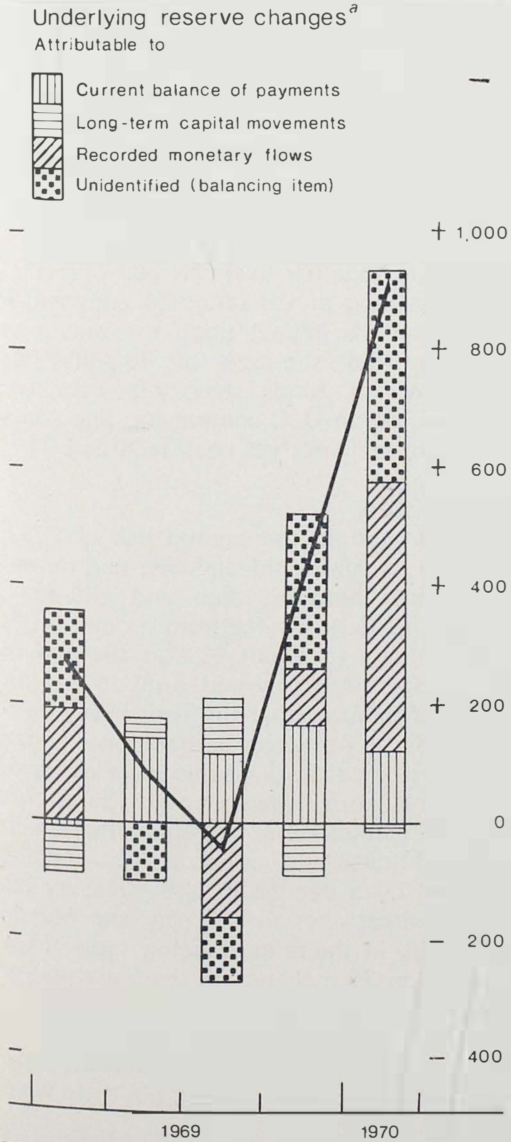
Commentary

This Commentary is mainly concerned with the three months February to April. Very heavy tax payments and continued official sales of gilt-edged stocks caused exceptional monetary pressures during the first half of this period; but the pressures were eased by unprecedentedly large inflows of funds from abroad. Short-term interest rates in international markets, which had been very high throughout the second half of last year, moved downwards until mid-April, when they started to rise again. In the United Kingdom, Bank rate was twice reduced by ½%, to 7%. Meanwhile, the prospective impact of large wage and salary increases upon industrial costs and prices caused increasing concern, and contributed to a sharp fall in the prices of both fixed interest stocks and equities in the second half of April; but sterling remained steady at that time.

Not seasonally adjusted
latest quarter provisional £ millions



Since last October there have been very large accruals of foreign exchange to the reserves.

[a] Changes in the official reserves before drawings on, or repayments of, support facilities.

Inflows of funds

As measured by accruals of foreign exchange to the reserves, the net receipt of funds from abroad totalled about £900 million during the first quarter of the year. There were further, though more modest, receipts in April.

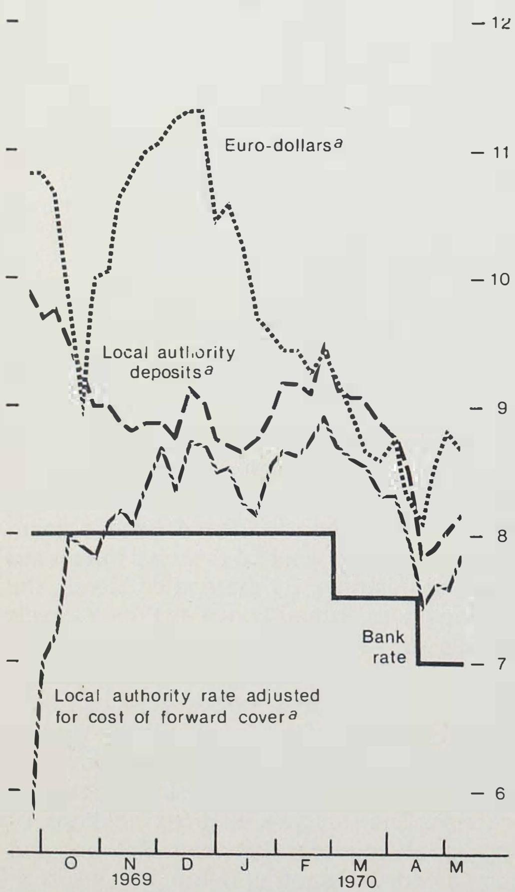
The inflow during the first quarter brought the total over the six months since the beginning of October, when sterling began to come into heavy demand, to some £1,350 million. About £200 million of this total can be attributed to the balance of payments surplus on current and long-term capital account, and over £500 million to changes in sterling holdings and other monetary balances. The forms in which the remainder of the inflow occurred have yet to be identified, so that there was a very large favourable balancing item of over £600 million in the balance of payments accounts.

Among the changes in monetary balances, sterling area countries increased their sterling holdings by nearly £300 million during these six months, mainly in the March quarter; a number of these countries have been earning large balance of payments surpluses, and seasonal influences tend to be favourable at this time. By the end of March, the total of these holdings was rather above the high levels reached in the middle of 1966. There was also some rebuilding of non-sterling countries' holdings which, leaving aside the counterpart of central bank swaps, rose by about £140 million, from an unusually low level. By the end of March these holdings had been built up to rather above the total at the end of 1968, but were still low in comparison with most earlier dates. The increase in gross holdings of sterling by this group of countries between October and March was accompanied by another large rise in U.K. sterling claims on them, mainly in the form of export credit.

In addition to these movements in the sterling balances, there were also changes in the banks' foreign currency positions. Following a reduction in euro-dollar rates since the beginning of the year and an increase, at times, in

Per cent per annum

Short-term interest rates in London



By mid-April, short-term rates had fallen well below the high levels in the second half of last year; but they rose in the second half of that month.

a Rate on 3 months' deposits; weekly, Fridays.

comparable sterling interest rates, some banks in the United Kingdom converted into sterling part of the foreign currency assets they held against their foreign currency liabilities. As a result, the banks as a group changed from having net claims in foreign currency at the end of 1969 to small net liabilities at the end of March – *i.e.* from being 'switched-out' of sterling to being 'switched-in'.

There are probably two main explanations for the large unrecorded inflows between October and March: pressures on liquidity in the United Kingdom, and an improvement in confidence, both in sterling and in the stability of other major exchange rates. Earlier in 1969, the timing of some settlements between U.K. and overseas traders probably still reflected fears of further parity alterations; for example, payment for some U.K. imports may have been hastened, and payment for exports delayed. As sentiment improved, there is likely to have been a return to more normal timing arrangements. Indeed the movement may well have gone beyond a return to customary patterns of settlement: to ease their liquidity difficulties, some U.K. companies have probably delayed payment for their imports in recent months, or required prompter than usual payment for exports. Even alterations of only a few days in the timing of payments can involve very large sums; settlements for U.K. imports and exports together average well over £50 million a day, to say nothing of the range of commercial services. Quite apart from its impact upon the timing of commercial settlements, the shortage of liquidity has also encouraged inflows of funds over intra-company accounts, to ease pressures on U.K. companies; and some of these inflows have probably not yet been recorded.

Short-term interest rates

After remaining high throughout the second half of 1969, euro-dollar rates started to fall in mid-January, and moved fairly steadily downwards between then and mid-April. The rate for three months' deposits fell from around $10\frac{1}{2}$% per annum early in January to about $9\frac{5}{8}$% at the end of that month. and then to about 8% by mid-April. It was not until after the middle of January that the very heavy end-year repatriation of funds by American corporations[1] began to be reversed. Later, as domestic pressures were reduced, U.S. banks began to repay euro-dollar borrowing from their overseas branches. The market came to believe that credit conditions in the United States were at last easing – a belief which was encouraged by a decline in U.S. Treasury bill and other short-term market rates in February and March, and by a reduction of $\frac{1}{2}$% in the prime lending rates of the major New York banks on 25th March. In the latter part of April, however, euro-dollar rates responded quickly when U.S. short-term rates began to rise again. By the end of that month, three months' deposits had risen to nearly $8\frac{3}{4}$%. The rise was checked in the first half of May, but there were then further increases.

The fall in euro-dollar rates up to mid-April was not at first accompanied by a reduction in U.K. interest rates.

1 See March 1970 *Bulletin*, page 3.

Indeed, local authority deposit rates rose very sharply towards the end of February and early in March – the three months' rate from 9% to 10% – reflecting withdrawals of company funds as tax payments were made, and seasonally heavy borrowing by local authorities in advance of the usual increase in their revenue in the second quarter. This brought the return on local authority deposits substantially above that obtainable on euro-dollars; and even including the cost of forward cover, the earlier margin in favour of euro-dollar deposits sometimes disappeared.

In these circumstances, it was decided to lower Bank rate by ½%, to 7½%, on 5th March. The authorities had no wish to see a large inflow of interest-sensitive funds; and a modest reduction in Bank rate was not felt to be inconsistent with the maintenance of monetary restraint. The likelihood of an excessive inflow was further reduced when the West German and Italian discount rates were raised by 1½% on the following day.

The reduction in Bank rate was immediately followed by a fall in local authority rates. Although these generally remained somewhat above euro-dollar rates, the comparison favoured euro-dollars when the cost of forward cover was included. With euro-dollar rates continuing to decline, however, a small covered margin in favour of local authority deposits occasionally emerged around the middle of March. In view of the reduction in both euro-dollar and U.S. short-term rates, the Chancellor of the Exchequer announced in his Budget speech that the Bank would make a further ½% reduction in Bank rate, to 7%, with effect from 15th April. Local authorities were seeking temporary funds less actively in April, and their deposit rates had already fallen closer to the return on euro-dollar deposits before the reduction in Bank rate. After that change, local authority rates fell a little below euro-dollar rates, even before allowing for the cost of cover; and the margin between the two widened as euro-dollar rates rose towards the end of the month and again in the middle of May.

Reserves and special facilities

In addition to the exchange inflows during the March quarter, the official reserves received the equivalent of £171 million at the beginning of January as the first allocation of Special Drawing Rights in the International Monetary Fund. Outstanding borrowing on the various facilities arranged in support of the reserves was reduced by £1,010 million during the quarter; and the reserves rose by £76 million, to a total of £1,129 million at the end of March.

The reduction in borrowing was made up as follows:

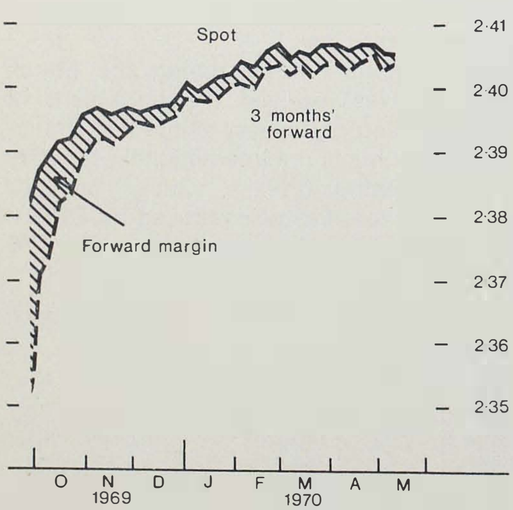
	Drawings outstanding end-Dec. 1969		Drawings outstanding end-Mar. 1970		Reduction in March quarter	
	£ million	($ million equivalent)	£ million	($ million equivalent)	£ million	($ million equivalent)
Drawings from I.M.F.	1,104	(2,650)	1,000	(2,400)	104	(250)
Central bank and related facilities	1,560	(3,744)	654	(1,569)	906	(2,175)
Total	**2,664**	**(6,394)**	**1,654**	**(3,969)**	**1,010**	**(2,425)**

Transactions with the I.M.F. during the quarter included the repayment of the £141 million ($338 million) still outstanding on the May 1965 drawing of $1,400 million (the final instalment of which was not due until May), and the receipt of the remaining £$62\frac{1}{2}$ million ($150 million) of the $1,000 million credit arranged in June 1969. Drawings on this credit have matched the greater part of the repayments on the May 1965 drawing, and so have effectively extended nearly three quarters of that facility for a further period. During the quarter, U.K. liabilities to the Fund were also reduced by a further £26 million ($62 million) as a result of the Fund's use of sterling in transactions with other countries. Repayment of the £1,000 million ($2,400 million) now outstanding from the Fund[1] is not due to begin until June 1971.

The repayments to central banks and other official monetary institutions during the quarter included the remaining £271 million ($650 million) outstanding on the $2,000 million reciprocal swap arrangement with the Federal Reserve System; this facility had thus been completely reconstituted by the end of March. A further £$62\frac{1}{2}$ million ($150 million) of the amount drawn under the Basle arrangements of June 1966 was also repaid. This credit, which was drawn on to finance fluctuations in the sterling balances,[2] is being repaid in eight quarterly instalments beginning in September 1969; the instalments due in March and June 1970 were repaid in advance in January and February. Repayments on other central bank and similar facilities during the quarter totalled over £570 million ($1,375 million).

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

$ to £



a Middle closing rates; weekly, Fridays.

Foreign exchange and gold markets

The main reasons for the demand for sterling between February and April have already been mentioned. The exchange rate against the U.S. dollar continued to rise and, from about $\$2{\cdot}40\frac{1}{4}$ at the beginning of February, touched $\$2{\cdot}40\frac{7}{8}$ early in March. At that time, the exchange inflow became extremely heavy, partly to take advantage of very high day-to-day interest rates for sterling as transfers of tax revenue to the Exchequer reached their height. After the reduction in Bank rate on 5th March, and the increases in West German and Italian discount rates which followed, market buying of sterling became rather less persistent, although demand was still substantial on some days over the remainder of the month. In April, conditions became a little quieter; the further reduction in Bank rate announced at the time of the Budget caused no great surprise. The foreign exchange market stood up well to the sudden weakness in the gilt-edged market towards the end of the month, and to the worsening situation in the Middle East and the Far East; the exchange rate at the end of April was about $\$2{\cdot}40\frac{5}{8}$. The rate moved somewhat lower, however, in the middle of May. The discount on three months' forward sterling in terms of U.S. dollars, expressed as an annual rate, generally remained in the region of $\frac{1}{2}$% during

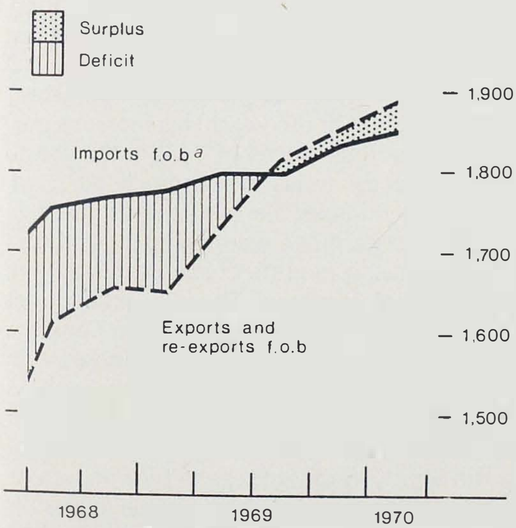
1 Including the drawing in June 1968, as well as the June 1969 credit.
2 See September 1966 *Bulletin*, page 209.

the three months, and continued at about this level in May.

The gold price in the London market had fallen as low as \$34·75 per fine ounce in January, but recovered to about \$35 by the end of that month. Trading continued at around this price until mid-March. Thereafter, the market price rose to approaching \$36 at one point in the latter part of April, but had fallen a little by the end of that month. Prices at or rather above \$36 were recorded at some fixings early in May but the price eased later. During the first part of the period under review, South Africa sold newly-mined gold to the I.M.F. under the arrangements made last December.[1]

Seasonally adjusted
latest quarter provisional £ millions

Balance of U.K. visible trade



Trade continued in surplus in the first quarter.

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

Balance of payments

In the March quarter there was another substantial surplus, for the fourth quarter in succession, in the balance of payments on current and long-term capital account. As a result, the surplus for the financial year as a whole came to about £600 million. These estimates take no account of the very large favourable balancing item already mentioned, the emergence of which suggests that long-term capital receipts as well as short-term inflows were probably larger than have so far been identified.

After seasonal adjustment, visible trade continued in surplus in the March quarter, as it has been generally since last August. The value of both exports and imports rose by about 1½%, with higher prices accounting for the increase in exports, but both prices and volume contributing to the growth of imports. Part of the surplus in this quarter was thus attributable to a change in the terms of trade. Sales to West European countries continued to increase, and those to North America recovered from the depressed level in the fourth quarter. Exports rose somewhat further in April, but imports rose more sharply. The growth in the volume of imports since the beginning of this year followed a long period of comparative stability since the middle of 1968.

Although the surplus on invisible transactions remained large in the March quarter, it was smaller than it had been during 1969. Compared with the fourth quarter of last year, the main reason for the change was that income from direct investment abroad was somewhat lower. Identified long-term capital transactions were in small deficit during the first quarter. As already noted, there were substantial inflows over intra-company accounts to ease liquidity shortages. But U.K. public authorities did not borrow overseas during this quarter, and overseas investors were no longer buying large amounts of gilt-edged stocks and U.K. equities. Official lending abroad under the aid programme, and repayments of inter-government loans, were larger than usual.

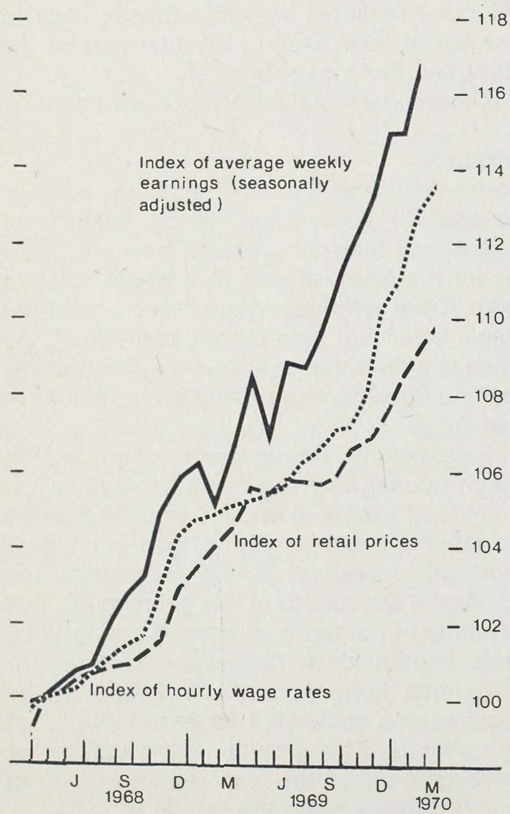
Domestic economy

Apart from a sharp increase in stocks of finished goods (which may have been partly the involuntary result of disappointing sales), demand increased only moderately in the fourth quarter. The volume of exports grew much more slowly than in the previous six months, allowing for

1 See March 1970 *Bulletin*, page 4.

April 1968=100

Wages, earnings and prices



Real incomes have been rising sharply in recent months.

seasonal factors; and private industry's fixed investment was virtually unchanged, after the large rise in the third quarter. Consumer spending continued to increase slowly, and public expenditure rose modestly.

There was little sign of any real buoyancy in total demand in the opening months of this year, and the increase in earnings had not yet generated a comparable rise in personal spending. To judge from the volume of retail sales, consumption rose only slowly, if at all, in the March quarter. Other indications of personal expenditure point to the same conclusion – new car registrations in the first quarter were no higher than in the previous three months; and hire purchase debt, which rose a little in the fourth quarter, then levelled off.

As the Chancellor of the Exchequer envisaged in his Budget speech, however, the recent sharp increase in earnings compared with prices suggests that consumption will begin to expand more positively before very long. Average wage and salary earnings began to rise rapidly last September. Between the third and fourth quarters of last year, earnings rose by more than 3% (seasonally adjusted) or about twice as fast as earlier in the year. This increase may be compared with a rise in retail prices of $1\frac{1}{4}$% in the fourth quarter. Although the rise in prices is not seasonally adjusted, and therefore not directly comparable with the increase in earnings, it seems clear that earnings were rising a good deal faster than prices in the closing months of last year, implying a significant growth in real earnings. There is little doubt that this movement continued in the first quarter. Earnings figures for March are not yet available, but the increase in January and February was again larger than the rise in prices – though perhaps less markedly so than at the end of last year. Using an alternative indication for the whole of the first quarter, basic hourly wage rates rose by as much as $3\frac{1}{2}$%, compared with an increase of 2% in retail prices; it is not known what influence seasonal factors may have had on either of these movements. Wage rates are an incomplete guide to earnings, because they do not take account of overtime payments, or of local agreements to pay above basic national rates. So far as they offer any indication, however, they suggest that the growth of earnings may have slowed in April, when retail prices rose by $1\frac{1}{2}$% – the largest monthly increase for two years. It is not yet possible to judge the significance of this apparent check to the growth in real earnings in April, because movements in a single month are particularly difficult to interpret. But the number of large wage claims still impending suggests that any slowing down that may have occurred is likely to have been temporary.

Among other elements of demand, the volume of exports was unchanged in the first quarter. However, new export orders taken by the engineering industry rose sharply during this period, and overseas orders on hand at the end of March were very large. There was also a marked increase in engineering orders for home delivery, which suggests that industrial fixed investment is still on a rising trend. Any further addition to stocks during this period is likely to have been much smaller than in the closing months of last year.

A fall in investment in new housing since the middle of 1968 may have been checked in the first quarter, to judge from a small rise in the number of houses completed. The improvement was not maintained in April, however, when there was a renewed fall in the number of completions. Although the amount of work started in recent months has been very small, there was some increase in April; and a recovery in advances by the building societies since the beginning of the year is perhaps a hopeful sign.

The seemingly slow growth in demand in the first quarter was accompanied by some increase in the volume of imports. There was thus probably only a fairly small rise in domestic output, a view which is broadly supported by the available indicators. The index of industrial production rose by about $\frac{3}{4}$%, seasonally adjusted; but within the total, manufacturing output changed hardly at all. Again, revised figures of unemployment, incorporating new seasonal adjustments, suggest that the numbers wholly unemployed continued to increase in the first quarter. However, the rise was checked in April and there was then a slight fall in May, to 561,000 or rather less than $2\frac{1}{2}$% of the total employed. The earlier increase in the numbers out of work had been accompanied by a fall in notified vacancies for adult workers between December and March, but this too was largely checked in April and May.

In sum, although the increase in activity was probably again modest in the opening months of the year, the prospects for a further increase in demand remain strong.

The Budget

The Chancellor proposed measures to ease moderately the fiscal and monetary restraints on the economy. His room for manoeuvre was limited by the rise in personal incomes which had already occurred, and the further increase in prospect. Against the background of a large natural growth of revenue because of rising incomes and expenditure, he announced a number of tax changes, calculated to cost the Exchequer about £180 million in 1970/71 and £220 million in a full year. The main changes were increases in allowances against income tax, which were partially offset by the abolition of the reduced rate of tax, so that most of the benefit will go to those with the lowest taxable incomes; a large number of people whose incomes had risen to the point where they became chargeable to tax were relieved of liability. Those paying small amounts of surtax were exempted from that tax. For the two years to April 1972, initial allowances on expenditure incurred on industrial buildings, previously 15%, were raised to 30% generally and to 40% in those parts of the country (the development and intermediate areas) where special inducements to industrial development are offered. Minor tax measures included the abolition during the next twelve months of certain stamp duties, and some alterations in the system of betting and gaming duties. For the financial year 1970/71 the central government is expected to be in surplus to the extent of about £620 million and the public sector by almost £250 million.

On domestic monetary policy, the Chancellor considered that restraint on the supply of credit would have to continue in 1970/71, though not as severely as in 1969/70. He wished to avoid an excessive degree of monetary stringency, and judged that an expansion of domestic credit of up to £900 million would be appropriate. (This would follow a contraction of £625 million in 1969/70.) Even though the prospects for the balance of payments were good, the money supply might rise by rather less than domestic credit if, for example, increased bank lending was financed partly from a rise in overseas deposits.

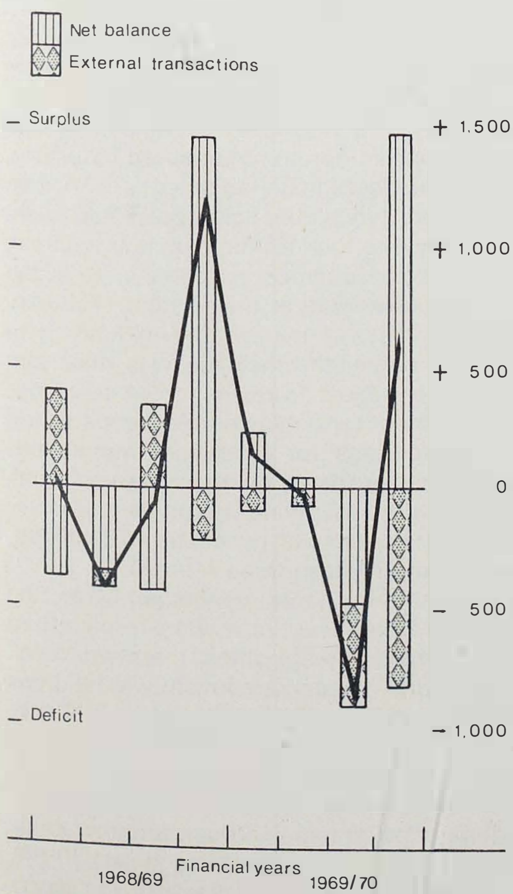
Accordingly, the Budget contained proposals for a modest relaxation in credit control. It was judged appropriate to plan for a gradual and moderate increase, over the year to next March, in those types of lending subject to restriction – sterling lending to the domestic private sector and to overseas borrowers, other than fixed rate lending under the special schemes for export and shipbuilding finance. It was also proposed that the Special Deposits scheme[1] would be used more freely in future to exert a continuing influence over the lending of the London clearing and Scottish banks; and that other banks would be subject to calls for Cash Deposits[1] if official guidance on lending was not followed. To emphasise the need for continuing restraint, the Bank called for further Special Deposits, to be paid by 6th May. The clearing banks were asked for an additional $\frac{1}{2}$%, making $2\frac{1}{2}$% of total deposits; as on earlier occasions, the call on the Scottish banks was smaller, at $\frac{1}{4}$% (to a total of $1\frac{1}{4}$%). The full rate of interest on the clearing banks' Special Deposits was restored as from 15th April (the rate had been halved as from 2nd June 1969[2]).

By varying their calls for Special Deposits and Cash Deposits when appropriate, the authorities will obtain additional flexibility in their control of bank lending. At the same time, it is still desirable to indicate what growth of lending in the restricted categories would be consistent with policy objectives. The Bank therefore issued a notice to banks and finance houses concerning their lending in the year from April 1970 to March 1971; the notice is reproduced after this Commentary. The clearing banks and Scottish banks were asked to ensure that the relevant types of lending by each group should rise only gradually, and by not more than about 5% in the aggregate, over the twelve months from mid-March 1970. Other banks were asked individually to keep the increase in their lending within 7% – the higher figure for these banks being an acknowledgment that, as a group, their restricted lending had been somewhat below the earlier ceiling at the starting point for the new arrangements (March 1970), whereas lending by the clearing and Scottish banks had been above. It was not intended that there should be any general relaxation on lending for personal consumption or imports; the additional lending should, as before, be directed to exports (in addition to shipments financed by the fixed rate schemes), and production and investment – both in manufacturing industry

1 The Special Deposits scheme was described in the December 1960 *Bulletin*, page 18; and Cash Deposits in the June 1968 *Bulletin*, page 166.
2 See June 1969 *Bulletin*, page 145.

Central government £ millions

Domestic borrowing requirement (–)



Much of the central government's large surplus in the first quarter was required to finance the inflow from abroad . . .

and agriculture – which could be expected to benefit exports and invisible earnings, or to save imports. Lending by the finance houses, to which this guidance as to priorities also applied, would remain exclusively subject to ceiling control. This technique might, however, be reviewed after the Crowther Committee on Consumer Credit had reported. The ceiling for the next twelve months would be 105% of lending at the end of March 1970.

As already noted, the Chancellor announced that a further ½% cut in Bank rate, to 7%, would be made by the Bank of England as from 15th April. He also proposed to take powers to vary interest rates payable on ordinary accounts with the National Savings Bank and accounts with the ordinary departments of trustee savings banks – in both cases 2½% at present – although changes would not be administratively feasible until 1971.

Among measures directly associated with the balance of payments, the rate of import deposits was to be lowered from 40% to 30% from 1st May. The Chancellor did not yet think it appropriate to relax exchange controls on investment abroad, and he asked companies to continue to observe the voluntary programme concerning investment in the more developed countries of the sterling area.

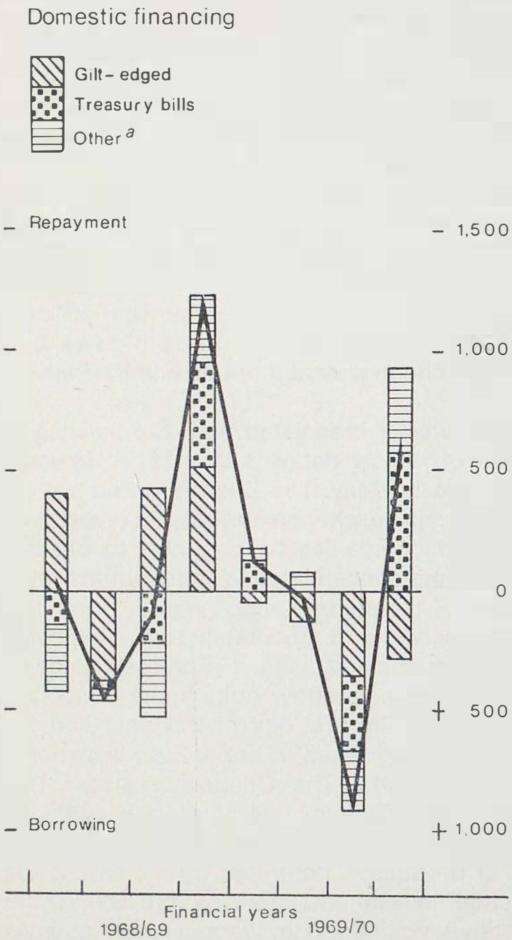
The Budget changes will add moderately to the expected growth of output over the year ahead. Forecasts accompanying the Budget statement show quite a sharp increase in consumption between the first half of this year and the first half of 1971, a slowing down in the growth of exports, and an increase in imports. The Chancellor stated that an improvement in the long-term rate of growth could be achieved only by keeping increases in total demand in line with the growth of productive potential; by increasing the growth of industrial investment; and by preserving the country's competitive position. He warned that incomes could not for long continue to rise at their recent rate.

Central government finance

The central government's surplus for the March quarter, the main revenue season, totalled over £1,450 million. This gave an unprecedentedly large surplus of about £1,120 million for the financial year 1969/70 as a whole, and was the second year in succession in which the central government's finances were in surplus. (The surplus in 1968/69 was smaller, at £273 million, but any surplus has, in the past, been unusual.) A better comparison of the two financial years can be made by leaving out import deposits, which were introduced in November 1968 at a rate of 50% and were extended at the rate of 40% from December 1969. On this basis, a small deficit of some £70 million in 1968/69 changed to a surplus of some £930 million last year. Tax receipts and other revenue increased more than expenditure between the two years; and net lending fell because, although local authorities borrowed more, drawings by the nationalised industries were very much smaller.[1] Including import

1 This comparison excludes drawings of £215 million by the electricity industry last year to redeem government-guaranteed stocks. For the reasons explained in the December 1969 *Bulletin* (page 393) these drawings did not affect the borrowing requirement.

Central government £ millions



. . . but enough remained to reduce domestic holdings of Treasury bills to the lowest level for many years.

a Net indebtedness to Bank of England, Banking Department; notes and coin in circulation; non-marketable debt.

deposits, the public sector as a whole achieved a net surplus of around £600 million in 1969/70, following a borrowing requirement of £450 million in the previous year.

A large part of the central government's surplus in the March quarter was required to finance external transactions which, because of the very large inflows from abroad, totalled £885 million. However, this still allowed the authorities to repay about £570 million of domestic debt. Domestic holders outside the banking system again bought large amounts of gilt-edged stocks, their net purchases of £346 million in the quarter bringing the total for the financial year to £895 million. Net surrenders of tax reserve certificates were seasonally large, at £98 million, but the decline in national savings seen throughout the previous three quarters was checked. In the event, it proved possible to repay some £870 million of debt held by the banks and discount houses. Their Treasury bill holdings were reduced by no less than £510 million, and they sold over £60 million of gilt-edged stocks. There was also a large seasonal fall in the banks' holdings of notes and coin.

Banks and discount houses

In the first quarter of 1970, the inflow of funds from abroad reduced the pressures on the banking sector arising from the very large Exchequer surplus, and from the continued heavy buying of gilt-edged stocks by the public. Advances increased and deposits fell, but both movements were rather smaller than might have been expected at this time.

Between mid-January and mid-April, advances by the *London clearing banks*, other than to nationalised industries, rose by some £90 million (seasonally adjusted) – a modest movement for a period when financial pressures were expected to be so strong. The total for the period as a whole, however, conceals an increase almost twice as large in the two months when pressures were at their height (February and March); there was then a marked fall in lending in April. Over the three months, the increase was mainly in the categories of lending subject to restriction. A steep rise in lending to local authorities between mid-January and mid-March, when rising rates for temporary money encouraged local authorities to draw on their clearing bank facilities, was reversed in the following month as temporary money rates fell. Net deposits rose by about £75 million, after seasonal adjustment, in these three months.

Liquid assets were drawn down very sharply as the revenue season reached its peak, but were replenished somewhat in April: over the three months, there was a fall of more than £400 million. This occurred mainly in holdings of Treasury bills – which fell to £77 million at mid-March, easily the lowest since the war – and in call money lent to the discount market. But liquidity ratios benefited from a reduction in gross deposits as a result of changes in accounting procedure,[1] and so remained comfortably above the minimum. At mid-April, the ratio stood at 30·9%. As well as drawing heavily on their liquid assets, the banks sold about £30 million of gilt-edged stocks over this period.

1 See additional notes to Table 8 of the statistical annex, pages 244 and 245

In the month to mid-May, the clearing banks' advances, other than those to nationalised industries, rose by £85 million after seasonal adjustment. There was, on balance, a small reduction in lending not subject to restriction, because local authorities continued to repay earlier borrowing. Restricted lending, including commercial bills as well as advances, rose in May by more than it had fallen in April; taking the two months together, there was a moderate rise, consistent with the increase of not more than 5% envisaged over the year to next March (see above). The banks' net deposits rose by about £55 million, seasonally adjusted, in May. A sharp fall in liquid assets – mainly in call money lent to the discount market and other borrowers – brought the combined liquidity ratio down to 29·5%, a fairly normal figure for May. During the month the banks had to find an additional £50 million of Special Deposits to meet the call made at the time the new lending arrangements were announced.

U.K. residents (other than banks) reduced their sterling deposits with *accepting houses, overseas and other banks* by a further £115 million during the March calendar quarter partly, no doubt, in order to meet tax payments. This fall was, however, much more than offset by increases in other sterling deposits. Overseas residents made further substantial additions to their sterling holdings with these banks, and there was another sharp rise in the amount of sterling certificates of deposit outstanding.

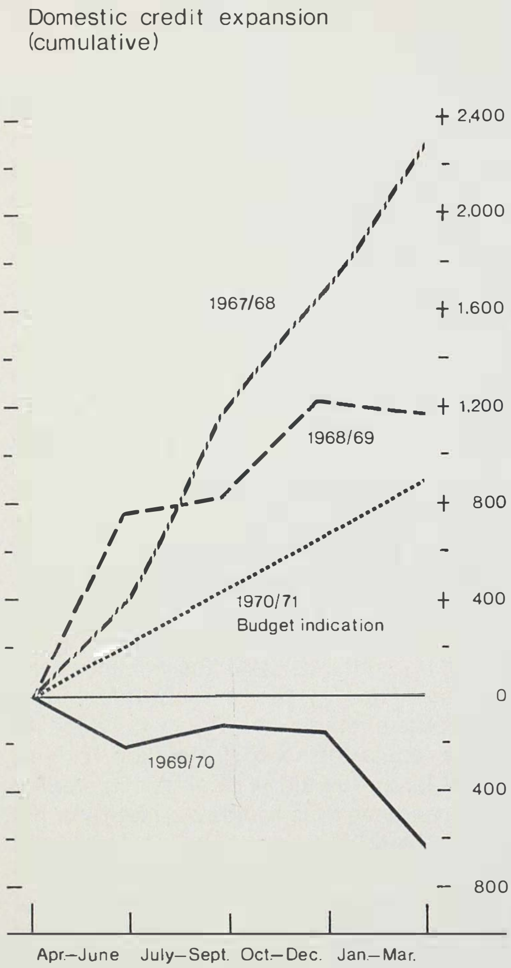
This group of banks lent a further £190 million to local authorities during the March quarter. A small rise in sterling lending to other U.K. residents was roughly offset by a net repayment of sterling advances by overseas residents, and the restricted lending of the group was little changed during the quarter. These banks changed from being net lenders of sterling funds to other banks through the inter-bank market at the end of December – the usual position – to being small net borrowers at the end of March; this represented a withdrawal of £100 million from the market during the quarter. The market was particularly active during the revenue season.

To finance the reduction in deposits in the March quarter, the banking system withdrew some £400 million of money lent at call to the *discount market*. As a result, the houses reduced their holdings of Treasury bills by no less than £200 million. They also sold £34 million of gilt-edged stocks, and their holdings of commercial and other bills fell by £120 million.

Domestic credit and the money supply

Domestic credit contracted by about £1,100 million in the March quarter. A large reduction is usual in this period because of tax payments, but the movement this year greatly exceeded the seasonal expectation – partly because the central government's surplus was unusually large, and partly because of further substantial purchases of gilt-edged stocks by investors outside the banking system. As a result, credit contracted by £450 million even after allowing for seasonal influences. This brought the contraction in domestic credit in the financial year 1969/70 to £625

Seasonally adjusted £ millions



Domestic credit contracted by £625 million in 1969/70, but is expected to expand by up to £900 million in 1970/71.

million, compared with an expansion not exceeding £400 million contemplated by the Chancellor of the Exchequer in the spring of 1969.

Despite the heavy flow of funds from abroad in the March quarter,[1] the money supply declined by some £550 million before adjustment for seasonal factors, because of the contractionary influences already referred to. Seasonally adjusted, however, there was a modest rise of some £40 million, which brought the increase for the financial year to £300 million, or about 2%.

Bill markets

Although the continuing inflow of foreign exchange made sterling funds available, conditions in the money market were generally tight in February and early March, as the transfer of tax revenues reached its seasonal peak. At this time too, changes introduced by the clearing banks in their accounting procedures enabled them to reduce their short-term assets (including call money) without jeopardising their liquidity ratios. The Bank gave substantial assistance to the discount houses, largely through purchases of Treasury bills, although appreciable quantities of commercial and local authority bills were also bought. For the first time since November 1967, however, the Bank also lent at Bank rate on several occasions. Some seven-day loans were extended on these terms in order to allow the discount houses concerned to make the necessary adjustments to their books, and to give them time to do so. Overnight funds were also lent at Bank rate during this period – largely because this lending was associated with the seven-day loans, but also at times because there would have been difficulty in choosing a market rate. When the Bank lend to the discount houses at market rates, these rates are normally based on the clearing banks' 'made-money' rates. The 'made-money' rate is the rate at which the banks lend overnight to the discount houses the proceeds of Treasury bills sold direct to the Bank to help meet market shortages. During the period under review the shortage of Treasury bills in the banks' portfolios meant that too few bills were sold in this way for clear 'made-money' rates to be established.

After the middle of March, conditions became somewhat easier, because tax payments abated and the inflow from abroad continued (though on a more modest scale). Shortages still developed at times, however, especially as a result of large official sales of gilt-edged stocks. When this happened, the Bank not only bought Treasury bills, but occasionally made further purchases of commercial bills; and there was also some further overnight lending at Bank rate. In particular, there was an exceptionally large shortage on 31st March, when settlements for sales of stock coincided with heavy tax payments to the Exchequer; on that day the Bank gave help on a very large scale, both by purchasing Treasury bills and commercial bills and by lending overnight at Bank rate.

1 These inflows are offset in the measurement of D.C.E., but tend to increase the money supply; see the article on domestic credit expansion in the September 1969 *Bulletin*.

The reductions in Bank rate were the principal influence on the cost of borrowing by the discount houses. The average cost of borrowed funds seems to have remained only a little below $7\frac{3}{4}\%$ in February, but to have fallen to about $7\frac{1}{4}\%$ after the $\frac{1}{2}\%$ reduction in Bank rate on 5th March. There was a further fall, probably to about $6\frac{7}{8}\%$, following the second reduction in Bank rate on 15th April.

From early February onwards, the amount of bills offered at the Treasury bill tenders fell to £80 million a week, the lowest in post-war years. Because of the high cost of borrowed funds in February, the houses raised their tender rate to $7\frac{5}{8}\%$, from just over $7\frac{1}{2}\%$ at the end of January. They had to reverse this move at the end of the month, however, in order to obtain bills in the face of outside competition and so limit as far as possible the inevitable fall in their portfolios. Subsequently, the two reductions in Bank rate gave more room for manoeuvre, and the houses were generally able to increase the proportion of bills they obtained, though they brought their tender rate down by rather less than the fall in Bank rate; at the last tender in April, their rate was a little over $6\frac{3}{4}\%$.

Hire purchase finance houses

Allowing for seasonal factors, the finance houses began to extend more new credit in the third and fourth quarters of last year. However, the rise did not continue in the March quarter, when the amount of new credit extended was only about the same as in the preceding three months. Repayments rose a little, so that the total of debt outstanding was very slightly reduced during the March quarter. As mentioned earlier, the finance houses have been asked to ensure that their lending does not rise by more than 5% above the end-March level during the following twelve months.

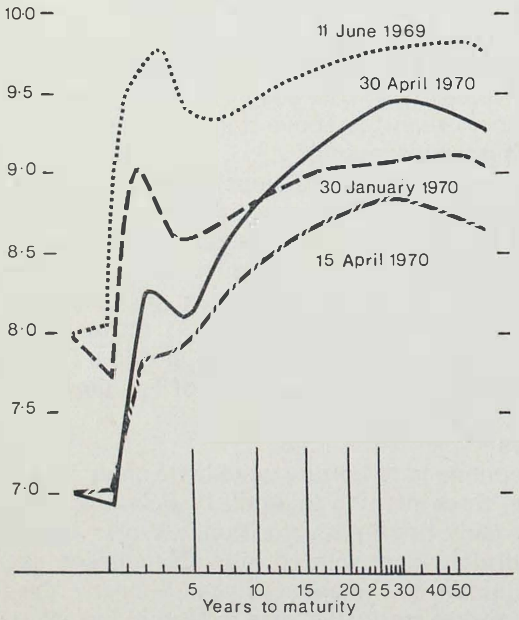
The general decline in the houses' deposit rates since the middle of last September was checked in February, when rates increased in line with those in the temporary money market. Thereafter, the downward movement was resumed, and the fall in March and April more than matched the reductions in Bank rate in those months. At the end of April, the three months' deposit rate stood at about $8\frac{3}{8}\%$, which was $\frac{7}{8}\%$ lower than at the beginning of February.

Local authorities

Local authorities continued to borrow quite large amounts at longer term in the three months to April. In February and March they drew fairly heavily on the Public Works Loan Board, but in April drawings were considerably smaller, as is usual at the beginning of the financial year. Similarly, the amount raised on market mortgages rose in March, but then fell again in April. Stock issues, which had increased in the previous three months, remained comparatively large, at £31 million; there were few new issues between February and April, but sizable calls on earlier issues. New bond issues, however, raised slightly less than was paid on maturities. All longer-term rates of interest fell during the period, P.W.L.B. rates from $9\frac{1}{8}\%$ to 9% for 10-15-year loans, mortgages from about $9\frac{1}{8}\%$ to $8\frac{5}{8}\%$, and one-year bonds from 9% to $8\frac{5}{8}\%$.

Per cent per annum

Time/yield curves of British government securities[a]



After falling steadily until mid-April, yields rose sharply at the end of that month.

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

Local authorities will this year be able to meet more of their capital requirements by drawings on the P.W.L.B. Their quotas have been increased, and will allow drawings of up to 40% of requirements (or 50% in development and intermediate areas).

The rise in temporary money rates in February and early March, and the subsequent fall, has already been described. By the end of April, the rate for three months' deposits had fallen to 8%, and was almost 1% lower than at the end of January; over the same period, seven-day money fell by $1\frac{3}{4}$% (to about $7\frac{1}{4}$%). Local authorities borrowed large amounts of temporary money during the March quarter. During the two months to mid-March, the increased cost of this borrowing encouraged them also to draw on their facilities with the clearing banks, but this movement was largely reversed in the following month.

Building societies

The fall in rates on alternative investments has made the societies' shares and deposits increasingly competitive since the latter part of last year, and this has been reflected in a marked increase in their receipts of funds. After seasonal adjustment, gross receipts rose strongly between February and April, and withdrawals remained relatively stable. Net lending began to recover in January, and was markedly higher in the following three months. Nevertheless the combined liquidity ratio had risen to 16·1% by the end of April. New lending commitments increased substantially so that outstanding commitments had become quite large by the end of the period.

Gilt-edged

The gilt-edged market remained generally firm until the middle of April, encouraged by the continuing surplus in the balance of payments and by the decline in international interest rates. Expectations of a rise in prices were heightened by the reduction in Bank rate early in March, and by the belief that U.S. monetary policy would become somewhat easier. Long-dated stocks continued in fairly steady demand in February and early March. Following the issue at the end of January of a new medium-dated tap stock – $8\frac{1}{2}$% Treasury Loan 1980/82[1] – the authorities allowed the demand for long-dated issues to be reflected in a fall in their yields relative to that on the new stock. This led to some switching into medium-dated maturities in mid-February, but the demand for long-dated stocks was resumed thereafter until early in March, when it slackened following the increases in the West German and Italian discount rates. Demand for short and medium-dated stocks remained generally buoyant up to the middle of April. There was, however, some selling of short-dated issues in February, and especially towards the end of that month; this was largely attributable to the discount houses, at a time when seasonal pressures were at their height. By mid-April, short yields were more than 1% lower than at the end of January, continuing the fall in the previous three months; yields on most medium-dated stocks

1 See March 1970 *Bulletin*, page 14.

had fallen by ½% or so, and by rather more on some of the low-coupon issues, although the yield on the newly-issued tap stock was not allowed to fall by more than about ⅛%. Long yields were about ¼% lower on balance, at 8¾% – 8⅞%.

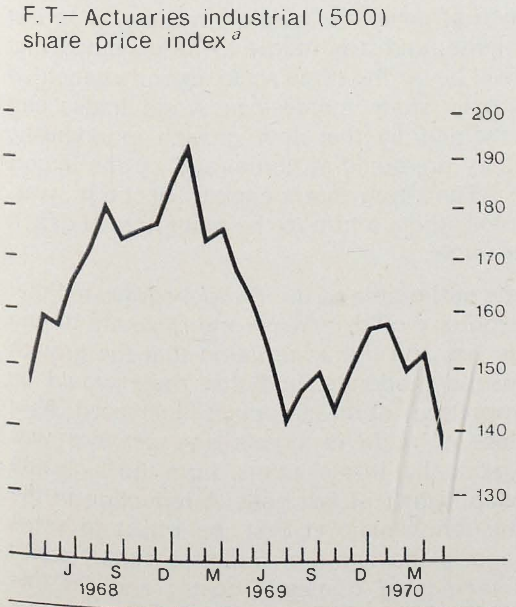
During the March calendar quarter, and especially in January, the authorities again sold large amounts of stock – totalling some £310 million for the period as a whole. Official purchases of stocks maturing within the next year amounted to nearly £410 million, but almost £100 million of other short-dated issues and nearly £620 million of medium and long-dated stocks were sold.[1] An analysis of the stock registers shows that private funds and trusts continued to be active buyers, especially of the newly-issued 8½% Treasury Loan 1980/82 and other medium-dated stocks.

From mid-April onwards, the market turned sharply. The Budget, and the further reduction in Bank rate, were received quietly, and investors continued to buy stock for a short time. Later, however, selling developed, which quickly gathered pace because of increasing concern about industrial costs, and a general acceptance that interest rates were unlikely to fall much further in the near future. The authorities allowed prices to fall unusually quickly; short yields rose by some ⅜%, and medium and long yields by about ½% – ⅝%, in the second half of the month. Thereafter, the market was considerably steadier for most of the time during May.

Company securities

The partial recovery in equity prices in the three months from November to January was not maintained. Prices had already begun to fall in the latter part of January and, by the end of February, over half the earlier gains had been lost. The factors which depressed the market at that time included a weaker tendency on the New York stock market, some discouraging company results, and fears about the effects of industrial disputes and large wage increases. The clearing banks' figures were also judged to be disappointing when they disclosed their profits for the first time at the end of February. Prices recovered a little at times in March and early April, in advance of the Budget, but then fell steeply in the latter part of April. There were growing fears of lower company profits, and the market was also disturbed by a very sharp fall on the New York stock market. The speed and size of the fall in the gilt-edged market also caused concern, and was taken as evidence of the authorities' determination to secure the monetary objectives announced in the Budget. Growing expectations that company finances would remain under pressure led to the view that demands on the capital market would become heavy, and that yields were more likely to rise than fall in the coming months. In these circumstances, the F.T.-Actuaries industrial share price index had fallen to 137·7 by the end of April, or some twenty points lower than it had been three months earlier. The fall was checked for a time at the beginning of May, but then continued even more steeply, although selling pressure was not unusually heavy. The market was mainly influenced by further very

Logarithmic scale 10 April 1962=100



Share prices fell in April to their lowest for over two years.

a Monthly, last working day.

1 See Table 3 (1) of the annex

large reductions in prices on the New York market, which also affected stock exchanges in other overseas centres.

Turnover in ordinary shares, which had been exceptionally large in January, fell in the following three months, though markets remained fairly active by recent standards. Dealings in fixed interest issues also remained quite large, and yields on company debentures and loan stocks followed much the same pattern as gilt-edged yields – falling until mid-April, but rising sharply, thereafter. First-class high-coupon stocks of about 25 years' maturity yielded $10\frac{1}{8}$% at the end of April, showing a margin of $\frac{3}{4}$% over government stocks of similar date; the margin widened a little in May.

Companies raised almost as much cash on new issues (£80 million) in the three months to April as in the previous three months, so that the modest recovery in the earlier period was broadly maintained. Equity issues brought in a little less, but the amount raised on fixed interest securities was virtually unchanged. For fixed interest stocks, the queue of new borrowers lengthened somewhat, particularly during April, and the size of some new issues was larger than of late. However, the renewed rise in yields after the middle of April led to a noticeable increase in the number of issues postponed, and this continued to be a feature in May.

Encouraged by the firmer equity prices at the end of last year, demand for unit trust units recovered somewhat in the first quarter, particularly in February. Gross sales of units, at £55 million, were distinctly above the rate in the second half of last year and, as repurchases rose only slightly, net sales also recovered. In April, sales held up well in spite of the weakening of the equity market in the second half of that month.

Conclusion

The overall balance of payments surplus in the year to last March was very large, and it is hardly to be expected that future surpluses will be on the same scale. Exports benefited from an exceptionally sharp increase in world trade; and imports were restrained by the slow growth in domestic demand, by liquidity pressures at home, and by the import deposit scheme. The long-term capital account was, unusually, in surplus, and a return to the more normal deficit is likely and acceptable.

Official forecasts at the time of the Budget suggested that the volume of exports would increase more slowly during the course of this year, on the assumption that the growth of world trade would moderate, and that there would be a larger rise in imports as domestic activity increased. As a result, the surplus on trade in goods and services was expected to fall gradually, in real terms, from the high rate reached in the second half of last year. A reduction in the surplus in volume terms may, at first, be offset to some extent by a change in the terms of trade, as export prices rise because of increasing domestic costs; and for this reason the current account is likely to show a good surplus for 1970. But in the longer run, this will not be maintained unless the United Kingdom remains competitive.

It is partly for this reason that the upward trend in domestic incomes and costs is disturbing. As already noted, earnings began to increase sharply towards the end of last year, and the movement shows no clear sign of abating as yet. It remains to be seen how far improvements in productivity will relieve these pressures on industrial costs and prices.

The problem is by no means confined to the United Kingdom. There has already been a rapid growth in incomes in many other industrial countries and, as in this country, further substantial increases are in prospect. But comfort can only be taken from this fact to the extent that increases in productivity in this country match those elsewhere.

The longer-term difficulties created by steeply rising incomes and costs also claim attention. It is not merely the damage to the competitive position of industry and commerce in this country that causes concern. There are other serious consequences. Some incomes advance rapidly without commensurate increases in productivity, while the incomes of other groups, because they lack bargaining power or are reluctant to use it, increase, if at all, much more slowly. As the increase in costs works through into prices, the rising cost of living erodes the transient advantage, in terms of higher real incomes, gained temporarily by the stronger groups, while actually reducing the real spending power of other groups. If allowed to continue, rapid and uneven increases in incomes and costs would make these shifts in the distribution of purchasing power – in many cases markedly inequitable – more and more difficult to accept and justify.