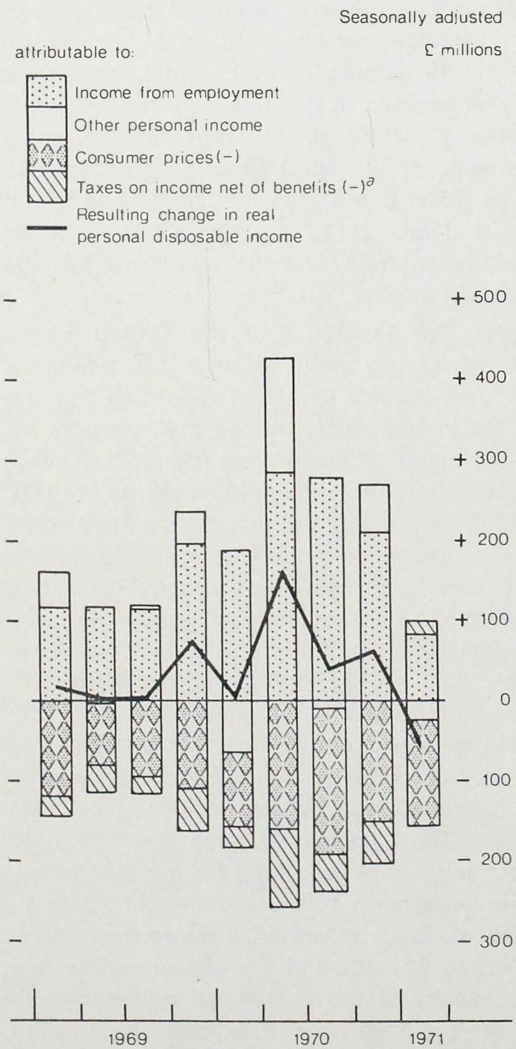
Commentary

Domestic output remained subdued during the three months from May to July, with which this Commentary is mainly concerned, and unemployment continued to rise. Earnings and prices were still increasing rapidly, although there seems to have been some slackening in the rate of growth of earnings and, more recently, perhaps also of prices. In July, the Chancellor of the Exchequer announced further measures to encourage consumer spending and investment; and the Confederation of British Industry called upon its members to limit price increases during the coming year. The balance of payments remained in large surplus on current account in the second quarter, and inflows from abroad, though smaller than in the previous three months, were again substantial. These inflows, together with some expansion in domestic credit, contributed to a further rise in the money stock. Extensive discussions have been taking place with banks and finance houses about the proposed changes in monetary controls, and the new arrangements are to come into force shortly.

On 15th August, the President of the United States announced new policies to stimulate the U.S. economy, contain inflation, and protect the U.S. dollar. Among the measures taken, the President announced that, temporarily, the dollar would no longer be convertible into gold or other reserve assets, except in conditions determined by the U.S. authorities; and that, as a temporary measure, an additional tax of 10% would be imposed forthwith on dutiable imports into the United States which were not already subject to quantitative restrictions. Following this announcement, the foreign exchange markets in London and some other West European centres were closed during the week to 20th August,[1] and there was no official intervention in those that remained open; the market in Japan, however, continued to operate and to be supported by the Bank of Japan. The London foreign exchange market was reopened on 23rd August. The sterling parity remained unchanged at $2·40 to the pound but it was announced that, for the time being, dealings would not necessarily be confined within the existing limits. The Bank of England withdrew the former official buying rate of $2·42 to £1, although the official selling rate of $2·38 remained. Many of the continental centres which had been closed the previous week also reopened on 23rd August, and a number of currencies which had hitherto been allowed to move only within established limits were now able to fluctuate more freely than before. Later that

1 Although the London market was closed, banks were allowed to meet commitments under existing foreign exchange contracts, to accept and make deposits in foreign currency, and to meet travellers' needs. Later, they were also allowed to lend foreign currencies to U.K. customers who had payments to make abroad for purposes normally permitted by exchange control.

Changes in spending power



After an appreciable increase in 1970, real incomes fell during the first quarter of this year under the pressure of rising prices and falling employment.

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

week, the Japanese authorities announced that, from 28th August, the yen would also be allowed to move outside its existing exchange limits against the U.S. dollar.

After the reopening of the London market sterling, in common with most continental currencies, was marked up against the dollar in cautious trading. By the close of business on 27th August, spot sterling was being quoted at a little over $2·47; and, in the forward market, the pound was at a premium for periods up to six months.

With the intention of preventing the sterling rate from rising unduly, a number of exchange control measures to discourage speculative inflows from abroad were announced on 27th August. These measures, which are similar to those already in use in a number of other countries, apply to inflows from non-sterling countries; the investments of overseas sterling countries – whether private, commercial or official – are not affected. Banks, discount houses and similar institutions in the United Kingdom operating sterling accounts for residents of countries outside the sterling area are now precluded from paying interest on any balances on such accounts in excess of those outstanding at the opening of business on 31st August; and, from the same date, local authorities and financial institutions such as finance houses, building societies and trustee savings banks have not been allowed to accept further deposits from residents of these countries. At the same time, investors in non-sterling countries are no longer allowed to add to their holdings of sterling certificates of deposit, Treasury bills or British government, government-guaranteed, or local authority securities having a fixed maturity date earlier than 1st October 1976 – although switching of existing securities is still permitted. Finally, the extent to which banks in the United Kingdom can convert foreign currency deposits into sterling has been restricted.

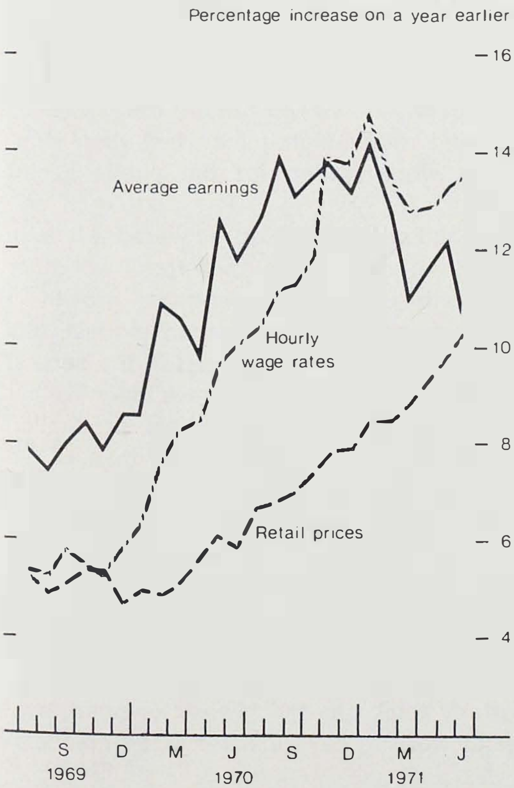
By the beginning of July, most of the major issues arising in the negotiations on the United Kingdom's application to join the European Communities had been resolved. The terms of entry were summarised in a White Paper issued on 7th July.[1]

Domestic economy

Since the Budget, there seems to have been some increase in demand, though only enough to reverse a fall in the first quarter. The modest recovery was mainly attributable to exports, which are discussed later in the Commentary, and to consumers' expenditure. Consumption increased by nearly 2% in the second quarter, but was no higher than in the last few months of 1970. The pronounced fall in the first quarter seems to have been temporary, associated partly with a loss of business by mail order houses during the postal strike and a fall in spending on tobacco following

1 *The United Kingdom and the European Communities*, Cmnd. 4715.

Wages, earnings and prices



In the June quarter, wages and earnings were again much higher than a year ago, though the increase was no larger than at the end of 1970. Retail prices continued to rise very rapidly.

the report of the Royal College of Physicians. Both these kinds of consumer spending increased in the second quarter; and registrations of new cars recovered from the effects of strikes in the motor industry in February and March. The Budget changes which could have been expected to encourage consumption did not become effective until mid-summer at the earliest;[1] but expenditure in the second quarter may have benefited from the reduction in the standard rate of income tax which had been announced the previous October and which became effective in April. Car sales rose again, and very sharply, in July; buyers were no doubt encouraged by the relaxation in hire purchase terms in the middle of the month, although many are likely to have waited until the beginning of August in order to take advantage of the later registration letter.

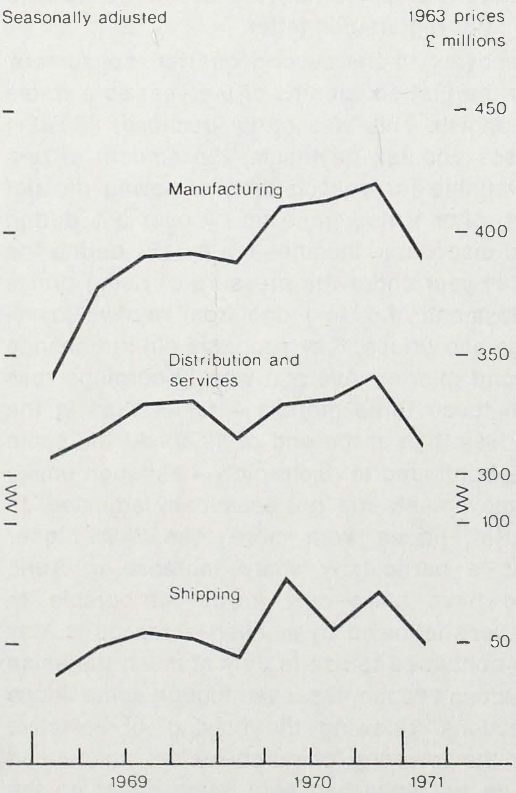
Despite the recovery in the second quarter, consumers' expenditure over the first six months of the year as a whole was relatively sluggish. This was partly because, allowing for price increases and tax payments, the amount of personal income available for consumption or saving did not grow any further, after it had gone up by over 3% during 1970. Indeed real disposable incomes fell by 1% during the first quarter of this year under the pressure of rising prices and falling employment; and, to judge from relative movements in earnings and prices, they probably did not change much in the second quarter. Average weekly earnings rose by some 2½% in those three months – faster than in the first quarter, but less than at the end of 1970.[2] At the same time, retail prices continued to rise rapidly – although unlike earnings, these movements are not seasonally adjusted. In the second quarter, prices were more than 3½% higher than in the first; a particularly sharp increase in April, which seems to have been only partly attributable to seasonal factors, was followed by smaller increases in May and June. Prices continued to rise in July at much the same rate as in the previous two months, even though some shops announced reductions following the halving of selective employment tax; the lowering of purchase tax announced on 19th July could not have had very much effect on the price index for that month, which was based on prices recorded on the following day.

Apart from exports and personal consumption, most of the other components of demand probably fell in the second quarter. The rate of private industrial investment had decreased by as much as 10% in the previous three months and, to judge from the response to the official survey of investment intentions taken in May, there has probably been no recovery since. This survey indicated that manufacturers expected the volume of their capital investment to be 6%-8% less this year than last; and these findings were

1 The Budget changes were described in the June 1971 *Bulletin*, on pages 149-50.

2 The size of wage settlements did not change very much between the first and second quarters, but more people received increases in the later period; and, although earnings continued to be affected by a reduction in overtime working, fewer working days were lost through strikes.

Industrial fixed investment



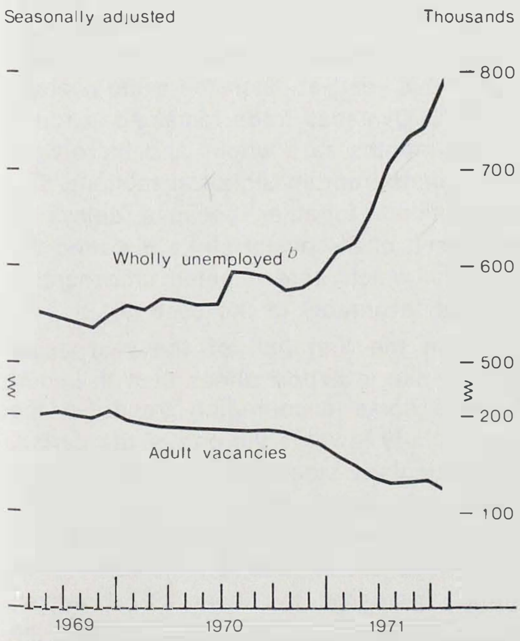
Although private industrial investment held up well in 1970, it fell sharply in the first quarter of 1971.

broadly confirmed, a little later, by the survey taken by the Confederation of British Industry, in which a majority of firms said that they were proposing to invest less during the next twelve months. There is no complete information as yet about the movement in private industry's stocks in the second quarter, but they were probably reduced in response to the earlier check to activity. Stocks had been built up throughout most of last year, but retailers ran their holdings down sharply in the first quarter, and manufacturers may have reduced theirs in the second. Private house-building continued in the second quarter at much the same rate as in other recent quarters, but the amount of new work started rose sharply in July; it may be that builders' earlier expectations are now beginning to be realised. In the three months to July the amount of work started for private ownership was the highest since the end of 1968; the number of houses completed remained about the same as earlier in the year, and rather higher than last year. However, the amount of work started for the public sector continued to decline.

Although total demand seems to have recovered a little in the second quarter, part of it was met from a further increase in the volume of imports. Thus the growth in domestic output was probably no more than modest, and perhaps not enough to restore it to the level in the second half of 1970. Industrial production may have been rather more buoyant than domestic output as a whole; production in the second quarter was about $1\frac{1}{2}\%$ higher than in the previous two quarters. Within the total, manufacturing output also recovered from the depressed level in the first quarter, though it was still little higher than at the end of last year. The recovery from the first quarter may reflect companies' attempts to make good losses caused by strikes in the earlier periods. Many fewer working days were lost from stoppages in the second quarter than in the first, and the quarterly total was the lowest for nearly two years; the number of working days lost remained comparatively low in July.

The further growth in unemployment confirms the impression that total output remained relatively subdued. The numbers wholly unemployed (excluding school-leavers and others temporarily stopped) rose by 68,000, seasonally adjusted, in the three months to mid-August, to a total of 799,000, or 3·5% of the estimated number of employees. This was, however, a rather slower rate of increase than earlier in the year, and the latest figures include students who seem to have followed their recent practice of registering as unemployed during the summer holidays; they have only done so on a large scale in the last two or three years, and it is not yet possible to make an adequate allowance when adjusting for seasonal influences. As well as this further, if slower, growth in the numbers wholly out of work, there were other signs of the continued slackening in the demand for labour. For example, an unusually large number

Unemployment and vacancies[a]



The numbers out of work had become very large by the middle of the year, and vacancies continued to fall.

a In Great Britain.
b Excluding school-leavers.

of school-leavers had not succeeded in finding work by mid-August; and, although the number of vacancies notified for adult workers has fluctuated in recent months there has, on balance, been a further fall.

The July measures

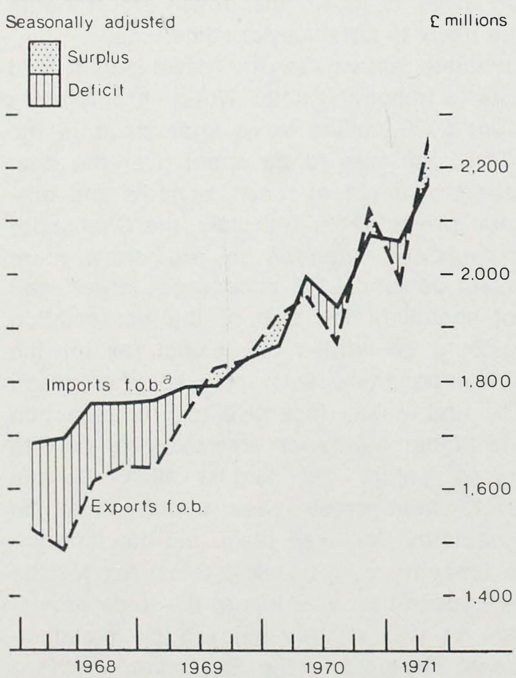
By July, it was clear that domestic output during the first half of the year had been less than expected at the time of the Budget. Unemployment was high and still rising; and the Chancellor of the Exchequer judged that, although the rate of increase in output between the first half of this year and the first half of 1972 now appeared likely to be a little greater than the 3% expected at the time of the Budget, unemployment might not be appreciably reduced by the first half of next year. What is more, the downward trend in investment seemed likely to continue for some time.

In order to stimulate activity in the development and intermediate areas, additional public works programmes amounting to about £100 million were announced in the middle of July. This sum was to be spent over the next two years on the improvement of roads, schools and hospitals and on similar projects. On 19th July, the Chancellor gave details of measures intended to provide a more general stimulus to demand. To encourage larger and earlier investment spending, the size of the depreciation allowance which could be written off against tax for the year in which the expenditure was incurred was raised from 60% to 80%; and, as an incentive to prompt action by companies, the higher allowance was to apply only to expenditure incurred before 1st August 1973. Service industries in development areas were in future to be allowed 'free' depreciation for fixed plant and machinery – that is, the whole amount could be set against tax for the year in which the expenditure was incurred – thus providing the same relief as was already enjoyed by manufacturers in those areas. The cost to the Exchequer of these two incentives was put at about £40 million in 1972/73 and £150 million in 1973/74.

The largest and most immediate impact of the Chancellor's measures, however, was expected to come from those which would directly affect personal consumption. All existing restrictions on the terms of hire purchase, credit sale and rental agreements were removed as from 20th July; and all rates of purchase tax were reduced by about 18%. This was the first time that purchase tax had been brought down since 1963, and was the largest reduction since 1953. Government revenue was expected to be reduced by £110 million in the current financial year and by £235 million in a full year.

The Chancellor commended the initiative taken earlier by the Confederation of British Industry, under which two hundred of the largest member firms have been asked to avoid price increases in the next year wherever possible, and to limit those that are unavoidable to no more than 5%

Balance of U.K. visible trade



Overseas trade remained in rough balance in the first half of the year. Export prices continued to rise faster than import prices . . .

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

per annum. He announced that the nationalised industries had agreed to accept the same restraint on price increases, and that they would be allowed to borrow from the National Loans Fund to finance investment which, in the absence of these restraints, would have been financed from their own resources.

Taking all these measures in conjunction with the substantial relaxations announced in the Budget – which were due to come into operation at various dates from the middle of the year onwards – the Chancellor estimated that domestic output would increase by 4%-4½% between the first halves of 1971 and 1972. Unemployment was expected to stop rising after a few months and, in due course, to fall.

Balance of payments

Partly because of the slackness of domestic demand, current account transactions yielded another substantial surplus in the first half of this year, at much the same average rate as throughout 1970. Overseas trade remained in rough balance taking the six months as a whole, and there were further substantial earnings from invisible transactions. The first six months are taken together because delays in documentation as a result of the postal strike distorted the figures for visible trade, which were affected unfavourably in the first quarter and favourably in the second.

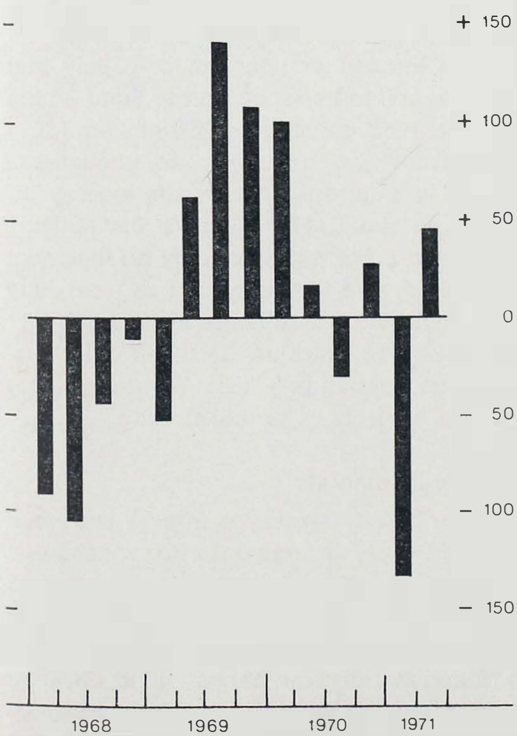
The trade balance in the first half of the year again owed much to a larger rise in export prices than in import prices, but there were some encouraging trends in the volume of trade, particularly towards the end of the period. Export prices rose particularly steeply, and – although the rate of increase varied widely from month to month – they were some 5% higher on average in the first half of the year than in the previous six months; on the same comparison, import prices increased by about 2%. However, the volume of exports increased by some 3% between the two half years, following a period of stagnation since the middle of 1969. Imports continued to grow rapidly in volume, but the rise was largely attributable to increased deliveries of ships and aircraft, including further Boeing 747 aircraft in March; other imports increased by only about 1% in the first half of this year compared with over 5% in the previous six months.

The figures for July provided further evidence of a strong improvement in external trade in recent months. A large surplus emerged in the three months to July, entirely as the result of a brisk rise in the volume of exports. Comparing the average figures for May to July with those for the four months from January to April, which are taken together to eliminate the effects of the postal strike, the volume of exports rose by no less than 8%, whereas the volume of imports was unchanged. For the first time in eighteen months, import prices rose rather more than export prices in the latest period, mainly because of increases in the cost

Transfer of resources into (+) the balance of payments[a]

Seasonally adjusted

1963 prices £ millions



... but there has been no net transfer of resources into the balance of payments over the past year or so.

a Exports less imports (of goods and services) at constant prices.

of oil following the recent agreements with producing countries.

The current account surplus in the first half of the year was, on the recorded figures, concentrated in the second quarter; as already noted, however, the postal strike distortions exaggerated the size of the surplus in those three months. Investment and other capital inflows were also large between April and June, although by no means as heavy as in the March quarter – when U.K. companies were borrowing or repatriating funds from abroad to pay taxes, and the continuing fall in euro-dollar rates left short-term uncovered interest differentials often substantially in favour of sterling. In the second quarter, overseas investment in the United Kingdom was roughly the same size as U.K. investment abroad. But overseas sterling countries continued to increase their sterling holdings as part of the further steep rise in their reserves as a whole; in this quarter the rise in these countries' reserves owed much to favourable seasonal influences, large capital inflows into some countries, and accruals of revenue to oil-producing territories. Oil revenue was also largely responsible for a moderate rise in the sterling reserve holdings of non-sterling countries. There was little change in the amounts of sterling held other than in official reserves in either sterling or non-sterling countries. U.K. companies continued to borrow foreign currencies through their banks and to convert the proceeds into sterling for domestic use but, following the restrictions imposed last January,[1] the amount borrowed was smaller than in most recent quarters. Finally, although the usual covered interest comparisons were markedly unfavourable to sterling for most of the second quarter, banks in the United Kingdom switched funds back into sterling which they were previously employing in foreign currency assets; however, this movement was concentrated in June and early July and is not unusual at this time of the year.

The recorded current surplus and the investment and other capital movements just described contributed more or less equally to the total currency inflow of £634 million in the second quarter. This followed an even larger inflow in the first quarter, and brought the total for the first half of the year to just over £1,600 million.

In view of the substantial improvement in the external position, changes were announced on 7th July in the arrangements under which public authorities raise medium and long-term finance in overseas capital markets. Since early in 1969, those nationalised industries and local authorities which had statutory powers to do so had been encouraged to borrow abroad and, where appropriate, the Treasury was prepared to relieve borrowers of the exchange risks.[2] The provision of exchange cover has now been limited to borrowing with an average life of ten years or

1 Borrowing was restricted to medium and longer-term finance; see March 1971 *Bulletin*, page 8.
2 See June 1969 *Bulletin*, page 142.

more, although existing borrowing is not affected by the change. Subject to the Treasury's consent, public authorities may continue to borrow abroad for shorter periods without exchange cover if they wish to do so.

Reserves and special facilities

Part of the currency inflow of £634 million in the June quarter was added to the reserves, which rose by another £126 million to stand at £1,508 million at the end of June. Most of the remainder was transferred into later months by means of special swaps with overseas monetary authorities; the amount of these swaps increased by £500 million during the second quarter, to a total of £708 million at the end of June.

There was also a reduction of £8 million in U.K. liabilities to the I.M.F. during these three months, as a result of the Fund's use of sterling in transactions with other countries. The Chancellor of the Exchequer announced in July that the whole of the amount still to be repaid to the Fund on the United Kingdom's June 1968 drawing – £256 million ($614 million) – was to be discharged in August; the amount was to have been repaid in quarterly instalments next year. After this repayment, a total of £417 million ($1,000 million) drawn from the Fund under the 1969 stand-by arrangement remained; this sum will fall due for repayment as from June next year. The Fund also hold £83 million ($200 million) of sterling accumulated over the years as the result of interest and service charges on outstanding U.K. drawings; there is no fixed term for the repurchase of this sterling.

Foreign exchange and gold markets

The June *Bulletin* described the events in foreign exchange markets early in May when, in response to widespread discussion of the possibility of exchange rate adjustments against the U.S. dollar, the movement of funds out of dollars into other currencies had become so large that a number of West European central banks withdrew from their foreign exchange markets on 5th May. Official dealings were resumed in most of these markets on 10th May; the exceptions were the markets in Western Germany and the Netherlands, where the authorities had announced the previous day that, for a period, they would no longer keep the exchange rates for their currencies within the established limits. The Swiss franc and Austrian schilling were revalued by some 7% and 5% respectively, also on 9th May.[1] Although markets then became quieter for a time they remained very nervous, and some countries continued to receive substantial inflows.

Sterling was not in the forefront during these developments. However the investment and other capital receipts which augmented the large current account surplus in the United Kingdom's balance of payments undoubtedly owed

1 See June 1971 *Bulletin*, page 156.

Short-term interest rates in London[a]

The rise in international interest rates in recent months has carried them back above comparable U.K. rates.

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

something to the excess of liquidity in exchange markets. Another reason for these inflows was that domestic short-term interest rates for periods up to one month sometimes moved above those in the euro-dollar market, before allowing for the cost of forward cover. In these conditions, the spot sterling exchange rate generally remained close to its upper limit from May to July.

Early in August markets became extremely unsettled again. The interruption of exchange dealings following the announcement of the U.S. measures on 15th August, and developments after the London foreign exchange market reopened on 23rd August, have been described earlier in this Commentary.

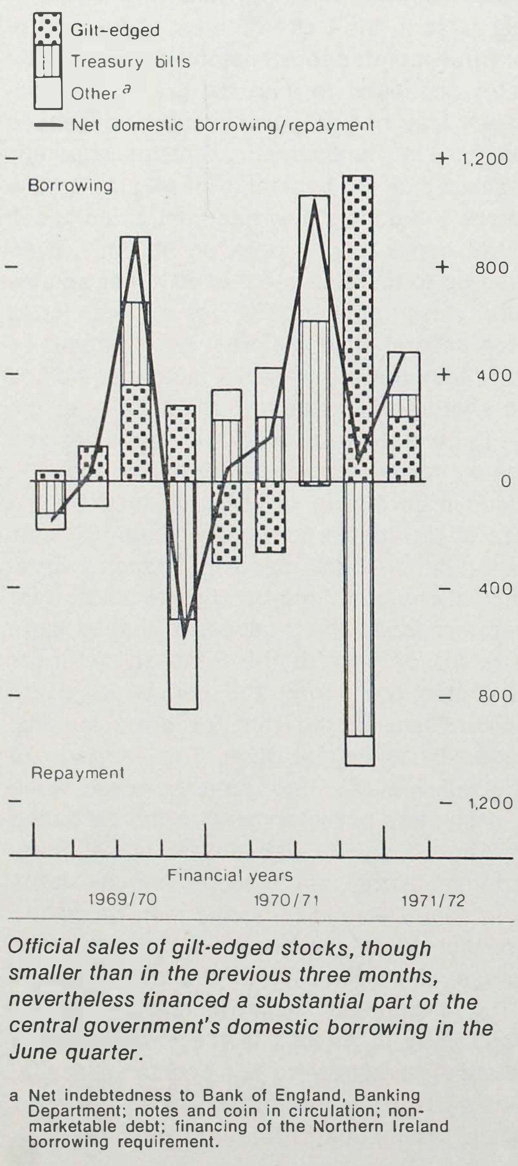
Except for the shorter maturities already referred to, uncovered interest rate comparisons became unfavourable to sterling from the beginning of May. Euro-dollar rates had begun to move upwards late in March following a rise in short-term interest rates in the United States; at the end of April, the rate for three-month deposits stood at about $6\frac{1}{4}$%. Although U.S. rates continued to increase gradually, euro-dollar rates between May and July were mainly influenced by the developments in continental exchange markets. Rates rose very sharply at the beginning of May as operators sought to borrow the dollars they had contracted to sell to European central banks; at the peak on 6th May, overnight funds fetched up to the equivalent of 30% per annum, and three months' rates reached 8% per annum. Rates remained high for several days before easing gradually. Towards the end of May however various factors combined to emphasise the shortage of funds in the market after the earlier large sales to central banks: there was some demand from Canadian banks for balance-sheet purposes; the U.S. Treasury announced a borrowing of $500 million from the overseas branches of U.S. banks to replace maturing notes issued by the Export-Import Bank; deposits financing European banks' participations in a large bond issue fell due for renewal; and operators faced the prospect of finding large amounts of dollars for delivery to the Bundesbank under forward contracts taken out during the period up to 5th May. Under these influences, the rate for three months' euro-dollars reached $8\frac{1}{16}$% on 1st June. The shortage of funds was quickly relieved after 3rd June, however, when the Bundesbank, which had not intervened in the exchange market since 5th May, began to sell dollars again. Euro-dollar rates eased immediately, and moved generally downwards until early in July. Demand for funds then recovered and, by the end of that month, the three months' rate stood rather higher than at the beginning of the period under review, at $6\frac{3}{4}$%. Rates continued to move upwards in the unsettled conditions early in August. In the middle of that month, when exchange markets were not operating, day-to-day rates became very high because of the need to extend borrowings. After the resumption of foreign exchange dealings, the demand to borrow dollars for rather longer terms brought the three months' rate to over 9%.

The main U.K. short-term interest rates tended to fall between May and July, despite some increase in the latter part of May. However, the cost of forward cover fell quite sharply, the three months' quotation moving from the equivalent of 2$\frac{1}{8}$% per annum to $\frac{5}{8}$% over the period; most of the reduction occurred at the beginning of May, when international interest rates moved well above domestic rates, and again in July. As a result, although covered interest comparisons remained markedly unfavourable to sterling during the three months, the adverse differential narrowed somewhat over the period, and especially between mid-June and mid-July.

The uncertainties in the exchange markets led to a rise in the London gold price from \$39·70 to above \$41 per fine ounce early in May. The price then fell back for a time but subsequently rose again to reach \$42·47$\frac{1}{2}$ at the end of July. The price continued to rise as a result of the unsettled conditions in exchange markets early in August and, on 9th August, was fixed at \$43·94, the highest since the major central banks withdrew from the gold markets in March 1968. During this period, speculative demand more than offset the decline in activity that is usual in the summer months. The London gold market was closed on 16th August, after the announcement of the U.S. measures, and when it reopened on the following day business was fairly quiet. At first, prices fluctuated between \$43 and \$43$\frac{1}{2}$, but with little buying interest the price later declined rapidly.

Domestic borrowing of the central government

£ millions



Official sales of gilt-edged stocks, though smaller than in the previous three months, nevertheless financed a substantial part of the central government's domestic borrowing in the June quarter.

a Net indebtedness to Bank of England, Banking Department; notes and coin in circulation; non-marketable debt; financing of the Northern Ireland borrowing requirement.

Central government financing

Revenue in the June quarter benefited from substantial tax receipts due in the previous three months but delayed by the postal strike. As a result, the central government's accounts were in approximate balance, even though expenditure rose sharply and nationalised industries continued to borrow large amounts. Virtually all the remaining import deposits, totalling £112 million, had been repaid by the end of June.

Despite the balance in the accounts as a whole, nearly £500 million had to be borrowed from domestic sources, because of the need to finance the large inflows from abroad. Investors outside the banking sector again subscribed unusually large sums to national savings, following the increased limits on holdings and other changes in terms announced in the Budget; the net amount taken up in the June quarter was more than £60 million, making a total of over £175 million in the past six months – a very much faster rate of saving than in most post-war years. These investors also bought another £200 million of gilt-edged stocks – a substantial amount, though not on the scale of the previous quarter, when purchases totalled nearly £730 million. The banking sector were left to provide nearly £175 million; they bought rather less than £50 million of gilt-edged stocks and £100 million of Treasury bills.

At the time of the Budget, the net borrowing requirement for the financial year 1971/72 as a whole was put at just over £600 million, compared with a deficit of £67 million in 1970/71. The total for this year will increase to the extent that output between January and June was lower than the expectations on which the Budget estimates of tax revenue were based; and, of course, the measures to stimulate the economy announced in July will, taken by themselves, add considerably to the borrowing requirement. But these additions would be partly offset if the economy began to expand more quickly – thus increasing revenue – and if the increase in prices were to moderate.

Gilt-edged market

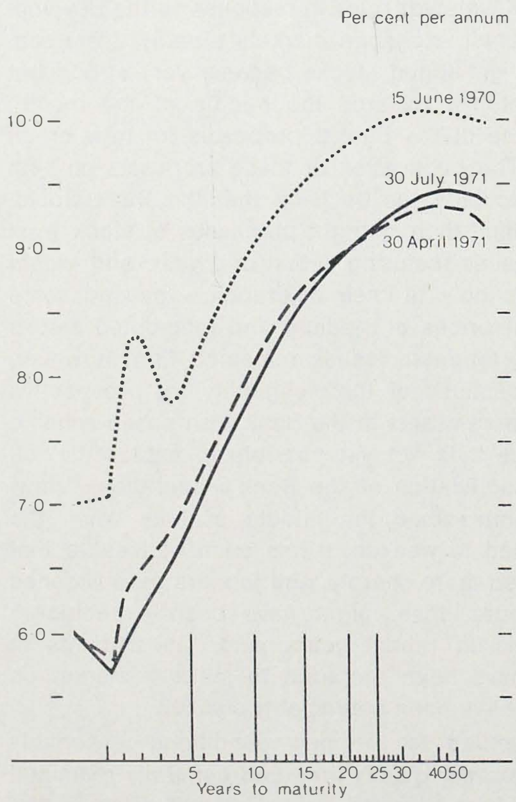
Early in May, there were growing expectations of further reductions in U.K. interest rates in response to the developments in continental exchange markets already described. The demand for gilt-edged stocks became very strong but the market quietened towards the middle of the month, before the release of the Bank's proposals for new credit arrangements.[1] The publication of these proposals on 14th May – and particularly the decision that the Bank would, from 17th May, limit their outright purchases of stock from the market to issues maturing within one year, and would buy other stocks only at their discretion – caused some marking down of prices of medium and long-dated stocks at first. The shorter-dated issues remained firm, however, perhaps partly because of their eligibility, or prospective eligibility, as reserve assets in the Bank's proposed scheme for credit control. It is not yet possible to assess the full effects of the modification of the Bank's operations. However, on occasions since the middle of May when the market has tended to weaken, it has been noticeable that prices have moved more sharply, and jobbers have widened their margins more, than might have been expected in similar conditions in recent years; and the amounts in which jobbers have been prepared to make a market on those occasions have been appreciably smaller.

The market settled to the new conditions reasonably quickly; prices became quietly firm, and generally remained so until late in June, despite rising interest rates in the United States. At that time, a large demand for longer-dated stocks developed as growing expectations of reflationary measures encouraged strong hopes that monetary policy would be relaxed and interest rates lowered; prices rose sharply.

During the June calendar quarter, the authorities sold a net £285 million of stock, mainly to the general public. This was a sizable total, even though it did not approach the amount of stock – nearly £1,250 million – sold in the

1 See June 1971 *Bulletin*, pages 151 and 189-93.

Time/yield curves of British government securities[a]



Except for long-dated stocks, most yields fell slightly in the three months to July; and at the short end the fall was quite marked.

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

previous three months. Official purchases of stocks maturing within a year were roughly matched by sales of other short-dated issues; and substantial amounts of long-dated stocks were sold.[1]

The market continued strong during the first week of July despite expectations, subsequently justified on 6th July, of a general rise in U.S. prime lending rates. On 7th July official holdings of the long tap stock – 9% Treasury Loan 1992/96 – were exhausted, and the authorities announced the issue on 13th July of a further £400 million of an existing long-dated stock – $8\frac{3}{4}$% Treasury Loan 1997. At the issue price of £95 per £100 nominal this new tranche carried a yield to redemption of $9\frac{1}{4}$%. The announcement of these terms caused prices to increase sharply, and the remaining amount of the short-dated tap stock in official hands was sold as the authorities tried to moderate the rise. On 9th July a new short tap was announced – £500 million of 6% Treasury Stock 1975 at £98·50 per £100 nominal to yield about $6\frac{1}{2}$% – for issue on 15th July. As with the long-dated issue, the terms were generally regarded as favourable. Prices rose and were further strengthened by the publication of the trade figures for June. The redemption of 5% Conversion Stock 1971 on 15th July had comparatively little impact, because only a fairly small amount of stock remained in market hands by that date; and it was announced the next day that no conversion offer would be made in respect of either $6\frac{3}{4}$% Exchequer Stock 1971 or British Gas $3\frac{1}{2}$% Guaranteed Stock 1969/71, both of which were due to mature on 10th September.

Following the Chancellor's announcement on 19th July of additional measures to stimulate the economy, expectations of further reductions in interest rates receded, and prices weakened. Over the remainder of that month, most prices declined further in quiet conditions. Early in August, the uncertainties in the exchange markets were a disturbing influence for a short time, but demand quickly strengthened after the announcement of the U.S. measures, because of renewed expectations that U.K. interest rates would be reduced.

Yields on the shortest-dated stocks fell sharply during the three months to the end of July, but other maturities were less affected. On the shortest-dated stocks the reduction was typically about $\frac{3}{4}$%, to some $5\frac{1}{2}$%-$5\frac{3}{4}$%. Yields on other stocks to five years maturity fell by up to about $\frac{1}{4}$%, to stand between $5\frac{7}{8}$% and $7\frac{1}{8}$%. Medium yields were about $\frac{1}{4}$%-$\frac{1}{2}$% lower over the period, but those on longer maturities changed little, with high coupon stocks standing in the region of $9\frac{1}{2}$% at the end of July.

Banks and discount houses

As already noted, the Bank have been discussing with the institutions concerned the proposals for changes in monet-

1 See Table 3 (1) of the annex.

ary controls which they circulated on 14th May,[1] and the new arrangements will shortly be introduced. The Chancellor of the Exchequer stated in his Budget speech that the existing methods of control would continue during this period while the proposals were being considered. Interim guidance was given at that time to cover the June quarter, and this guidance was subsequently extended for a further three months. The combined effect is that banks and finance houses have been asked to ensure that their restricted lending does not rise in the period to September by more than about 5% above the limits previously set for March 1971.[2]

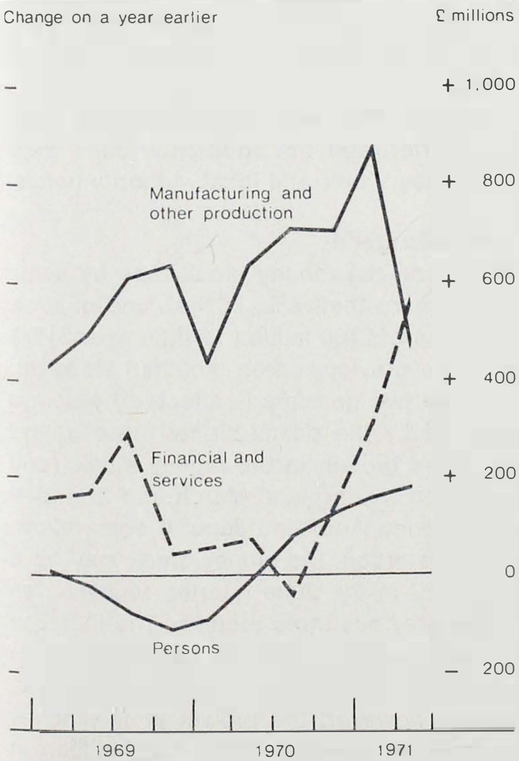
Net deposits with the *London clearing banks* were falling at the beginning of the three months to mid-July, but the fall was checked in June and deposits then rose sharply enough in July to show a net increase of about £60 million (seasonally adjusted) over the three months as a whole. The earlier fall was no doubt partly the result of tax payments which had been delayed by the postal strike; and official sales of gilt-edged stocks were a contractionary influence throughout the period. However, these factors seem to have been outweighed by the continued inflow of funds from abroad.

Advances other than to the nationalised industries rose by about £75 million, after seasonal adjustment, over these three months. There was little sign that the demand for bank finance from manufacturing industry was picking up; the increase was largely attributable to other customers such as builders and, particularly, personal borrowers. Among their other assets, the London clearing banks bought a further £70 million of gilt-edged stocks over the three months. Their liquid assets were not greatly changed in total, but the banks increased their holdings of commercial bills by nearly £140 million, and reduced the amount of call money lent to the discount houses by almost as much. The combined liquidity ratio, at 32·0% in mid-July, remained unusually high.

The inflows from abroad contributed to another steep rise – about £120 million after seasonal adjustment – in the London clearing banks' net deposits in the month to mid-August. Their advances, excluding lending to nationalised industries, fell seasonally; and the banks added £205 million to their liquid assets, mainly through increased lending to the discount market. As a result, the combined liquidity ratio rose as high as 33·6%.

Early in August, the Government announced that the limit up to which they were prepared to guarantee loans for the purchase of ships built in British yards for British shipowners was to be raised from £700 million to £1,000 million.

Banking sector's advances to U.K. residents



Industrial companies have reduced their drawings on bank advances in recent months, but other domestic borrowers have continued to take more.

1 The text of the consultative document *Competition and credit control*, which was circulated as a basis for discussion with banks and finance houses, was given on pages 189-93 of the June 1971 *Bulletin*. Separate proposals made to the London Discount Market Association are described in a notice issued by the Bank on 21st July and reproduced on page 314 of this issue.

2 A notice which the Bank issued to banks and finance houses on 30th March appeared on page 194 of the June 1971 *Bulletin*; a further notice issued on 30th June is on page 316 of this issue.

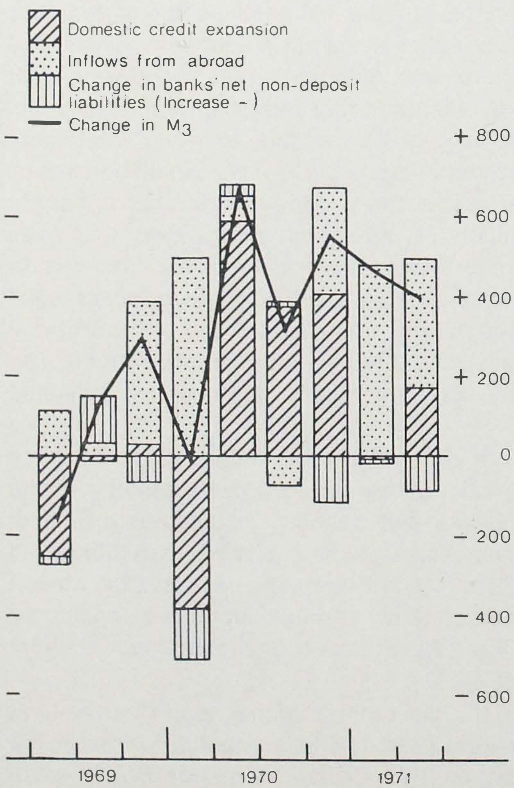
The London and Scottish clearing banks agreed to make additional medium and longer-term finance available at fixed rates, at present 7%, for transactions covered by these guarantees.

During the June calendar quarter, domestic sterling deposits with the *accepting houses, overseas and other banks*, excluding inter-bank funds, rose by about £90 million, resuming the strong upward trend which had been interrupted in the previous three months when tax payments were seasonally large. The increase in overseas sterling deposits was much more modest, but the total of sterling certificates of deposit in issue rose by another £240 million; once again, these certificates were largely taken up by other banks within this group. For the rest, the extra resources were mainly lent to local authorities, whose borrowing from these banks increased by as much as £400 million in the six months to June.

The *discount market's* borrowed funds rose by £150 million in the June quarter, and the additional funds were mainly employed in Treasury bills and local authority bonds.

Changes in money stock[a]

Seasonally adjusted £ millions



The inflow from abroad has contributed most to the rise in money stock in the first half of this year; but domestic credit also expanded in the June quarter.

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

Money stock and domestic credit[1]

After seasonal adjustment, the money stock rose by some £400 million, or rather more than 2%, in the June quarter. This followed an increase of £460 million (a little over $2\frac{1}{2}$%) on revised figures in the previous three months.[2] However, comparison between the two quarters is affected by delays in tax payments caused by the postal strike; these delays tended to exaggerate the growth in the money stock (and domestic credit) between January and March and to understate the increases between April and June. If some allowance is made for this distortion, the money stock may have risen by approaching 3% in the June quarter, following an increase of 2% in the previous three months. The increase between January and March reflected the inflow from abroad, and this was also an important factor in the June quarter. In that period, however, the growth in the money stock was accompanied by a rise of about £160 million in domestic credit, which had not changed in the previous three months.

The expansion of domestic credit in the June quarter was nevertheless smaller than in other recent quarters. The increase reflected further borrowing from the banks by local authorities, which raised particularly large amounts in these three months, and bank lending in sterling to the private and overseas sectors. The rise in bank lending in the calendar quarter was larger than was to have been expected from the mid-monthly figures and, as in the same period last year, may have included some unusually large transactions at the end of the quarter. Against these expansion-

1 The references to the money stock are based on the broadest definition, M_3, in Table 12 of the annex; figures of domestic credit expansion are given in Table H of the analysis of financial statistics (see page 330).

2 The revisions to earlier quarterly figures mainly reflect a recalculation of the seasonal adjustment; however, the average quarterly rate of increase in the money stock in the financial year 1970/71 remained about 3% on the revised figures.

ary influences, the central government had a surplus (after seasonal adjustment) as a result of the delayed tax receipts; and, as already noted, there were substantial official sales of gilt-edged stocks to domestic investors outside the banking sector, and national savings were again unusually large.

Bill markets

Conditions in the money market were fairly quiet during much of the period from May to July. Foreign exchange inflows often brought funds into the market, but in the middle of May and again towards the end of June large official sales of gilt-edged stocks were having an opposite effect. The amounts of Treasury bills offered at the weekly tenders did not lead to appreciable shortages, and the authorities provided such assistance as was necessary mainly by purchases of Treasury bills and corporation bills. They also lent occasionally overnight to smooth out day-to-day fluctuations and, in the last week of June, for two and three days over the end of the half year; all this lending was at Bank rate.

At the Treasury bill tenders, the houses gradually raised their bid over the period, and often received satisfactory allotments from the fairly large amounts on offer. On three occasions between the middle of June and July, however, the amounts on offer were reduced in order to avoid creating undue shortages in the following weeks; and at two of these tenders, the houses received no allotment. The tender rate fell from $5\frac{11}{16}\%$ at the end of April to a little over $5\frac{9}{16}\%$ three months later; and the average cost of the discount houses' borrowed funds appears to have followed the same trend. During the period the market's minimum buying rate for fine bank bills also fell, from 7% to $6\frac{5}{16}\%$.

As from 6th August the discount market has abandoned the practice – in existence since before the war – of agreeing a minimum rate for fine bank bills each Friday for the following week. This move, which was consistent with the Bank's proposals for greater competition in the banking system as a whole, resulted in a fall of a little over $\frac{1}{4}\%$ in rates, and some narrowing of the margin between the houses' buying and selling rates. The Bank's proposals to the discount market for changes in monetary controls are reproduced on page 314.

Local authorities

Local authorities borrowed more from the Public Works Loan Board during the three months to July, when they were able to draw upon the quotas for the new financial year, but raised slightly less on stock issues than in the previous three months. Otherwise they borrowed mainly at shorter term, no doubt encouraged by the larger fall in interest rates at that end of the range. Thus they raised less finance on market mortgages whereas new bond issues (mainly for one year) brought in unusually large amounts, well in excess of the sums redeemed. The total of local authority bills in issue also increased and, at £167 million, was larger than ever before. As already noted, local authorities also continued to borrow large sums in the temporary money market.

The costs of most types of finance fell over the three months. P.W.L.B. rates were altered on several occasions and, by the end of July, were $\frac{1}{2}$% lower, at $8\frac{1}{2}$% for 10-15 year loans. Mortgages with lives of 5-10 years remained at about $8\frac{1}{8}$%-$8\frac{1}{4}$%; but yields on one-year bonds stood at about $6\frac{1}{2}$% compared with 7% three months earlier. $6\frac{1}{8}$% was being paid on three months' deposits as against $6\frac{3}{8}$%-$6\frac{1}{2}$% at the end of April, and the seven-day rate had fallen by some $\frac{3}{8}$%, to 6%.

Finance houses

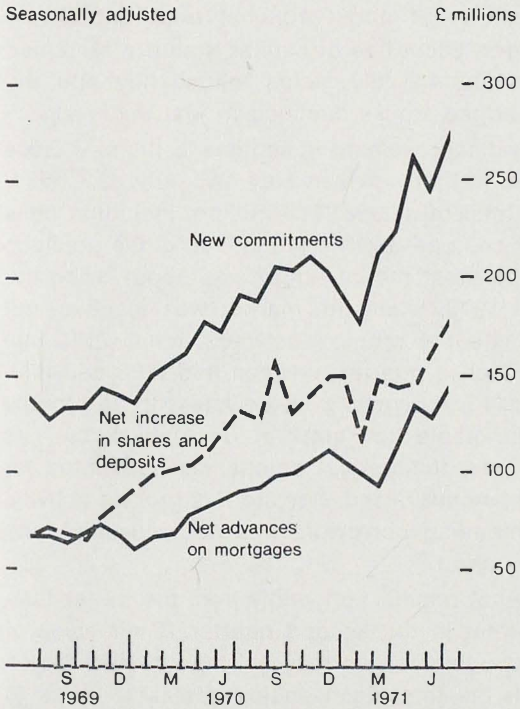
Allowing for seasonal influences new credit extended by the finance houses did not change very much in the June quarter. Repayments were larger than in the previous three months, and instalment debt outstanding increased by only £8 million. This was a much smaller rise than in other quarters since the spring of last year. The progress made towards implementing the Bank's proposals for altering the methods of credit control has already been described, together with the arrangements for continuing the existing lending restrictions while these new proposals were being discussed.

The rates offered by the houses for three months' deposits rose by about $\frac{1}{2}$% to some 7% during May, but fell thereafter to about $6\frac{1}{4}$% at the end of July. Meanwhile the Finance Houses Association's base rate, on which some charges for long-term lending are calculated, was reduced from $7\frac{1}{2}$% to 7% on 1st June and to $6\frac{1}{2}$% on 2nd August.

On 18th June some members of the Finance Houses Association announced that they could no longer comply with the Bank's request to refrain from making personal loans for the purchase of goods subject to hire purchase terms control on conditions easier than those permitted by law for hire purchase contracts. This move was made against the background of the recommendation by the Crowther Committee, reporting in March, that official terms control over instalment credit contracts should be abandoned, and at a time when the effectiveness of these controls was being increasingly eroded.

The removal of all terms controls on hire purchase, credit sale and rental agreements as part of the measures introduced by the Chancellor of the Exchequer on 19th July is mentioned earlier in this Commentary. The Chancellor pointed out that all those who provide consumer credit will now compete on an equal footing. He repeated, however, that the control of consumer credit and the general methods of quantitative monetary control went together. Arrangements for consumer credit would eventually have to be considered in this wider context, in the light of the Crowther

Building society funds



Building societies' receipts and lending both resumed their upward trend in the three months to July.

Committee's recommendations and of experience with the new methods of credit control.

Building societies

Although comparisons with the earlier months of this year are distorted by the postal strike, the inflow of funds to the building societies seems to have begun to increase again in the period from May to July. Their receipts had been rising strongly from about the time that interest rates paid on share and deposit accounts were raised in April 1969 until towards the end of 1970, when they had levelled off at a high figure. The fall in other domestic interest rates following the reduction in Bank rate on 1st April may have been one reason for the renewed growth, for building society rates remained unchanged. The increase, which occurred when national savings were also doing particularly well, brought net receipts in the period from May to July some 30% higher than in the same three months last year, to a seasonally adjusted average of over £160 million a month.

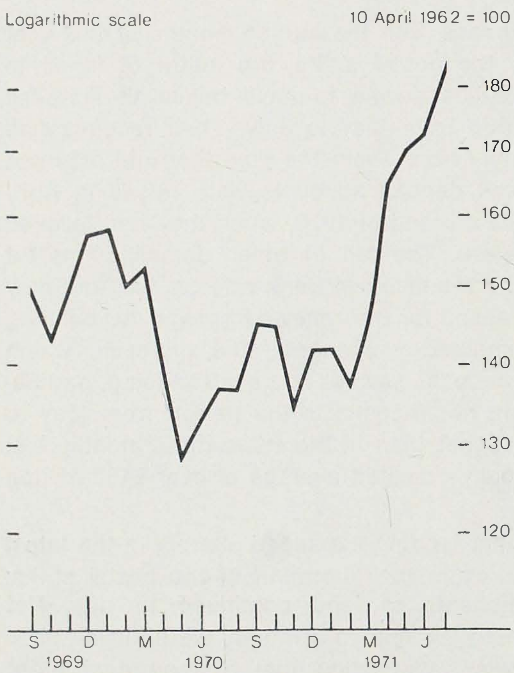
The societies' net lending expanded sharply in the latest three months, partly in the aftermath of the postal strike; and new commitments to lend continued to rise. Net advances, at about £135 million a month, were almost 50% higher on the year, suggesting that a good deal more housing was being financed through the building societies, even after allowing for higher prices. The combined liquidity ratio has been verging on 18% for several months now, more than one percentage point higher than a year ago.

Company securities

After rising rapidly in the second half of April, the equity market remained firm during May and June. In the first half of July hopes of early reflation raised share prices further, to where they last were early in 1969. By 19th July, when the Chancellor's measures were announced, the F.T.-Actuaries industrial share price index had risen to 183·5; and it ended the month at 183·8, to show a rise of 12% over the period as a whole.

Sentiment was also helped during the period by fewer strikes, a rise in reported company profits, and hopes that the rate of wage and price inflation might be beginning to ease. The difficulties in continental foreign exchange centres created uncertainty for a time early in May, but the market later judged that the measures taken to overcome these difficulties should benefit the U.K. economy. During June and most of July, a decline in share prices on the New York stock market and news of further company liquidations at home had little effect on the London market. At the end of July, however, these developments began to exercise a restraining influence. Early in August, the market was also affected by the renewed uncertainties on the foreign exchanges, and prices fell somewhat although the fall was

Industrial share prices[a]



Share prices rose very rapidly from March to July.

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

short-lived. News of the American measures weakened the market in mid-August, but prices soon began to recover.

Yields on company fixed interest securities changed very little between the end of April and the end of June. Those on first-class high-coupon debenture stocks of about 25 years' maturity stood at about 10% at both dates, and yields on gilt-edged securities of similar maturity remained some $\frac{5}{8}$% lower. During July yields fell slightly and the margin over gilt-edged stocks declined to just under $\frac{1}{2}$%.

With the general improvement in sentiment, the new issue market recovered further between May and July. U.K. companies raised a total of nearly £140 million, including calls on earlier issues, compared with £110 million in the previous three months. The most recent figure was about twice the quarterly rate in 1970, when the market was inactive, but compares with amounts ranging between about £190 million and £250 million a quarter between mid-1968 and mid-1969. The increase in borrowing in the latest three months was mainly attributable to financial companies but, as usual, industrial and commercial companies accounted for most of the total amount raised. Despite this greater activity, the 'queue' of intending borrowers was not unusually long at the end of the period.

Unit trusts did not benefit noticeably from the better tone in the equity market in the second quarter. Their sales of units were appreciably larger than in the previous three months, although the total again included sizable sales to investment trusts rather than to individuals; but repurchases also increased sharply so that net sales, at £24 million, rose only a little. Repurchases of units continued to rise in July, when they were higher than ever before. As a result, net sales in that month remained very small.

Conclusion

The recent American measures and the related uncertainties in the exchange markets have brought unsettled conditions for international trade and payments for the time being. There is a danger that, in changing and unfamiliar circumstances, countries will be more ready to adopt restrictive trading practices or to take other steps to protect themselves from increased competition; and once this process starts it could quickly spread. The primary aim must therefore be to resist such divisive tendencies, and to safeguard or enhance the progress which has been made over the post-war years, in the International Monetary Fund and through the General Agreement on Tariffs and Trade, towards orderly and liberal arrangements for international trade and payments. A return to more stable exchange arrangements would help to reduce uncertainty, provided an appropriate realignment of parities had been achieved; such a realignment should itself encourage the removal of some existing hindrances to trade, especially in the United States. The recent developments will no doubt also give further impetus to the discussion of the reserve base of the exchange system.

At home, demand and activity may soon begin to expand more vigorously. There has already been a marked recovery in exports since the spring; and the Budget and the additional relaxations in July could well have a considerable effect on consumers' expenditure and, later, on other domestic demand.

If output accelerates in response to a faster growth in demand, the more intensive use of plant and equipment should to some extent reduce the pressure of wage and salary costs upon prices. At the same time the measures taken by the Confederation of British Industry to restrain the growth of prices should have a significant impact in the coming months. But these measures cannot succeed for very long unless parallel attempts are made to reduce the growth of wages and salaries. Conditions now seem favourable for such attempts: as well as the C.B.I.'s initiative and the faster growth of output now envisaged, the recent tax reductions should help to hold prices down. Hopes of achieving steady economic expansion depend largely upon the success of these efforts to moderate the growth of earnings and prices; and they will need time to work.

Monetary conditions have been relatively easy in recent months; and as a result of the various measures which have been taken to stimulate the economy, a public sector borrowing requirement will add to domestic liquidity in the months ahead. This will help to finance any expansion that occurs. However, if changing circumstances later make it appropriate to moderate the increase in liquidity, this would require suitable action in the field of monetary management.