the clearing banks continued to sell gilt-edged stocks between mid-July and mid-October; they reduced their holdings by some £50 million during these three months, to about £950 million. Treasury bill holdings were lower in August than at any time since the War; and though there was some recovery on balance over the next two months, holdings in mid-October, at a little over £150 million, were still some £40 million lower than they had been in mid-July. However, the banks lent about £70 million of call money, roughly equally to the discount market and to others. Largely as a result of the authorities' sales of gilt-edged stocks to investors other than the banks net deposits continued to fall – on balance, by about £100 million, seasonally adjusted – over these three months. Although, as noted above, this fall was largely

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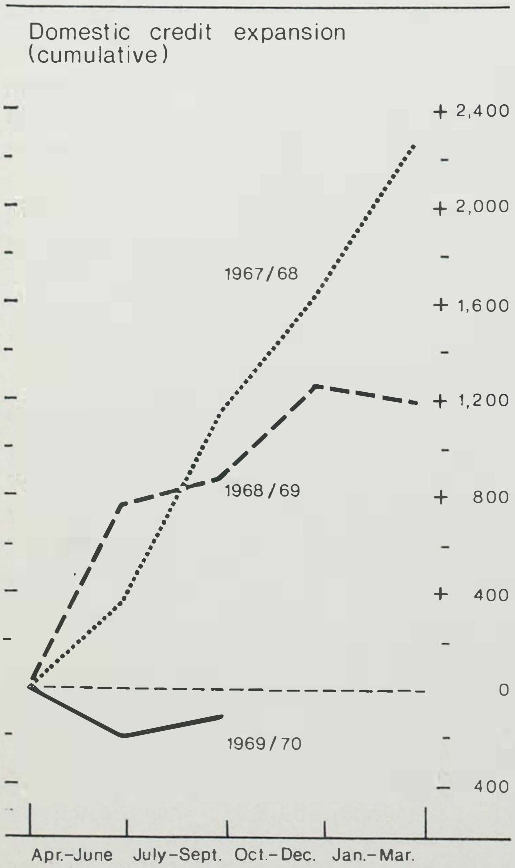
1 An article describing special features of the system of finance for export credit, including the arrangements referred to above, appears on page 424.

Seasonally adjusted £ millions



There was a contraction in domestic credit in the first half of the financial year.

reversed in the following month, deposits in mid-November were still almost £150 million lower than at the same time last year.

In the calendar quarter to end-September, the *accepting houses, overseas and other banks* increased their sterling lending (excluding loans to local authorities and inter-bank lending) by some £55 million. There was a small rise in restricted lending, but the total for this group of banks remained well below their combined ceiling. Their lending to local authorities fell by about £70 million; the fall was concentrated in the middle of the quarter when, as short-dated temporary money rates continued to rise, local authorities may have turned instead to the clearing banks and the Public Works Loan Board to meet their needs. There was little change in the banks' other sterling assets.

Domestic sterling deposits from outside the banking sector and issues of sterling certificates of deposit both rose more than in the previous quarter, but these increases were partly offset by a sharp fall in the sterling deposits of overseas residents; the fall was concentrated in the middle of the period, at about the time of the devaluation of the French franc. Activity in the inter-bank market remained high.

The *discount market's* borrowed funds fell by some £25 million during the third quarter, largely because of the withdrawal of money lent at call by the clearing banks. Among the houses' assets, Treasury bill holdings fell sharply, but there was an increase in holdings of local authority securities (which are now shown for the first time in Table 7 of the statistical annex). The houses' holdings of other bills and of gilt-edged stocks were broadly unchanged.

Domestic credit expansion

During the quarter ended 30th September, domestic credit is estimated to have expanded by about £85 million, or a little less after seasonal adjustment. The public sector reduced its borrowing from the banks, but obtained more finance from overseas; and bank lending to the private sector increased sharply. For the first half of the financial year, the recorded figures show little change in domestic credit, which means that, after seasonal adjustment, credit contracted by nearly £120 million – a result which is well within the Government's expectations of an increase not exceeding £400 million for the financial year as a whole. The pattern suggested by the adjusted quarterly figures of both domestic credit and money supply – a contraction in the June quarter, followed by an increase in the September quarter – is largely attributable to erratic movements in the banking figures over the end of each quarter. The true underlying trend in both D.C.E. and the money supply is unlikely to have shown any great variation between these two quarters, or very much movement in either quantity over the six months as a whole. More details of the quarterly movements are given in the analysis of financial statistics.[1]

1 See page 414.

Bill markets

The money market was generally short of funds during the three months August to October. One important reason was the transfer of funds in settlement of the substantial sales of gilt-edged stocks by the authorities. Such purchases were especially large at times in September and October. Earlier, foreign exchange outflows following the French franc devaluation in August also took sterling out of the money market; but later in the period, movements the other way helped to relieve shortages. The Bank's intervention in the market[1] was mainly by purchases or sales of Treasury bills but, with the discount houses' holdings becoming extremely low in August, it was occasionally necessary for the help given in that month to take the form of purchases of commercial or local authority bills as well; and there were further such purchases in October. On one occasion, temporary help was given in the form of overnight lending at market rates. This was on 11th August, when the market received rather less than had been expected of the redemption proceeds of two maturing gilt-edged stocks. As a result, part of the unusual eighteen-day advances which were to have been repaid to the Bank on that day[2] was effectively extended until the following day.

On average, the discount houses are thought to have paid 7 9/16% for their money during the first half of the period, but the cost probably moved up to about 7 5/8% in the latter part of September and remained at that level during October. The houses were tendering for Treasury bills at around 7 13/16% in August and September. In a successful attempt to obtain a larger proportion of the bills on offer, they raised their bid sharply at the first two tenders in October to bring the rate down to 7 11/16%; the rate rose again in the middle of the month, and ended the period at 7 3/4%.

Hire purchase finance houses

During the third quarter, new credit extended by the finance houses rose, for the first time this year, by some £20 million, or 12%, after seasonal adjustment. However, repayments were also higher, and instalment debt outstanding rose by only £2 million over the quarter. By the end of September the houses were, in aggregate, about 1% above their lending ceiling.

The houses raised their deposit rates in August and early September, in line with the increase in other market rates. By mid-September, the rate for three months' deposits had risen to about 10 3/8%, but it later eased to about 9 1/2% at the end of October, to show a slight fall over the three months as a whole.

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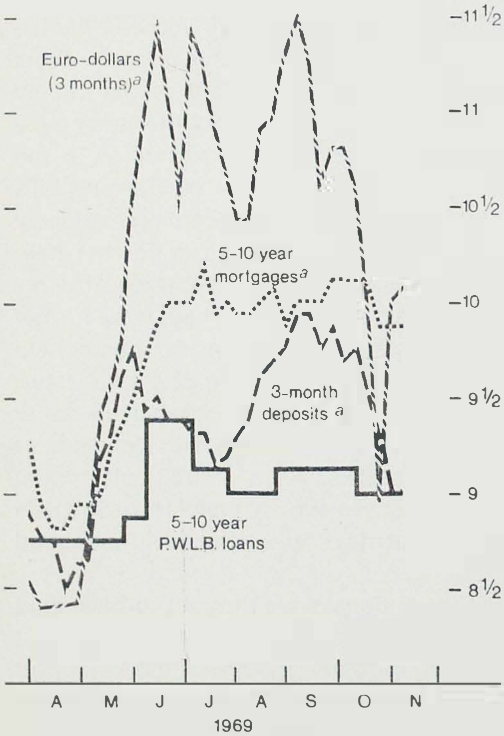
1 The statistical annex includes a new Table 6 which gives monthly details of the Bank's operations in the money market.

2 September 1969 *Bulletin*, page 285.

Per cent per annum

Local authority and euro-dollar rates



Rates were still high early in November, though below earlier peaks.

a Weekly, Fridays.

Local authorities

Despite high and rising interest rates, local authorities increased their borrowing at longer term between August and October. They drew more from the Public Works Loan Board and also raised more on market mortgages. P.W.L.B. rates were increased with effect from 23rd August by up to ⅜%, but were lowered again from 11th October by roughly the same amount and, at 9%–9¾%, showed little change over the three months as a whole. Rates on market mortgages fluctuated narrowly over the period and at the end of October stood at 9¾%–9⅞%, marginally lower than at the end of July.

A few more local authorities issued stock – which sometimes had to be taken up by the underwriters – after issues had been hesitantly resumed in the previous quarter. The amount raised in this way between August and October was still small, at £18 million, including calls on earlier issues. The yield on one-year bonds rose to 10⅜% in September and proved attractive to private as well as to institutional investors. Nevertheless, the amount raised on new bond issues during the three months exceeded maturities by only a little.

Temporary money rates rose quite sharply in August and early September, so that they were about as high as during the currency disturbances in May. These movements appear to have been a response to the rise in euro-dollar rates, already described. From mid-September onwards, rates began to ease and by the end of October they were generally lower than at the beginning of August. As noted earlier, there was a very sharp fall in local authorities' borrowing of temporary money from the accepting houses, overseas and other banks in the period from mid-July to mid-August, and they did not draw very heavily in the following month. Although they made some further use of their facilities with the clearing banks between mid-July and mid-October, their drawings were quite modest; and they made substantial repayments of clearing bank borrowing in the month to mid-November.

Building societies

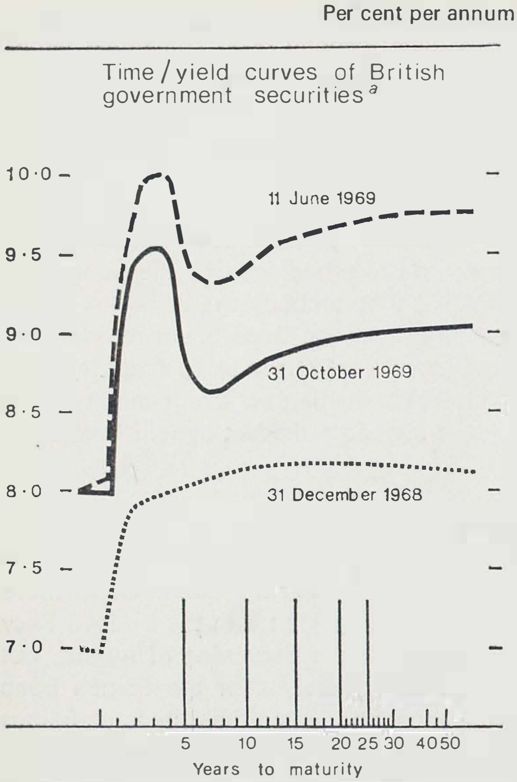
The societies' net receipts had increased, after seasonal adjustment, following the announcement in mid-March that the recommended rate of interest paid on shares would be raised from 4½% to 5% tax paid from 1st April. The gross inflow of funds remained quite high throughout the summer, but there were increased withdrawals from the societies following the sharp rise in other interest rates in May and, it seems, the movement of funds into gilt-edged stocks from mid-June onwards. As a result, net receipts between June and August fell to much the same monthly totals as at the beginning of the year; there was, however, some recovery in September and October. The fall in receipts during the summer did not at first lead to any reduction in mortgage advances – partly, perhaps, because repayments on earlier mortgages have recently been somewhat larger – but new lending commitments fell in August, and advances were themselves lower in September and October. The societies' combined liquidity ratio, which had fallen as low as 15% last February, had improved a little, to 15·7%, by October.

The societies' new schemes for contractual savings were introduced in October. As foreshadowed by the Chancellor in his Budget last April, they embody the same tax reliefs as the parallel scheme run by the Department for National Savings, which was introduced at the same time. It is too soon yet for the full effects of the new arrangements to be seen, but the societies derived a modest benefit from them in October.

Gilt-edged market

A strong demand for gilt-edged stocks had developed in the middle of June, partly as a result of the exemption of these stocks from long-term capital gains tax in the Budget. They were still in good demand at the beginning of August, but the situation changed immediately after the French franc devaluation on 8th August and, when the July trade figures were released a few days later, the market lowered prices promptly. This discouraged sales, and the authorities made only modest purchases of stock. Thereafter the market became subdued, but a feature of this period – as, indeed, of the whole of the three months under review – was the fairly persistent buying by small investors even at times when the institutions were reluctant to invest. The buying was directed particularly to stocks with low coupons and up to ten years to maturity. The total number of holdings of all gilt-edged stocks rose by almost 25,000 between the end of March and the end of October, of which over 20,000 were classified as the accounts of private individuals and private trusts. The increase in the total represents a rise of little more than 1% in the seven months, but marks a distinct change of trend – for many years, except only after an industry has been taken into public ownership, the number of accounts has fallen steadily.

The institutions came back into the market briefly in mid-September, when the balance of payments surplus in the second quarter was announced, followed by the good trade figures for August. Thereafter the market proved remarkably resilient in the face of growing fears of currency disturbances as funds began to flow into Western Germany before the Federal Government elections. When these fears were reduced as a result of the decision temporarily to abandon the Deutschemark parity, the market went sharply ahead, especially after the release in mid-October of another set of good trade figures. There was some further improvement over the remainder of the month, after the revaluation of the Deutschemark had been announced.



Yields remained high; the large demand for gilt-edged was satisfied by the authorities' substantial sales.

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

Yields on long-dated stocks rose by over ¼% in the week following the French devaluation, but then fell fairly steadily throughout September and October to finish the period at about 9%. This represented a fall of ¼% over the three months as a whole, and brought long yields about ¾% below the peak in mid-June. Short yields, under competition from high rates in other markets, did not fall as fast, and at the end of October were only ½% below the June peak.

The authorities sold large amounts of stock over the September calendar quarter, especially in July. Redemption payments to the market on two stocks[1] maturing on 11th August totalled nearly £190 million, but the authorities sold over £350 million (net) of other stocks, including the bulk of the long-dated tap stock – 9% Treasury Loan 1994 – issued on 23rd July. The authorities bought about £130 million of stocks due to mature within one year, but sold some £210 million of other short-dated stocks and £270 million of medium and long-dated issues – most of these sales being at the longer end of the range.[2] The persistent buying of short and medium-dated stocks by small investors referred to above was not fully reflected in sales of these stocks by the authorities. Part of the demand for medium-dated stocks was met in the market, by investors wishing to switch into longer-dated issues; and it was the demand for the longer issues which the authorities mainly satisfied. There were further very heavy official sales of stock in October, but the market turned considerably easier in November.

With supplies of 9% Treasury Loan virtually exhausted, a new long-dated tap stock – 8¾% Treasury Loan 1997 – was issued on 9th October, at a price of £95 per £100 nominal. This represented a yield only ⅛% lower than had been offered on 9% Treasury Loan when it was issued. The new stock has been in some demand since its issue.

Company securities

The fall in equity prices which had begun in February was halted towards the end of July. But, although prices rose on balance between August and October, there was no indication that a firm upward trend had been established. The F.T.-Actuaries industrial share price index stood at 142·1 at the end of July and, after recovering some lost ground early in August, fluctuated between 146 and 150 for most of the period. Prices fell in the last week of October, bringing the index down to 142·8 at the close, but there was a recovery early in November.

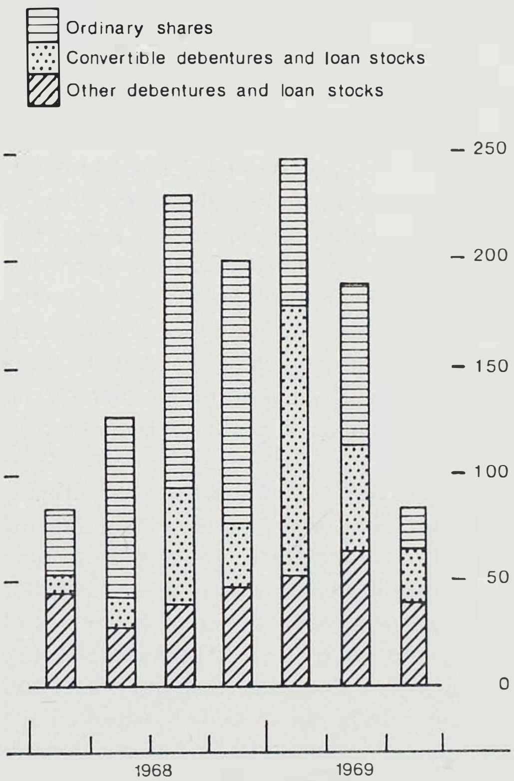
Some good company results were a cheering influence early in August, but the effect was soon dispelled by the devaluation of the French franc and the market's reception

1 6½% Exchequer Stock 1969 and 4½% British Electricity Guaranteed Stock 1967/69. A third maturity – 4½% South of Scotland Electricity Guaranteed Stock 1967/69 – was held entirely by the authorities.

2 See Table 3(1) of the annex.

£ millions

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



Companies were reluctant to make capital issues at the high yields prevailing in the third quarter.

a New money raised on the U.K. market excluding preference shares. Debenture and loan stock issues are net of redemptions; convertibles net of cash redemptions only.

of the trade figures for July. For most of the period, however, the market was featureless. A certain buoyancy following the trade and payments figures released in September and October was sufficient to counteract the effect on the London market of the general drift of prices on Wall Street. There was, however, no noticeable reaction to the Deutschemark situation at the end of September and early in October. Turnover on the London stock exchange remained very small in August and the first part of September, but increased a little thereafter.

Yields on company debentures and loan stocks fell only slightly over the three months. At the end of October, yields on first class high-coupon debentures of about twenty-five years' maturity stood, on average, at under 9¾% – less than ¾% above the yield on comparable gilt-edged stocks. The margin indicated by the F.T.-Actuaries calculation of 20-year redemption yields was much larger; indeed, at about 1¾%, it was the largest since the calculation was started in 1964. However, this comparison takes little account of high-coupon issues.

As in the earlier part of the summer, companies announced only very few new issues of either equities or fixed interest stocks. The fall in stock market prices had discouraged equity issues, and many companies were no doubt reluctant to pay for any long term of years the high rates necessary at present for loan capital. Investors, on the other hand, were seeking to obtain such yields for as long as possible – especially the large institutional buyers, which usually prefer to employ their funds at long term. The amount of cash actually raised on new issues between August and October was also very much smaller, as calls on earlier issues dwindled. Towards the end of October, however, there were signs of a revival in the new issue market, and the queue for both equity and debenture issues was lengthening as some companies took action in good time to meet the liquidity strains in the revenue quarter.

As a result of the quiet conditions in the markets, sales of units by unit trusts fell even further. Gross sales, which had already been roughly halved, to £63 million, in the second quarter, were reduced to £41 million between July and September. Although the amount of units repurchased also fell, net sales by the trusts were the lowest for two years. Sales remained low in October.

Conclusion

The changes in the parities of the French franc and the Deutschemark have substantially removed the uncertainty which has been hanging over the exchange markets. Sterling has benefited, but the recovery still has some way to go and will take time. If confidence is not again to be upset, as so often in the past, the balance of payments will have to be maintained in sufficiently large surplus to make satisfactory progress with the repayment of overseas debt and to provide the basis for sustained growth.

There has already been a strong and welcome recovery in the balance of payments so far this year, and the lessening of tension in the foreign exchange markets should itself bring benefit as distortions to trading, commercial and investment flows diminish. The recent parity changes should, on balance, also help the United Kingdom's trading position to some extent – the benefit to be derived from the revaluation of the Deutschemark outweighing the adverse consequences of the devaluation of the French franc. The percentage change for the Deutschemark was rather smaller than for the franc, and was partially offset by the withdrawal of the import rebate and tax on exports which had been operative in Western Germany since November 1968; but Western Germany is the larger trading partner of the United Kingdom, and the more important competitor in overseas markets.

The prospects of achieving substantial and continuing surpluses over the years to come will to some extent depend upon the rate of growth of world trade. The sharp increase in exports which has contributed to the surplus – together with particularly large earnings from commercial and financial services – has occurred when world trade has been expanding unusually rapidly and when domestic demand has been subject to severe restraint. So far this year, U.K. exports have kept pace with the expansion of world trade – a considerable achievement when set against the earlier decline in the United Kingdom's share of overseas markets. The growth in U.K. imports, on the other hand, has been modest. The problem will be to maintain the present balance between exports and imports even if the growth of world trade moderates and domestic demand grows at a more normal rate. This will only be achieved if U.K. companies can remain sufficiently competitive to secure export orders and to displace imports.

If, because of increases in wages and salaries or because of inadequate growth of productivity, industrial costs in this country were to rise more steeply than those abroad, this would be to the detriment of the balance of payments. It would tend to reverse the encouraging progress which has been made so far this year with the diversion of resources to the improvement of the trade balance. Industrial investment has at least equally important claims upon resources; and continuing reports of shortages of skilled manpower and productive capacity in some industries, and especially engineering, suggest that the scope for expansion of other forms of domestic demand – whether from the private or public sector – can only be modest.

The extension of the import deposit scheme has reduced the net repayments which would otherwise have been made, and so has effectively increased the liquidity pressures on companies shortly before the main tax payments to the Exchequer fall due in the first quarter of next year. But these pressures will be eased to the extent that the improvement in sentiment in the exchange markets encourages a further inflow of funds, including the unwinding of commercial 'leads and lags' – that is, the re-establishment of more normal timing relationships in payments for overseas transactions. And there have been recent signs that companies are returning, after an interval, to the capital market, which is now in a better position to accept new issues. The amounts raised have not yet reached any volume, but it remains to be seen whether this movement will develop before the revenue season reaches its peak next February.