Commentary

This Commentary is mainly concerned with developments during the three months from February to April. Costs and prices continued to rise steeply, although there were signs of a check to the rate at which wages and salaries were increasing. At the same time domestic activity slackened further. In his Budget statement, the Chancellor of the Exchequer announced measures to increase demand modestly later in the year, and to ease financial pressures on companies. He also proposed a number of fundamental changes in the tax system, to take effect in 1973 or later; more immediately, new techniques of monetary control are being examined. There were further substantial inflows of exchange during the first quarter, partly to relieve liquidity shortages in the revenue season and partly to take advantage of favourable interest differentials. Bank rate was reduced on 1st April. Sterling remained firm during that month and continued so early in May, when movements of dollar funds into deutschemarks and some other currencies became very large; it was announced on 9th May that the deutschemark and the Dutch guilder would, for a time, be allowed to find their own levels in the exchange markets, and that the Swiss franc and the Austrian schilling were to be revalued. The expansion of the money stock as a result of the exchange inflows in the first quarter was partly counteracted by unprecedentedly large official sales of gilt-edged stocks; in the event, the money stock increased at much the same rate as in earlier quarters of the financial year, but domestic credit contracted somewhat.

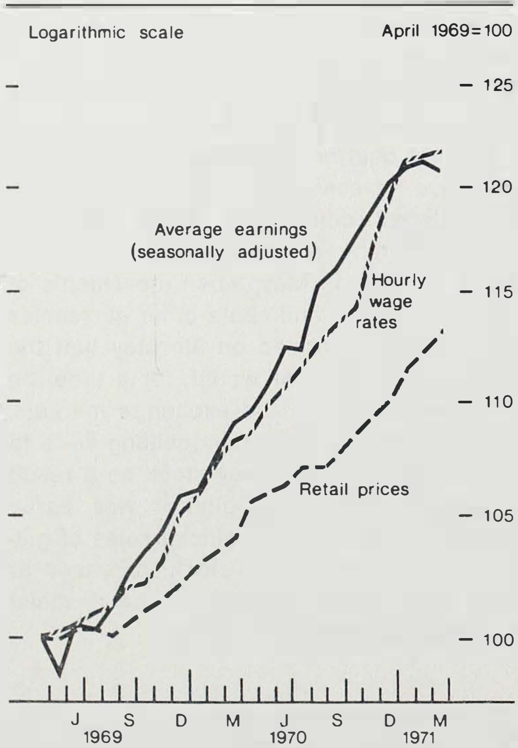
Domestic economy

There was an air of increasing hesitancy and uncertainty about the economy in the weeks before the Budget. The central problem remained what it had been for the past year or more – an unusually steep rise in industrial costs accompanying only a small increase in output. But the effects of this situation upon unemployment, company profits and industrial investment – and therefore the prospects for growth – were becoming increasingly apparent; and the resulting pessimism was heightened by a number of business failures, including the appointment of a receiver for Rolls-Royce Limited at the beginning of February.

Although wage and salary costs continued to rise very steeply, there were some signs that the rate of increase was no longer accelerating. Average earnings in the first quarter were less than 2% higher than in the preceding three months, following quarterly increases of between 3% and 4%

throughout last year. As a result, earnings rose by about 11% over the twelve months to March, whereas earlier comparisons with the previous year had shown increases ranging up to 14%. Part of the slowing down in the first quarter was attributable to a reduction in overtime earnings and an increase in the numbers working short time; part, too, must have been caused by the loss of earnings in a period when an unusually large number of working days was lost through strikes. The average level of wage settlements seems to have shown little decline, but the numbers receiving pay increases happened to be much smaller in these months. However, the effect of some recent substantial settlements in the motor industry and in other parts of the private sector remains to be seen.

Wages, earnings and prices

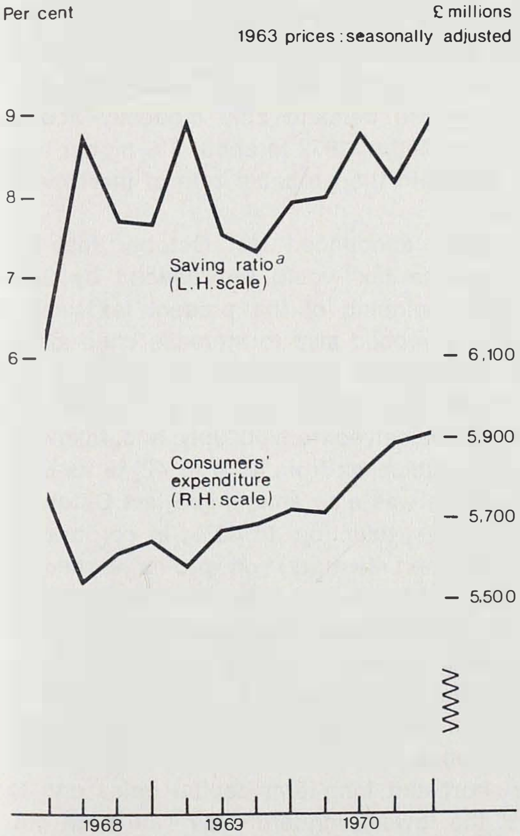


Earnings and prices are still rising steeply but the rate of increase of earnings may now be levelling off.

With earnings rising somewhat less than in previous quarters, and a further rise in the numbers out of work, the growth of incomes probably slowed during the first quarter. The rise in retail prices, on the other hand, seems to have continued to accelerate in recent months – although, unlike earnings, these movements are not seasonally adjusted. A particularly sharp increase in the month to mid-April brought prices almost $9\frac{1}{2}$% higher than they had been twelve months previously; in January and February, the rise over the year had been about $8\frac{1}{2}$%. Allowing for this continued rise in prices, for payments of taxes on income, and for national insurance contributions, the amount available for expenditure on personal consumption or for saving may not have grown much, if at all, since the beginning of this year. The volume of personal consumption began to expand quite quickly in the spring of 1970, but the rise was checked towards the end of last year, and there was almost certainly some fall in consumption in the first quarter. Quite apart from the trend in real incomes, however, there were a number of special factors contributing to this fall, including a sharp reduction in mail order business during the seven-week postal strike from late January to early March.

There were few signs of buoyancy about the other main elements of demand in the first quarter. There has been little or no growth in the volume of exports since the spring of last year. Private manufacturing investment grew only slowly in 1970 as a whole, and seems to have fallen a little at the end of the year. There is unlikely to have been any improvement at the beginning of this year, to judge from a decline in the engineering industries' deliveries to the home market in the first quarter; nor does a pronounced fall in new domestic orders look hopeful for the future. In the early months of the year, a number of companies announced that they were curtailing their plans for capital expenditure. On the other hand, investment in new housing may have increased a little in the first quarter when, perhaps because of the mild weather, there was a rise in the number of new houses completed. Builders expect a significant increase in the amount of new work started for

Consumers' expenditure and saving



The increase in consumers' expenditure slowed at the end of last year and the saving ratio rose again.

a Personal saving as a percentage of personal disposable income.

private ownership this year; there was only a small increase between the fourth and first quarters and there has, indeed, been little change since the middle of last year, but the growth in building societies' advances, and in their liquid funds, may perhaps be taken as a hopeful sign. However, the number of houses started for the public sector continues to decline. Finally, private industry's stocks were built up substantially in the fourth quarter, but this must partly have been an involuntary reaction to the check to consumers' expenditure, and it is unlikely that there has since been much further accumulation.

With reductions in demand and some further rise in the volume of imports, domestic output appears to have fallen appreciably in the period before the Budget. Industrial production was more than 1% lower in the first quarter than in the preceding three months and was the lowest for two years; within the total, manufacturing output fell by more than 3%. As already noted, production was again hampered by industrial stoppages; although the number of disputes was rather smaller than in other recent quarters, the number of working days lost in the first quarter, at 9½ million, was almost as large as in the whole of last year, and larger than in any other post-war year. This total relates only to stoppages arising from industrial disputes and does not include time lost from other causes, such as demonstrations against the Industrial Relations Bill. The number of days lost in April, however, was very much smaller than the monthly rate in the first quarter.

Unemployment continued to rise steeply in the early months of the year. Seasonally adjusted, the numbers wholly out of work (excluding school-leavers and those temporarily stopped) had risen to 731,000 early in May, or 3·2% of the total number of employees. This brought the increase since last October, when unemployment began to rise sharply, to 155,000. The movement probably reflected not only the slackness of demand but also the pressure on company profits and liquidity caused by rising wage and salary costs when output was depressed. Some companies may also have decided that they need no longer keep a reserve of labour against a prospective rise in output now that the numbers unemployed have become so large. The rise in the numbers unemployed was, until April, accompanied by a reduction in the number of vacancies notified for adult workers; although the fall in vacancies was checked in May, it is too early as yet to know whether this represented a change of trend.

The Budget

The Chancellor judged that, in the absence of any change of policy, output would probably continue to grow only slowly, offering little incentive to industrial investment. He therefore proposed measures to achieve a moderate increase in activity and to encourage investment. His proposals are expected to reduce tax revenue in the present financial year by some £550 million and to bring the borrowing requirement for the public sector as a whole to some £1,200 million. But the changes were designed particularly to encourage savings and to ease the financial pressures on companies; they are expected to increase demand only modestly and to raise output in the first half of 1972 to about 3% higher than a year earlier, in line with the probable rate of increase in productive potential.

It had already been announced last October that the standard rate of income tax would be reduced by 2½% from 6th April (the beginning of the present tax year).[1] The Chancellor now proposed also to increase child allowances, and to reduce the rates of taxation on higher earned incomes from a maximum of nearly 89% to 75%. Selective employment tax would be halved from 5th July; and, following the reduction in corporation tax from 45% to 42½% as from 1st January 1971, which was also announced last October,[1] there would be a further reduction, to 40%, in corporation tax payable (mostly next January) on profits earned in the financial year 1970/71. After allowing for the increased national insurance contributions mentioned below, these reductions in selective employment and corporation taxes will reduce commercial tax payments by rather more than £300 million in the present financial year. Among smaller changes, the Chancellor proposed to abolish the tax distinction between short and long-term capital gains and to tax such gains at the lower long-term rate (although gilt-edged stocks will continue to be exempt if held for more than twelve months); and, where sales of assets do not exceed a total of £500 in a year, capital gains will be exempt from tax. National insurance benefits are to be increased in September, involving higher contributions from employers and employees. Finally, various improvements were made in the terms of national savings.

The Chancellor also announced a number of fundamental tax reforms to take effect from April 1973 or later. Income tax and surtax are to be combined into a single graduated tax on personal income; selective employment tax and purchase tax are to be replaced by a value-added tax; and corporation tax will be changed so as to abolish discrimination against distributed profits.

Dealing with the balance of payments, the Chancellor stressed the need to maintain a large surplus on current account to finance the repayment of the remaining debt to the International Monetary Fund and to support normal capital and investment flows. He felt unable at present to authorise any general relaxation of exchange control on overseas investment, and he asked companies and institutions to continue to observe the voluntary restraints on investment in the more developed countries of the sterling area.

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1 See December 1970 *Bulletin*, pages 386 and 387.

Monetary policy

The Chancellor judged that, in view of the growth of incomes, any immediate attempt to reduce the rate of increase in the stock of money to much below 3% a quarter – the average between April and December last year – might carry risks for liquidity and employment; but as the rise in costs and prices moderated, his aim would be to slow the growth of the money stock. Speaking of monetary policy more generally, the Chancellor said that the techniques of monetary control should be made flexible enough to allow scope for competition and innovation in the banking system. He envisaged arrangements which would operate on the banks' resources, as an alternative to the existing quantitative guidelines and ceilings on lending, and which could be extended to the finance houses and other relevant institutions. Such arrangements were being investigated, but meanwhile the present methods of control would continue. The banks and finance houses have been asked to ensure that their restricted lending does not rise in the quarter to June to more than about 2½% above the limits previously set for last March, and the Bank have advised them not to enter into commitments during this relatively short period which would later result in a significantly faster expansion of their lending.[1] The general guidance on the direction of lending still stands.

The Bank have since circulated to the banks and finance houses, as a basis for discussion, a paper setting out proposals for changes in the system of credit control; this document is reproduced on pages 189-93. The proposals are now under discussion with the institutions concerned.

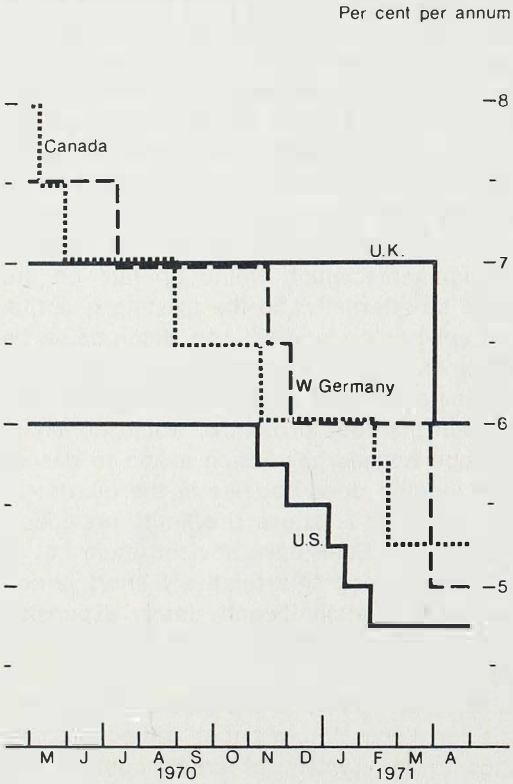
At the same time, the Bank have decided to restrict their operations in the gilt-edged market, and to return towards the position in the market which they occupied up to some ten years ago. From 17th May onwards, the Bank have no longer been prepared to offer a price, when requested, at which they will buy stock outright, except for stocks with one year or less to run to maturity; purchases of longer-dated stocks will in future be made only at the Bank's discretion and initiative. The Bank will exchange stock with the market, at prices of their own choosing, except where this would unduly shorten the life of the debt; and they are prepared to sell stocks on terms which they consider appropriate. These changes will help to limit the fluctuations in the banking system's resources arising from official operations in the gilt-edged market; and, by leaving prices to reflect market conditions more closely, the changes are consistent with the move to greater freedom of competition in the banking system.

Short-term interest rates

International interest rates continued to fall steeply in February and early March, as they had since the middle of last year, largely in response to easier monetary conditions in the United States. U.S. discount rates were reduced by

1 The notice which the Bank issued on 30th March to banks and finance houses is reproduced on page 194.

Central bank discount rates



Central bank discount rates continued to fall between February and April . . .

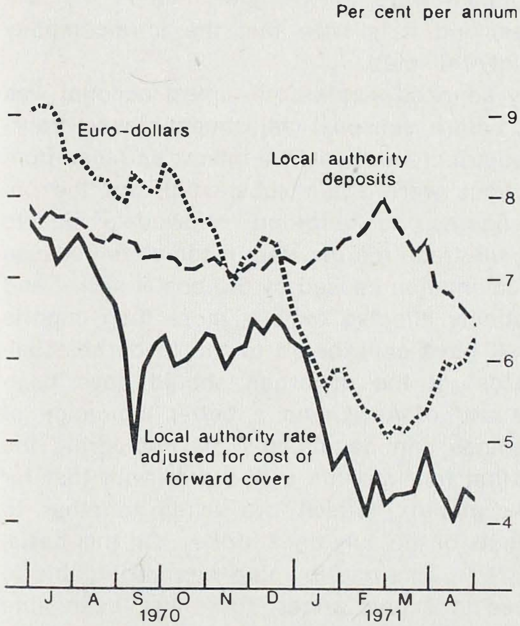
a further $\frac{1}{4}$%, to 4$\frac{3}{4}$%, in mid-February – the fifth such reduction since last October – and U.S. commercial banks similarly lowered their prime lending rates a few days later, to 5$\frac{3}{4}$%. Domestic demand for loans remained small, however, and prime rates were reduced yet again, by $\frac{1}{2}$%, towards the middle of March. These movements contributed to a further decline in euro-dollar rates as U.S. banks continued to repay funds borrowed from their branches abroad. Three-month euro-dollars fell from about 5$\frac{7}{8}$% at the end of January – half as high as when rates began falling at the end of 1969 – to rather over 5% early in March. In order to limit the repayment of euro-dollar borrowing by U.S. banks, the Export-Import Bank announced on 23rd February an offer of $500 million of three months' notes at 5$\frac{1}{8}$% to the banks' overseas branches for payment early in March; this followed an earlier, and larger, issue in January.[1]

Euro-dollar rates steadied during March, and then rose somewhat at the end of that month. International demand for funds over the end of the quarter coincided with an upward turn in short-term interest rates in the United States – the three-month Treasury bill rate rose from about 3$\frac{1}{4}$% per annum in mid-March to about 4% in mid-April – as a result of market operations by the U.S. authorities in an attempt to reduce the outflow of dollars. To the same end, the U.S. Treasury issued $1,500 million of three months' certificates of indebtedness to overseas branches of American banks early in April which, with the earlier issues by the Export-Import Bank, brought the total of such borrowing to $3,000 million in less than three months. Towards the end of April, most U.S. banks raised their prime lending rates by $\frac{1}{4}$%, to 5$\frac{1}{2}$%. Under these influences, the rate for three-month euro-dollar deposits had risen to 6$\frac{1}{4}$% by the end of April, and rates rose further in May.

Interest rates in many other overseas countries were lowered in response to the earlier reductions in U.S. rates and those in the euro-dollar market, and the movement continued after euro-dollar rates steadied in March. The West German discount rate was reduced by a further 1% with effect from 1st April. U.K. rates, however, had been comparatively stable for several months; indeed, some market rates had tended to increase between late-January and early-March, although the rise was largely reversed over the remainder of that month. The U.K. authorities wished to avoid any further widening of the margin between rates in this country and those abroad, and Bank rate was therefore reduced by 1%, to 6%, on 1st April. This reduction was consistent with the requirements of monetary policy as outlined by the Chancellor in his Budget statement. After these reductions in West German and U.K. rates, several other Continental countries lowered their official discount rates during the following weeks, in order to keep their interest rates in line with those abroad.

1 See March 1971 *Bulletin*, page 6.

Short-term interest rates in London[a]



. . . but the fall in euro-dollar rates was checked during March and rates later rose.

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

U.K. market rates fell after the reduction in Bank rate but, before allowing for the cost of forward cover, most remained above comparable euro-dollar rates at the end of April – as they had been since the end of last year. However, the cost of cover more than offset the disparity between U.K. and overseas interest rates. Forward margins had increased sharply towards the end of January and remained large during the following three months; this reflected increased borrowing of sterling by means of swaps by those who preferred to avoid buying it outright at the high spot rates which prevailed. For three months' cover, the cost rose to the equivalent of $4\frac{1}{8}$% per annum in mid-February, and still stood at $2\frac{1}{8}$% at the end of April. As a result, the main covered interest comparisons were unfavourable to sterling throughout the three months, especially during February and after the reduction in Bank rate.

Balance of payments

Part of the large movement of funds from the United States in the first quarter was attracted to the United Kingdom. The currency inflow totalled as much as £973 million during the quarter, a little more even than in the same period last year. Although covered interest differentials were unfavourable, some of these funds were no doubt attracted by the high uncovered rates. Others were brought in to ease shortages of liquidity in the revenue season and, to the extent that these were intra-company transactions, interest comparisons may not have been the dominant consideration.[1] Yet other funds were probably attracted by the expectation of capital appreciation as security yields fell. Finally, part of the inflow represented seasonal additions to the reserves of overseas sterling countries.

Among identified movements, overseas investment in the United Kingdom was much larger than U.K. investment abroad, mainly because of borrowing abroad by U.K. public corporations and increased portfolio investment by overseas residents in gilt-edged stocks and U.K. company securities. But additions to monetary balances accounted for a large part of the recorded inflow. As already noted, overseas sterling countries added very substantially to their holdings of sterling, reflecting both seasonal movements and the continued strength of the balance of payments of many of these countries; and there was also some rise in the holdings of non-sterling countries, which no doubt included funds attracted by the favourable uncovered interest differentials. As well as these increases in sterling balances, U.K. companies again borrowed quite large amounts in foreign currency through their banks for domestic use, though much less than in the previous quarter.[2] (After 12th January, this borrowing was restricted to medium and

1 The relevant interest comparisons might in any case differ from those based on rates in the main markets.

2 In Table 19 of the annex, this borrowing is included in the item "Foreign currency transactions of U.K. banks".

longer-term finance, although existing authorisations to borrow were allowed to stand.[1]) Unidentified flows reflected in the balancing item were even bigger than in the first quarter last year, and it is here that the intra-company transfers are mainly reflected.

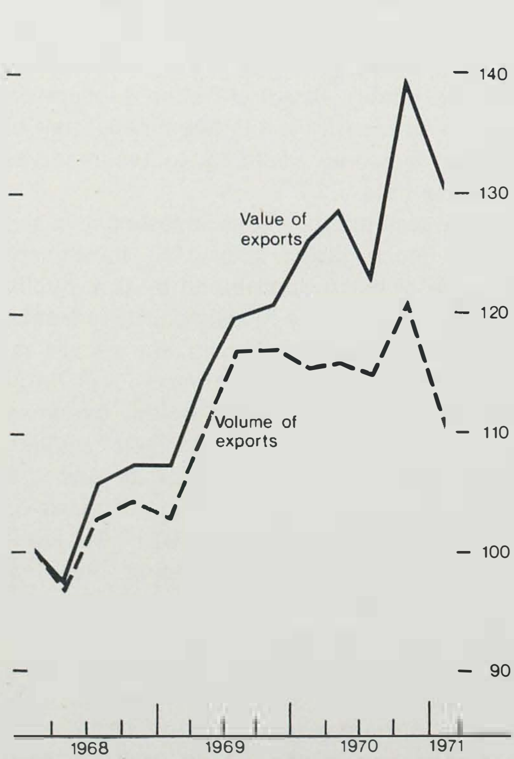
The seasonally adjusted surplus on current account was fairly large but, before seasonal adjustment, these transactions did not contribute much to the inflow; earnings from invisible transactions were again substantial, but the unadjusted trade figures, as recorded, showed a sizable deficit. However, the trade returns were incomplete because of delays in documentation caused by the postal strike; and the shortfall probably affected exports more than imports (which must itself have contributed to the favourable balancing item). Most of the distortion should have been reversed by the end of April, and a better indication of recent trading trends can be obtained by comparing the average for the first four months of the year with that for the previous six months (which are taken together to eliminate the effects of the July dock strike). On this basis, exports rose by 2½%. This rise in value was attributable to a further increase in export prices; there has been little change in volume since last spring. The volume of imports, on the other hand, rose fairly sharply over the first four months of the year, despite the slackness of domestic demand. The comparison with the second half of last year is affected by the arrival of three more Boeing 747 aircraft in March but, when these are left out of account, the increase in the volume of imports was probably still in the region of 2%.

The moderate trade deficit which emerged as a result of these developments continued to reflect the larger rise in export prices than in import prices. Export prices have recently risen rather faster than domestic prices, so restoring some of the relative profitability of selling abroad; but they have also been rising more than those in competing countries overseas, and the price advantage afforded by devaluation has now been considerably eroded. However, this process will have been checked to the extent that the exchange values of a number of Continental currencies were increased in May, as a result of developments described later in this Commentary, in the section on foreign exchange and gold markets.

A White Paper published on 26th April[2] announced that the Government are to introduce a scheme to insure overseas investment against such risks as war, expropriation and restrictions on remittances. This is intended primarily to encourage private investment in developing countries. The scheme will be administered by the Export Credits Guarantee Department, and will be comparable with those already in existence in most other industrialised countries. It will cover only direct investment, and existing assets will not be

Value and volume of U.K. exports

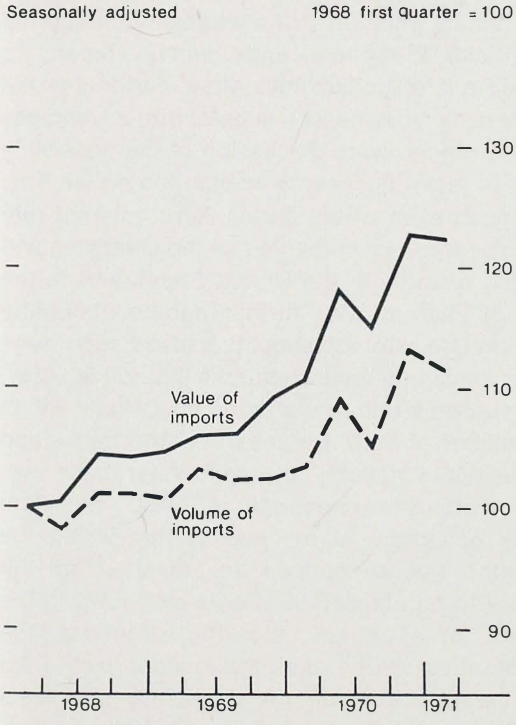
Seasonally adjusted 1968 first quarter = 100



The growth in exports since the beginning of 1970 has depended almost entirely on higher prices . . .

1 See March 1971 *Bulletin*, page 8.
2 *British private investment in developing countries;* Cmnd. 4656.

Value and volume of U.K. imports[a]



. . . but increases in imports have been due mainly to a rise in volume. More recently, however, import prices have been rising too.

a Imports c.i.f. including deliveries of military aircraft and missiles purchased from the United States.

eligible (although the extension or modernisation of existing investment could qualify). The White Paper also considers other methods of encouraging investment flows to developing countries. Among these, some changes in taxation arrangements on income arising overseas are envisaged; but the Government have decided against any relaxation of exchange control on investment flows at present, because this would probably cost substantial amounts of official exchange and yet have little effect on the volume of direct investment in developing countries of the non-sterling area. The Government would, however, be prepared to consider a request from the International Bank for Reconstruction and Development for renewed access to the London market at an appropriate time.

Reserves and special facilities

The reserves benefited during the March quarter not only from the large currency inflow but also from the second allocation, in January, of Special Drawing Rights on the International Monetary Fund, amounting to £125 million. Thus the total available for official financing transactions was as large as £1,098 million.

Of this total, £686 million was used to reduce the amount outstanding on special borrowing facilities from overseas monetary institutions. The whole of the remaining amount due to central banks and institutions other than the I.M.F. – a total of £399 million ($957 million) – was repaid, and the assistance which had been generously and promptly forthcoming from these lenders at times of need was thus completely discharged for the first time in almost six years. As well as these repayments to central banks and other institutions, liabilities to the I.M.F. were reduced by £287 million ($689 million) in the first quarter, mainly by the payment in March of the four quarterly instalments due this year in respect of the United Kingdom's June 1968 drawing.[1] The four remaining instalments, each of £67 million ($160 million), are payable by the end of each quarter next year. A further $1,000 million drawn from the Fund under the 1969 stand-by arrangement will fall due for repayment as from June next year.

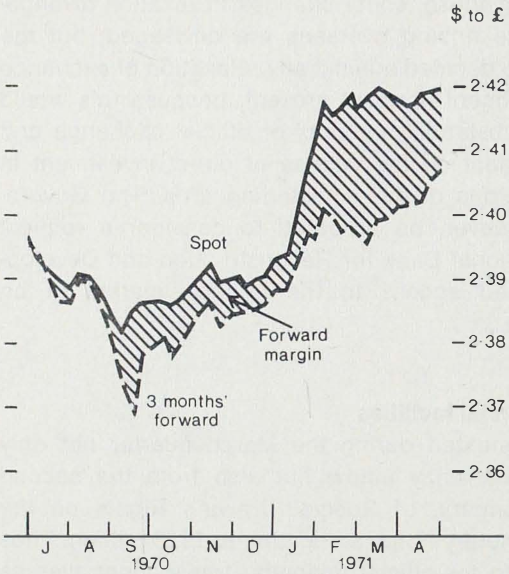
After these debt repayments in the March quarter, accruals of £412 million remained. £204 million of this was added to the published reserves and £208 million was transferred into later months by means of special swaps with overseas monetary authorities.

Foreign exchange and gold markets

For almost the whole of the period from mid-February to the end of April sterling was consistently stronger in the

1 The original drawing totalled £583 million ($1,400 million), but the repayment liability had, by March, been reduced to £552 million ($1,325 million) as a result of the Fund's use of sterling in transactions with third countries. These sterling operations by the Fund accounted for £2 million ($4 million) of the reduction in U.K. liabilities during the first quarter.

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



The spot exchange rate was close to its upper limit throughout the three months from February to April, and the forward discount remained substantial.

a Middle closing rates; weekly, Fridays.

spot foreign exchange market than at any time since immediately after devaluation in November 1967. The strength of spot sterling was mainly a reflection of the general weakness of the U.S. dollar, which at times was being supported in nearly every major European centre and in Japan. As funds were moved out of dollars into other currencies the original reason for such movements – interest rate advantages – became overtaken by growing discussion of the possibility of further exchange rate adjustments against the dollar. This uncertainty continued even when, during April, interest rate reductions in Europe were accompanied by the steadying and subsequent firming of rates in the United States and in the euro-dollar market. Early in May further debate about the desirability of exchange rate adjustments caused such large transfers of dollar funds into deutschemarks that, on 5th May, the Bundesbank suspended their quotation for dollars; within a few hours, a number of other European central banks had also stopped dealing in dollars, as demand for their own currencies intensified. After meetings of E.E.C. ministers and central bank governors at the end of that week, the West German authorities announced on 9th May that the deutschemark was to be allowed to find its own level in the exchange markets for a period. Later the same day, the Netherlands authorities stated that the guilder would be similarly free to fluctuate according to market demand for a time; and the Swiss and Austrian Governments revalued their currencies by 7·07% and 5·05% respectively. When the exchange markets reopened on 10th May, sterling was little affected by these developments.

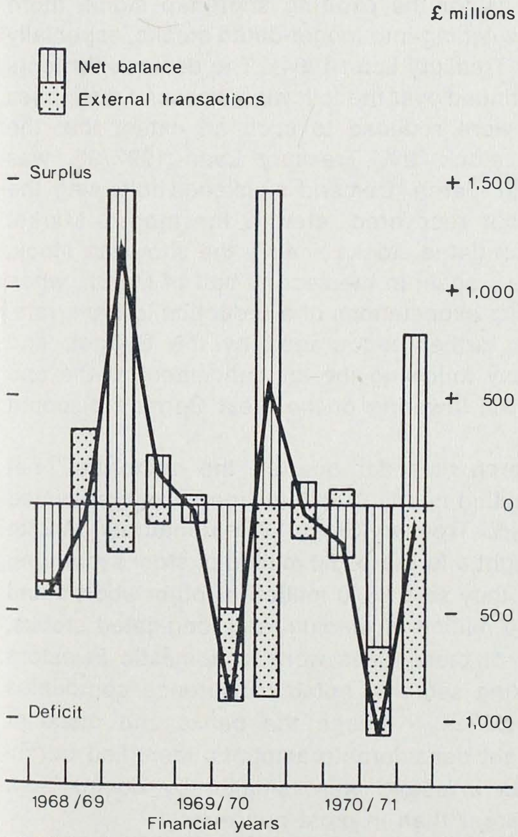
For most of February and March the spot exchange rate stood above $2·41¾. The rate fell to $2·41¼ on 2nd April, following the reductions in the West German and U.K. Bank rates and the announcement of the U.S. Treasury borrowing from the overseas branches of U.S. banks; but this fall proved short-lived, and the rate was close to its upper limit during most of the remainder of April and in May.

Despite the currency uncertainties, the gold price was steady for most of the three months to the end of April, in the range $38·75 to $39·00 per fine ounce. The market appeared to be adjusted to dealing with current production at this level. There was a rise at the end of April, however, following talk of an increase in the monetary price of gold and reports that the market had absorbed appreciable East European supplies in recent months without lowering prices. Following the temporary withdrawal of a number of European central banks from their exchange markets at the beginning of May, the price moved yet higher, to exceed $41 for the first time since September 1969.

Central government financing

The central government's surplus in the March quarter, the main revenue season, totalled £725 million. The surplus

Central government's
domestic borrowing requirement (–)



The central government was in substantial surplus in the March quarter but, when the inflow from abroad had been financed, there was a small domestic borrowing requirement.

would have been larger – perhaps approaching £1,000 million – but for delays in tax payments caused by the postal strike between late January and early March.[1]

Because of the large inflows from abroad during the quarter, the whole of the surplus was required to finance external transactions; and an additional £80 million had to be found for this purpose from domestic sources. Investors outside the banking sector made substantial purchases of gilt-edged stocks, totalling more than £730 million over the period. They also invested over £110 million in national savings, the largest quarterly sum for several years; in particular, there were substantial additions to savings bank accounts, probably to take advantage of the increased rates of interest which became payable around the turn of the year. As a result, £710 million of debt was repaid to the banks and discount houses. The banks purchased over £400 million of gilt-edged stocks but their holdings of Treasury bills were reduced by no less than £935 million; and there was a seasonally large reduction in net government indebtedness to the Banking Department of the Bank of England.

For the whole of the financial year 1970/71, the central government had a borrowing requirement of about £60 million, following a surplus of about £1,120 million in the previous financial year. This comparison is, however, significantly affected by the change from net receipts to net repayments of import deposits. Leaving these deposits aside, the surplus would have been reduced from £930 million in 1969/70 to some £350 million last year; the postal strike may have been responsible for approaching one half of this reduction, and increased borrowing by local authorities and nationalised industries was another important factor.

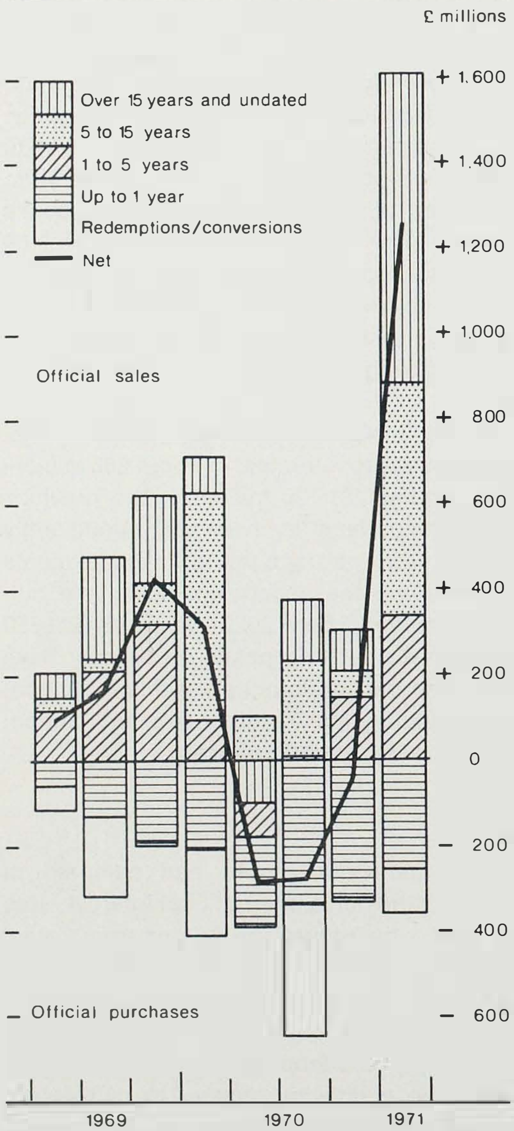
Gilt-edged market

A strong demand for gilt-edged stocks had emerged in January, in the belief that the fall in international interest rates would soon be matched by reductions in domestic rates. This remained the dominant influence in the market throughout February and March, and the demand continued to be very heavy. The authorities wished to resist any substantial fall in yields, and sold unprecedented amounts of stock. In the two months from the middle of January to mid-March, four new issues of tap stocks were made – two short-dated and two long – to a nominal total of £2,300 million.[2] In each case, the issues were made on terms calculated to emphasise the authorities' reluctance to see any rapid fall in yields.

1 For example, the strike delayed discussions between the Inland Revenue and taxpayers about the amount of tax due, where this remained to be settled.

2 *13th January* A further £600 million of 6½% Treasury Loan 1976 at £94·25 per £100 nominal, to yield just over 7¾% to redemption.
20th January A further £500 million of 9% Treasury Loan 1994 at £94·50, to yield about 9 9/16%.
23rd February £600 million of 6½% Exchequer Stock 1976 (a new stock) at £95·50, to yield just under 7⅝%.
11th March £600 million of 9% Treasury Loan 1992/96 (a new stock) at £95·50, to yield about 9½%.

Official transactions in gilt-edged stocks by maturity



Official sales of gilt-edged stocks were exceptionally heavy in the March quarter, particularly of medium and longer-dated maturities.

Early in February, the market demand was mainly for short-dated stocks but, when the issue of 6½% Exchequer Stock 1976 was announced on 17th February on virtually the same terms as for the expiring short tap stock, there was substantial switching into longer-dated stocks, especially the long tap (9% Treasury Loan 1994). The demand for long-dated stocks continued over the following weeks and supplies of the long tap were reduced to such an extent that the issue of a new stock, 9% Treasury Loan 1992/96, was announced on 5th March. Demand slackened following the announcement, but recovered later in the month. Market purchases of short-dated stocks, mainly the short tap stock, also became heavy again in the second half of March, when there were growing expectations of a reduction in Bank rate. The market was further encouraged by the Budget, and demand was heavy following the announcement at the end of the month of the lowering of the West German discount rate.

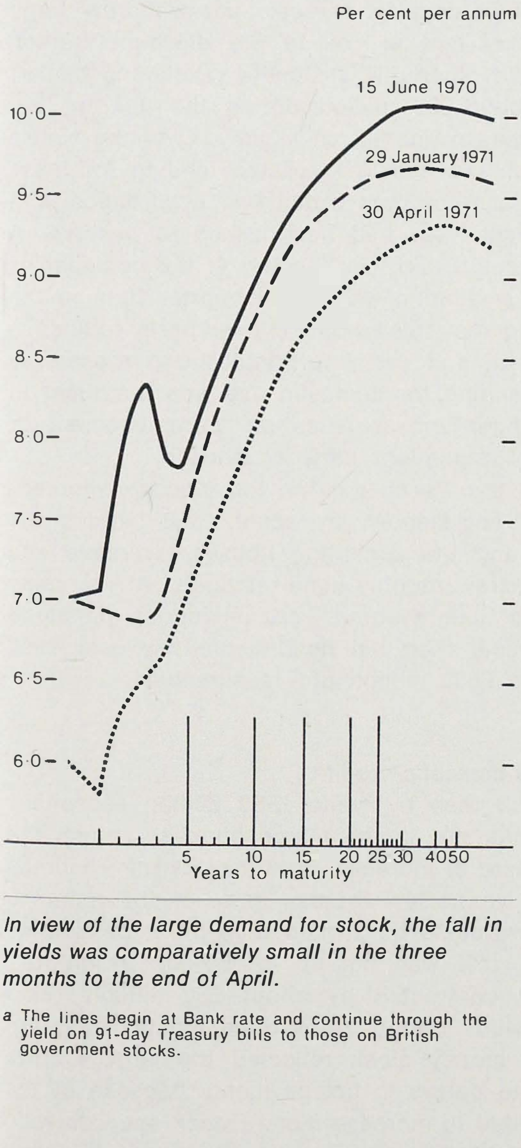
During the March calendar quarter, the authorities' net sales of stock totalled nearly £1,250 million.[1] They redeemed £104 million of 6½% Treasury Stock 1971 at maturity on 28th January, and bought a further £260 million of stocks maturing during 1971; but they sold £340 million of other short-dated issues and £1,270 million of medium and long-dated stocks. The greater part of these sales were to domestic investors outside the banking sector – notably insurance companies and building societies – though the banks and discount houses also bought considerable amounts; identified purchases by overseas investors were smaller by comparison, although much larger than in most quarters.

The market was considerably quieter in April, following the reduction in Bank rate, but on balance investors did not sell any significant amount of stocks; small net sales in the first half of the month were almost matched by purchases in the last two weeks. Market purchases became heavy again early in May, particularly of long-dated stocks, when the developments in Continental exchange markets encouraged expectations of a further reduction in U.K. interest rates. The publication of the new proposals for credit control on 14th May caused some initial marking down of prices; but there was then a recovery and the market soon became quiet and reasonably well balanced.

The reduction in yields in February and March was comparatively small, given the demand for stocks. The fall was typically in the region of ¼% on short-dated issues and ½% on the longer maturities, though the tap stocks changed much less. Following the reduction in Bank rate, most short yields fell by rather more than ¼% in April, and were mainly in the region of 6⅜%–6½% (again excluding the tap stocks) at the end of that month. Medium yields changed little in April; but long yields tended to rise over the month as a whole, by amounts ranging up to about ⅛%, and closed the period in the region of 9¼%.

1 See Table 3 (1) of the annex.

Time/yield curves of
British government securities[a]



In view of the large demand for stock, the fall in yields was comparatively small in the three months to the end of April.

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

Banks and discount houses

Tax payments during the revenue season had a smaller effect on bank deposits and advances than had been expected because, as already mentioned, some payments were delayed by the postal strike. But there were considerable movements of funds both into and out of the banking sector as a result of the inflows of exchange and the investment in gilt-edged stocks.

In the three months to mid-April net deposits with the *London clearing banks* rose by £340 million after seasonal adjustment. Deposits were swollen by the substantial inflow of funds from abroad, although tax payments to the Exchequer and official sales of gilt-edged stocks to the public were working in the opposite direction. Restricted lending rose very little during these three months. Over the year to mid-March, this lending had risen by some 3¾%, which was well within the limit of about 5% which the banks were asked to observe in April last year. The banks' efforts to achieve the necessary restraint were reinforced by a slackening in the commercial demand for advances because of the slow growth of the economy, the inflows of funds from abroad, some improvement in the new issue market in recent months, and the delays in tax payments because of the postal strike.

The clearing banks bought £85 million of gilt-edged stocks in the three months to mid-April, but their liquid assets were reduced by £300 million, mainly because of falls in the amount of money lent at call to the discount market and in the banks' holdings of Treasury bills. Even so, the combined liquidity ratio in April was 32·3%, a comparatively high figure for that month.

Towards the end of the three-month period, in the banking month to mid-April, the clearing banks' net deposits turned downwards, and fell by close on £100 million (seasonally adjusted). Tax payments were catching up after the postal strike and this, together with the continuing substantial official sales of gilt-edged stocks, offset the effects of the inflow from abroad. There was a further fall of £40 million in net deposits in the four weeks to 19th May. In this period restricted lending was unchanged, but there were substantial reductions in the clearing banks' advances to local authorities and nationalised industries. The combined liquidity ratio hardly changed on the month and, at 32·2%, remained unusually high for this time of year at the end of the revenue season.

During the March calendar quarter, sterling deposits with the *accepting houses, overseas and other banks,* excluding inter-bank funds, rose by nearly £50 million. The rise was entirely due to a substantial increase in overseas deposits; domestic deposits were drawn down, as they usually are in the revenue quarter, although the reduction might well have been greater but for the postal strike. As well as the rise in deposits, there was another increase in sterling certificates of deposit in issue: the amount of these certificates outstanding more than doubled during the financial year 1970/71, although there was also a considerable increase in the amount held by this group of banks.

Local authorities borrowed heavily – some £240 million – from these banks in the March quarter, after relying mainly on longer-term borrowing from the Public Works Loan Board and market mortgages in the previous six months. The banks increased their holdings of longer-dated gilt-edged stocks for the first time for a year, but withdrew large amounts of money lent at call to the discount market. Sterling lending to other U.K. residents (excluding banks) increased by about £55 million during the quarter, but lending to overseas residents fell slightly. Over the twelve months to March, the rise in restricted lending for these banks taken as a group was broadly in accordance with the 7% limit which they had been asked to observe. A further rise in foreign currency lending to U.K. companies was very much smaller in the March quarter than in the previous three months. This lending is used partly to finance investment abroad, and partly for domestic purposes; as already noted, lending for domestic use was restricted to medium and longer-term facilities by an amendment to exchange control regulations early in January.

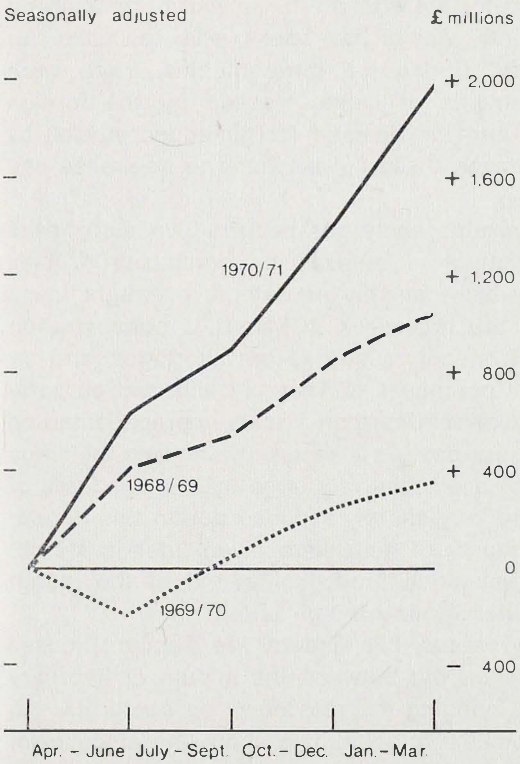
As is usual in the March quarter, the *discount market's* borrowed funds fell steeply, by some £550 million; the clearing banks and the accepting houses, overseas and other banks withdrew roughly equal amounts. At the same time, the houses bought about £220 million of gilt-edged stocks. As a result, their bill holdings fell by over £800 million, including £680 million of Treasury bills.

Money stock and domestic credit

The money stock rose by some £560 million seasonally adjusted, or about 3%, in the March quarter – much the same quarterly rate of increase as in the first nine months of the financial year. But whereas most of the increase in earlier quarters could be attributed to the expansion of domestic credit, this was not so in the March quarter. Domestic credit contracted by about £50 million (also seasonally adjusted) during these three months, and the increase in the money stock reflected the large inflows from abroad. The delays in tax payments because of the postal strike tended to increase money stock and domestic credit, both in the March quarter and in the financial year as a whole.

The reduction in domestic credit in the March quarter was attributable to the very large official sales of gilt-edged stocks which, together with sales of other central government debt, were more than enough to offset expansionary movements elsewhere. The central government had a sizable borrowing requirement on a seasonally adjusted basis, because of the delays in tax receipts caused by the postal strike; and, as in the previous quarter, other parts of the

Changes in money stock[a]
(cumulative)



Despite the large inflow from abroad, the increase in the money stock in the March quarter was at much the same rate as earlier in the financial year.

a The broadest coverage (M_3) as in Table 12 of the annex.

public sector – notably the local authorities – borrowed large amounts. Bank lending to the private sector and in sterling to overseas was much the same as in the two previous quarters; within the total, foreign currency lending to U.K. borrowers for domestic use was markedly lower than in the fourth quarter of last year, as mentioned earlier in the Commentary, following the restrictions imposed in January.

Over the financial year as a whole, the stock of money rose by about £2,050 million, or some 13%; the increase would probably have been nearer 12% but for the distortions caused by the postal strike. Inflows of overseas funds were superimposed on domestic credit expansion of about £1,360 million. The main factors contributing to the expansion of domestic credit were increased bank lending to domestic customers – including, as well as restricted lending, fixed rate finance for exports and shipbuilding and foreign currency lending for domestic purposes – and the borrowing requirements of local authorities and public corporations. These expansionary influences were partly offset by the very large official sales of gilt-edged stocks to domestic investors other than the banks and discount houses.

The increase of £1,360 million in domestic credit during the year compares with an increase of about £900 million – and a somewhat smaller rise in the money stock – contemplated at the time of the Budget in April last year. The central government had a small borrowing requirement, as already described, in place of the surplus of about £600 million which was originally envisaged; borrowing by other parts of the public sector was larger than had been allowed for; and the banks' foreign currency lending to U.K. companies for domestic use was another contributory factor. On the other hand, the authorities succeeded in selling much larger amounts of gilt-edged stocks than had been expected.

Bill markets

During much of the three months to the end of April the money market was affected by uncertainties arising from the postal strike. As already mentioned, tax payments were smaller than expected in the revenue quarter as a whole, which eased conditions in the market; and some of the payments which were made took place later than usual, so that the volume of transfers was lighter than was to have been expected at the end of January and in February and heavier in March. On the other hand, the strike similarly delayed some government payments, and it also caused a rise in the note issue; both these developments tended to make conditions tighter, and so to counteract the effects of the shortfall in revenue. When deciding the size of the weekly Treasury bill tenders, the authorities had to judge the extent to which each of these distorting factors was likely to influence the movement of funds during the coming weeks. In mid-February, the market was temporarily affected by the disruption to money flows when the banks were closed to prepare for the change to decimal currency, and by large payments which the banks had to make for the new currency. During the three months, there were also large movements of money caused by the foreign exchange inflow and the demand for gilt-edged stocks; as it happened, however, these flows tended to neutralise one another.

In the result, sizable shortages occurred on many days in February, which were relieved by purchases of bills (mainly Treasury bills) and by occasional overnight loans at Bank rate. In the first week in March, a concentration of delayed tax payments caused severe shortages, and on 3rd March official purchases of Treasury bills and corporation and commercial bills were on a scale unprecedented on any normal business day. As a result, the houses' holdings of bills, which had been relatively large by the standards of recent years, were very sharply reduced during this period. Further large amounts of help were given later in March, but the market quietened towards the end of the month and remained generally uneventful during April.

At the weekly Treasury bill tenders, the discount houses gradually raised their bid between the middle of February and early March, bringing the rate down by about $\frac{1}{8}$% (to $6\frac{11}{16}$%). Because of the uncertainties about the amounts of funds expected to be in the market, the authorities offered unusually large amounts of bills at most of these tenders, and the houses often received sizable allotments. During the remainder of March the amounts of bills on offer were small, mainly because of the delayed tax payments; the market left their bids unchanged and received no allotments of bills – an unusual event if it happens at one tender, and unprecedented on three occasions in succession. At the tender following the reduction in Bank rate, the tender rate was lowered by a little less than $\frac{3}{4}$% and the houses received a fairly large allotment; thereafter the rate was reduced by a further $\frac{1}{4}$%, to the region of $5\frac{11}{16}$%, at the end of April. The average cost of borrowed funds appears to have followed the reduction in the tender rate over the three months as a whole.

Local authorities

Longer-term borrowing by local authorities in the three months to April fell fairly sharply from the high figures of the previous six months. They borrowed much less from the Public Works Loan Board, as they usually do at this time of the year, but continued to raise substantial amounts on market mortgages. Very little was borrowed on new stock issues, and calls on earlier issues were also lower than in the previous three months. New bond issues in February and March again brought in little more than the amounts redeemed in those months, but a somewhat larger net amount was raised in this way in April. Longer-term rates, though not greatly affected by the reduction in Bank rate at the beginning of April, nevertheless tended to fall over the three months: P.W.L.B. rates for 10-15 year loans stood at 9% at the end of April, compared with $9\frac{3}{8}$% at the end of January; rates on market mortgages of over five years ended the period at $8\frac{1}{8}$%–$8\frac{3}{8}$%, and one-year bonds at 7%, in both cases some $\frac{3}{4}$% lower than three months earlier. As already noted, temporary money rates tended to rise in February and early March before falling back over most of the remainder of that month. During this period, the three-month rate was often lower than the seven-day rate, probably because of market shortages towards the end of the tax year. Rates at most maturities fell in April by almost enough to match the 1% reduction in Bank rate; at the end of that month, the three-month rate stood at $6\frac{3}{8}$%–$6\frac{1}{2}$% and the seven-day rate at $6\frac{1}{4}$%–$6\frac{3}{8}$%.

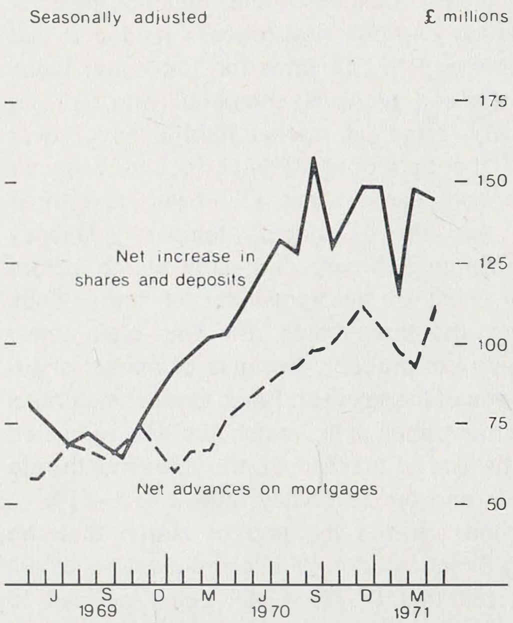
It was announced towards the end of March that the ceiling on lending by local authorities for house purchase is to be abolished, but that they are still being advised to confine such lending to certain specified categories of borrowers who cannot generally get funds from the building societies. The ceiling in 1970 was £155 million, but not all this sum was used.

Finance houses

The postal strike is likely to have affected the level of outstanding debt owed to finance houses: agents were delayed in submitting new contracts to the houses, and repayments of instalments were held up. Thus changes in finance house lending during the first quarter must be interpreted with some caution. But it appears that instalment debt outstanding continued to increase quite vigorously, as it had since the spring of last year; the total rose by £17 million over these three months, making a rise of £76 million for the financial year. Restricted lending probably rose by some 9% over the financial year, which was well above the 5% limit which the houses were asked to observe last April. At various times, individual houses were reminded of the need for continued restraint in their lending.

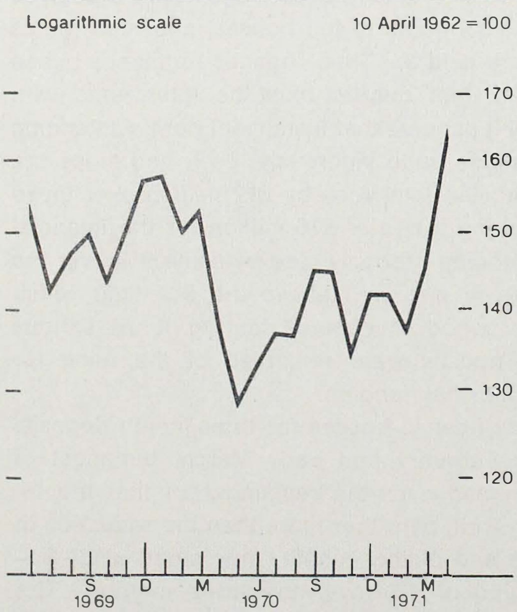
Rates offered by finance houses for three-month deposits increased during February and early March, but most of the rise was reversed over the remainder of that month. Rates then fell in April, by rather more than the reduction in Bank rate. At the end of that month, they stood at $6\frac{1}{2}$% – a fall in the region of 1% over the three months. The Finance Houses Association's base rate, which provides a basis for calculating charges on long-term lending, was raised from $7\frac{1}{2}$% to 8% on 1st March, but was reduced to $7\frac{1}{2}$% again from the beginning of May.

Building society funds



Receipts and lending were affected by the postal strike, but later recovered.

Industrial share prices[a]



Share prices turned sharply upwards after the Budget.

a F.T.-Actuaries industrial (500) share price index: monthly, last working day.

The report on consumer credit by the committee under Lord Crowther's chairmanship was published on 24th March.[1] The committee found that the existing law on consumer credit was so full of inconsistencies and defects that thoroughgoing reform was required; they proposed new legislation governing credit transactions and providing for the protection of the consumer. The committee also concluded that consumer credit, though naturally subject to monetary controls applying to the economy as a whole, ought not to be subject to selective restraints; and accordingly recommended the abandonment of official terms control over instalment credit contracts. The committee's report is now being considered by the Government. As mentioned earlier, the Chancellor of the Exchequer stated in his Budget speech that the authorities are to explore with the banks and finance houses a system of more flexible controls on lending, to replace quantitative ceiling controls.

Building societies

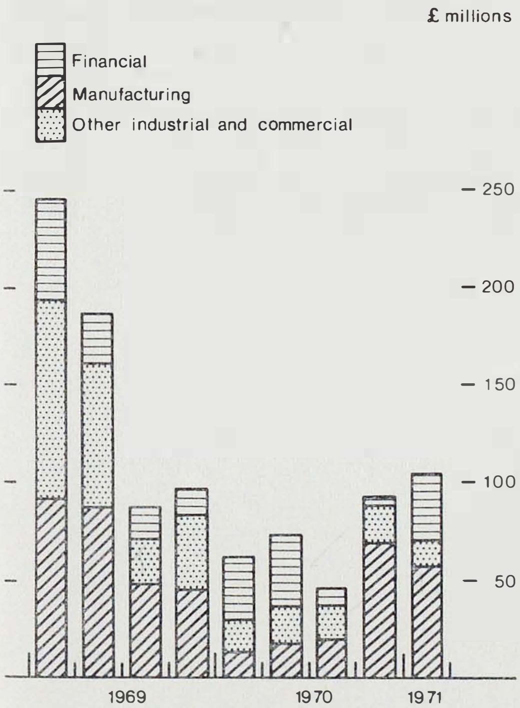
The inflow of funds into the building societies recovered strongly in March, and remained large in April, after an earlier fall which seems to have been caused by the postal strike. After seasonal adjustment, the amount of new money received, and the amount withdrawn, both increased rapidly from low figures in February. On balance, net receipts over the three months amounted to £408 million, which was about £30 million less than the very large total in the previous three months. The societies' net lending seems also to have been affected by the postal strike, and was somewhat lower over the latest period despite a recovery in April; but new lending commitments increased. The combined liquidity ratio rose from 17·6% at the end of January to 17·9% at the end of April.

Company securities

Company failures and low profits kept the equity market depressed in February and early March. Continuing labour disputes, and reports that investment plans were being curtailed, were other factors working in the same direction, and prices fell. Later in March, however, the end of the postal strike, the announcement of the record balance of payments surplus for 1970, and a belief that the Budget would improve companies' cash flow and raise their sales, caused prices to recover slowly. The Budget itself was well received both for the tax reductions which were announced and the changes which were foreshadowed, and prices rose by around 4% in three days. Although this rally was checked for a time, prices moved ahead vigorously in the second half of April. The F.T.-Actuaries industrial share prices index stood at 164·1 at the end of April, a recovery of nearly 25% from the low point in early March, and of 15% over the three

1 *Report of the Committee on Consumer Credit*; Cmnd. 4596.

Capital issues by quoted U.K. public companies



Capital issues by industrial and commercial companies were rather smaller in the March quarter than in the preceding three months, but were still well above the amounts raised earlier last year.

months as a whole. The recovery was checked early in May, but the upward trend was later resumed.

Yields on company fixed interest securities changed little during the three months; those on first-class high-coupon stocks of about 25 years' maturity fell by around $\frac{1}{8}$%, to 10% at the end of April. Yields on gilt-edged securities of similar maturity fell rather faster, so that the differential between them widened slightly, to about $\frac{5}{8}$%.

There were fewer new issues by companies than in the previous three months and, despite some large calls on the earlier issues, the amount of cash raised was somewhat lower, at about £110 million. This was well above the amounts issued earlier last year, but it hardly approached the sums raised each quarter between mid-1968 and mid-1969. Financial companies raised rather more than in the previous three months, but the bulk of the borrowing was again by industrial and commercial concerns. The 'queue' of intending borrowers reflected some bunching of applicants once the postal strike was settled.

Reflecting the depression in the equity market for most of the period, net sales of units by unit trusts remained low in the first quarter at £21 million, despite purchases by a new investment trust. These institutional transactions ceased in April and, as the amount of units repurchased by unit trusts increased somewhat, their net sales were again very small.

Conclusion

Most companies seem to feel that the Budget will improve the outlook. It remains to be seen how soon the reductions in tax payments, the less severe restrictions on bank lending, and the prospect of tax reforms will stimulate investment. The rise in wage costs provides an incentive to install labour-saving equipment, but companies are likely to wait for evidence of a renewed increase in demand before committing themselves to additional capital outlays. Export prospects, or the profitability of selling abroad, should be somewhat improved by the recent currency changes on the Continent, although the benefits will take time to work their way through and will depend mainly on the future course of the deutschemark and the Dutch guilder. All in all, it seems likely that investment will be slow to recover until the prospects change markedly; consumption may begin to increase strongly as the Budget measures take effect.

Much, however, depends on further progress in containing the growth of domestic costs. There may in fact have been some recent check to the rate at which wages and salaries are rising, but they are still growing very fast. There are indications that companies have become increasingly determined to resist further reductions in profit margins as costs rise. Instead they seem ready both to increase prices more rapidly than in the past and to reduce their labour force. Unless additions to wage and salary costs can be restrained, prices are likely to continue to rise almost as steeply as in recent months, with implications for the growth of real incomes. The prospects for output would not be encouraging in such conditions. On these as on other grounds, therefore, it remains a major priority to moderate the growth of incomes.

It is too early yet to assess fully the reactions to the proposed changes in the methods of monetary management. However, the gilt-edged market, which was immediately affected, has responded satisfactorily to the Bank's new policy.