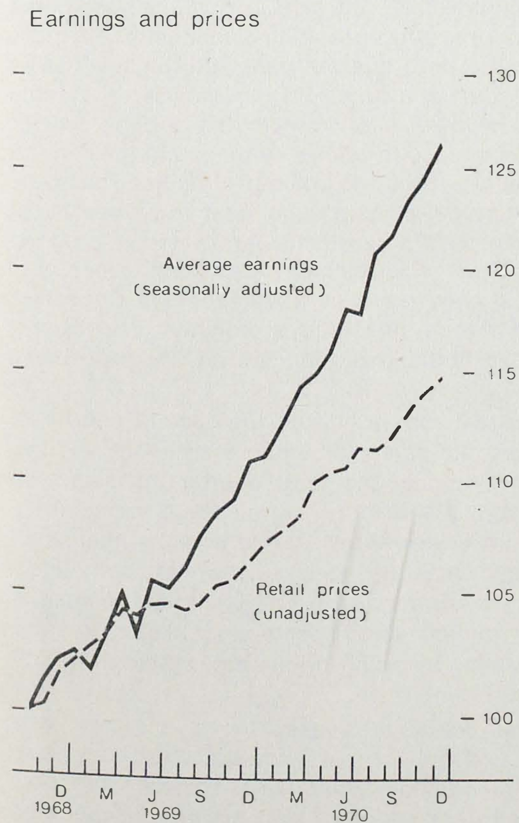
Commentary

Incomes and prices continued to rise strongly during the three months from November to January, with which this Commentary is mainly concerned. Yet the economy remained subdued, although output began to increase towards the end of the year. U.K. interest rates changed little, despite a steep fall in international rates from late December onwards, for the authorities were unwilling to relax monetary restraints when domestic costs and prices were rising so fast. Thus interest differentials attracted inflows of exchange, particularly in January, in addition to those generated by a large balance of payments surplus on current account; U.K. companies also converted into sterling further substantial amounts borrowed in foreign currency to assist their domestic financing. These exchange inflows tended to ease domestic liquidity; but very large official sales of gilt-edged stocks in January had the opposite effect. The increase in domestic credit in the fourth quarter was not significantly larger than in the third, but the money stock rose more than domestic credit, because of the inflow of exchange.



Earnings and prices were still rising steeply at the end of last year.

The domestic economy

The excessive growth of incomes and prices continued, and even accelerated, towards the end of last year. Average weekly earnings in the fourth quarter were some $3\frac{3}{4}$% higher than in the previous three months, compared with increases of about $3\frac{1}{4}$% earlier in the year; earnings last December were some 14% higher than a year previously. Part of the increase in earnings last year went to meet larger payments of direct taxes and national insurance contributions, and part was absorbed by higher retail prices – which rose by $8\frac{1}{2}$% over the twelve months to January; even so, real income in the hands of consumers rose by $5\frac{1}{2}$% over the twelve months to last September (the latest available figure), following very little change over the previous two years.[1]

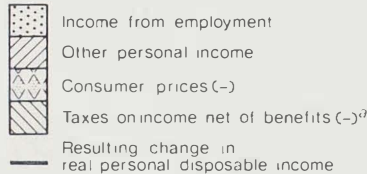
This rise in real incomes was accompanied by a marked, though smaller, increase in the volume of personal consumption, which rose by some $3\frac{1}{2}$% in the same twelve months, and particularly between April and September. The first indications are that there was little further increase in the fourth quarter. The volume of retail sales was only fractionally higher than in the previous three months, perhaps in part because of slower trade in some large shops in the early part of December, when power supplies were interrupted during a dispute in the electricity supply industry. A slight fall in new car registrations in the fourth quarter may have reflected production difficulties caused by strikes in earlier months, and fewer purchases by businesses. On the other hand, hire purchase trading continued

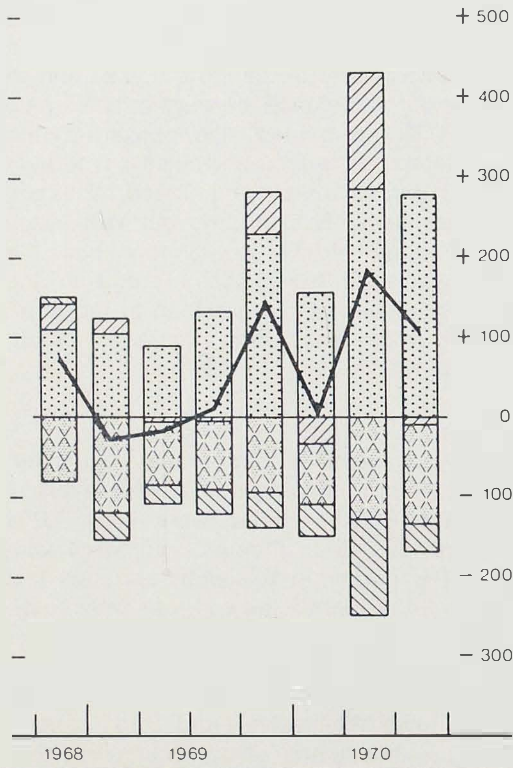
1 The increase in real incomes is taken from national income statistics ("personal disposable income at constant prices"), and the coverage is wider than that of the more up-to-date figures of weekly earnings and retail prices quoted earlier in the paragraph.

Seasonally adjusted £ millions

Changes in spending power

attributable to quarterly changes in





Real purchasing power continued to increase rapidly in the third quarter of 1970, despite price rises and tax payments . . .

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

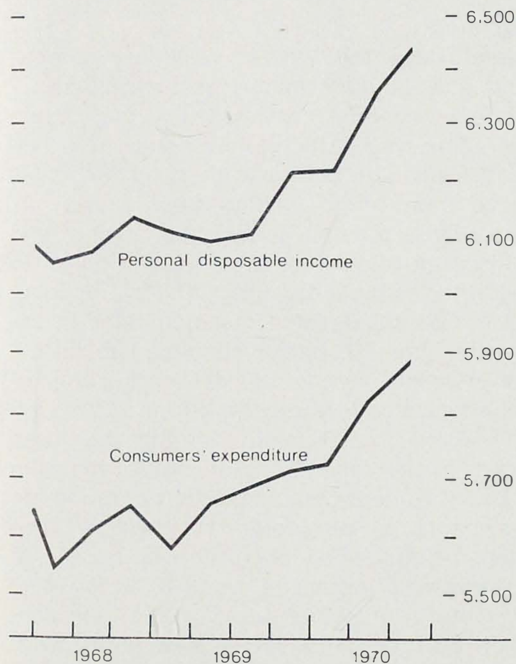
to increase, and there was an unusually large rise in debt outstanding; most of the additional credit extended was to finance purchases of new and used cars, but the amount borrowed for other durable goods also increased.

If spending was checked in the fourth quarter, it was probably because of temporary factors such as those already described. In view of the continuing steep rise in incomes, consumption seems likely to remain on an upward trend, especially as the probability of further price increases can be expected to encourage spending rather than saving. Nevertheless, the growth in consumption since the autumn of 1969 has not matched the increase in real personal incomes, and additions to savings seem to have been larger than usual. In part, this is no doubt attributable to the normal slowness to adjust spending to a rapid growth of incomes. But recently, some of the saving may also have reflected uncertainty about the prospects for employment.

Most of the other elements of demand appear to have increased little, if at all, in the latter part of last year. The volume of exports remained much as it had been since the spring, as described later in this Commentary. Private manufacturing investment was higher in the third quarter than on average in the first half of the year, but may not have risen much further in the fourth; indeed there may have been a fall, if deliveries to the home market by the engineering industries are a reliable guide. Companies are likely to restrict their outlays on investment, except perhaps in labour-saving equipment, as the rise in costs reduces their profits and brings pressure upon their finances. Their gross trading profits in the third quarter were little higher than in the first half of the year and, throughout the first nine months, were at a lower rate than in the second half of 1969, despite the increase in prices. In these circumstances, and with the slow growth in the volume of demand over the last two years, it is hardly surprising that the Department of Trade and Industry's surveys have revealed a progressively gloomier view of investment prospects since late 1969. The latest survey, taken in November and December last year, suggests that, measured at constant prices, new manufacturing investment this year will be 2% lower than last.

Housing investment rose a little in the second quarter of last year, following the steep fall since the middle of 1968. The recovery continued in the third quarter but seems to have been checked in the fourth, when there were reductions in the amount of new work started and the number of houses completed. Over the year as a whole, both totals were lower than for several years. The vigorous increase in building society lending since last spring seems to have been absorbed mainly by rising prices and by purchases of existing property.

All in all, final demand appears to have grown only slowly in the second half of last year. But there may have been quite a large addition to industrial stocks – probably in part as a reaction to steeply rising prices, and perhaps also because companies were anxious to minimise the risk of dislocation if supplies were held up by strikes.



... and the rise in incomes was accompanied by a further increase in personal consumption.

This stockbuilding seems to have contributed to a rise in domestic production towards the end of the year rather than to a further rise in the volume of imports. The index of industrial production was about 2% higher in the fourth quarter than in the third; and within the total, there was a somewhat larger rise in manufacturing output. There had previously been little change in the index since the middle of 1969. It is, however, difficult to be sure about the timing and extent of the upturn, because of distortions caused by industrial stoppages – particularly those in the docks in July, in the motor industry in August and September, and in the coal mines in November. Production was hampered and disrupted to a quite unusual extent by industrial disputes throughout the whole of last year. In fact, nearly eleven million working days were lost, even before counting workers laid off because of stoppages in other plants; this was a much larger figure than in any other post-war year – indeed, the largest since the General Strike in 1926.

Whatever the extent of the recovery in output in the autumn, it was not sufficient to prevent a further rise in unemployment between October and February. During this period, the numbers wholly out of work, excluding school-leavers and others temporarily stopped, rose by 47,000, seasonally adjusted, including a particularly sharp increase in the month to mid-January; as a result, the number wholly unemployed stood at 623,000, or 2·7% of all employees in mid-February. A prolonged period of slow growth, coupled with rising wage costs and difficult financial conditions, seems likely to have put pressure on companies to reduce their labour force. The slackening in the labour market was emphasised by a continued fall in the number of vacancies notified for adult workers. On 17th February, the Chancellor of the Exchequer announced measures to assist certain areas where unemployment is particularly high because of the impact of structural changes in local industries. In future, these areas will be able, as 'special development areas', to offer greater incentives to attract new industries. The measures will involve additional expenditure which in due course will amount to some £10 million a year.

Immediate employment prospects weakened further, and industrial uncertainties increased, following a statement issued by the board of Rolls-Royce Limited on 4th February. The board announced that, because of expected losses associated with the RB.211 engine, they had decided to ask for a receiver and manager to be appointed. The statement added that, whatever arrangements were made for the future of the company, substantial redundancies were inevitable. Later the same day, the Minister of Aviation Supply told the House of Commons that the Government were to acquire the assets of various divisions of the company, in order to ensure the continuity of those activities which were important for national defence and certain other purposes.

To alleviate the possible difficulties which might face the large number of companies with trading and commercial relationships with Rolls-Royce, the Bank let it be known that credit policy would not be applied in such a way

as to prevent banks from accommodating, subject to normal banking criteria, trade creditors, suppliers or subcontractors of the company which might need temporary additional finance as a result of these developments.

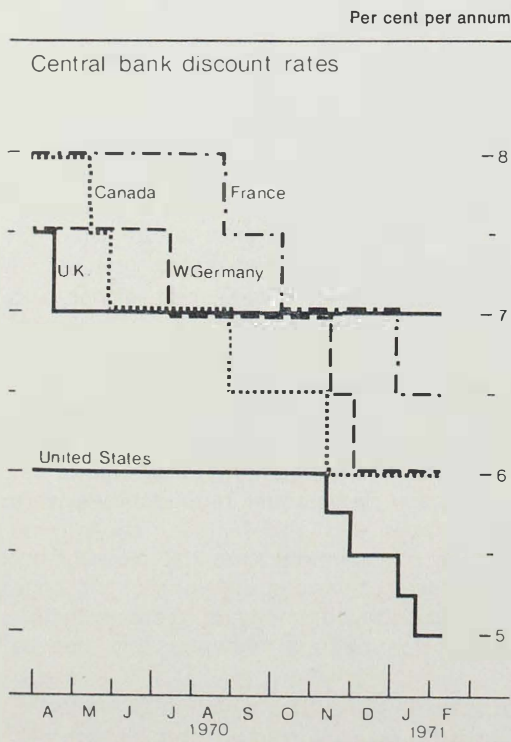
Short-term interest rates

International interest rates fell further, and very steeply, between November and January, mainly as a result of the continued easing of monetary conditions in the United States. The fall in rates was particularly marked from late December onwards. With little domestic demand for loans, U.S. banks reduced their prime lending rates in six ¼% stages during these three months, to 6% per annum; and Federal Reserve discount rates were lowered four times, to 5%. There were further reductions, again of ¼%, in prime lending rates and in Federal Reserve discount rates in the first half of February. The U.S. banks continued to attract large amounts of domestic funds against certificates of deposit, and reduced euro-dollar borrowing from their overseas branches by about $1,500 million during the three months to the end of January. On 30th November, the Federal Reserve Board announced measures to "moderate the pace of repayments of euro-dollar borrowings". The reserve requirement against such borrowing in excess of the reserve-free base was increased from 10% to 20%; repayments reduce the size of this base, so that any subsequent increase in borrowing above the new, and lower, base would attract the increased reserve requirement.

The large repayments by U.S. banks were reflected in a sharp decline in euro-dollar rates; the rate for three-month deposits fell by about 2% over the period, to around 5⅞% at the end of January. This was lower than at any time since the autumn of 1968, and meant that rates had been halved since they began falling at the end of 1969.

Euro-dollar rates steadied for a time, and even increased a little, towards the end of January; but the fall was resumed in February. The temporary check occurred partly because of some shortage of funds in Continental money markets, and partly because of a further attempt by the U.S. authorities to moderate the reduction in U.S. banks' borrowings. On 15th January, the Export-Import Bank announced an offer to the banks' overseas branches of $1,000 million of three months' notes at 6%; and the Federal Reserve Board amended its regulations to permit the parent banks to count funds which their overseas branches invested in these notes towards the maintenance of their reserve-free euro-dollar bases. The issue was made on 21st January, and was more than twice oversubscribed. Another similar issue, this time totalling $500 million at 5⅛%, was announced towards the end of February.

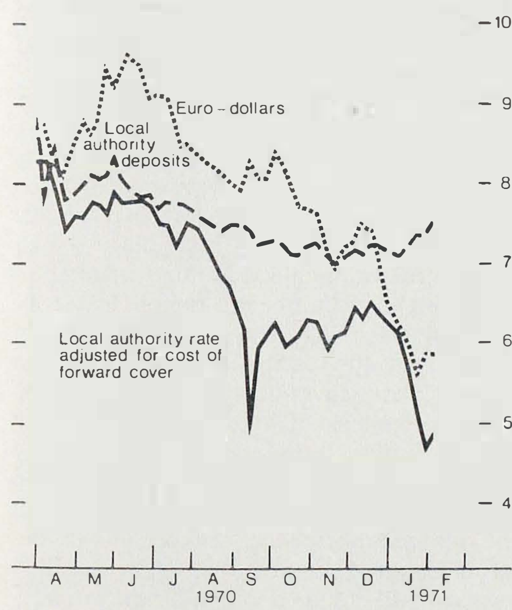
The fall in interest rates in the United States and in the euro-dollar market was accompanied by reductions in several other countries overseas. Central bank discount and advances rates were lowered during the three months in a number of Continental countries and in Canada and Japan. In most cases these reductions were judged necessary to suit internal as well as external conditions, but



A number of central banks reduced their discount rates between November and January.

Per cent per annum

Short-term interest rates in London[a]



Euro-dollar rates have fallen significantly below comparable U.K. rates, before allowing for the cost of forward cover.

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

some countries responded to the external pressure with reluctance. By contrast, local authority deposit rates and other key market rates in the United Kingdom were much the same at the end of January as they had been three months earlier.

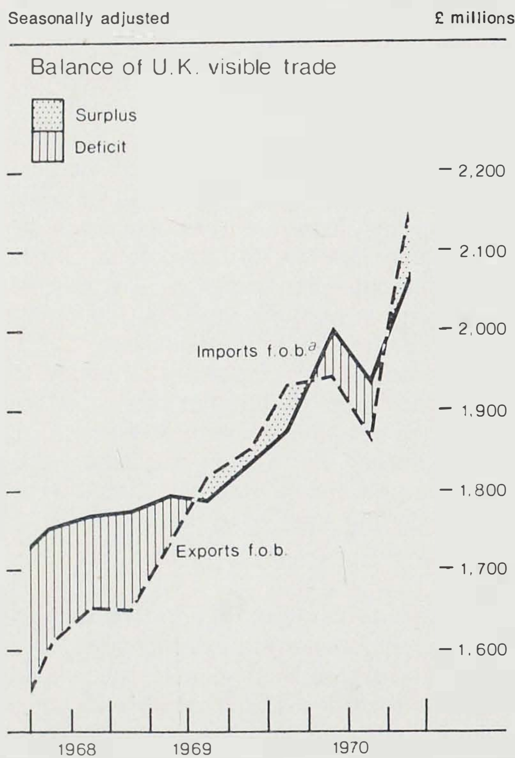
As a result, euro-dollar rates fell significantly below comparable U.K. interest rates, before allowing for the cost of forward cover; in the main, this uncovered interest advantage to sterling emerged from late December onwards, by which time a seasonal demand for euro-dollar funds over the end of the year had been satisfied. The cost of forward cover did not vary very much until the latter part of January, when it roughly trebled, to the equivalent of 3% per annum, partly because of the increasing tendency to borrow sterling on a swap basis as the spot rate rose, but also as a reflection of the growing disparity between U.K. interest rates and those abroad. For a short time before this widening of forward margins, some interest comparisons favoured investment in sterling even on a covered basis.

Balance of Payments

In total, the currency inflow in the fourth quarter was nearly £350 million. This large inflow was attributable more to a substantial surplus on current account than to receipts of investment funds and unrecorded flows. As already described, interest differentials did not become markedly favourable to the United Kingdom until towards the end of December. The current surplus was the result of a favourable balance of trade superimposed on the already high rate of invisible earnings. For the year as a whole, there was a surplus of well over £600 million – about half as big again as the already notable surplus in 1969, and the largest current surplus in post-war years.

Both the trade surplus in the fourth quarter and the deficit in the third reflected distortions caused by the July dock strike and its aftermath. Figures for the six months as a whole are relatively free from such distortions; over this period, there was a small trade deficit, following a small surplus in the first half year. The deficit in the second half might have been appreciably larger but for an improvement in the terms of trade: export prices rose by nearly 4% between the two periods, and import prices were little changed. Indeed, the rise in export prices accounted for the whole of the increase in the value of exports so that, even making some allowance for the once-for-all losses from the dock strike, the volume of exports was virtually unchanged in the second half. The trend of imports is equally disturbing. Allowing for some bunching of arrivals in the first half of the year – for example, three Boeing 747 aircraft were delivered then, and none thereafter – the volume of imports rose by some 4%–5% between the two half years. The trade pattern in more recent months is not yet clear. The figures for January were badly distorted because of delays in documentation caused by the postal strike which began on 20th January; and those for February will be similarly affected.

Investment and other capital flows were in rough balance in the fourth quarter. Private investment transactions,



External trade was roughly in balance in the second half of 1970, when export prices were rising much faster than import prices.

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

inward and outward, were broadly offsetting; but end-year capital repayments fell due on the long-term North American loans, and further large sums were extended as export credit. There was little change in gross sterling balances during the quarter; overseas sterling countries reduced their holdings somewhat, but non-sterling countries added to theirs. However, U.K. companies continued to expand their euro-dollar borrowing for use in the United Kingdom, as they had throughout the year, and drew very substantial amounts in the fourth quarter.

This foreign currency borrowing for domestic use has since been restricted to medium and longer-term finance, following an amendment to exchange control regulations on 12th January. In recent years, such borrowing has been readily permitted at all maturities, except for purposes for which banks are asked to be especially restrictive in their domestic lending. As already mentioned, the amount borrowed, much of it at short term, increased rapidly last year, as international interest rates fell. The further decline in interest rates abroad, and the continued restrictions on sterling credit, seemed likely to encourage still larger inflows and thus to make the task of credit control progressively more difficult. In future, therefore, foreign currency borrowing for domestic use will normally be permitted only when it is for a period of at least five years – a term chosen so that, in general, borrowing appropriate to the financing of fixed investment is not restricted. Existing authorisations to borrow will stand. Under the new arrangements, U.K. residents will not ordinarily be permitted to borrow sterling (or other sterling area currencies) from non-residents of the sterling area, a source of finance which might otherwise develop as an alternative to loans in foreign currencies. Borrowing to finance investment overseas is not affected by the new procedures; and U.K. exporters will still be allowed to borrow foreign currency to enable them to provide credit to overseas buyers.

Reserves and special facilities

The currency inflow of nearly £350 million in the fourth quarter occurred despite the payment of £110 million of debt service, mainly on the North American post-war loans. Part of the inflow was used to finance the United Kingdom's increased gold subscription to the International Monetary Fund, which amounted to the equivalent of £38 million and was paid in November. This left a total of £309 million to be added to the reserves or used to repay debt.

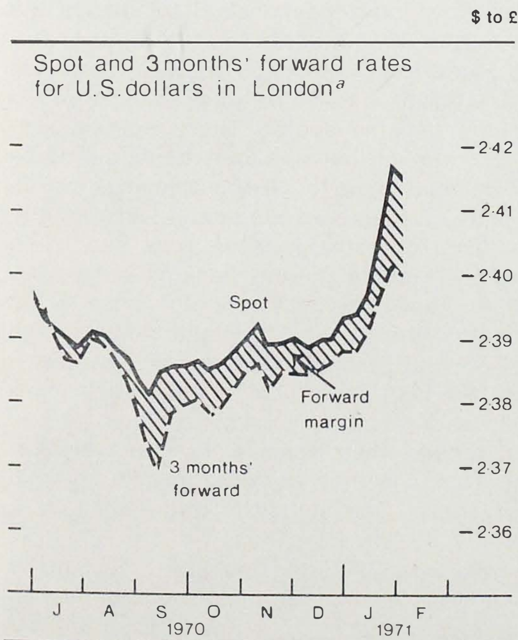
The reserves rose by £67 million over the quarter, to stand at £1,178 million at the end of December. The repayment of special borrowing therefore amounted to £242 million, the details of which are shown in Table 25 of the statistical annex (page 130). The largest component was the reversal of the £167 million ($400 million) drawn under the reciprocal swap arrangement with the Federal Reserve system in the third quarter; this swap facility had thus been fully reconstituted before the end of the year. Earlier drawings under this arrangement had been repaid by the end of March 1970; its brief use in the autumn was to meet a bout of pressure on the reserves towards the end of the

third quarter. The quarterly instalment of £31 million ($75 million) due in December under the Basle arrangements of June 1966,[1] was repaid to the Bank for International Settlements in advance in November; and £16 million ($39 million) was repaid to the United States in respect of a parallel facility. There was a further reduction of £15 million in the United Kingdom's repayment liabilities to the I.M.F. as a result of purchases of sterling from the Fund by other countries.

Foreign exchange and gold markets

The major influences affecting these markets – the fall in overseas interest rates and the surplus in the U.K. balance of payments – have already been described. Concern about inflationary pressures and industrial disputes in the United Kingdom was never very far below the surface but, in the conditions prevailing, was rarely a dominant feature. End-year pressures, which tend to be adverse to sterling, were weaker than usual; and, once these were out of the way, companies' preparations to meet the liquidity pressures expected in the revenue season added to the demand for sterling.

The spot exchange rate at the beginning of November was a little above $2·39 and it moved above parity early in January. In order to discourage inflows of the more volatile funds, the authorities allowed the rate to move towards its upper limit as the demand for sterling increased. It rose above $2·41 in the third week of January, and ended that month at about $2·41¾. The announcement about Rolls-Royce caused a momentary fall in the rate early in February, but it quickly recovered and rose further, to $2·41 15/16.



The spot exchange rate had risen to nearly its upper limit by the end of January, but forward margins widened sharply.

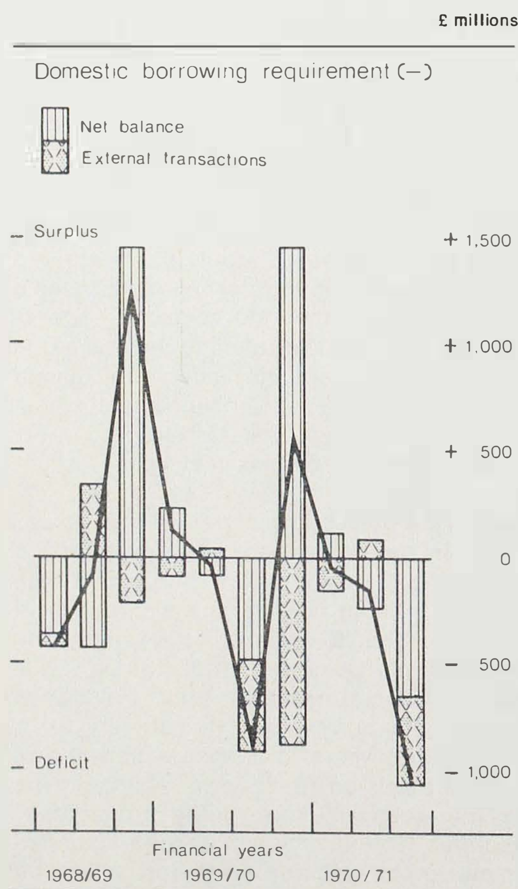
a Middle closing rates; weekly, Fridays.

On 23rd December, the investment currency market was affected by a change in the exchange control over foreign currency borrowing by U.K. residents for portfolio investment abroad. This was a minor change in the direction of greater flexibility, which should assist in maintaining the quality of portfolios of overseas securities. Since 1963, institutional investors such as investment trusts have been allowed, on application, to borrow foreign currency for a period of not less than five years to finance a portfolio of foreign currency securities on their own account; the amounts borrowed are repayable out of the proceeds of sales of these securities. This facility will now be extended to professional managers of security portfolios, either on their own account or on behalf of a client. Henceforth there will be no restriction on the length of the borrowing. Securities remaining in the portfolio after the repayment will be exempt from the requirement to offer for sale, at the official rate of exchange, 25% of the foreign currency proceeds upon switching into other securities; but the 25% requirement will apply when the capital profits on the portfolio are converted into sterling through the investment currency market. As a condition of the loan, borrowers will normally be required to hold, as excess cover throughout the life of the loan, marketable foreign currency securities or investment currency equivalent to at least 15% of the

1 See September 1966 *Bulletin*, page 209.

amount of the loan outstanding. These changes caused some uncertainty in the investment currency market; the premium for investment dollars stood at 33% just before the relaxations were announced, but had fallen to 22% early in January and was slightly below that figure at the end of the month.

Conditions in the London gold market were very quiet throughout the three months. The fixing price varied around $37½ per fine ounce in November and December, but some increased demand in January took the price up to around $38; and the rise continued early in February.



For seasonal reasons, the central government deficit increased further in the December quarter; together with the exchange inflow, this resulted in a large domestic borrowing requirement.

Central government financing

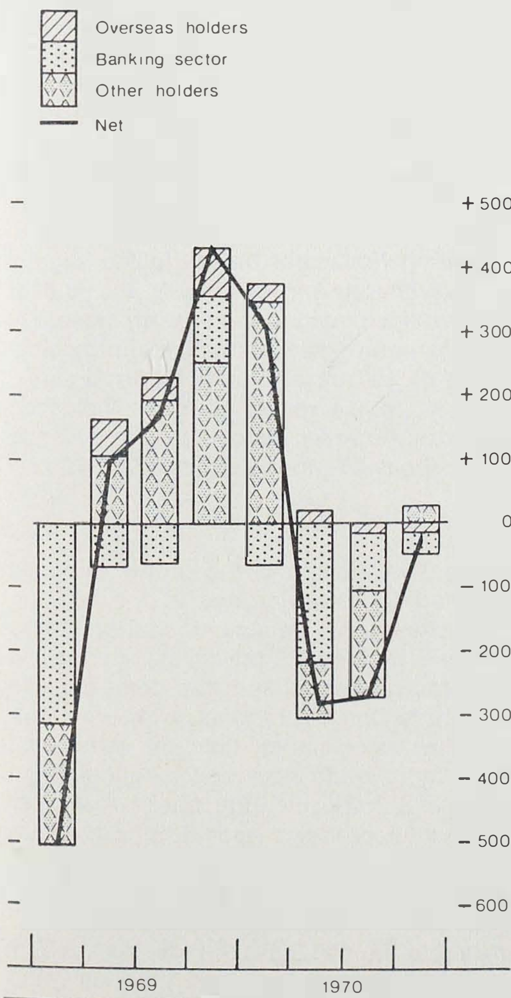
The central government's borrowing requirement was seasonally large in the December quarter, at about £650 million; receipts from income tax were lower than in the previous three months, and expenditure was higher. Net repayments of import deposits again increased; these deposits ceased to be payable after 4th December, and will be completely repaid by early June.

Over and above the basic borrowing requirement, a substantial amount of sterling was needed to finance the exchange inflows during the quarter. Thus a total of £1,060 million had to be found from domestic sources. There was a seasonal increase in the amount of notes and coin held by those outside the banking sector. These holders also invested modest amounts, on balance, in national savings – especially in the Decimal Issue of national savings certificates, which became available in October – and in gilt-edged stocks; holdings of both forms of asset had fallen over the previous six months. In the banking sector, an unusually large rise in net government indebtedness to the Banking Department of the Bank of England reflected the call for additional Special Deposits from the London clearing banks and the Scottish banks which was met in November.[1] The banks and discount houses continued to sell gilt-edged stocks, though their sales were much smaller than earlier in the year; and they were left to take up £590 million of Treasury bills – an unusually large total for a quarter.

The borrowing requirement during the first nine months of the financial year was some £450 million larger than in the comparable period of 1969/70, at nearly £790 million. The change from net receipts to net repayments of import deposits more than accounted for the increase. Allowing also for the sterling required to finance external transactions, domestic borrowing over the nine months amounted to £1,270 million. A small part of this total was met from those outside the banking sector; they increased their holdings of notes and coin over this period but, mainly because of the redemption of 3% Savings Bonds 1960/70 in September,[2] disposed of gilt-edged stocks. The banks and discount houses also reduced their holdings of gilt-edged stocks, and were left to take up £1,060 million of Treasury bills over the nine months.

1 See December 1970 *Bulletin*, page 395.
2 See December 1970 *Bulletin*, page 393.

Tax receipts are particularly large in the final quarter of the financial year, and the central government's accounts can be expected to show a very large surplus – perhaps in the region of £1,000 million – during these three months, unless the postal strike is further prolonged.



Holdings of gilt-edged stocks changed little in the December quarter.

Gilt-edged market

During November and December domestic developments generally tended to depress the market – because of the continuing evidence of inflation and industrial unrest – whereas external conditions were a cheering influence: the trade and reserves figures were taken to confirm that the balance of payments remained strong, and the steepening fall in international interest rates encouraged expectations of an accompanying reduction in domestic rates.

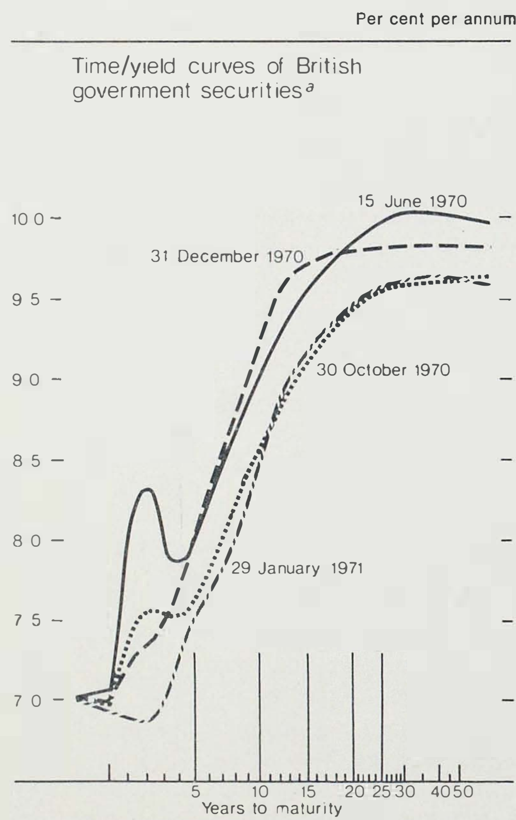
Sentiment had been weak just before the beginning of the period because of a belief that monetary policy might be tightened still further. The settlement of the wage claim for local authority manual workers caused some further selling, especially of long-dated stocks, early in November, because the market considered that the settlement was inflationary. Conditions then improved a little on the news of reductions in interest rates in the United States and Western Germany. The trade figures announced in the middle of the month were also well received and encouraged some buying of long-dated stocks; but prices moved downwards in the last week. Sentiment improved in December, especially in the middle of the month, when normal working was resumed in the electricity supply industry after a week in which it had been interrupted.

During the December quarter, the authorities' stock transactions were, on balance, very small. They bought in £325 million of stocks maturing during 1971, and sold roughly the same amount of other stocks; rather over half these sales were of medium and long-dated issues.[1] On 5th November it was announced that there would be no conversion offer for 6½% Treasury Stock 1971, which matured on 28th January. By the time of the redemption, the amount of the stock still in the market was only about £100 million.

In the new year, widespread expectations of a reduction in interest rates became the dominant influence in the market. The authorities were reluctant to see any substantial fall in yields, and sold very large amounts of stock during January. The short tap stock, 6¾% Treasury Stock 1974, was in particularly strong demand, and supplies were exhausted on 7th January, when it was announced that a further £600 million of an existing stock, 6½% Treasury Loan 1976, would be issued on 13th January; the issue was made at £94·25 per £100 nominal, to yield just over 7¾% to redemption.

Buying pressure in the market was maintained, but was now met from the medium-dated tap stock, 8½% Treasury Loan 1984/86. Within the week, however, this too had been exhausted. On this occasion, the authorities decided to provide themselves with a longer-dated stock, and an additional £500 million of 9% Treasury Loan 1994 was issued on

1 See Table 3 (1) of the annex.



Short and medium yields at the end of January were lower than three months earlier, but longer yields were, if anything, higher.

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

20th January; the issue price was £94·50, giving a yield of about $9\frac{9}{16}$% to redemption. The terms of both the new issues were designed to discourage expectations of any rapid fall in yields.

Demand for short-dated stock was very heavy indeed during the second half of January. Over the month as a whole, turnover on the London stock exchange in gilt-edged stocks of all maturities totalled over £5,000 million – almost three times as large as in December, and very much higher than in any other month since the figures began to be compiled in September 1964.

The market remained very firm during February, with continued heavy demand for stock on particular days. On 17th February, another issue of a new tap stock was announced – the third in six weeks. £600 million of $6\frac{1}{2}$% Exchequer Stock 1976 was issued on 23rd February at a price of £95·50, which gave a yield to redemption of just under $7\frac{5}{8}$% – almost exactly in line with the yield on the expiring short tap stock.

Most yields rose during November before falling slightly in December and more sharply in January. At the end of that month, short and medium-dated yields were generally lower than three months earlier; representative short yields, other than that on the $6\frac{1}{2}$% Treasury Loan 1976 tap stock, had fallen by some $\frac{1}{2}$%, to the region of $7\frac{1}{8}$%. Yields on most longer-dated stocks, however, tended to rise over the three months, often by about $\frac{1}{8}$%, to the region of $9\frac{5}{8}$%.

Banks and discount houses

The central government's deficit and the inflow of funds from abroad contributed to a further rise in the banking sector's sterling deposits in the December quarter. There was very little increase in sterling advances; companies borrowed large amounts of euro-dollars for domestic use and (as noted later in this Commentary) also raised appreciably more on the new issue market than for some time past. Thus, the banks' liquid funds increased substantially.

Net deposits with the *London clearing banks* rose very steeply, by some £330 million after seasonal adjustment, in the three months from mid-October to mid-January. The rise would no doubt have been still larger, but for the strong demand for gilt-edged stocks which emerged in January.

Advances, other than to the nationalised industries, fell by about £90 million (again seasonally adjusted), the fall being concentrated in the month to mid-January. This left advances at much the same figure as they were six months earlier, after a substantial increase last July. Restricted lending, including commercial bills as well as advances, was also reduced in the latest three months; as a result, this lending showed only a modest rise over the period since mid-March last year. The slackening in recent months reflects the banks' continued efforts to moderate the growth in their lending in response to official requests; they were reminded of the need for restraint in July, and the request was emphasised by a call for additional Special Deposits in October.[1] However, the slow rate of growth in the economy,

1 See page 261 of the September 1970 *Bulletin*, and page 395 of the December issue.

and the increases in company borrowing from other sources already mentioned, must also have contributed to the less buoyant trend in lending since last summer.

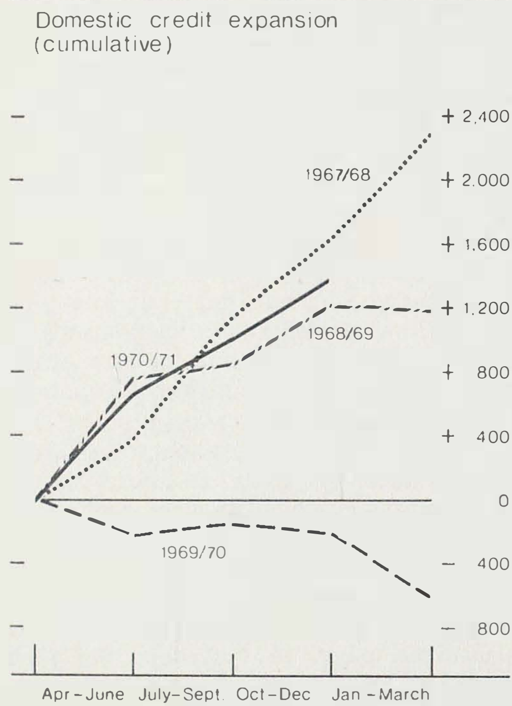
Following the October call, the clearing banks added £108 million to their Special Deposits in November. Their liquid assets nevertheless rose by more than £430 million over the three months to mid-January, including large additions to Treasury bill holdings and to the amount lent at call to the discount market. This brought the clearing banks' combined liquidity ratio to 35·7% in mid-January, and so left them well placed to meet the strains of the revenue season. The combined cash ratio at that date had fallen a little below the customary 8%, apparently because the banks were faced with unexpectedly large withdrawals of notes and coin by the public shortly before the start of the postal strike, which coincided with the banks' make-up day.

In the month to mid-February, the clearing banks' net deposits rose more, after seasonal adjustment, than in the previous three months taken together. This was an unprecedentedly large increase in a month which usually sees heavy tax payments, and it occurred despite substantial official sales of gilt-edged stocks; the large inflows of exchange must have been one factor in the growth in deposits, but it also seems that the postal strike probably caused some delay in tax payments. Advances also rose rather more than was to have been expected seasonally. Restricted lending increased, but the total rise in such lending over the eleven months since last March remains within the official guidelines. It is not known whether advances to customers affected by the Rolls-Royce development contributed significantly to the rise in the banks' lending in February, nor whether the postal strike was an important influence – one way or the other. The combined liquidity ratio fell very much less than usual, and stood at 34·4% at mid-February; the cash ratio was restored and was, indeed, unusually high.

The *accepting houses, overseas and other banks* increased their sterling deposits by £112 million, excluding inter-bank funds, in the December calendar quarter. Most of the rise was again in domestic deposits, although there was also some further increase in overseas holdings. Accompanying the rise in deposits, the amount of sterling certificates of deposit in issue continued to grow; but in this quarter, the increase of £105 million was almost matched by a rise in the holdings of these certificates by this group of banks.

Among other additions to assets, lending at call to the discount market rose by £121 million. These banks lent only a modest amount of temporary money to local authorities which, as in the previous quarter, borrowed mainly at longer term from the Public Works Loan Board and on market mortgages. Sterling lending to other U.K. residents (excluding banks) continued to rise slowly, but advances to overseas residents fell a little; in total, restricted lending did not change much during the quarter.

There was another very steep rise, of £374 million, in the *discount market's* borrowed funds in the December quarter. Almost the whole of this amount was used to finance a



Domestic credit expanded in the December quarter at much the same rate as in the previous three months.

further rise in the houses' Treasury bill holdings, which totalled £876 million at the end of the year – the highest ever recorded.

Domestic credit and money stock[1]

The growth of domestic credit in the December quarter was not significantly larger, at about £375 million, seasonally adjusted, than in the preceding three months. The main expansionary factor in the latest period was the steep rise in the banks' foreign currency lending to U.K. companies to finance domestic expenditure; as mentioned earlier in the Commentary, steps have recently been taken to restrict these foreign currency facilities to medium and longer-term finance in future. There was also a partly erratic increase in bank lending to the public sector outside the central government; the banks and discount houses acquired some local authority debt when a seasonal reduction might have been expected, and lending to the nationalised industries happened to be high at the end of the year. There was virtually no further growth in the fourth quarter in bank lending in sterling to the private sector, which had already moderated in the third. The central government had a very small borrowing requirement (seasonally adjusted), but this was more than matched by official sales of gilt-edged stocks and other debt.

The money stock increased more than domestic credit in the December quarter, because of the inflow of foreign exchange. The seasonally adjusted rise was about £500 million (rather over 3%) – a somewhat larger rate of increase than in the previous six months.

Over the first nine months of the financial year, domestic credit and the money stock both increased by amounts in the region of £1,400 million which, for the money stock, represented a rise of about 8½%. Since the end of December, the increase will have been restrained by the heavy official sales of gilt-edged stocks in January; on the other hand, the inflow from overseas will have been an expansionary influence, at least on the money stock.

Bill markets

The amounts of Treasury bills offered at the tenders during the three months to the end of January took account, as usual, of the authorities' aim to create a shortage of funds in the market each week; in this way, they seek to give themselves some flexibility in deciding how the shortages should be relieved, so that they can influence short-term interest rates.[2] The amounts offered proved to be generally lower than in the preceding three months, but larger than in the same period of 1969/70. It is not possible to arrange that the planned shortages will be spread evenly throughout the week because, whereas the discount houses tend to take up their allotments of bills in fairly equal amounts from day to day, there are marked fluctuations in the flows

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

2 The methods by which the authorities intervene in the money market were described more fully in an article on "The management of money day by day" in the March 1963 *Bulletin*.

of government receipts and payments; for example, some especially large payments are regularly made on Tuesdays, and conditions are often easier on that day than on other days.

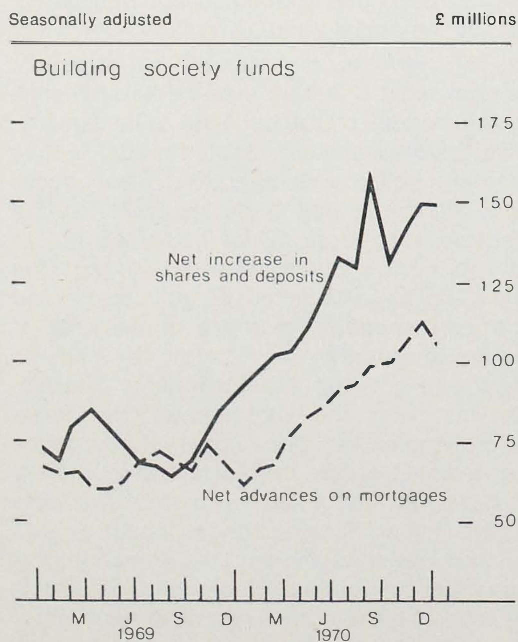
The market situation is also affected by other movements of funds – especially settlements for official transactions in the gilt-edged and foreign exchange markets – which cannot be predicted with any certainty when the size of the weekly tender is decided. Thus conditions in the market were generally easy in the first three weeks of November, because of the sterling funds generated by foreign exchange inflows and occasional official purchases of gilt-edged stocks. Towards the end of that month, however, a temporary recovery in the gilt-edged market caused a severe shortage of funds on one day, part of which was relieved by overnight lending. Another abnormal shortage at the beginning of Christmas week, again attributable in part to the settlement of gilt-edged transactions, was relieved by large official purchases of bills and some overnight lending. The first half of January was dominated by an enormous demand for gilt-edged stocks on various days, often in expectation of a reduction in Bank rate. Market shortages were relieved by large purchases of Treasury bills; but on three occasions during this period, discount houses were forced to borrow for seven days at Bank rate to emphasise the authorities' reluctance to see any marked fall in interest rates. This was the first such use of Bank rate for several years. There were further shortages of funds after the middle of the month, because of the renewed demand for gilt-edged stocks and the onset of the main tax-gathering season. Despite the redemption of $6\frac{1}{2}$% Treasury Stock 1971 on 28th January, conditions remained difficult during the last week of the month, partly because of disruptions caused by the postal strike.

At the Treasury bill tenders, the houses' bid remained unchanged at the equivalent of a little over $6\frac{13}{16}$% for twenty-one weeks, from the middle of August until 15th January; bill rates have never before remained stable for such a long period when monetary policy was operative. The houses received substantial allotments and made few sales, so that their holdings became very large. Their decisions not to lower their tender price no doubt reflected in part the losses they would then have incurred on any sales, and also the risk of a corresponding increase in the cost of their borrowed funds; the need for liquidity as the revenue season approached, and growing expectations of a reduction in Bank rate, increased the attraction of their large portfolios. In view of these expectations about interest rates, the houses raised their bid a little in mid-January, bringing the tender rate down to rather below $6\frac{13}{16}$%. The rate remained unchanged at the following tender when, in anticipation of the stock redemption on 28th January, the amount of bills on offer was sharply increased. The total offered at the last tender in the period remained very large, at £250 million, in order to absorb surpluses which were expected to emerge if tax receipts were delayed by the postal strike. In the event, only £100 million of bills was allotted – again at the same rate – partly because revenue

was not being delayed as much as had been expected, and partly because of further market demand for gilt-edged stocks on the day of the tender, for settlement on the following Monday. The average cost of borrowed funds seems to have followed the reduction in the tender rate at the end of the period.

Local authorities

In the three months to January, longer-term borrowing by local authorities, already quite high in the previous three months, continued to increase. They borrowed more from the Public Works Loan Board, but the amount raised on market mortgages was much the same as in the earlier period. Although there were few new stock issues, the total included a large issue by the Greater London Council on 12th November; and calls on earlier issues were substantial. The total raised on new bond issues, however, was again little in excess of the amount paid on maturities. Longer-term rates rose over the three months, despite some easing from end-December onwards. P.W.L.B. quota rates for 10–15-year loans, which were changed on several occasions, stood at $9\frac{3}{8}$% at the end of January, compared with $9\frac{1}{4}$% at end-October; loans of over 25 years reached 10% in December – the highest ever reached for any maturity – but were lowered in January. Rates on market mortgages of over five years rose from $8\frac{3}{4}$%–9% to 9%–$9\frac{1}{2}$%; those on one-year bonds also rose at first, from 8% to $8\frac{3}{8}$%, before falling in January to $7\frac{3}{4}$%. As already noted, temporary money rates changed little over the three months, and the amounts borrowed from the banks during the December quarter were fairly small.



In the three months to January, building societies continued to attract large inflows and to increase their lending.

Finance houses

Allowing for seasonal factors, the finance houses again extended more new credit in the December quarter and, although they also received somewhat larger repayments, the total of debt outstanding rose by £29 million. This was the biggest quarterly increase since the present series of figures was started at the beginning of 1966, and it brings the rise over the first nine months of the financial year to £59 million.

The earlier decline in deposit rates was checked in the latest period and, at the end of January, the three months' deposit rate was much the same as at the end of October, ranging between $7\frac{1}{4}$%–$7\frac{3}{4}$%. The Finance Houses Association's base rate, which provides a method of calculating charges on long-term lending,[1] was reduced in November, and remained at $7\frac{1}{2}$% during the rest of the period.

Building societies

The building societies' share and deposit rates remained highly competitive during the three months to January, and attracted still larger inflows. The postal strike was probably responsible for some decline in both gross receipts and lending in January. Despite this, the amount of new money received rose further, in seasonally adjusted terms, in these

1 The rate, which was described in the September 1970 *Bulletin*, on page 264, was raised to 8% as from 1st March.

three months; and although withdrawals were a little higher, the societies' net receipts totalled £437 million during the period, following an inflow of £416 million in the previous three months. The societies continued to expand their net lending – and further increased their new lending commitments – but their combined liquidity ratio rose again, to 17·6% at the end of January.

The gross amount advanced by the building societies last year, taken as a whole, was higher than ever before, at £1,986 million (against £1,556 million in 1969).

Company securities

Equity prices fell during November and made only a partial recovery in December and January. Investors saw no signs of inflationary pressures abating, nor of any faster growth in the economy; and labour disputes had a generally depressing influence. Meanwhile, there were continuing reports of lower profits, or of companies facing more severe financial difficulties. A rally early in December proved to be short-lived, but there was a recovery in the middle of that month following the resumption of normal working in the electricity supply industry. The earlier rally was strongly influenced by a rise in prices on the New York stock market, which was also the major factor in keeping prices in London steady in the first half of January. Thereafter, the postal strike exerted a slightly depressing effect and, by the end of January, the F.T.-Actuaries industrial share price index stood at 141·8 compared with 144·4 three months earlier. Prices fell sharply early in February, because of uncertainties about Australian markets and the developments at Rolls-Royce, but there was some recovery in the middle of the month.

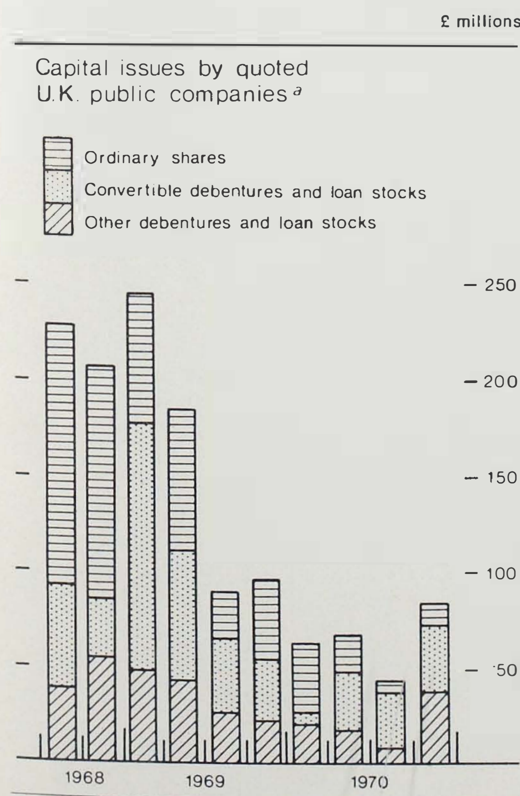
Yields on company fixed interest securities moved fairly closely with those on gilt-edged stocks, rising during November, levelling off in December and then falling in January; at the end of that month, first-class high-coupon stocks of about twenty-five years' maturity were yielding around $10\frac{1}{8}$%, which was about $\frac{1}{4}$% more than three months earlier. The differential over gilt-edged stocks of comparable term widened slightly, to just over $\frac{1}{2}$%.

More cash was raised on new issues in the months November–January than in any three-month period since the middle of 1969. The total amount raised – £130 million – was over £100 million more than in the previous three months. There were a number of sizable issues during this period, mainly by industrial and commercial companies. However, although several companies announced new issues, many of those which had been contemplating raising funds deferred or cancelled their plans. At the end of the period, the 'queue' of intending borrowers had again shortened.

Net sales of units by unit trusts fell even further in the fourth quarter, to £14 million; and sales in January were again very low.

Conclusion

Consumption, which had grown quite markedly last summer, seems to have been checked towards the end of 1970. The rise in personal incomes has so far been accompanied by



There was a marked increase in the amount of cash raised on new issues in the December quarter, and a further rise in January.

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.

high savings. It takes time for consumers' spending to increase fully in response to a rapid increase in earnings; but the high level of savings may now also be reflecting feelings of uncertainty and insecurity of employment.

The slow growth of demand over the past two years, and the uncertain prospects now, may well mean that industrial investment will fall this year. Financial constraints are also a factor; apart from the low level of profits, liquidity has been strained by the rise in costs, and monetary policy has continued to keep credit scarce and expensive.

The combination of rapid inflation of costs and prices and uncertain prospects for investment, and for demand generally, poses severe difficulties for policy. In these circumstances, the authorities have been reluctant to countenance easier financial conditions or lower domestic interest rates. The interest differentials which have emerged with the fall in interest rates abroad since late December have attracted large inflows of exchange; and there is no doubt that domestic liquidity has been eased in this way, as it was in the revenue quarter last year. However, the new restrictions on borrowing abroad for domestic use, the rise in the spot rate towards its upper limit, and the sharp rise in the cost of forward cover are working to limit these inflows; and their effects on domestic liquidity have been at least partly offset by very large official sales of gilt-edged stocks.