Commentary

Seasonally adjusted £ millions

Growth in spending power

attributable to quarterly changes in.

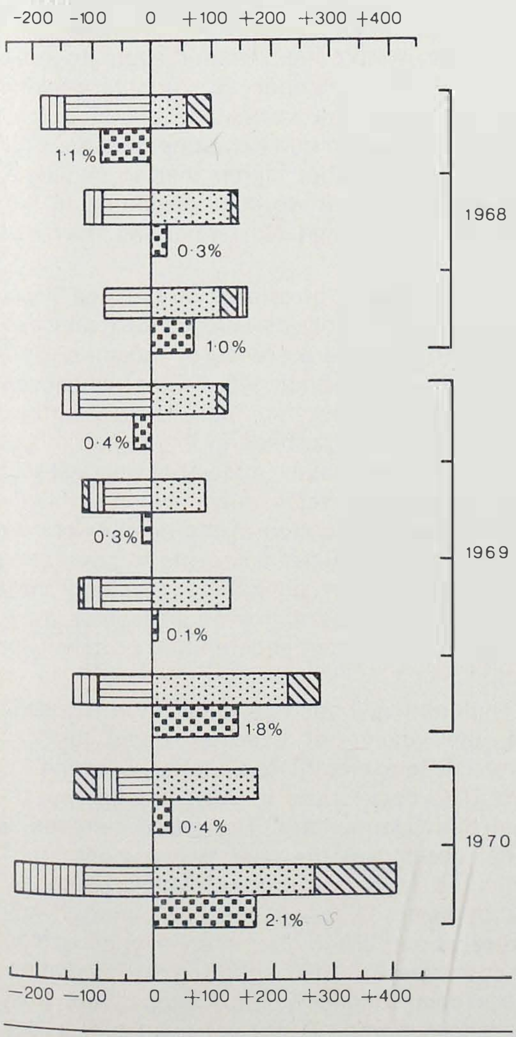
Income from employment

Other personal income

Consumer prices (-)

Taxes on income net of benefits (-)[a]

Resulting change in real personal disposable income



Personal incomes accelerated in the second quarter, and despite increased prices and much larger tax payments, real spending power was more than 2% higher than in the first.

a U.K. taxes on income, transfers abroad (net) and taxes paid abroad, national insurance and health contributions *minus* national insurance benefit, family allowances, supplementary benefits, etc.

During the three months from August to October, with which this Commentary is mainly concerned, industrial costs and prices continued to rise very much faster than domestic output. Consumption was still increasing but, apart from some further stockbuilding, there was probably little change in other elements of demand. In the balance of payments, the current account remained in moderate surplus in the third quarter, but this was outweighed by investment and other capital outflows, particularly in September. The growth of bank advances slackened appreciably but, to emphasise the need for continued restraint, a further call for Special Deposits from the clearing banks and the Scottish banks was announced on 29th October. Money supply and domestic credit increased much less rapidly in the third quarter than in the second, despite the redemption of a large government stock.

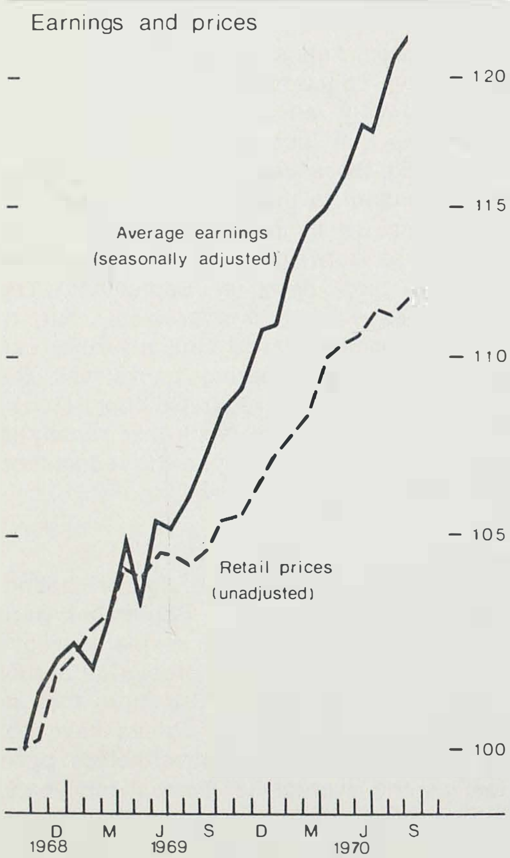
The domestic economy

The rise in incomes and prices showed no sign of abating. Weekly earnings in the three months to September were $3\frac{1}{4}$% higher, seasonally adjusted, than in the previous three months – much the same rate of increase as earlier in the summer – and were then about 13% more than in the corresponding period a year earlier. Prices have not risen as much as earnings, but have nevertheless been rising twice as fast as the average in the last ten years; retail prices in October were some $7\frac{1}{2}$% higher than a year previously. More comprehensive, though less up-to-date, figures show that real incomes – after allowing for tax payments, national insurance contributions and price increases – rose by $4\frac{1}{2}$% in the nine months to the middle of this year; previously, they had risen by less than 1% since the devaluation of sterling in November 1967.

This steep rise in personal incomes has been taking place against the background of what has so far been only a slow rate of domestic growth. A comparatively sharp rise in the volume of the gross domestic product in the second quarter followed a decline in the first and, over the first half of the year, there was barely any change compared with the preceding six months. Thus the expansion in the second quarter may to some extent have been erratic, and there are signs that the rate of growth has since been more modest.

The recent trend of output cannot yet be clearly determined. Industrial production rose by about 1% in the third quarter, according to the monthly index. But this did little more than make good a fall in the previous three months, when an apparent decline in industrial production – which accounts for rather under half the total of domestic output – was more than offset by increased activity in the distributive and service industries and in agriculture. (The output of these industries in the third quarter is not yet known.) The recent fluctuations in the index of industrial production are

Logarithmic scale Oct. 1968=100



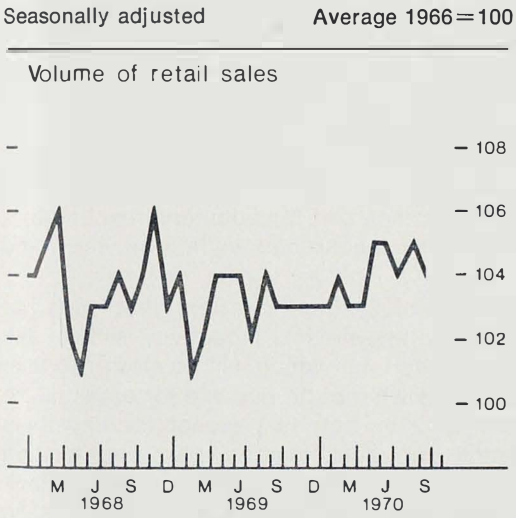
In the September quarter, too, earnings outstripped prices.

probably attributable in part to difficulties of seasonal adjustment, but also reflect distortions caused by industrial disputes, which have continued to disrupt output. The available figures of working days lost by such disputes cover only those directly involved, and not the many workers laid off in other plants – for example, because of dislocation of supplies. Even on this limited basis, working days lost in the first nine months of this year totalled just under 9 million; this was substantially more than in the same period of 1969 – itself a year when the number of days lost was unusually large.

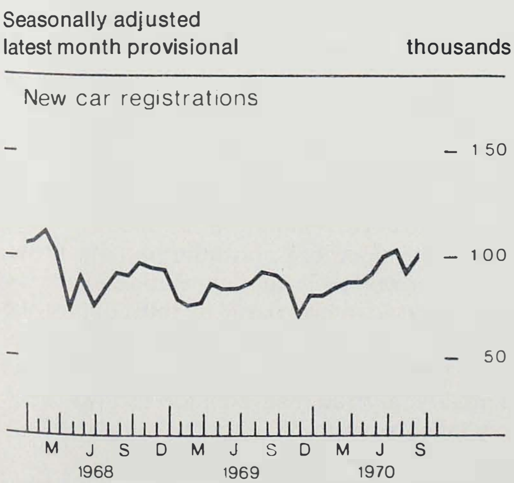
The rise in the industrial production index has not so far been accompanied by any clear signs of a renewed demand for labour. After a sudden rise in the month to mid-July, the number of wholly unemployed (excluding school-leavers and others temporarily out of work) fell somewhat over the period to mid-November, when adjusted for seasonal influences. But the figures during the summer seem to have included an unusually large number of students seeking work during their holidays. The seasonally adjusted total of 579,000 wholly unemployed in mid-November – some 2½% of all employees – was still rather higher than in mid-June; and notified vacancies for adult workers continued to fall, on balance, between August and November, as they had earlier in the year.

Whatever the recent rate of growth of output has been, it seems to have occurred mainly as a result of rising personal expenditure following the increase in incomes. Consumption rose sharply – by about 1½% – in the second quarter and the indications are that there was a further, though probably slower, rise – perhaps in the region of ½% – in the third quarter. Reports since September suggest that any further increase in retail sales may have been fairly small; and there was some reduction in the number of new cars registered in October, though this seems to have been mainly because of production difficulties resulting from strikes. In view of the continued rise of real incomes, however, it seems probable that some acceleration of consumption is in prospect.

Although the engineering industries have large overseas orders on hand, the volume of exports seems to have changed little over the four months to October, allowing for the effects of the U.K. dock strike in July; the figures are described later in this Commentary. The sharp increase in domestic industrial costs over the past twelve months has clearly been reflected in export prices, which continued to rise steeply – by some 1½% – in the third quarter, and in September were about 7% higher than a year earlier. Other industrial countries are also suffering from inflationary conditions, but comprehensive information about their export prices in recent months is not yet available. In any case, factors other than price – such as design, delivery dates and servicing facilities – are often equally important. Nevertheless it is worth noting that the rise of 5½% in U.K. export prices over the twelve months from mid-1969 – or very broadly from the time when U.K. costs began to rise particularly steeply – was matched, and sometimes exceeded, by a number of overseas competitors; export



The volume of retail sales rose a little further in the third quarter . . .



. . . and the number of new cars registered was also higher (though there was then some decline in October).

prices of the main industrial countries taken as a group rose by some 7% in dollar terms over these twelve months. But profit margins on U.K. sales abroad must by now be reflecting the steeper rise in domestic costs than in export prices. The latest survey of industrial trends by the Confederation of British Industry, taken at the beginning of October, found that firms were, on balance, less optimistic about export prospects than they had been four months previously, and that prices had become even more important as a factor affecting export orders than they were earlier.

Private manufacturing investment recovered in the second quarter from a comparatively low figure in the first but, on balance over the first six months of the year, was little higher than in the second half of 1969. There may not have been very much further growth in the third quarter. The engineering industries increased their domestic deliveries in that quarter, and a further rise in new orders taken for the home market might seem to be a hopeful sign for the future; but these figures are particularly erratic. The Department of Trade and Industry's latest investment intentions survey, taken in August and September, looks for a much smaller increase in manufacturing investment this year than had earlier been foreshadowed; the survey now suggests that the volume of new investment might be some 2% to 3% higher this year than last, compared with earlier expectations of a rise of 7% or 8%. The revised forecast implies that investment expenditure will continue broadly unchanged between the two halves of this year. One of the factors behind this check to the growth of investment may well have been the reduction in the company sector's saving since the latter part of last year as a result of larger payments of wages, taxes, and dividends. The results of the latest survey of investment intentions are broadly supported by the Confederation of British Industry's October enquiry, which found that more firms than in June are expecting to reduce their expenditure on plant and machinery in the next twelve months; this enquiry found that large firms are now considerably more pessimistic about the outlook for investment than are small firms.

Among other elements of demand it seems possible that stocks may have risen further in the third quarter, after a moderate rise in the second. Companies are reported to have built up stocks to reduce the disruption caused by strikes in components plants, and perhaps also to forestall price increases.

Public expenditure and taxation

On 27th October the Chancellor of the Exchequer announced reductions in public expenditure as the result of changed policies concerning the role of the public sector. The Chancellor expected that expenditure in the financial year 1971/72 would be about £330 million lower, at constant (1970) prices, than was envisaged in the latest annual survey of public expenditure prepared in the early summer.

About one quarter of the expected net saving is to be achieved in ways which seem likely to have a direct impact on personal expenditure: certain grants to the railways for the provision of unremunerative passenger services are to be reduced; and some education, health and welfare services will be withdrawn, and charges for others increased; but these savings will be partly offset by net increases in social security benefits. In the longer term there will also be substantial savings from the new system of agricultural support based on levy arrangements, and from changes in the system of housing subsidies. The remaining savings are the net result of reductions envisaged in other expenditure, mainly on defence and industrial projects, after allowing for small revisions to earlier estimates and for additional expenditure on hospital facilities, other health and welfare services, and school buildings.

The expected saving of £330 million next year does not allow for changes in investment incentives which the Chancellor also announced, but which will be slower to take effect. Investment grants will not be payable for expenditure incurred on and after 27th October, except for payments made under existing contracts. Instead, new depreciation allowances against tax have been introduced for expenditure on plant and machinery. All sectors of industry qualify, whereas investment grants were applicable only to manufacturing concerns. In order to concentrate most of the benefit of the allowance in the early life of the asset, 60% of such investment can be written off against tax for the year in which the expenditure is incurred, and thereafter 25% of the reducing balance each year. As before, there are special provisions for the development areas, to encourage the location and expansion of industry in these parts of the country. Expenditure incurred on most forms of new machinery and plant for industrial purposes in such areas qualifies for 'free' depreciation – *i.e.* the whole amount can be set against tax for the year in which the expenditure is incurred. The increase to 40% in initial allowances on new industrial buildings in development and intermediate areas, introduced for a two-year period in the last Budget, will now be continued indefinitely; in other parts of the country the rate will revert to 15%, from 30%, after April 1972. Capital expenditure on new ships and on equipment for scientific research will also qualify for 'free' depreciation as at present, and will be the only investment to do so outside the development areas.

The new scheme will only benefit companies earning sufficient profits to enable them to take advantage of their depreciation allowances. Partly because of the long interval between the time when company profits are earned and the time when tax is paid upon them, and partly because of the transitional arrangements for the payment of investment grants, the financial effects of the new scheme will not become substantial until 1972/73. In the meantime, company liquidity will benefit from a reduction in corporation tax from 45% to 42½% beginning with tax due to be paid on 1st January next. This reduction will improve companies' finances to the extent of an estimated £60 million in the present financial year, and by £90 million in 1971/72. Thereafter, the change from investment grants to tax allowances is expected to cost companies more than they will gain from the reduction in corporation tax, by an amount reaching some £150 million in 1974/75.

The Chancellor also proposed to reduce the standard rate of income tax by 6*d.*, to 7*s.* 9*d.* in the £, at the beginning of the tax year 1971/72. This reduction is expected to cost the Exchequer £315 million in the first year – at the beginning of which P.A.Y.E. contributions will still be coming in at the old rate for a time – and £350 million in a full year. The Chancellor estimated that the combined effect of the reductions in income tax and in public expenditure would be broadly neutral in their effect upon demand in 1971/72. By 1974/75, the net saving to public funds from all the measures proposed, except for the reductions in income tax and corporation tax, was expected to amount to nearly £1,100 million a year. The average annual rate of growth in the volume of public expenditure between 1971/72 and 1974/75, excluding the transitional payments of investment grants, was forecast to be 2·8%, compared with an average increase of 3·5% on previous expectations.

Balance of payments

After the very large receipts from abroad during the previous nine months, net currency outflows in the third quarter led to calls on the official reserves and support facilities totalling £202 million. This almost reversed the inflow in the second quarter. The change was caused partly by adverse seasonal influences – which affected not only U.K. current transactions, but also the sterling holdings of overseas sterling countries – and partly by investment and other capital outflows.

Allowing for seasonal variations, current transactions yielded another surplus in the third quarter, though it was somewhat smaller than in the second; net invisible earnings were again well in excess of the trade deficit, which increased a little between the two periods. The estimates for both quarters include an allowance for the under-recording of exports in the official trade statistics; as announced in November, the under-recording was revealed by checks on export documents relating to the early months of this year,[1] and it is assumed to have continued since. The shortfall is thought to have been of the order of 2% of exports, which implies that export receipts so far this year may have been understated to the extent of something over £150 million at an annual rate; in the balance of payments accounts, the error will have been reflected in the balancing item. To improve the recording of the export figures in future, traders will be required to lodge export documents with H.M. Customs before the goods are loaded on the ship or aircraft; this means reverting to a procedure which, for most exports, had been relaxed by the end of 1963.

The current account surplus in the third quarter would have been larger had it not been for distortions caused by the U.K. dock strike in the second half of July. Clearance of the goods held up by the strike was not fully reflected in the trade figures over the remainder of the quarter and, as is usual after a dock strike, exports were affected more than imports. This was partly because of physical delays in shipment: when work was resumed, vessels had to discharge

1 These checks were instituted in June 1969, following the discovery of earlier under-recording of exports; see September 1969 *Bulletin*, page 276.

their import cargoes before they could take on exports; and, because of the general disruption of schedules, a shortage of shipping space persisted for some weeks after the end of the strike, particularly on the long sea routes. Over and above these physical delays, exports are recorded in the trade figures less promptly than imports, for the reasons explained on page 256 of the September 1970 *Bulletin.*

Most, though probably not all, of the backlog was cleared by the end of October, so that a comparison of the monthly averages for the four months July to October with those for the previous four months may give some guide to recent trends in overseas trade. On the assumption that the amount of under-recording of exports did not differ greatly between the two periods, the value of exports was virtually the same between July and October as in the preceding four months. As export prices rose by about 2%, the volume of shipments fell by broadly the same amount. Most of the fall in volume could probably be accounted for by a once-for-all loss of exports cancelled because of the dock strike, together with any remaining backlog still to be cleared at the end of October. The value of imports fell a little between the two periods, but the figures for March to June included the delivery of three Boeing 747 aircraft and erratically large arrivals of Canadian nickel (following the ending of a strike in that country). Allowing for these concentrations in the earlier months, and for the fact that import prices were virtually unchanged, the volume of imports seems to have continued to rise – perhaps by about 2% – between the two four-monthly periods. It is unlikely that there were any significant arrears of imports from the dock strike still to be cleared at the end of October.

After making an allowance for under-recorded exports, the average trade deficit between July and October was small. There was a slight reduction in the deficit compared with the previous four months; but this was more than accounted for by the concentration of imports referred to above, and the outcome was also favourably affected by the continued improvement in the terms of trade.

Investment and other capital flows were heavily unfavourable in the third quarter, in contrast with the exceptional inflows in the first half of the year. Overseas direct investment in U.K. companies was unusually small. At the same time U.K. direct investment abroad rose from a rather low figure in the June quarter; but this additional investment was financed partly by increased euro-dollar borrowing from U.K. banks, and partly by means of an exchange of shares with an overseas company, which caused a corresponding increase in overseas investment in U.K. company securities. Among other capital flows, overseas sterling countries added comparatively little to their gross sterling balances in the seasonally unfavourable third quarter, following the very large increase in these holdings in the first half of the year; and non-sterling countries reduced their holdings somewhat. There was a net repayment of import credit during this quarter, partly as a result of the reductions in the rate of import deposits in May and September;[1] as in the previous three months, a relatively large amount of export

1 See *Bulletins* for June 1970, page 127, and September 1970, page 256.

credit was extended. Finally, although London banks had some of their foreign currency assets converted into sterling at the end of June, they had reverted to holding net assets in foreign currency at the end of September. This movement out of sterling occurred in a period when the usual covered interest comparisons became, for a time, markedly unfavourable to sterling, as noted later in the Commentary.

The impact on the reserves of the switch out of sterling by the banks was, however, partly offset by the conversion of euro-dollars into sterling by some U.K. companies. Companies did not confine their borrowing of euro-dollars from banks in London to what they needed to finance overseas investments; some borrowed large sums which they converted into sterling for use in the United Kingdom. Indeed, borrowing of euro-dollars for domestic purposes has increased rapidly since the beginning of the year, in response to the high cost of raising funds on U.K. capital markets and the restriction on sterling borrowing from the banks.

Reserves and special facilities

In order to provide the official financing of £202 million required in the third quarter, a net amount of £150 million was drawn on special support facilities. The remaining £52 million was found from the reserves, which fell to £1,111 million at the end of September. This financing requirement was almost wholly concentrated in September.

The net drawing of £150 million on special facilities in the third quarter was made up as follows:[1]

£ millions

	Outstanding drawings on:			
	I.M.F.	F.R.B. $2,000 million swap arrangement	Other facilities	Total
End-June 1970	992	—	469	1,461
End-September 1970	985	167	459	1,611
Borrowing (+) in September quarter	— 7	+167	— 10	+150
$ millions equivalent	*— 17*	*+400*	*— 24*	*+360*

The reduction of £7 million ($17 million) in liabilities to the International Monetary Fund resulted from the Fund's use of sterling in transactions with other countries; the repayment of outstanding U.K. drawings is not due to begin until June 1971. The quarterly instalment of £31 million ($75 million) due in September on the Basle arrangements of June 1966 to finance fluctuations in the sterling balances[2] had been repaid in advance in June.

Foreign exchange and gold markets

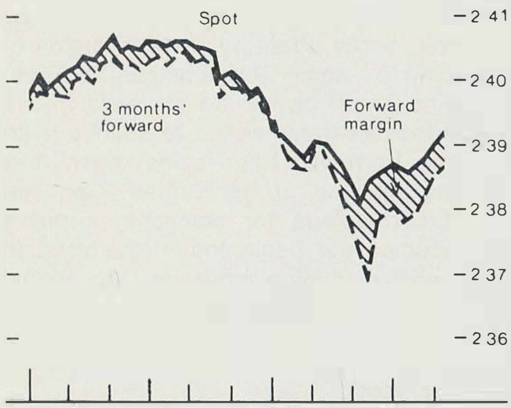
An important underlying influence on the exchange markets during the period from August to October was a reduction in the demand for sterling as a result of the seasonal pattern of the balance of payments, both of the United Kingdom and of overseas sterling countries. Following the settlement of the U.K. dock strike, sterling was quietly steady at the beginning of August, and the spot exchange rate against

1 Quarterly details of the amounts outstanding on special facilities since the end of 1962 are summarised in Table E of the article "A revised presentation of external liabilities and claims in sterling" on page 446 of this issue.

2 See September 1966 *Bulletin*, page 209.

$ to £

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



a Middle closing rates; weekly, Fridays.

the U.S. dollar was a little above $2·39. Some pressure developed in August because of uneasiness caused by further industrial disputes, especially in the motor industry, and by discussion among some commentators of the possibility of a future change in the sterling parity. Most of the strain was taken on the exchange rate, in order to minimise the impact upon the reserves; and the cost of forward cover, which had stood at the equivalent of about $\frac{3}{16}$% per annum at the beginning of the month, increased to about $\frac{15}{16}$% per annum.

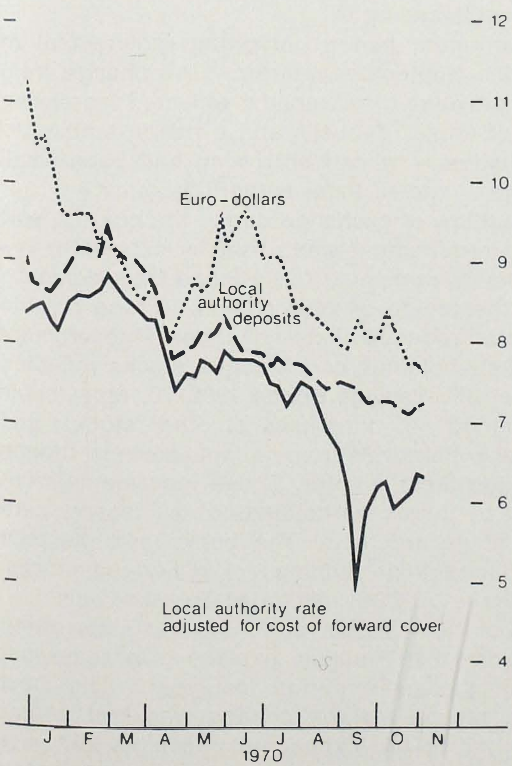
Selling of sterling became heavy early in September, when the approach of the joint annual meeting of the I.M.F. and I.B.R.D. led some to believe that there might be a change in official exchange rate policy. The selling pressure was largely concentrated between 4th and 8th September, during which time the spot rate was supported at around $2·38$\frac{1}{8}$. As a result of the selling, however, an acute shortage of sterling developed. The authorities did not relieve the shortage by buying dollars, preferring to allow the exchange rate to rise rapidly in order to discourage further speculation. In the event, the rate rose to touch $2·39 on 9th September, the largest movement in one day for a long time. Forward margins, on the other hand, continued to widen as the shortage of sterling led some operators to borrow from day to day by means of swaps; the cost of three months' cover rose to touch 3$\frac{1}{4}$% per annum on the 9th, but fell back over the remainder of the month.

After this brief bout of speculative pressure, the exchange market remained nervous but subdued over most of the remainder of September. The settlement of a long-standing strike in the car component industry and the $\frac{1}{2}$% reduction in the prime lending rates of U.S. banks were helpful to sterling during this period; and the market was reassured when the Fund-Bank meetings passed without changes in exchange arrangements. Conditions were very quiet in the first half of October, and the spot sterling rate fluctuated a little above $2·38$\frac{1}{2}$. Thereafter, sterling benefited from the announcement of the September trade figures, which were better than the market had expected, and from the continued decline in the demand for euro-dollars. The Government's statement on changes in public expenditure on 27th October was at first quietly received in the exchange markets, but there was a good demand for sterling two days later, following the call for additional Special Deposits from the clearing banks and the Scottish banks. The spot rate ended the period slightly above $2·39, by which time the cost of three months' forward cover had fallen to about $\frac{7}{8}$% per annum.

During the period, there was an alteration in exchange control affecting the investment currency market. Since 19th August, U.K. residents' purchases of private houses and land for foreign currency in countries outside the sterling area have been financed through this market, in which most of the sales proceeds of foreign currency securities have, for a number of years, been traded between U.K. residents. Before the change, property purchases had, since April 1965, been effected through a separate market in so-called 'property currency'; this meant that U.K. residents wishing to use

Per cent per annum

Short-term interest rates in London[a]



The continuing fall in euro-dollar rates was accompanied by a reduction in local authority rates.

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

foreign currency to buy private property in non-sterling countries could do so only by buying from other residents the foreign currency proceeds of their sales of such property. Because more U.K. residents wished to buy houses abroad than to sell them, these sales proceeds – property currency – commanded a premium; and, as the market was narrow, with a turnover estimated at only about £3 million a year, the premium fluctuated a great deal and could be very large – it stood at about 60% just before the arrangements were changed. The authorities judged that the transfer of property purchases and sales to the larger investment currency market would have little effect upon the premium in that market, and would improve the conditions under which U.K. residents could buy private property abroad. As expected, the premium for investment dollars was little affected by the change; it fluctuated between 24% and 28% in August, much as in the previous four months. During September, however, the premium began to increase – because of the rise in prices on the New York stock market rather than property purchases by U.K. residents; and in October it fluctuated between 30% and 36%.

In the London gold market, prices remained in the region of $\$35\frac{1}{4}$ per fine ounce during the greater part of August, a period when demand for gold is seasonally low. Towards the end of that month, however, demand from industrial users and eastern countries revived, and the price rose above $36 on 2nd September. Thereafter demand became strong, and included some speculative purchases encouraged by widespread discussion of a possible future shortage of gold for industrial and investment purposes. The fixing price rose to $\$39\frac{3}{16}$ on 27th October – the highest since November 1969. However, this movement proved to have been overdone, and the price fell back sharply, to about $\$37\frac{1}{4}$ at the end of October.

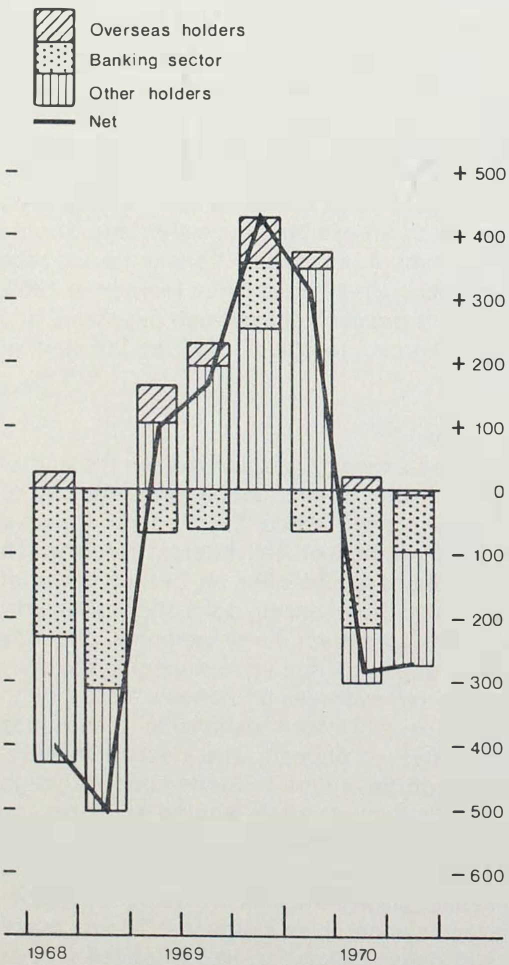
Short-term interest rates

The fall in euro-dollar rates which began towards the end of June continued during the three months from August to October. The fall had started when the Federal Reserve Board suspended its limitation on the interest rates which banks in the United States could offer on certain types of deposits;[1] benefiting also from easier domestic conditions, these banks were able to attract large amounts of funds against certificates of deposit. They were thus able to repay euro-dollar borrowing from overseas branches which, though becoming cheaper, was still more expensive than funds taken against certificates of deposit. The decline in euro-dollar rates was checked for a time in September. Although a $\frac{1}{2}$% reduction in U.S. banks' prime lending rates on the 21st might ordinarily have encouraged an associated fall in euro-dollar rates, these increased quite sharply at the end of the month because of withdrawals of some European funds for end-quarter balance sheet purposes. The increase was quickly reversed early in October, and rates fell further after the middle of the month, when one major U.S. bank announced that it was going to reduce its euro-dollar borrowing below the base level – broadly the average amount of

1 See September 1970 *Bulletin*, page 259.

£ millions

Changes in holdings of gilt – edged stocks



Despite the redemption of 3% Savings Bonds 1960/70, the fall in holdings of gilt-edged stocks was smaller than in the previous quarter.

borrowing in May 1969 – upon which reserve requirements are calculated.[1] By the end of October, the rate for three months' deposits had fallen to about $7\frac{3}{4}$% – the lowest since January 1969; this represented a fall of some $\frac{3}{4}$% over the three months. Rates for shorter periods, on which U.S. banks usually concentrate, fell even more steeply.

The easier conditions in the euro-dollar market spread to other money markets outside the United States and, during September and October, central bank discount rates were reduced in France, Belgium, Canada and Japan. There was also some continued downward movement in U.K. interest rates, perhaps assisted by money coming into the market following the redemption of 3% Savings Bonds 1960/70 at the beginning of September. Between August and October, rates on three months' local authority deposits fell by $\frac{1}{2}$%, to rather less than $7\frac{1}{4}$% at the end of October. Three-month rates remained below the comparable euro-dollar rates as they have, generally speaking, for the past eighteen months; towards the end of October, however, the sharp fall in rates on shorter-term euro-dollars – for up to two months – took them below those on local authority and similar sterling deposits. But allowing for the cost of forward cover, these comparisons were unfavourable to sterling at all maturities throughout the period; the unfavourable margin was particularly large early in September, because of the widening of forward margins already referred to.

Central government financing

The central government had a borrowing requirement of £240 million in the September quarter. The change from a surplus in the previous three months reflected increasing net repayments of import deposits and a rise in lending to nationalised industries – whose borrowing had been small in recent quarters – and to local authorities.

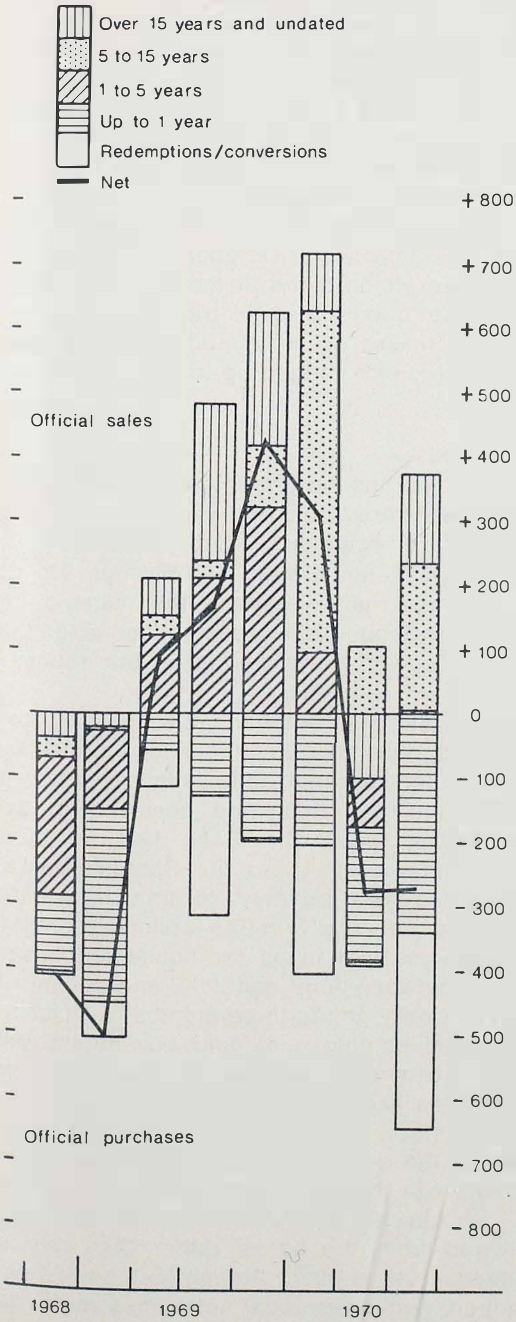
Owing to the outflow of exchange during the quarter, part of the borrowing requirement was offset by external transactions. The amount remaining to be found from domestic sources was in the region of £150 million. Those outside the banking sector reduced their holdings of government debt. A fall in their holdings of gilt-edged stocks reflected the redemption of 3% Savings Bonds 1960/70, repayments of which outweighed net purchases of other stocks; and there were further withdrawals from national savings, though smaller than in the June quarter. These movements were only partly offset by increased holdings of tax reserve certificates and of notes and coin. The banks and discount houses also reduced their holdings of gilt-edged stocks, and were left to take up £244 million of Treasury bills.

In the first half of the financial year, there was a borrowing requirement of some £130 million in place of a somewhat larger surplus in the same period last year. The most important single reason for the change was that import deposits contributed to the Exchequer's receipts last year but, with the scheme now being run down, have necessitated large net repayments this year. The out-turn for the first half of the financial year was broadly as expected and, allowing

1 See December 1969 *Bulletin*, page 389. The effect of reducing borrowing below the base level is to produce a new and lower base, and the 10% reserve requirement would be payable on any subsequent increase in borrowing above the new base.

£ millions

Official transactions in gilt-edged stocks by maturity



Substantial official sales of medium and long-dated stocks were outweighed by the redemption of 3% Savings Bonds 1960/70.

for seasonal influences, was consistent with the emergence of a sizable surplus for the year as a whole. In addition to the borrowing requirement, external transactions required sterling finance on balance over the six months, so increasing the amount to be raised from domestic sources. Partly because of the Savings Bonds redemption, those outside the banking sector reduced their holdings of government debt – and especially of gilt-edged stocks – over the six months, so that the banks and discount houses were required to take up £470 million of Treasury bills.

Gilt-edged market

The market was firm at the beginning of August, following the settlement of the dock strike. But the growing evidence of the strong inflationary trends in the economy, unease about industrial disputes and, early in September, nervousness about the exchange situation with the approach of the I.M.F. and I.B.R.D. joint annual meeting, all contributed to a marked weakening in sentiment between mid-August and mid-September. In these conditions, the funds arising from the redemption of 3% Savings Bonds 1960/70 on 1st September were slow to be reinvested in gilt-edged stocks at first. After the middle of September, however, the market became much more buoyant – and for a time at the end of the month was very firm – following the settlement of a long-standing strike in the motor industry and the $\frac{1}{2}$% reduction in U.S. banks' prime lending rates.

The authorities sold some £375 million of medium and long-dated stocks during the September quarter. Against this, their purchases of 3% Savings Bonds 1960/70 from the market prior to redemption on 1st September, and the redemption of the amount still in market hands at that date, cost a total of some £570 million.[1] Allowing also for purchases of other short-dated stocks, net official payments to the market during the quarter amounted to some £275 million.[2] The Savings Bonds were issued in wartime and were very widely spread among numerous small holdings – private holders were easily the largest group at the time of redemption. When a stock is dispersed in this way, it is not easy for the authorities to spread the impact of the redemption over a long period by purchases in the market well in advance of maturity. An additional factor with this stock was that investors bought large amounts in the middle of 1969, when yields reached new heights, and could then not dispose of their purchases for twelve months if they wished to avoid short-term capital gains tax. However, there were considerable sales towards the end of last July, because there was a tax advantage to many holders in selling before they received the final dividend;[3] and, over the whole of the period in which they were buying this stock in the market prior to maturity, the authorities were able to acquire some £440 million. Other operations during the quarter included the issue of two new stocks – 6$\frac{3}{4}$% Treasury Stock 1974 and 8$\frac{1}{2}$% Treasury Loan 1984/86 – on 12th August.[3]

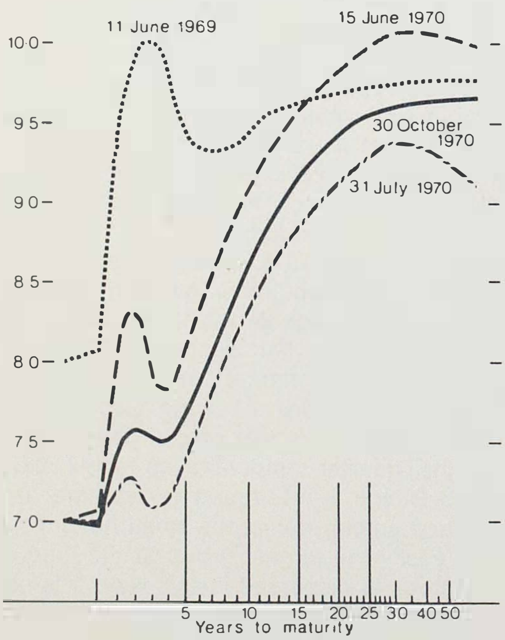
1 The total of Savings Bonds outstanding was reduced from £1,018 million following a conversion offer into a new stock – 8$\frac{1}{4}$% Treasury Loan 1980/82 – on 1st March (see March 1970 *Bulletin*, page 14). The offer was accepted by holders of £260 million of Savings Bonds, so that the amount outstanding at redemption, including stock in official hands, was £758 million.

2 See Table 3(1) of the annex.

3 See September 1970 *Bulletin*, page 266.

Per cent per annum

Time/yield curves of British government securities[a]



Most of the rise in yields between July and October occurred in the last few days of the period.

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

The gilt-edged market remained quietly firm at the beginning of October and was encouraged in the middle of the month by the indications already referred to that U.S. banks were continuing to reduce their borrowing in the euro-dollar market. However, the market turned sharply easier following the announcement of the changes in public expenditure on 27th October, at first because of renewed doubts about inflationary pressures and later because of fears that monetary policy was about to become still tighter. A short-lived rally following the announcement of the call for Special Deposits was not maintained, and the market was generally rather weak in the first half of November.

Yields did not change greatly over most of the period, but rose sharply in the closing days of October. At the end of that month, short-dated yields stood in the region of $7\frac{5}{8}$%, a rise of rather more than $\frac{1}{4}$% over the three months; there were similar increases on most medium and longer-dated stocks, on which yields ranged up to $9\frac{1}{2}$% at the end of October.

Banks and discount houses

The banking sector's sterling advances and deposits rose more slowly in the September quarter than in the previous three months. The funds becoming available from the central government's deficit and from the Savings Bonds redemption may perhaps have lessened the demand for bank advances, but also tended to increase deposits; on the other hand, the exchange outflows worked in the opposite direction.

Between mid-July and mid-October, advances by the *London clearing banks,* other than to nationalised industries, rose by £80 million after seasonal adjustment. This was a very much smaller increase than had occurred in the previous three months, when the Bank had, in July, requested the clearing banks – and the Scottish banks, whose lending had also risen rapidly – to limit the growth in their lending more effectively in the coming months.[1] Personal lending (aside from loans for house purchase) recovered markedly between April and July, and continued to rise, though more slowly, in the three months to October. The total of restricted lending, including commercial bill holdings as well as advances, increased only modestly over the latest three months – and in fact fell in the month to mid-October. Nevertheless, over the period from March to October as a whole, the growth in this lending was larger than was consistent with the need for monetary restraint – partly because, as described later in the Commentary, companies borrowed from the banks rather than raising funds on the new issue market. Among categories not subject to restriction, lending to local authorities remained low.

The clearing banks sold £52 million of gilt-edged stocks between mid-July and mid-October and increased their holdings of Treasury bills by £113 million. They also lent substantial amounts of call money to the discount market during these three months, and particularly in August and September, so that in total liquid assets rose by £355 million.

1 The Bank's notice was reproduced on page 327 of the September 1970 *Bulletin.*

Net deposits rose strongly, after seasonal adjustment, in August and September, but there was little change in the following month. In the result, the clearing banks' combined liquidity ratio rose over the period to 32·6% at mid-October.

In the month to mid-November, there was a fall of about £30 million, seasonally adjusted, in the clearing banks' advances, leaving aside lending to nationalised industries; restricted lending fell for the second month in succession. Net deposits rose steeply – by some £120 million, seasonally adjusted – mainly reflecting an inflow of foreign exchange and a deficit in the central government's accounts. Although the £108 million addition to Special Deposits called for in October became payable during the month, the clearing banks' liquid assets rose by a further £90 million. They reduced the amount lent at call to the discount market and elsewhere, but again increased their Treasury bill holdings substantially. As a result, the combined liquidity ratio rose further, to 33·3% – a comparatively high figure for the month.

The *Scottish banks'* advances continued to increase, seasonally adjusted, over the three months to mid-October. By that date their restricted lending since last March had risen even more, proportionately, than such lending by the clearing banks. Net deposits also rose, after seasonal adjustment, during this period; and the combined liquidity ratio of the Scottish banks at mid-October was quite high, at 34·5%.

To emphasise the need for a substantially slower growth in restricted lending by these two groups of banks over the months ahead, the Bank announced on 29th October that the amount of Special Deposits was to be increased from $2\frac{1}{2}$% to $3\frac{1}{2}$% for the clearing banks, and from $1\frac{1}{4}$% to $1\frac{3}{4}$% for the Scottish banks. The additional deposits were to be made by 11th November. The banks' liquidity was quite high at this time and, as noted above, increased still further in the month to mid-November despite the additions to Special Deposits.

The arrangements under which the London clearing banks and the Scottish banks provide fixed rate finance for exports and shipbuilding for U.K. owners[1] were changed as from 1st October. Previously, the banks concerned provided medium and long-term credit (two years or more) at a rate of interest of $5\frac{1}{2}$% for the whole term of the credit where the lending was supported by an unconditional guarantee to the bank by the Export Credits Guarantee Department, or, in the case of shipbuilding for U.K. owners, by the Ministry of Technology (now the Department of Trade and Industry). The rate of $5\frac{1}{2}$% had remained unchanged since January 1965, when these banks took on all fixed rate lending for exports, including the longer-term finance previously provided by the insurance companies. This was considered at the time an appropriate average lending rate for the duration of the credit, given the E.C.G.D. guarantee. Longer-term interest rates in the United Kingdom and abroad have since risen substantially, and rates charged in other coun-

1 For a description of these arrangements, and the associated refinancing facilities, see the following articles in earlier issues of the *Bulletin:* "Finance for exports" – December 1969, page 424; "Finance for shipbuilding" – June 1967, page 157; "New refinance facilities for exports and shipbuilding credits" – September 1969, page 292.

tries for export credits have also increased. With the approval of the Government, the Bank of England therefore agreed with the London clearing banks and the Scottish banks that, as from 1st October, the rate of interest for contracts under new commitments would be raised to 7%. The commitment fee was also changed from the same date, from a fixed once-for-all charge of 1% to an amount representing $\frac{1}{8}$% for each year of the loan, with a minimum of 1%.

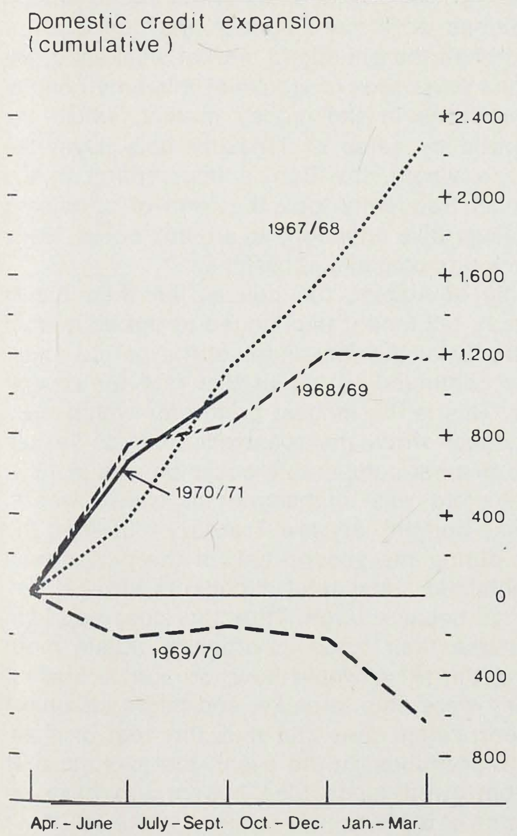
The arrangements for refinancing medium and long-term export and shipbuilding finance with the Bank of England were also extended, to provide the London clearing banks and the Scottish banks with the right to refinance not only eligible fixed rate lending included in their advances in excess of 5% of their gross deposits, but also such lending included in their liquid assets in excess of the same percentage. At the same time, the rate of interest applicable under the Bill and Open Account Schemes – under which the London clearing banks, the Scottish banks and the Northern Ireland banks are prepared to make shorter-term export finance available against a direct E.C.G.D. guarantee – was increased from Bank rate to Bank rate plus $\frac{1}{2}$%, in each case with a minimum of $4\frac{1}{2}$%; the higher rate applies to all facilities granted as from 1st October, and to all earlier facilities as they are renewed.

Domestic sterling deposits with the *accepting houses, overseas and other banks* rose by a further £128 million, leaving aside inter-bank funds, in the September calendar quarter. The rise in overseas sterling deposits was smaller than in recent quarters, but there was another substantial increase, of £190 million, in sterling certificates of deposit outstanding.

As noted earlier, these banks converted some sterling assets into foreign currencies during the third quarter. For the rest, the additional sterling funds taken during these three months seem to have been employed mainly in the more liquid types of assets. The amount lent at call to the discount market rose sharply, by £72 million; and these banks again increased their own holdings of sterling certificates of deposit, in this period by £87 million. But they disposed of a further £43 million of gilt-edged stocks, and the rise in their lending to local authorities was much smaller than in other recent quarters; instead of borrowing from the banks, local authorities drew large amounts from the Public Works Loan Board. Sterling advances to U.K. residents (other than banks) and to overseas residents increased moderately during the September quarter, but restricted lending by this group of banks was not greatly changed; nor was the increase in their restricted lending over the six months to the end of September unduly large.

The *discount market's* borrowed funds rose very steeply, by £335 million, during the September quarter. The houses' holdings of gilt-edged stocks were virtually unchanged. They took up another £154 million of Treasury bills, and their holdings of sterling certificates of deposit and of local authority bonds also rose.

Seasonally adjusted £ millions



The expansion in domestic credit in the September quarter was about half as large as in the previous quarter.

Domestic credit and money supply[1]

Despite the Savings Bonds redemption, the growth of domestic credit and money supply was much slower in the September quarter than in the previous three months. In seasonally adjusted terms, domestic credit expanded by some £350 million, or little more than half the revised figure of £670 million from April to June. Money supply rose less than domestic credit, mainly because of the reserves outflow in September; the rise of some £240 million, or about 1½%, followed an increase of 4% in the June quarter.

The contrast between the two quarters owed something to statistical distortions, which exaggerated the increases in the June quarter and helped to reduce those from July to September.[2] But apart from these distortions, there was a slower rate of growth in bank lending to the private sector which, together with official sales of medium and long-dated gilt-edged stocks to the general public, helped to offset the effects of the Savings Bonds redemption.

During the first half of the financial year, domestic credit expanded by about £1,000 million, seasonally adjusted, and money supply by nearly £900 million, or about 5½%. At the time of the Budget, it was thought that domestic credit might increase by some £900 million during the financial year, and money supply by rather less. Thus the results for the first half exceeded the forecast for the year as a whole. It had been expected that the rate of increase would be considerably larger in the first half of the period than in the second, particularly because of the redemption. In the event, the rise in bank lending in the June quarter was heavier than had been foreseen (though the rate of increase has recently been much slower). But the central government's borrowing requirement developed broadly as predicted; and the outcome of official transactions in gilt-edged stocks was better than had been expected, because of the sales of medium and long-dated stocks to the market.

Bill markets

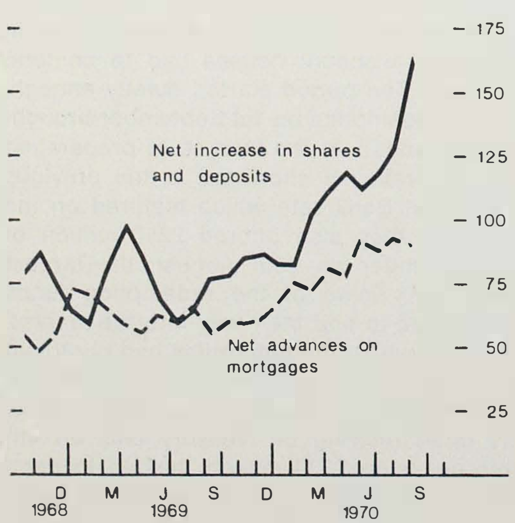
The three months to the end of October included four main occasions on which the discount houses had to contend with unusual conditions. The period started quietly enough, but the Savings Bonds redemption on 1st September brought very large amounts of funds into the market. In preparation for this, the authorities relieved shortages in the previous week by making loans at Bank rate which matured on the day of the redemption; they also offered £250 million of Treasury bills at the tender on 28th August, the largest amount since late 1967. Some of the redemption funds took longer than expected to find their way into the market, and part of the shortage which the authorities had contrived in order to absorb these funds was therefore rolled forward to the following two days by means of overnight loans. Another unusually large offering of Treasury bills on 4th September, on this occasion £220 million, helped to complete the mopping-up operation. In the following week,

1 Figures of domestic credit expansion are given in Table H of the analysis of financial statistics; the references to money supply are based on the broadest definition, M_3, in Table 12 of the annex.

2 The exaggeration in the June quarter – see September 1970 *Bulletin*, page 262 – would have been partly offset in the figures for January – March, as well as in those for July – September.

Seasonally adjusted £ millions

Building society funds



There was a particularly steep rise in net receipts in the third quarter, and advances remained high.

settlements for foreign exchange outflows took funds out of the market, and caused severe shortages on some days; and towards the end of September, there were further large shortages as the result of official sales of gilt-edged stocks. Thereafter, conditions were more normal until the last few days of October, when the gilt-edged market weakened; the proceeds of official purchases of stocks at this time contributed to large surpluses in the money market, which the authorities absorbed by sales of Treasury bills. Over the three months as a whole, the Bank's intervention in the money market most frequently took the form of purchases and sales of Treasury bills although, as already noted, loans were made at Bank rate on some occasions.

After the middle of August, the houses left their bid at the weekly Treasury bill tender unchanged at the equivalent of slightly over $6\frac{13}{16}$% for the remainder of the period under review; and they continued to bid at this rate for several weeks thereafter. This is the longest period for which rates have remained stable since the re-introduction of flexible rates in 1951; the nearest comparable occasion was in 1964, when the market's bid was unchanged for twelve weeks. The clearing banks bought very few Treasury bills from the discount houses during the second half of the period and, as the houses obtained substantial allotments at most tenders, their holdings became large. They therefore had little incentive to increase their price in order to obtain more bills; but lowering the price would have brought a loss on such sales as they were able to make, and might also have increased their borrowing rates and thus the cost of maintaining their large portfolios. In the event, the average cost of the houses' borrowed funds also appears to have remained in the region of $6\frac{13}{16}$%.

Hire purchase finance houses

After seasonal adjustment, new credit extended by the finance houses, particularly for the purchase of cars, continued to increase in the third quarter. With little change in repayments, the total of debt outstanding rose by £18 million, the largest quarterly increase since early 1968. But, taken with the rather smaller rise in the previous three months, the growth in lending over the six months since March was still moderate.

Deposit rates fell steadily over the three months, in parallel with most other domestic short-term rates. By the end of October, rates on three months' deposits were about $\frac{3}{4}$% lower than in July, at about $7\frac{1}{2}$%. With bank borrowing costing at least $8\frac{1}{2}$%, the houses continued to repay bank advances, as they have each month since March. The Finance Houses Association's base rate, introduced at the beginning of September as a means of calculating charges on long-term lending,[1] remained at 8% in September and October, but was reduced to $7\frac{1}{2}$% in November.

Building societies

The building societies may have attracted some of the funds generated by the Savings Bonds redemption. Seasonally adjusted, their share and deposit receipts reached new

1 See September 1970 *Bulletin*, page 264.

heights in the three months to October. Withdrawals also rose but the net inflow of funds continued to increase. Over the first ten months of this year, net receipts totalled £1,164 million, compared with £895 million in the whole of 1969. Net lending continued to expand; and, as new lending commitments also rose further, the total of commitments outstanding at the end of October was very large. The combined liquidity ratio rose from 16·7% at the end of July to 17·5% at the end of October – the highest since 1967.

Local authorities

In the three months to October local authorities continued to borrow large amounts from the Public Works Loan Board. They also borrowed more on market mortgages and made several new stock issues, though they received little by way of calls on earlier issues. However, only a small amount was raised on new bond issues, after allowing for redemptions. Longer-term rates changed little on balance over the three months: P.W.L.B. rates for 10–15-year loans stood at $9\frac{1}{4}$% at the end of October, compared with $9\frac{3}{8}$% in July; the rate on mortgages of similar term ended the period at about 9%, and one-year bonds at about 8%.

Rates for temporary money continued to ease, reflecting not only the general trend in short-term rates but perhaps also rather less borrowing of short-term funds after the large amounts taken earlier in the year. As already noted, rates for three months' deposits fell by $\frac{1}{2}$% over the period, to $7\frac{1}{4}$% at the end of October.

Company securities

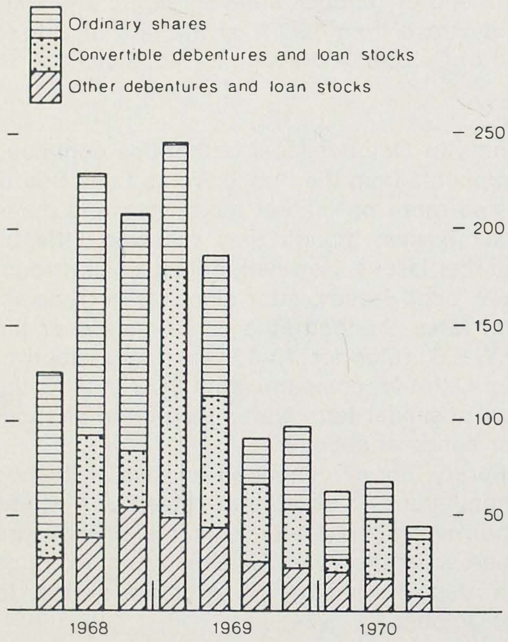
The equity market remained quiet during the three months to the end of October, with investors seeking clearer signs as to the way in which the economy was developing, and awaiting the expected policy measures from the new Government. Early in August the brief rally induced by the ending of the dock strike subsided, but in the second half of that month the market became firmer under the influence of a steady advance on the New York stock market. Over the next two months, Wall Street moved only narrowly; on the London market, however, prices rose further during the second half of September and early in October, and were then broadly maintained until towards the end of that month. At the end of October, the government measures caused some optimism at first, but the market soon became more hesitant, and prices drifted downwards in quiet trading. The F.T.-Actuaries industrial share price index stood at 144·4 compared with 136·8 three months earlier, but fell back in November.

The market in company fixed interest securities was also fairly quiet. Yields on first-class high coupon debentures of about 25 years' maturity moved downwards on balance to just under 10% at the end of October. As a result, the differential over yields on government stocks of similar term narrowed to about $\frac{1}{2}$%.

The amount of cash which companies raised on new issues, already very low since the middle of last year, fell even further – to less than £25 million – during the three months to October. Short-term funds were comparatively cheap and companies were reluctant to borrow at the

£ millions

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



Very little cash has been raised on new issues so far this year.

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

prevailing long-term interest rates. By contrast with the earlier months of this year, industrial and commercial companies were responsible for the whole of the amount issued in the latest three months; on balance, financial companies redeemed more than they raised during this period. Most of the issues were of fixed interest stocks. Although the amount of cash raised in these three months was very small, there was a marked recovery in the total of new issues announced in October; and the queue of new borrowers lengthened noticeably over the period.

Demand for unit trust units was again very subdued in the third quarter with net sales of only £21 million; and sales remained low in October.

Conclusion

Incomes and prices continue to increase very rapidly while, at least until recently, the economy has remained sluggish. The large additions to real incomes have predictably encouraged an increase in consumption since the early summer, and this could accelerate. But there are no convincing signs of renewed growth in the volume of industrial investment or exports; and domestic output has been hampered and distorted by an unusually large number of industrial disputes.

Despite the rapid rise in industrial costs, the balance of payments continues in reasonable surplus on current account at present. This is partly because consumption was slow to respond to the rise in incomes; and partly because other countries have also been in the grip of strong inflationary pressures for some time past. However, the rise in domestic costs must now be reducing either the profitability or the competitiveness of an increasing range of exportable goods; and disruptions of supply continue to give a fillip to imports. The longer the present domestic conditions continue, the more the balance of payments is likely to be affected. But quite apart from external considerations, wage and price increases at current rates present grave economic and social problems at home.

To cure the present inflation solely by restricting demand would be likely to involve very high costs in terms of unemployment, bankruptcies and falling output. But this is not to say that there is no role for demand management. On the contrary, with industrial costs increasing at their present rate the overall stance of policy must clearly be restrictive.

The severity of the restraint to be imposed under varying conditions is a matter of judgment. For example, domestic credit could not have been allowed to continue to expand as rapidly as in the June quarter. The expansion was partly attributable to the public sector's use of bank finance, but mainly to an excessive rise in bank lending to the private sector; yet this lending was largely a manifestation of the difficult condition of company finances. As described in the financial analysis (page 407) the financial deficit of industrial and commercial companies was more than twice as large in the first quarter of this year as in the previous three months, and it doubled again in the second quarter – when the deficit was the largest on record. In these circumstances, companies drew heavily on their bank facilities because the cost of borrowing from other sources would have been higher.

In the September quarter the increase in domestic credit and money supply was much more moderate, as bank lending rose less fast. Both the central government's borrowing requirement and official transactions in gilt-edged stocks developed much as had been expected over the first half of the financial year. Indeed, the results of gilt-edged transactions exceeded expectations, because the Savings Bonds redemption in September was offset by official sales of medium and long-dated stocks to a greater extent than had been foreseen.

The decision to call for additional Special Deposits from the clearing banks and the Scottish banks at the end of October was taken in order to emphasise the need for continued and increased restraint in lending. Such restraint will exert considerable pressure on companies as, to judge from the more recent moves in costs and prices, the reduction in companies' net income has probably continued since the summer; and they are likely to face additionally difficult conditions as the revenue season approaches – although the difficulties should to some extent be alleviated by repayments of import deposits and the recent reduction in corporation tax.

Within total lending, it is therefore desirable that the banks should be particularly restrictive about personal lending, which has begun to rise again since the spring, after a fall in the latter part of 1969. This lending is likely to encourage consumption, which is already increasing steadily and may accelerate in response to the large increases in real incomes.