Commentary

During the three months from November to January, with which this Commentary is mainly concerned, large receipts of funds from overseas benefited the exchange position and also helped to relieve domestic shortages of liquidity.

Foreign exchange markets

Sterling generally continued in heavy demand during these three months, as it had been in October. The atmosphere in the exchange markets was more relaxed following the revaluation of the Deutschemark; and sentiment improved with the growing evidence, confirmed in December, that the balance of payments had moved into substantial surplus during the summer. As a result, sterling benefited from withdrawals of funds from Western Germany after the change in parity, and from the reversal of positions previously taken up against the pound; there were probably also inflows to relieve liquidity pressures in the United Kingdom. Although the Exchange Equalisation Account took in large amounts of foreign exchange – which were used principally to repay outstanding debt – the exchange rate against the U.S. dollar moved above parity at the end of December and stood at \$2·40¼ at the end of January.

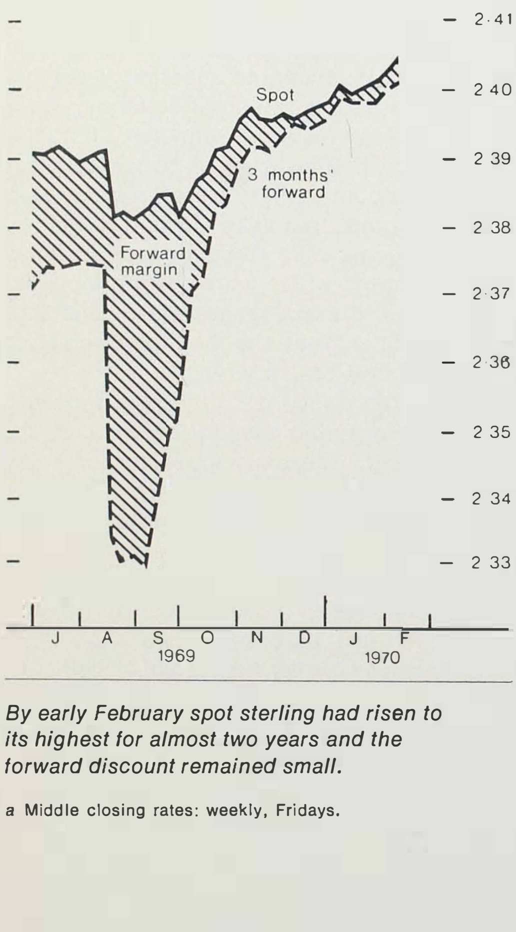
The improvement in sterling occurred despite a renewed shortage of dollars in November which became acute towards the end of the year. The shortage emerged even though the funds withdrawn in large amounts from Western Germany[1] were to a considerable extent repatriated to the United States or channelled into the euro-dollar market. U.S. banks borrowed euro-dollars heavily in November, following proposals by the Federal Reserve Board that the regulations limiting rates of interest paid by banks should be extended to include the rates paid by their holding companies and affiliates on issues of commercial paper.[2] Towards the end of the year, as at the end of 1968, the dollar shortage was accentuated when American corporations with overseas interests repatriated funds to meet the balance of payments guidelines set by the U.S. Administration. The usual end-year 'window-dressing' operations in Europe also resulted in a withdrawal of funds from the euro-dollar market, and the shortage would have been even more pronounced if dollars had not been channelled back into the market by some central banks.

Reflecting the dollar shortage, euro-dollar rates rose sharply in November and December. The rate for three months' deposits, already 10% per annum at the end of October, rose to over 11½% – the highest since June; and the cost of day-to-day money reached the equivalent of over 20% per annum shortly before the end of the year. Rates fell thereafter, when dealing for the New Year commenced, but the funds which had been withdrawn from the market were

1 In total these withdrawals contributed to a fall of some \$5,000 million in Western Germany's net official foreign exchange holdings in the fourth quarter.
2 The implementation of these proposals was later postponed.

$ to £

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



By early February spot sterling had risen to its highest for almost two years and the forward discount remained small.

a Middle closing rates: weekly, Fridays.

slow to return, and conditions remained tight until beyond the middle of January. There was, however, some easing later in that month, when the market judged that there were signs of a slight relaxation in U.S. monetary policy; the increase in the maximum interest rates which U.S. banks are allowed to pay on time deposits was generally interpreted in this way. The rate for three months' euro-dollar deposits had fallen to about $9\frac{5}{8}\%$ by the end of January.

The shortage of dollars in November and December brought considerable pressure to swap sterling into dollars, which tended to reduce the discount on forward sterling in terms of U.S. dollars. Margins had already narrowed very sharply because of the improvement in confidence in September and October, and the cost of three months' cover had fallen to about 1% expressed as an annual rate. A further fall in November and December, to a low point of about $\frac{1}{8}\%$ per annum, resulted mainly from the swap transactions to relieve the shortage of dollars; at times the one-month margin was at a small premium. As the demand for dollars eased later in January, the margin widened a little, to around $\frac{1}{2}\%$ per annum.

Gold markets

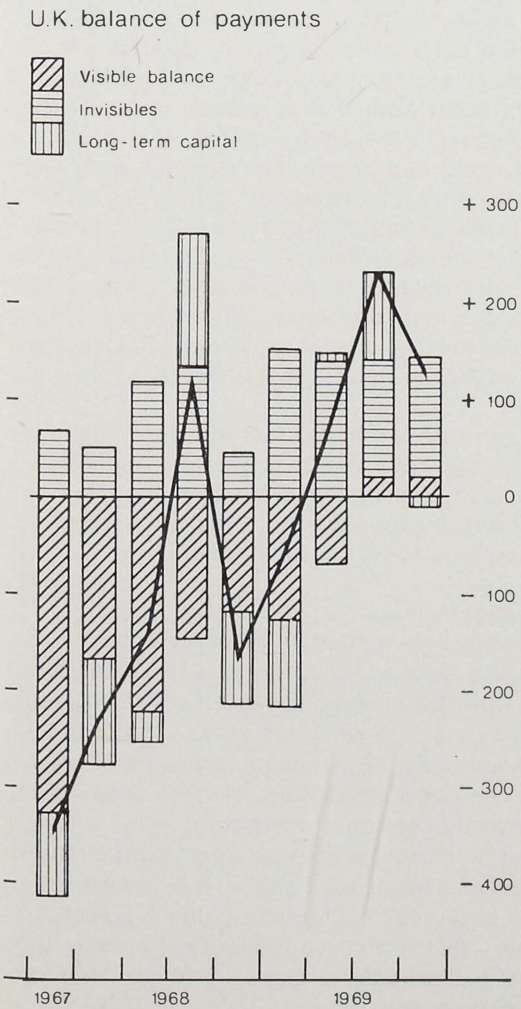
The gold price began to fall steeply during October and, by early December, the London fixing price had dropped from well over $40 per fine ounce to the official parity of $35. The fall occurred mainly because further large sales by producing countries coincided with a marked reduction in demand, and some disposal of stocks, following the relaxation of tension in the foreign exchange market. Other contributory factors included the continuation of very high international interest rates and the general shortage of credit, the decision to activate the Special Drawing Rights scheme, and the delay in reaching an agreement on the disposal of South African gold.

After steadying for a time, the price fell further in January, to $34·75. This was below the lowest point at which gold had previously been traded in London since the reopening of the market in 1954 ($34·84½ on 21st January 1957[1]). However, some demand re-emerged at these levels and the price moved back to around $35.

New arrangements for South African gold sales were announced by the International Monetary Fund at the end of December. Various circumstances have been defined in which South Africa may sell gold to the I.M.F. (sales will not ordinarily be made to other monetary authorities). First, newly-mined gold may be sold to the Fund when the market price falls to $35 or below and South Africa indicates that the sales are necessary to meet current foreign exchange needs. Secondly, sales may be made from South Africa's reserves, regardless of the market price, to the extent that the country has a foreign exchange requirement, over a six-monthly period, larger than can be met from the sale of all newly-mined gold in the market (or, if the market price is below the agreed minimum, to the Fund). Thirdly, South Africa may also make regular sales of up to $35 million a

1 In 1957, central banks were prepared to buy in the London market, but they have withdrawn from the market since March 1968.

Seasonally adjusted
latest quarter provisional £ millions



The balance of payments continued in surplus in the fourth quarter . . .

quarter from the stock of gold it held on 17th March 1968 – when the main central banks decided to withdraw from the gold market[1] – as reduced by subsequent sales to monetary authorities (including the I.M.F.). Finally, South Africa may sell gold to the Fund when designated to receive Special Drawing Rights in return for its currency, and will continue to convert into gold, on request, rand purchased from the Fund by other member countries. The arrangements thus put an effective floor of $35 (less the Fund's charge of $\frac{1}{4}$%) to the price South Africa receives for its gold, but not to the market price.

Balance of payments and monetary movements

Recently published estimates show that the balance of payments on current and long-term capital account remained in substantial surplus in the fourth quarter of last year. For the year as a whole, the surplus was in the region of £400 million – which is probably the largest since the War, and a striking improvement on the deficit of about the same amount incurred in 1968. In addition to the recorded surplus in the fourth quarter, the estimates include a large favourable balancing item. This no doubt reflects the unwinding of speculative positions and some other unrecorded inflows of short-term funds, but it probably also includes some inflows (for example over inter-company accounts) which, had they been identified, would have been recorded in the long-term capital account.

The current surplus in the fourth quarter was much the same, seasonally adjusted, as in the third quarter. Long-term capital transactions were in rough balance, in contrast to the substantial net receipts in the third quarter, when there were a number of special transactions. There was further large overseas investment in U.K. equities and also substantial net purchases of gilt-edged stocks.

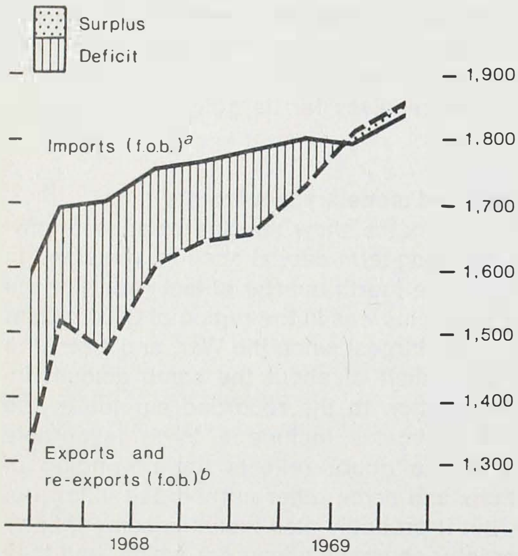
Visible trade remained in surplus, with exports and imports each rising by about 2% in value. Prices and volume contributed roughly equally to the growth in exports, but the rise in imports was mainly due to higher prices. Exports to North America fell sharply, but shipments to most other areas, and especially countries in Western Europe and the sterling area, grew quite strongly. There was a further encouraging increase in exports in January. Imports may have been held back to some extent before the announcement on 21st October that the import deposit scheme was to be extended for a further year, at a lower rate,[2] and the subsequent reaction may have affected the figures for December. But these fluctuations seem on balance to have had little effect over the quarter as a whole, and the higher figure for December was not maintained in January.

Although interest differentials were generally unfavourable, even before allowing for the cost of forward cover, there was quite a large recorded inflow of short-term funds in the fourth quarter. The sterling holdings of sterling area countries rose by approaching £100 million; and there was also an increase in non-sterling countries' holdings, leaving

1 See June 1968 *Bulletin*, pages 108-9.
2 See December 1969 *Bulletin*, page 385.

Seasonally adjusted
latest quarter provisional £ millions

Balance of U.K. visible trade



. . . with exports again higher than imports.

a Including payments for military aircraft and missiles purchased from the United States.
b Adjusted for distortions in recorded figures.

aside the counterpart of central bank swap operations. (These additions to sterling holdings were, however, accompanied by a further rise in U.K. sterling claims, especially on non-sterling countries.) On balance, there was comparatively little change in the banks' foreign currency positions with overseas residents. Deposits and lending rose roughly equally, and the increases were much smaller than earlier in the year. There were further quite large inflows in January, when the sterling holdings of sterling area countries continued to rise, mainly as a result of large receipts of oil revenue in sterling.

It was announced early in December that, after discussions with the Bank, London silver dealers had agreed to reduce stocks of silver financed in sterling to levels held at the end of 1968. The reduction is to be achieved over six months. U.K. banks and other institutions concerned with the financing of silver stocks were asked to support the arrangements made with the silver dealers. These arrangements became necessary because dealers had built up stocks to meet a growing volume of forward purchases by overseas clients last year, when the large discount on forward sterling made such purchases attractive. Although this business would benefit the balance of payments in the long run, with the silver eventually being sold abroad and dealers earning a profit from their overseas clients, it had serious disadvantages in the shorter term. The additional stocks were purchased at a cost to the reserves and, when brought into this country, increased the import figures. The new arrangements will benefit the reserves to the extent that dealers either arrange euro-dollar financing of stocks or reduce them by sales abroad as their forward commitments decline. Silver imports should also be reduced in the coming months. They were, indeed, significantly lower in December and January, when stocks held in the United Kingdom also began to fall.

As from 2nd January, exchange control restrictions on foreign currency expenditure for travel in non-sterling countries were effectively abolished, though there are still procedures to ensure that amounts drawn for this purpose are not used to acquire capital assets abroad.

Reserves and special facilities

The gold and convertible currency reserves rose by £39 million in the fourth quarter, to stand at £1,053 million at the end of the year. The increase occurred after very substantial debt payments. The end-year service on long-term North American loans cost £110 million; and £31 million was repaid to the Bank for International Settlements, as the second quarterly instalment on drawings under the arrangements announced in June 1966 to counter fluctuations in the sterling balances. There was also a net repayment of £10 million to the I.M.F.: £83 million was paid in November – ahead of schedule – as the sixth repayment on the May 1965 drawing, but £73 million was drawn in December on the stand-by credit arranged last June.

Taken together, these payments totalled about £150 million. Very much larger amounts were also repaid on central bank and other special facilities during the quarter. For example, £187 million ($450 million) was repaid on the Federal Reserve swap arrangement, which reduced the total outstanding on this facility to £271 million ($650 million).

At the beginning of January, the United Kingdom's initial allocation of I.M.F. Special Drawing Rights was taken into the reserves. The allocation was equivalent to £171 million. There were further repayments on central bank facilities far in excess of this amount, but the reserves nevertheless rose again, by £21 million, in that month.

Domestic economy

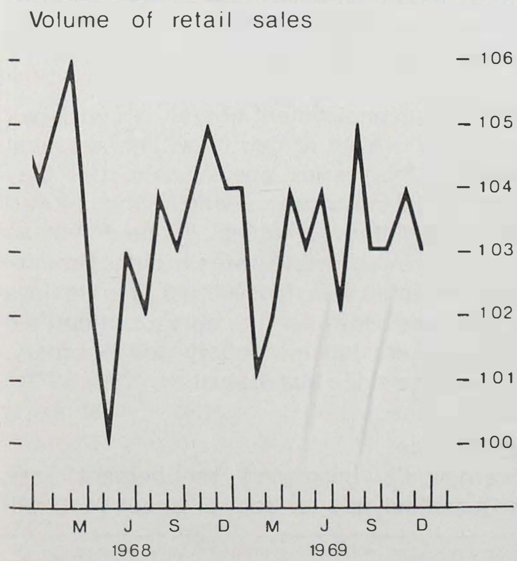
There seems to have been a modest increase in activity in the third quarter, after a pause in the first half of the year. Allowing for seasonal factors, the volume of exports and private industry's fixed investment both grew strongly, and consumers' expenditure increased a little. But these increases were accompanied by a running down of stocks and work in progress – especially manufacturers' stocks, which were already unusually low in relation to output. The fall was probably the result of industrial disputes, liquidity shortages, and expectations that the import deposit scheme would not be renewed beyond December.[1]

The indications are that most components of demand continued to rise, though only slowly, in the fourth quarter. Consumers may have spent more but, to judge from the volume of retail sales, the increase was very small; reports from retailers suggest that business was still fairly slack early in the New Year, although it may have picked up a little since then. Changes in the amount of hire purchase debt outstanding provide another indication of the course of consumers' expenditure. Debt rose in the fourth quarter, after it had fallen throughout the earlier part of the year; but again the rise was only small. Moreover, there was a fall in purchases of new cars; the number of registrations was lower in the fourth quarter than in the third, and remained low in January. Such modest growth as there may have been in consumer spending occurred against a background of vigorously rising earnings. Average earnings rose by $3\frac{1}{4}$% (seasonally adjusted) in the fourth quarter; the increase in retail prices, allowing for seasonal movements, was probably very much smaller, so that the growth in real earnings almost certainly accelerated. With substantial wage settlements for agricultural and construction workers taking effect in February, earnings probably continued to rise strongly in the opening months of this year – and a number of other large claims have yet to be settled. In these circumstances, the recent subdued behaviour of consumption is not likely to continue for very long.

Among the other elements of demand, the growth of exports slackened temporarily towards the end of last year but there was a further increase in January. As the engineering industry still has large overseas orders to fulfil, it seems likely that the trend of shipments will continue to rise. Industrial fixed investment probably increased again in the fourth quarter, to judge from a further rise in home deliveries

1 As noted earlier, the Government in fact took powers to continue the scheme for a further twelve months at a lower rate.

Seasonally adjusted — Average 1966=100



The volume of retail sales was little higher than in the third quarter . . .

Seasonally adjusted
latest month provisional Thousands

. . . and there was a fall in the number of new cars registered.

by the engineering industry. A survey taken by the Ministry of Technology in November and December suggested that manufacturers' investment intentions remained buoyant. Investment was expected to increase by some 7½% this year, following an estimated rise of about 11½% in 1969.[1] These would be encouraging rates of expansion, after three years (1966-68) during which the growth of manufacturing investment was very restrained. However, the Confederation of British Industry interpret a survey of industrial trends which they took at the end of January as suggesting that the growth of investment will slacken by the end of 1970. For the first time since mid-1967, they find that, on balance, both large and small companies are now expecting to authorise less investment expenditure during the next twelve months. Little is yet known about movements in stocks after the reduction in the third quarter, but to the extent that strikes and uncertainty about the renewal of the import deposit scheme influenced that reduction, some upturn in the fourth quarter would not seem implausible.

Investment in new housing has been falling since the middle of 1968 and, to judge from the amount of work started in the latter part of last year, the prospects for the coming months are not very encouraging. Investment by private developers has been falling fairly consistently, and may partly reflect an increasing shortage of credit. Development in the public sector recovered in the latter part of last year, having been low in the first half; but a fall in the amount of work started in the fourth quarter suggests that the improvement may not be maintained.

Taken together, these indications of demand suggest that, unless there was a marked revival of stockbuilding, any rise in output in the fourth quarter of last year can have been only modest. The index of industrial production rose only fractionally in the fourth quarter (though this has been a rather uncertain indicator recently). An upturn in November was probably no more than a rebound from a fall in October, when production was hampered by strikes in the car, steel and coal industries; and there was virtually no further change in December.

The movement in the unemployment figures is consistent with a fairly slow rate of growth at this time. The seasonal adjustments applied to this series are suspect, but they suggest a fall of 24,000 in the numbers wholly unemployed between November and February, which is about half as large as the reduction in the previous three months. In mid-February, the adjusted total was 512,000, or a little less than 2¼% of all employees. However, the number of notified vacancies for adult workers fell in January and February, following a steady increase since last August.

Central government finance

The central government's borrowing requirement rose seasonally in the December quarter and, at about £480 mil-

1 These rates of increase have been adjusted to make rough allowance for the distortions to investment outlays at the end of 1968 and the beginning of 1969, when some expenditure was brought forward into 1968 to qualify for the higher investment grants ruling until the end of that year. The unadjusted increase suggested by the survey was about 10% in 1970; on the same basis, the rise in 1969 is estimated to have been in the region of 7%.

lion, was rather larger than at the same time a year earlier. The increase compared with the previous year is more than explained by import deposits, which brought in about £80 million in the earlier period but called for small net repayments in the December quarter. Otherwise, revenue increased more than expenditure between the two periods. Lending rose to about £500 million which, though virtually the same as at the end of 1968, was much higher than in any of the intervening quarters; the nationalised industries and local authorities both took more than earlier in the year.[1]

External transactions also needed a great deal of sterling finance in the December quarter – indeed, almost as much as the borrowing requirement – because of the very large foreign exchange receipts. In total, therefore, domestic borrowing was extremely heavy, at rather over £900 million. So far as can be judged, holders outside the banking sector provided about £350 million, leaving the banks to take up some £550 million of government debt. These amounts can only be taken as broad orders of magnitude, however, because comprehensive figures are not available for some of the banks at the end of December.[2]

There was again a very heavy demand for gilt-edged stocks from investors outside the banking sector. As before, some purchases of stocks may have been at the expense of the various national savings media, holdings of which fell by nearly £100 million; only part of this large fall is likely to have been seasonal. As is usual in the Christmas period, there was a sharp increase in notes and coin with the public.

Taken as a group, the banks and discount houses also increased their holdings of gilt-edged stocks – the first quarter in which they did so for over a year. Their holding of notes and coin rose seasonally, and they also took up a large amount of Treasury bills.

Banks and discount houses

Although the liquidity generated by the financing of the seasonal Exchequer deficit and the large inflows of funds from abroad was partly absorbed by the heavy official sales of gilt-edged stocks to investors outside the banking sector, there was nevertheless a significant easing of the pressures on the banks in the last quarter of 1969. Deposits rose, liquidity improved, and the demand for advances moderated.

Between mid-October and mid-December, advances by the *London clearing banks*, other than to the nationalised industries, fell by about £90 million after seasonal adjustment. Local authorities reduced their borrowing quite a lot, but there was also a fall of some $2\frac{1}{2}$% in the banks' restricted lending. It seems probable that companies benefited from the inflow from abroad, and so needed less bank finance.

Despite the fall in advances, net deposits in these two months rose by some £120 million, seasonally adjusted, largely because of the foreign exchange inflow. Reflecting the Exchequer's need for a substantial amount of funds, the

1 This comparison excludes drawings of £215 million by the electricity industry in the September quarter to redeem government-guaranteed stocks. For the reasons explained in the December *Bulletin* (page 393) these drawings did not affect the borrowing requirement.

2 See page 67.

clearing banks' holdings of Treasury bills rose by £240 million. They also lent nearly £70 million of call money to the discount market, but other borrowers at call from the banks repaid about £40 million. There were further reductions totalling about £20 million in holdings of gilt-edged stocks in the month to mid-November, but little change in the following month. The combined liquidity ratio rose by more than two percentage points, to a little over 32% in mid-December, which was somewhat higher than at the same time a year earlier.

Only partial figures are at present available of the clearing banks' liabilities and assets at more recent dates, because of accounting changes connected with the disclosure, in February, of their profits.[1] These changes will not have been carried through fully until later in March. One effect is to reduce the total of gross deposits at all dates after the mid-December make-up day; the coverage of liquid assets is not affected so that, other things being equal, the changes tend to increase the banks' liquidity ratios (the ratio of liquid assets to gross deposits).

In the month to mid-January, there was a further rise of some £90 million, seasonally adjusted, in the clearing banks' net deposits. Their advances other than to nationalised industries rose somewhat more than the seasonal expectation and, after allowing for the change in exempt advances, including some renewed borrowing by local authorities, the banks' restricted lending rose by rather less than 1%, partly offsetting the fall in November and December. The liquidity ratio rose by another percentage point, to rather over 33%, but this owed something to the accounting changes.

As the revenue season reached its height, the banks' net deposits fell by £35 million, seasonally adjusted, in the month to mid-February. A rise in advances other than to the nationalised industries was only a little larger than was to be expected seasonally and, taking advances and commercial bills together, restricted lending was slightly higher. The liquidity ratio fell by about three percentage points, to 30·5%, but this was nearly 1% above what it has often been at this time of the year.

In the December calendar quarter, there was another rise in the sterling deposits taken from outside the banking sector by the *accepting houses, overseas and other banks*. Overseas residents increased their holdings as sentiment improved, and the amount of sterling certificates of deposit outstanding continued to rise quite quickly. These movements outweighed a fall in domestic deposits – the first for nearly three years.

Restricted lending was a little higher but, in aggregate, these banks remained well below their ceiling. In contrast, lending to local authorities increased by over £100 million, more than reversing the fall in the previous quarter when local authorities had found it cheaper to meet their short-term requirements from the clearing banks. The inter-bank market remained very active.

The increase in deposits in the December quarter enabled the various groups of banks to increase their lending to the

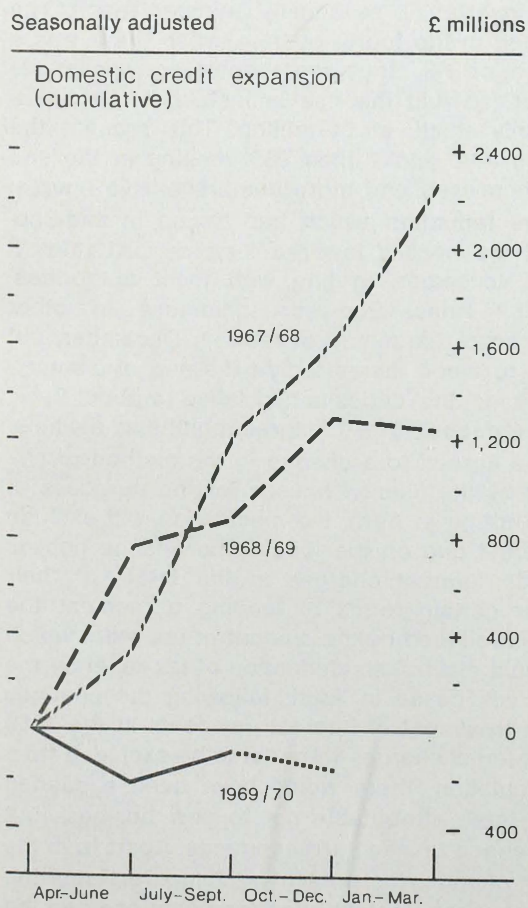
1 See page 67.

discount market by more than £400 million. The houses were able to rebuild their holdings of Treasury bills by nearly £190 million, although holdings at the end of the year were still unusually low. They also bought nearly £110 million of gilt-edged, and commercial bill holdings rose by over £60 million.

Domestic credit expansion and money supply
Domestic credit is estimated to have expanded by some £375 million in the December quarter. This was, however, smaller than the increase to be expected from the seasonal growth of the public sector's borrowing requirement so that, seasonally adjusted, credit contracted by about £70 million. Bank lending to the public sector rose sharply, because of the seasonally large borrowing requirement and the need to finance the foreign exchange inflow. The expansionary effects were, however, partly offset by the large official sales of gilt-edged stocks to investors outside the banking sector. Bank lending to the private sector apparently rose only a little over the quarter. These movements bring the rise in D.C.E. over the first nine months of the financial year to some £425 million which, seasonally adjusted, represents a contraction of about £170 million.

As explained above, the seasonally adjusted fall in domestic credit in the December quarter was in large part due to the very heavy sales of gilt-edged stocks by the authorities during recent months. The continued strength of the market was, in turn, largely due to the improvement of confidence in sterling, and the encouraging performance of the balance of payments. Similarly part of the reduction in the clearing banks' seasonally adjusted advances between mid-October and mid-December was probably attributable to the inflow of funds from abroad. An improvement in the balance of payments can thus induce a contraction in domestic credit, just as changes in domestic monetary conditions can affect the balance of payments.

There was an increase in money supply in the December quarter – in the region of £570 million, or £210 million after seasonal adjustment – reflecting the inflow from abroad (which tends to increase the money supply, but is offset in the measurement of domestic credit expansion and thus does not directly affect that total[1]). The seasonally adjusted increase in the money supply over the first nine months of the financial year was of the order of £250 million; unadjusted, the rise was about £800 million.



There was a further contraction in domestic credit during the third quarter of the financial year.

Bill markets
Conditions were generally easier in the money market during the three months November to January. This was partly because of the large inflow of funds from abroad, but also because the amount of Treasury bills offered at the weekly tenders was kept very small by the standards of past years. The authorities preferred to absorb surpluses by selling bills to mature at dates of their own choosing during the revenue quarter. Occasional shortages nevertheless developed as the result, for example, of flows of revenue to the Exchequer or large official sales of gilt-edged stocks.

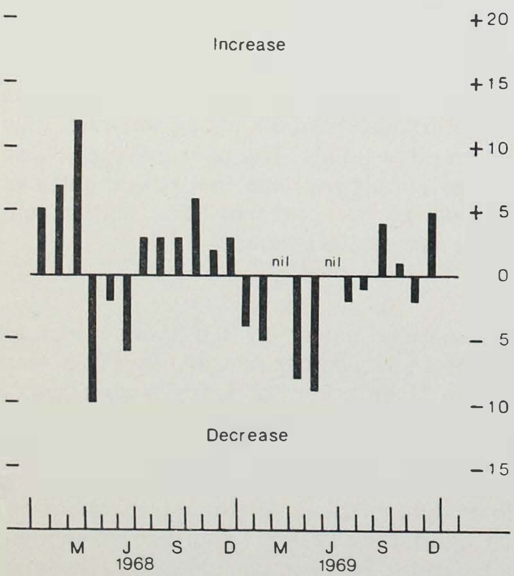
1 See the article on domestic credit expansion in the September 1969 *Bulletin*.

In the main, the Bank relieved such shortages by purchasing Treasury bills, but there was also some lending at market rates. During January, as conditions became tighter with the onset of the main Exchequer revenue season, help was also given by purchases of corporation and commercial bills.

The average cost of the discount houses' borrowed funds seems to have fluctuated narrowly over the period and, at $7\frac{11}{16}$% at the end of January, was probably a little higher than at the end of October. Encouraged by the improvement in sterling and, after mid-December, by growing expectations of a reduction in short-term interest rates, the houses raised their bids for Treasury bills throughout most of the period, bringing their tender rate down from $7\frac{3}{4}$% at the end of October, to just over $7\frac{1}{2}$% at the end of January. Although outside competition was strong, the houses were moderately successful in their attempts to obtain a reasonable proportion of the available bills for most of the period. But they were outbid at the last tender in January, and received very few bills in the following weeks.

Seasonally adjusted £ millions

Changes in hire purchase debt outstanding to finance houses



There was a small net increase in hire purchase debt in the fourth quarter.

Hire purchase finance houses

New credit extended by the finance houses had begun to rise in the third quarter, in seasonally adjusted terms. The increase continued in the fourth quarter, when there was a rise of £14 million, or 8%. Once again, however, repayments were also higher, so that the rise in instalment debt outstanding was only small, at £4 million. This brought the finance houses a little above their 98% ceiling at the end of December, on revised and more comprehensive figures.

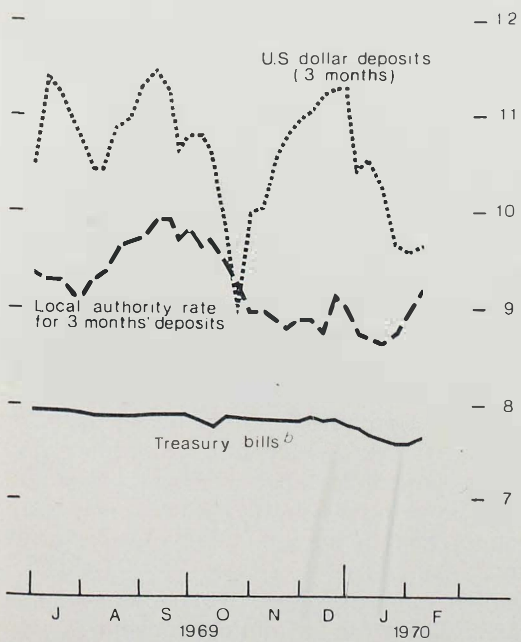
Continuing the reduction which had begun in mid-September, most of the houses lowered their deposit rates a little further in November, in line with local authorities' temporary money rates. End-year influences in other markets caused some hardening of rates in December, but the decline was resumed thereafter. At the end of January, the rate for three months' deposits had fallen to about $9\frac{1}{4}$%, to show a small reduction over the three months as a whole.

The Bank have agreed to a change in the method of calculating lending by the finance houses for the purposes of credit control. Starting in April, the calculation will exclude charges for interest due on the loans. The finance houses ordinarily include interest charges in the totals of their lending; and for certain forms of lending agreement the interest charge is reduced by the amount of tax relief which the borrower could claim. This deduction of tax relief by the finance houses will cease in April, following the changes made in the tax treatment of interest payments in the 1969 Finance Act. If interest charges were not to be excluded from the lending calculation, there would have been a sudden increase in the total, attributable not to new business but simply to the changed taxation arrangements. Apart from the effect of the tax change, the present system overstates the amount of lending when interest rates are rising or when the terms of finance house business are lengthening.

In order that finance houses should cease to be at a disadvantage compared with independent leasing companies, the Bank had earlier agreed that the houses might transfer their leasing business to separate subsidiaries. A subsidiary's borrowing from banks and other financial institutions would, of course, be subject to the restrictions applied to those institutions; and its short-term borrowing from the parent company would count against the parent's lending ceiling. However, it is expected that these subsidiaries will be financed mainly by medium and long-term borrowing. The size of a parent company's subscription to such capital will be strictly limited, but the subscription will not be set against the parent's ceiling as restricted lending. A number of finance houses have so far set up such subsidiaries. The banks are allowed to make similar arrangements.

Per cent per annum

Short-term interest rates in London[a]



Market rates, which had risen at the end of 1969, were easier in the New Year, but then turned upwards at the end of January.

a Weekly, Fridays.
b Average yield on 'hot' bills.

Local authorities

Longer-term borrowing by local authorities in the three months to January 1970 continued at the high level of the previous three months. They drew slightly less from the Public Works Loan Board but raised more on market mortgages. P.W.L.B. rates were changed on several occasions and, after three alterations in January, were a little lower than three months earlier, ranging between 9% and $9\frac{1}{4}\%$. Rates on market mortgages eased further and, at the end of January, were around $9\frac{1}{8}\%$.

The amount raised on stock issued by local authorities between November and January – £32 million, including calls on earlier issues – was substantially more than in the previous three months. New bond issues, however, remained small, and raised only slightly more than maturities. The yield on one-year bonds had fallen to 9% by the end of January.

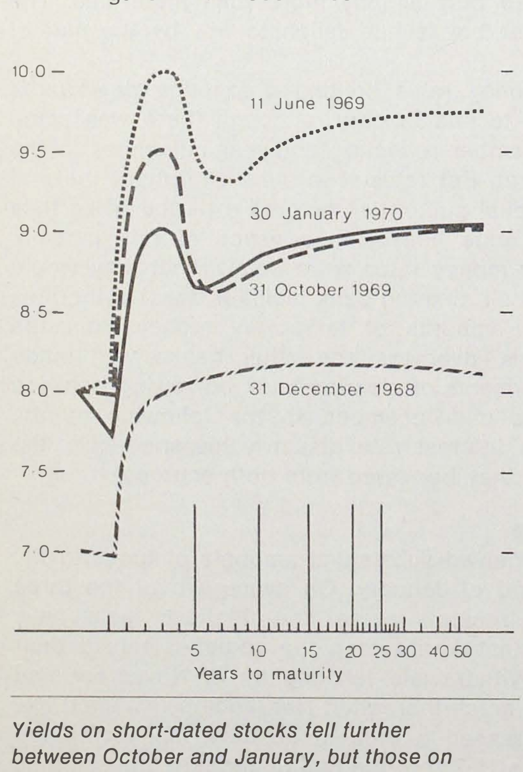
Temporary money rates continued to edge downwards over the period to mid-January, although there was some increase in December reflecting end-year influences in the euro-dollar market. But rates rose quite sharply at the end of January, as local authorities entered a period when they usually borrow quite heavily in advance of rate income. While temporary money rates were below what they would have to pay on their clearing bank facilities, local authorities borrowed large amounts of temporary money from the accepting houses, overseas and other banks, and made substantial repayments of clearing bank borrowing between mid-October and mid-December. In the following month, however, as the interest rate disparity lessened over the turn of the year, they borrowed from both sources.

Building societies

The societies received substantial amounts of funds in the period to the end of January. On average over the three months, gross receipts were the highest, seasonally adjusted, since last April, when the societies raised their interest rates. Withdrawals fell slightly in November and did not increase much thereafter. Net lending remained low at first, but increased a little in January. The combined liquidity ratio was 15·7% at the end of January, the same as it had been three months earlier. New lending commitments rose steadily; and outstanding commitments were also higher over the three months as a whole.

Per cent per annum

Time / yield curves of British government securities[a]



Yields on short-dated stocks fell further between October and January, but those on longer-dated stocks changed little.

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

Gilt-edged

The gilt-edged market was generally very firm between November and January. There were short periods of weakness, especially in the latter part of November, when rising interest rates abroad and large wage settlements at home caused some selling. At other times, however, the market was reassured by the continuing evidence of a substantial recovery in the external position, and there was persistent buying of most maturities. On balance over the period, short yields fell by about ½%. Medium and long yields, however, were barely changed, the generally heavy demand having been met by sales by the authorities.

Official sales were exceptionally large during the December calendar quarter, totalling some £430 million; about half these sales occurred in October. The authorities bought about £200 million of the 1970 maturities, but sold about £320 million of other short-dated issues, and £300 million of medium and long-dated stocks.[1] An analysis of the stock registers indicates that private funds and trusts continued to be active buyers of both short and long maturities during the quarter, as they have been since gilt-edged stocks were exempted from long-term capital gains tax last April.

On 30th December it was announced that there would be no conversion offer for 6% Exchequer Stock 1970, which matured on 1st March, and that a further £200 million of 6¾% Exchequer Loan 1971 was to be issued on 5th January to replenish official holdings of short-dated stocks; the issue price was £96 : 6 : 3 per £100 nominal, to yield nearly 9 3/16% to redemption. An additional tranche of this particular stock was chosen for two main reasons. First, most of the next maturing stock had been refinanced through official dealings in the market and, with a large surplus expected to accrue to the central government in the early months of the year, no substantial new issue was necessary. Secondly, the authorities had in mind the issue of a new medium-dated stock later in January (see below).

The smallness of the Exchequer Loan issue, however, and its very short life, led the market to assume that a reduction in interest rates was imminent. At the turn of the year, buying of long-dated stocks became very heavy for a few days, to obtain the high yields for as long as possible while they were still available. The effective abolition of the travel restrictions, announced at the beginning of January, was another cheering feature at this time. Later in the month, the news that the Federal Reserve Board had increased the maximum interest rates which U.S. banks can pay on time deposits was well received, in the expectation that this measure would reduce the pressure on euro-dollar rates. Official sales were again large in January, and the market remained very firm at the end of that month.

On 23rd January, it was announced that holders of 3% Savings Bonds 1960/70 would be offered conversion into a new stock – 8½% Treasury Loan 1980/82 – on 1st March, and that £600 million of this stock woud be offered for cash on 28th January. The cash issue was at a price of £96 : 5 : – to yield fractionally over 9%, and was intended to provide a

1 See Table 3(1) of the annex.

medium-dated tap stock for official dealings. The amount of Savings Bonds outstanding was substantial (£1,018 million), and the stock was very widely held. It was therefore judged best that the conversion offer should be made well in advance of the final maturity date. The offer closed on 16th February. By that date, acceptances had been received by the Bank of England and the Bank of Ireland, Belfast, in respect of some 45,000 to 50,000 accounts – about one third of the number on their registers – to a nominal total (including certain official holdings) of some £250 million. In addition, holders of about £9 million of stock on the National Savings stock register, representing some 15,000 accounts, accepted the conversion offer.

Company securities

The resumed fall in equity prices at the end of October and early in November took the F.T.-Actuaries industrial share price index down to 140·5. Prices recovered somewhat over the next three months, however, and by the end of January the index stood at 158·0. This was still 18% below the peak reached twelve months previously, and prices fell in February.

The partial recovery between November and January was assisted by the return of many institutional investors to the market, as confidence in the United Kingdom's external position strengthened. There were hopes that the improved outlook might lead to some relaxation of the Government's restrictive policies. On the other hand, developments on the New York stock market were a depressing factor.

The announcement early in November that the $3\frac{1}{2}\%$ ceiling on dividend increases would lapse when the reserve statutory powers in the 1968 Prices and Incomes Act expired at the end of December was well received. In a White Paper on "Productivity, Prices and Incomes Policy after 1969",[1] published in December, the Government called for continued moderation in distributions to shareholders.

Yields on company debentures and loan stocks were not greatly changed on balance over the period; they rose a little in the latter part of November, along with gilt-edged yields, but fell thereafter. Yields obtainable on first-class high-coupon company debentures of about twenty-five years' maturity stood at about $9\frac{7}{8}\%$ at the end of January. The margin over gilt-edged yields of similar maturity was less than $\frac{3}{4}\%$ – much the same as three months earlier.

Companies raised rather more cash on new issues of both equities and fixed interest stocks than in the preceding months, perhaps partly because some of them were taking steps to overcome difficulties expected in the revenue quarter. But there was only a small rise in new issues announced during the period, and the queue of new borrowers shortened.

Sales of units by unit trusts remained low in the fourth quarter. Their gross sales totalled £40 million, much as in the preceding three months. As there was some increase in the amount of units repurchased, net sales fell even further.

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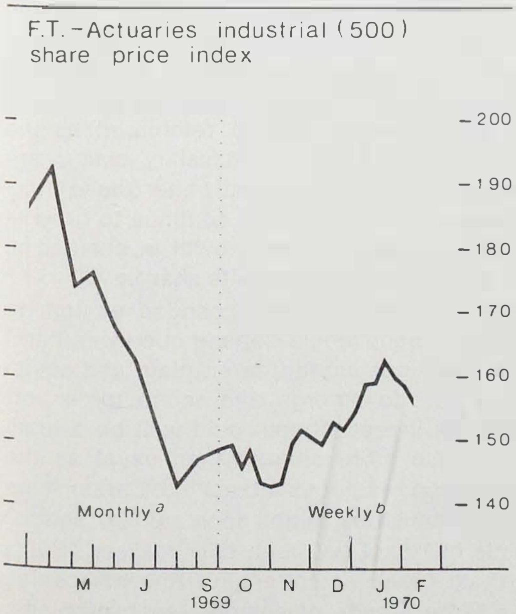

The index showed some recovery at the turn of the year, but this was checked at the end of January.

a Last working day.
b Fridays.

1 Cmnd.4237.

A small recovery in gross sales in January was accompanied by some further rise in repurchases, so that net sales were again very low.

Conclusion

The large movement of funds into sterling in recent months occurred when most international interest rate comparisons were unfavourable to the United Kingdom, even before counting the cost of forward cover. The inflow was undoubtedly encouraged by the present strength of the balance of payments. But the reasons for it and the forms it took must be conjectural at the moment, because the larger part of the movement has yet to be identified. Positions which may previously have been taken against the pound by varying the timing of commercial payments for overseas transactions are likely to have been reversed as sentiment improved; such positions were expensive to maintain, especially as liquidity pressures in the United Kingdom grew. Indeed the shortage of liquidity may more recently have encouraged variations in the opposite direction – some U.K. importers may have tended to delay payments to overseas suppliers, and exporters may have pressed to receive prompt payment. Liquidity pressures may also have attracted some inflows of inter-company funds, as yet unrecorded. It is too early yet to gauge the pressures on companies at the height of the revenue season, but it is probable that the various inflows from overseas have contributed to making the pressures less severe than at one time seemed likely. There could be some outward movement of funds if the credit shortage eased.

The transformation in the balance of payments last year owed much to an unusually sharp growth in world trade and a rather modest expansion of domestic demand. Consumer spending still seems to be fairly restrained. But average earnings were rising noticeably faster than prices at the end of last year, and this tendency will be reinforced as the large number of more recent wage and salary claims are settled. If consumption begins to expand under these influences, and exports and fixed investment continue to grow at an adequate rate, the seemingly slow growth in demand at the moment might begin to accelerate quite sharply.

Whether domestic output could be expanded enough to satisfy this increased demand would depend upon whether it were hampered by shortages of manpower, plant and equipment. If such shortages do emerge, the scope for import saving will be reduced; indeed, there could well be a tendency for imports to rise more sharply than usual as the pressure of demand upon resources intensified. Earlier fears that the engineering industries might soon run up against capacity constraints have not yet been fully realised. But it still seems likely that, if mechanical engineering companies were faced with a large growth of demand, such problems might quite quickly emerge.

If imports increased as a result, this would not necessarily jeopardise the external surplus, unless the growth of imports outstripped the increase in exports and other external receipts. Exports are likely to rise less this year than last, because of a smaller expansion of world trade; and the unusual receipts of long-term capital in recent months cannot be counted upon to continue. The margin for an expansion of imports, and therefore of spending at home, is thus likely to be limited.