Commentary

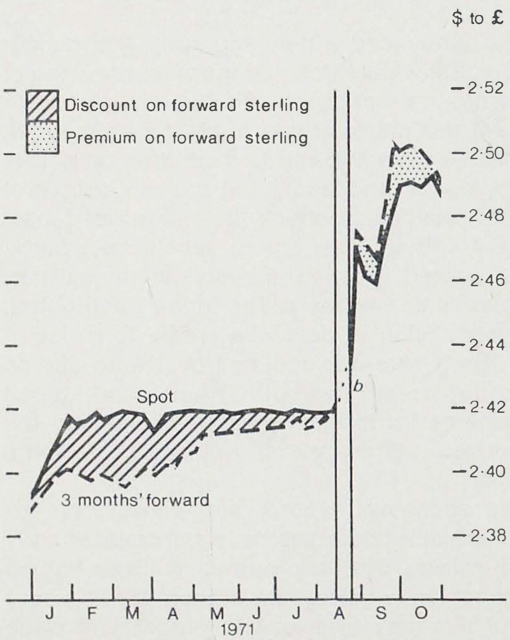
The United States announced a new economic programme in the middle of August which included measures to protect the dollar and, during the rest of the three months August to October with which this Commentary is chiefly concerned, most major currencies were allowed to float. Sterling appreciated against the dollar and additional exchange control restrictions were introduced to check the inflows of funds. The total currency inflow was again substantial, partly because of a large and growing surplus on the current account of the balance of payments. The inflow contributed, together with an expansion in domestic credit, to a rise in the money stock. Bank rate was reduced by 1% to 5% on 2nd September and interest rates both at home and abroad fell. New arrangements for monetary controls affecting the banks, finance houses and money market came into force on 16th September.

In the domestic economy, exports and consumers' expenditure on cars and other durables have increased sharply but so far without raising domestic output much or halting the growth in unemployment. The rate of increase in prices has slackened but this may owe less to moderating wage costs than to other influences, such as tax reductions and the initiative taken by the Confederation of British Industry.

International exchange developments

Widespread uncertainty about rates of exchange against the U.S. dollar has affected foreign exchange markets throughout the period. Most of the events of August were described in the September *Bulletin*. In brief, in the first fortnight there was heavy selling of the dollar against most currencies, including sterling. The United States announced measures on 15th August to stimulate the U.S. economy and protect the dollar. These measures included the suspension of convertibility into gold and other reserve assets and a 10% surcharge on dutiable imports not subject to quantitative restrictions. In the following week most European foreign exchange markets were closed. The London market reopened on 23rd August and it was announced that, although the official sterling parity remained at \$2·40 to the pound, the Bank of England had abandoned their former buying rate of \$2·42. At the same time the exchange rates of most other European currencies were being allowed to fluctuate more freely than hitherto, and before the end of the month the yen had followed suit.

When the London market reopened, sterling and most continental currencies were marked up against the dollar, the spot rate for sterling reaching over \$2·47 by 27th August. The U.K. authorities then announced measures, similar to those in force in some other countries, to check the inflow of funds: banks, discount houses and similar institutions in the United Kingdom could no longer pay interest on any additional sterling deposits from non-sterling countries; residents of these countries were prevented from adding to their holdings of sterling certificates of deposit, Spot and 3 months' forward rates for U.S. dollars in London[a]



After the withdrawal of the official buying rate, sterling rose sharply against the dollar, and the forward exchange rate was at a premium.

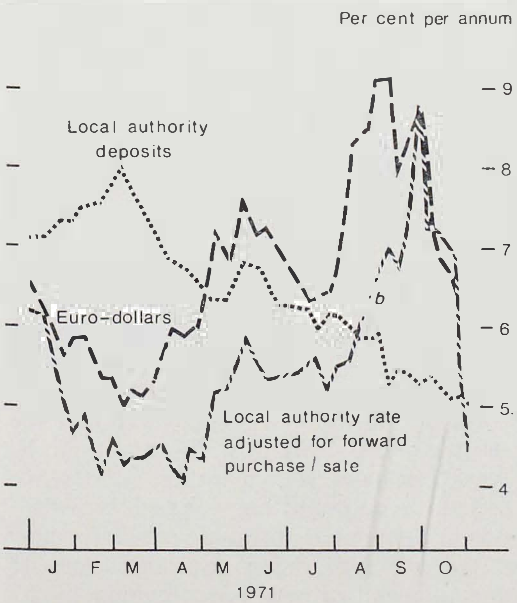
a Middle closing rates; weekly, Fridays.
b No quotations are available for the period 16 to 22 August because of the closure of the London foreign exchange market.

short-dated securities issued or guaranteed by the British Government or by local authorities, and deposits with local authorities and financial institutions; and restrictions were placed on the extent to which banks in the United Kingdom could convert foreign currency deposits into sterling by means of swaps. Following these measures and, with demand for euro-dollars heavy at the end of the month, sterling dropped back to around $2·46. The rate was little further affected by the subsequent reduction of Bank rate by 1% to 5% on 2nd September, a move which the authorities regarded as consistent with the recently introduced exchange control measures to discourage speculative inflows.

Throughout the first half of September conditions remained quiet. Around the middle of the month, however, demand for sterling and other currencies became heavy, following reports that the U.S. administration would be seeking a larger adjustment in the U.S. balance of payments than had previously been intimated and that other leading countries would seek a readjustment of the gold parity of the U.S. dollar. When the meeting in London of the Group of Ten Finance Ministers began on 15th September, the sterling spot rate rose above $2·47. Intermittent speculation on the prospects for currency realignments against the dollar continued both before and during the Annual Meeting of the International Monetary Fund at the end of September, and sterling rose to well above $2·48. It continued to be in demand in early October, partly because of foreign buying to make payments of oil royalties and taxes to producing countries and partly because of a view that, if there were to be a general currency realignment, sterling's new dollar rate would be higher than the current market rate. By 6th October, the spot rate was over $2·49 and the U.K. authorities announced that the exchange control measures made public on 27th August were to be reinforced. As from 7th October, residents of non-sterling countries were prevented from adding to any of their holdings of securities issued or guaranteed by the British Government or by local authorities, regardless of the period to maturity: the August controls had covered only securities maturing up to 1st October 1976. At the same time, the restrictions were extended to sterling acceptances, commercial bills and promissory notes. After this announcement, markets remained fairly quiet until mid-November and the rate for sterling moved gradually above $2·49, mainly when there was further buying to make oil payments. Demand for sterling became heavy, however, in the second half of November, when it was announced that the next meeting of the Group of Ten would be on 30th November and when a bill was introduced in the United States Congress which would give the President discretionary powers to raise the price of gold. For several days up to 26th November, the spot rate was close to $2·4940.

By the end of October, successive ministerial meetings of the Group of Ten and the annual meeting of the I.M.F. had not yet produced international agreement on an appropriate realignment of exchange rates. At that date, sterling stood some $3\frac{3}{4}$% above its official par value. Taking into account

Short-term interest rates in London[a]



International interest rates remained substantially above comparable U.K. rates, but with forward sterling at a premium there was little difference on a covered rate comparison towards the end of the period.

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

b No adjusted rate is available for the period 16 to 22 August because of the closure of the London foreign exchange market.

the movement of other rates, this represented an effective appreciation against other currencies,[1] including the U.S. dollar, of about 2% since sterling started to float, or $\frac{3}{8}$% when compared with parities immediately before the currency changes at the beginning of May.[2]

With foreign exchange markets unsettled, the price of gold in August rose to a peak of \$43·94 per fine ounce before the U.S. measures were announced and the London market closed. After it reopened on 17th August, prices at first fluctuated between \$43 and \$43$\frac{1}{2}$, but during the last week of the month there were heavy sales by speculators and the price fell as low as \$40·65 on 31st. Early in September it became clear that gold had been oversold, and the price recovered to over \$41$\frac{1}{2}$ again. Renewed speculation in the foreign exchange market around mid-September led to more buying of gold and the price rose above \$42. Subsequently, it remained fairly steady, generally fluctuating between \$42$\frac{1}{4}$ and \$42$\frac{3}{4}$ to the end of October. With further speculation in foreign exchange markets in the second half of November, demand for gold increased and the price rose above \$43.

Short-term interest rates

Interest rates in the United Kingdom have for the most part remained below those on comparable investments abroad. During August, euro-dollar rates rose rapidly. Early in the month they stood at 6$\frac{3}{4}$% per annum for three months' deposits but after 15th August they reached 10% because of heavy borrowing to finance speculative inflows into other currencies. Rates subsequently eased as the U.S. Treasury repaid \$500 million of certificates of indebtedness, but rose again with the end-month demand for funds, rates for three months' deposits being a little above 9% per annum. There was a temporary fall to 7$\frac{7}{8}$% in mid-September because of quieter conditions in foreign exchange markets, further repayments of U.S. Treasury certificates, and news of other repayments including that of a \$300 million loan by the Italian State Electricity Authority (E.N.E.L.) before the due date. Fresh uncertainty in currency markets in the second half of September, however, soon produced another shortage of funds and took the rate to 8$\frac{5}{8}$%. At the end of September and during October, interest rates in the United States and elsewhere were falling and more U.S. Treasury certificates were run off. The rate for three months' deposits declined sharply to 6% at the end of October, a net fall of $\frac{3}{4}$% since the end of July.

In the United Kingdom, most domestic short-term interest rates fell sharply after the reduction in Bank rate on 2nd September. A slow decline in rates followed to the end of October but the whole fall was less than that in euro-dollar rates so that interest rate comparisons became less unfavourable to the United Kingdom. From mid-August forward sterling was at a premium in the foreign exchange markets.

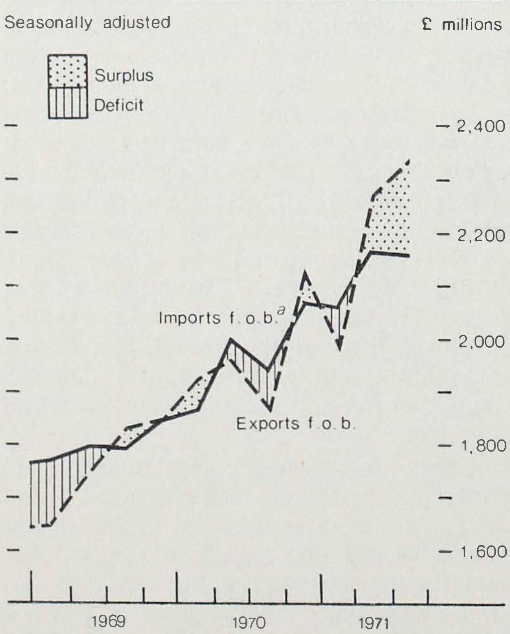
1 Measured as the appreciation of sterling against a weighted average of the movement of all other leading currencies. The appreciations are based on par values in May and August, except where currencies were already floating, where market rates were taken. The weight attached to each trading partner reflects its importance as a market for U.K. exports, as a source of imports and as a competitor in third markets.

2 See September *Bulletin*, page 302.

The premium for three months' sterling was generally equivalent to an annual rate of between 1½% and 2% throughout September and the greater part of October. Because of this premium on forward sterling, most of the usual covered interest rate comparisons were in favour of sterling investments for a time in the first half of October. This was reversed during the second half as forward sterling reacted rather faster than the decline in euro-dollar rates. However, since the announcement on 27th August of exchange controls, which curtailed interest-bearing investment facilities in the United Kingdom for residents of non-sterling countries, the relevance of all such interest rate comparisons has been reduced.

Official discount rates have fallen in many other countries: Swedish bank rate was lowered from 6% to 5½% on 10th September, Dutch bank rate from 5½% to 5% on 15th, Belgian bank rate from 6% to 5½% on 23rd, German and Italian bank rates both from 5% to 4½% on 14th October, Canadian bank rate from 5¼% to 4¾% on 25th and French bank rate from 6¾% to 6½% on 28th. The discount rates of the Federal Reserve banks in the United States were reduced from 5% to 4¾% in mid-November.

Balance of U.K. visible trade



The surplus in the third quarter was by far the largest ever recorded; the volume of exports increased sharply while import volume declined a little.

a Including payment to the United States for military aircraft and missiles.

Balance of payments

Underlying the appreciation in the sterling exchange rate in recent months has been the continuing strength of the balance of payments on current account. In the third quarter of 1971 the surplus – at about £350 million – was more than the total for the first half of the year. The improvement was largely due to an exceptional surplus of some £180 million on visible trade, which had earlier been in only modest surplus and now reflected an increase of nearly 9% in the value of exports compared with the quarterly average in the first half of the year. Although prices of exports continued to rise quite steeply, two thirds of the increase was in volume. Exporters, faced with continuing spare capacity, may well have begun to look more actively at overseas markets and were able to offer more prompt delivery dates. Also there were unusually large shipments to the United States – no doubt in anticipation of the East Coast dock strike, which began on 1st October, and of possible changes in exchange rates; and exports of diamonds were erratically large.

Meanwhile, the increase in the value of imports compared with the quarterly average in the first half of 1971 was 1%. As prices rose a little more than this, there was a fall in volume. This was consistent with a further rundown of stocks and little change in output at home. Large arrivals of manufactured goods in September, however, may have been the first signs of the effect of rising consumer demand. Confirmation of this renewed growth was provided by the October trade figures. Imports once again were high, and were apparently little affected by the U.S. dock strike. The main impact of this seemed to be on U.K. exports, which fell back after the large total in September; but there was still a very large visible trade surplus.

Invisible earnings continued to grow in the third quarter, mainly because of larger net receipts of interest, profits and dividends.

Investment and other capital flows were again substantial and, in total, the net inflow was rather more than in the second quarter. In part, it reflected the demand for sterling which developed before the measures to protect the U.S. balance of payments were announced in August and which reappeared in mid-September. Thus there was a substantial increase in sterling held by private holders abroad. On the other hand, banks' net foreign currency borrowing from abroad was less than in previous quarters, probably because of successive exchange control restrictions. First, from January, foreign currency borrowing by U.K. residents for use at home has not normally been authorised for periods of less than five years. Second, in August, banks were prevented from converting foreign currency deposits into sterling by means of swaps, when this would cause their spot foreign currency liabilities to exceed their spot currency assets; and banks which had already carried out such swaps were required to restore their foreign currency positions as the swaps matured. Third, in September, the limits were raised on the amount of spot foreign exchange which banks were allowed to hold against forward liabilities. Sterling holdings of overseas sterling countries were built up further because of the continued strength of these countries' balance of payments on capital account. All the overseas sterling countries whose sterling agreements were due to expire in 1971 (except Libya and Malta) agreed in September to extend them for a further two years. The Basle group of central banks agreed to extend for the same period the $2,000 million medium-term facility with which these arrangements were linked. Overseas investment in the U.K. public sector was much less than in the two previous quarters, partly because nationalised industries did not borrow abroad. Private investment, both into and out of the United Kingdom, resulted in a small net outflow, compared with net inflows earlier in the year.

The investment and other capital flows described above contributed rather more than the recorded current surplus to yet another very substantial total currency inflow of £668 million. This brought the total inflow for the first three quarters to as much as £2,275 million.

Reserves and special facilities

A substantial part of the currency inflow in the third quarter was added to the reserves which rose by £576 million, valued at par up to 20th August and at transactions rates thereafter. At the end of September the reserves valued at par stood at £2,089 million, an increase of £581 million. In addition, liabilities to the I.M.F. were reduced by £259 million. As mentioned in the last *Bulletin*, an early repayment of the remaining amount of the United Kingdom's June 1968 drawing from the Fund – £256 million, which had been scheduled for next year – was made in August. There was also a small reduction on account of the Fund's use of sterling in transactions with other countries. Outstanding drawings on the Fund have now been reduced to an amount of £415 million, the first instalment of which falls due from June 1972. Charges of £83 million previously paid in sterling also have to be redeemed but by no fixed date. To help meet the I.M.F. repayment, the amount of foreign currency placed with overseas monetary authorities by special official swaps was allowed to run down and, during the quarter, the total was reduced by £166 million to £541 million.

Shortly before the U.S. measures were introduced on 15th August, the Federal Reserve Bank of New York was asked to activate the reciprocal swap facility in order to provide the Exchange Equalisation Account with forward cover as protection against a possible depreciation of the U.S. dollar – a transaction which does not immediately affect the reserves. The Federal Reserve Bank drew the sterling equivalent of $750 million on the facility.

Domestic economy

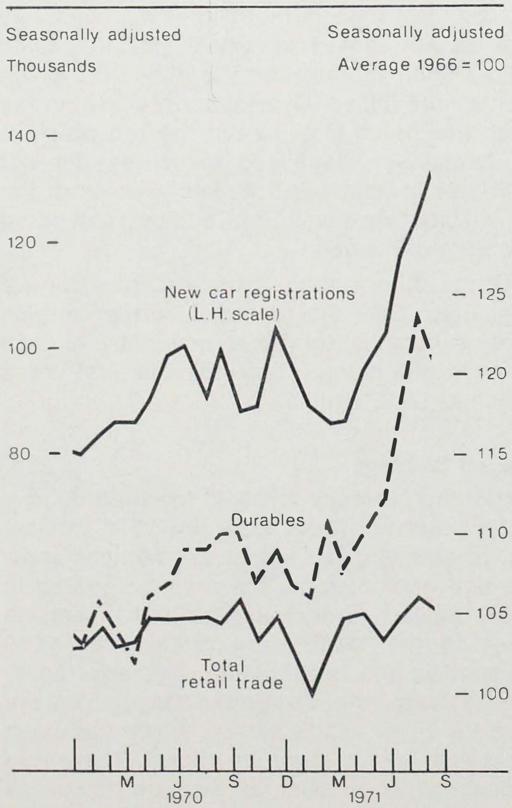
The marked increase in the volume of exports in the third quarter was an expansionary influence on the home economy. It was augmented by the first effects on domestic demand of the reflationary measures introduced by the Chancellor both in the Budget and on 19th July.[1] Taken together, they were probably enough to raise total expenditure at constant prices to at least the same level as in the second half of 1970.

Apart from exports, described in more detail on page 438, the main growth was in spending by persons, both on consumption and on housebuilding. Personal consumption in the third quarter increased by $1\frac{1}{2}$%. The main impetus came from sales of new cars, which rose very sharply, even after allowing for the introduction of the new registration letter in August. There was also a substantial increase in sales of other durable goods, especially colour television sets.

Although the recent reductions in taxation, particularly purchase tax, must have helped, this increase in spending was also associated with a much freer availability of credit. The banks lent considerably more to persons at this time and total outstanding hire purchase debt rose sharply following the removal of terms control in July. So marked and immediate an effect from a change in terms control is broadly in line with past experience, which also suggests that the effect on expenditure may be expected to decline fairly rapidly. The prospects for a sustained growth in demand will therefore depend partly on the slower acting influence of the reductions in direct and indirect taxation and partly on the increase in pensions in September. Apart from durable goods, there have been few other signs so far of buoyancy in retail trade: food sales were little changed compared with the second quarter and there was a decrease in clothing and footwear. This decrease may perhaps have been partly because of continuing good weather in the late summer and partly because people had little money to spare after buying durable goods.

Private housebuilding, after little change during the previous twelve months, began to show clear signs of growth during the third quarter, when there was an increase of nearly a quarter in the number of new dwellings started. A steady rise in the building societies' new commitments to lend had presaged this recovery for some time; and the reduction in mortgage rates which was announced on 8th

Retail trade[a] and new car registrations

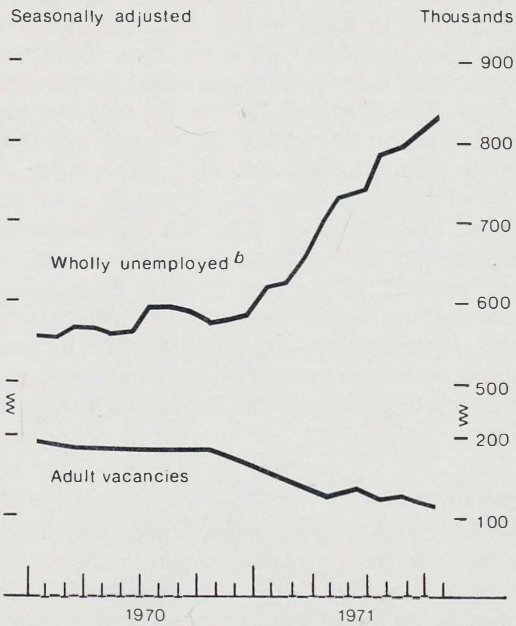


Spending on new cars and durable goods rose rapidly after the July measures but other retail trade was little changed . . .

a Volume.

1 September *Bulletin*, pages 299-300.

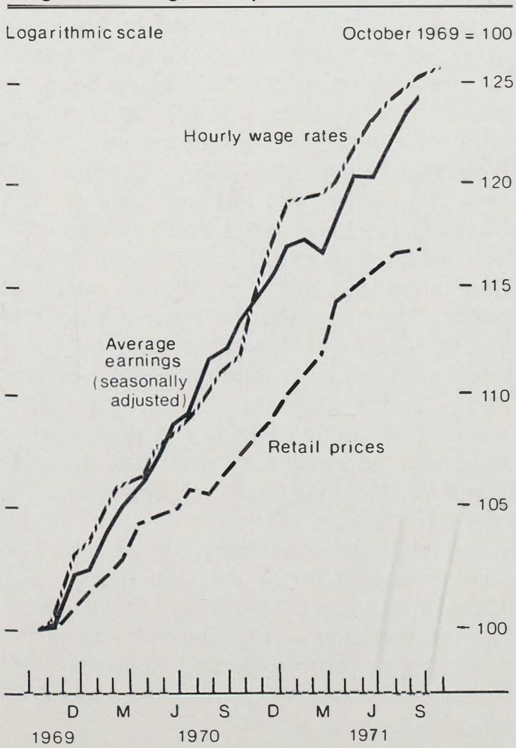
Unemployment and vacancies[a]



. . . and the numbers out of work continued to grow.

a In Great Britain.
b Excluding school-leavers.

Wages, earnings and prices



The rise in prices has slowed appreciably in recent months and there has also been some moderation in wage increases.

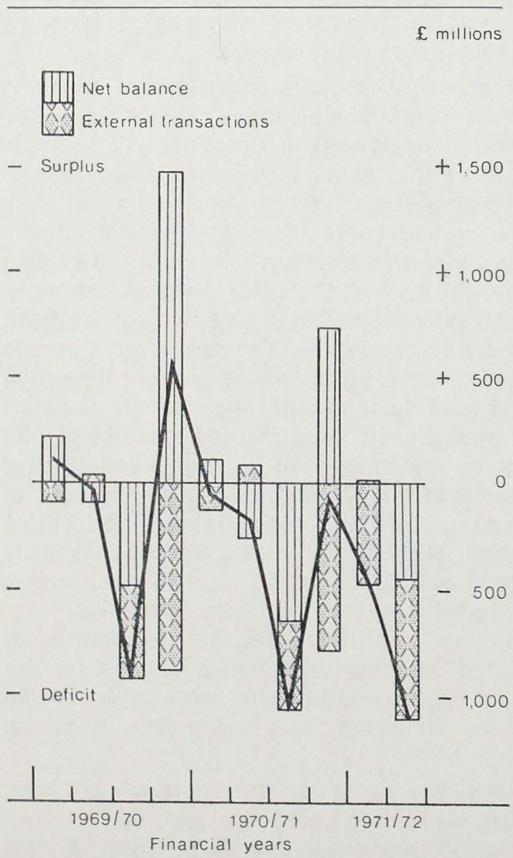
October may carry the recovery further. Meanwhile, house-building in the public sector has continued to decline.

The strength of consumer spending on at least some kinds of goods contrasts with the continuing dullness of other domestic demand. It normally takes a considerable time, however, before public expenditure – which has recently been rising only slowly – is affected by new decisions or before private investment responds to general increases in output. The Government had announced in July measures to increase public spending in the development areas. This spending was raised by a further £50 million in September. Another £185 million of public expenditure was announced in November including £100 million of projects from the capital budgets of nationalised industries, which were to be completed within two years. As regards private investment, apart from shipping where orders placed some time ago are now being delivered, industrial expenditure was 7% lower in the first half of 1971 than in the second half of 1970 and, to judge from the latest official enquiry into investment intentions and the September survey by the Confederation of British Industry, is unlikely to have recovered in the third quarter. A majority of firms in the C.B.I. survey reported that they were expecting to reduce investment in the next twelve months, but this majority was substantially smaller than in the last survey taken in May; while the results of the official enquiry for 1972 – a forecast of little change – could be consistent with capital spending picking up during the course of next year.

Although the increase in exports and personal spending more than made up for the sluggishness of public expenditure and companies' investment, it does not yet seem to have had any appreciable effect on output. Industrial production in the September quarter was about the same as in the previous quarter and spare capacity was still large – see page 492. As there was also a small fall in the volume of imports, it may well be that the extra demand was satisfied through a further reduction of stocks, which had been run down sharply during April-June. The reduction in private industries' stocks so far this year has played an important part in depressing total demand and, when companies start to rebuild them, there should be a marked stimulus to output. In the meantime unemployment has continued to rise. In the three months to mid-November, the number out of work in Great Britain, excluding school-leavers and others temporarily stopped, rose by a further 56,000 (seasonally adjusted) to a total of 855,000, or 3·7% of all employees. Even this may underestimate the underlying rate of increase, because of the uncertain influence on the figures of previously registered students returning to college for the new academic year. Vacancies for adult workers have also declined further and are lower than at any time since the war.

Wages and prices have continued to rise rapidly but their rate of growth now seems to be slowing down. For much of this year, hourly wage rates were over 13% higher than a year earlier but, by October, they had fallen below $12\frac{1}{2}$%. The rate of growth in average earnings was sharply reduced in the March quarter because a large number of working

Central government's domestic borrowing requirement (—)



A substantial deficit and further inflows from abroad left the central government with a very large domestic borrowing requirement . . .

days were lost from stoppages. Since then, the number of days lost has been much less, and the growth of earnings has changed from 2·1% in the March quarter compared with the previous quarter to 2·5% in the June quarter and 2·9% in the September quarter. This latest rise, however, was still slower than the very sharp increases averaging 3·3% a quarter recorded during 1970. As regards prices, there has been a distinct slackening in recent months. Manufacturers' home selling prices rose by 1·0% in August-October compared with 2·1% in May-July because of some decrease in the costs of certain raw materials and seasonal influences. Retail prices in their turn increased by only 1·0% in August-October against 3·1% in May-July. Even after allowing for seasonal movements, the growth in prices still slowed appreciably. It was helped by the reduction in purchase tax and selective employment tax, and by the introduction of the Confederation of British Industry's initiative on prices.

Central government financing

The Chancellor's successive reflationary measures contributed to an increase in the borrowing requirement of the central government during the September quarter. There was also a substantial inflow of exchange so that a large amount of domestic financing was required.

The central government's borrowing requirement rose to £451 million. The growth in revenue showed signs of slowing under the cumulative impact of this year's tax reductions but expenditure continued to rise. A further £660 million was needed to finance the large exchange inflows during the quarter, so that a total of £1,111 million had to be found from domestic sources. About two thirds of this was provided by investors outside the banking sector. They again bought a very substantial amount – £520 million – of gilt-edged stocks, bringing the total to £717 million for the financial year so far; and for the third consecutive quarter they subscribed unusually large sums – £56 million – to national savings. The return on savings certificates became particularly attractive towards the end of the quarter as other domestic interest rates declined. The banks and discount houses were left to provide £375 million. They purchased £934 million of gilt-edged stocks and £50 million of Treasury bills, but their holdings of notes and coin fell by £138 million and net government indebtedness to the Banking Department of the Bank of England fell by £471 million. These changes in large part reflect the implementation of the special arrangements between the Bank and the clearing banks to bring about the transition to the new system of monetary control. Under these arrangements (which are described in more detail on page 445) the London and Scottish clearing banks' outstanding Special Deposits – some £415 million in total – were repaid, reducing the government's net indebtedness to the Banking Department by a corresponding amount. The London clearing banks simultaneously purchased some £750 million of newly issued gilt-edged stocks.

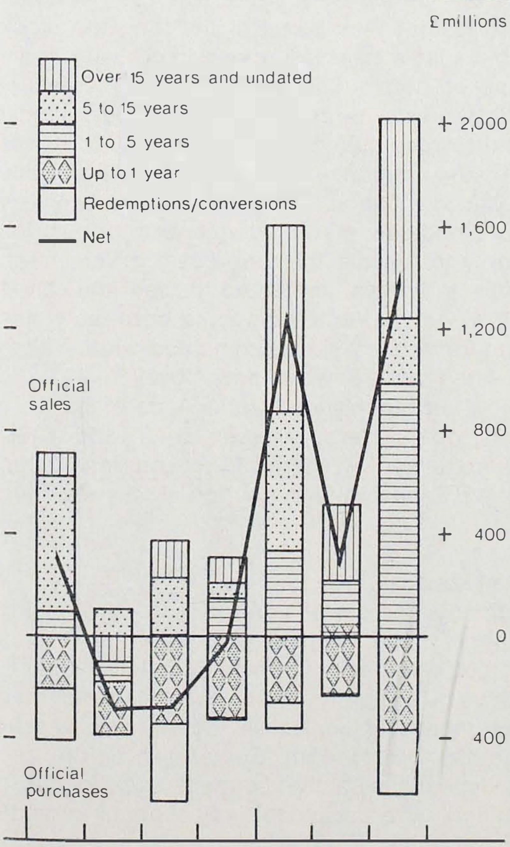
Over the first six months of the financial year, the central government's borrowing requirement was £445 million, compared with £150 million in the corresponding period last year. This increase in the deficit, which reflects the Government's measures to stimulate the economy, would have been perhaps some £185 million larger but for the carrying forward of tax receipts from the first calendar quarter to the second as a result of the postal strike.

Gilt-edged market

Demand for gilt-edged stocks was strong during most of the period under consideration.

At the beginning of August, however, the market was uncertain in view of the international currency situation, and prices were depressed. But, after the announcement of the U.S. measures in the middle of the month, demand – particularly for long-dated securities – strengthened appreciably: there were growing expectations that the authorities would reduce Bank rate in order to discourage foreign exchange inflows and that this would bring with it a general fall in rates. The announcement on 27th August of the new exchange controls on overseas investment in British government and government-guaranteed stocks maturing before 1st October 1976 appeared to confound these expectations, and the market reacted with falls in most prices.

Official transactions in gilt-edged stocks by maturity



. . . but exceptionally heavy official sales of gilt-edged stocks – which included special sales to the London clearing banks – were more than enough to meet this.

The subsequent reduction in Bank rate to 5% on 2nd September was largely unexpected and prices rose firmly, more than recovering the ground lost two days earlier. Demand was strong and the long tap stock – $8\frac{3}{4}$% Treasury Loan 1997 – was quickly exhausted. A new long tap – £600 million of $8\frac{1}{4}$% Treasury Loan 1987/90 at £96 per £100 nominal yielding nearly $8\frac{3}{4}$% to redemption – was announced for issue on 8th September, partly because a considerable government financing requirement and substantial maturities of stocks lay ahead. The terms were generally regarded as indicating a willingness to see a continued gradual decline in interest rates, and the strong demand for longer-dated stocks persisted until shortly before the Bank's statement on 10th September about reserve ratios and Special Deposits. The redemption of $6\frac{3}{4}$% Exchequer Loan 1971 and British Gas $3\frac{1}{2}$% Guaranteed Stock 1969/71 also took place on that day but outstanding market holdings were not large.

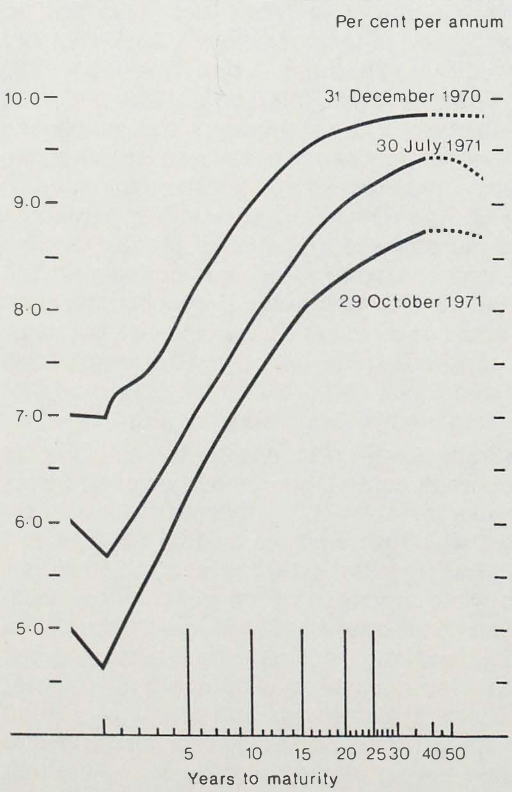
As part of the transitional arrangements for adjusting to the new system of credit control, the London clearing banks agreed to subscribe for some £750 million of three new government stocks, which were issued on 15th September – £550 million $5\frac{1}{4}$% Treasury Stock 1973 priced at £99·25 per £100 nominal to yield nearly $5\frac{5}{8}$% to redemption, £400 million $5\frac{1}{2}$% Treasury Stock 1974 at £98·69 per £100 nominal to yield nearly 6%, and £350 million $6\frac{1}{4}$% Treasury Stock 1977 at £97·94 per £100 nominal to yield nearly $6\frac{3}{4}$%. After publication of the new arrangements and of the very good trade figures for August, the market quickly strengthened and there was heavy buying on several days during the rest of the month.

During the September calendar quarter, the authorities sold some £1,410 million (net) of stock, though just over half of this represented the special transactions with the London clearing banks referred to above. Even excluding this operation, the net volume of sales – at £650 million – was very considerable. Redemptions of maturing stocks of some £250 million and large official repurchases of stocks maturing within a year more than outweighed sales of other short-dated issues; but very substantial amounts of long-dated stocks were sold, especially to domestic holders outside the banks. Although the inflow of funds from abroad in this period was considerable, there does not appear to have been any significant direct overseas buying of gilt-edged stocks.

The market continued firm in early October. There was heavy demand for the short tap stock – 6% Treasury Stock 1975 – and on 5th October it was announced that, as official supplies were then low, it had ceased to be available as a tap stock and would not be replaced immediately. The authorities took this decision in the context of the reduction in Bank rate and the large official sales of stock which had taken place in the previous month; they had no wish to affect short-term interest rates at that time; and they already held considerable amounts of the relatively short-dated stocks issued in connection with the banks' funding. The announcement on the following day of further exchange control measures restricting non-resident purchases of gilt-edged stocks had only a temporarily depressing influence and prices were soon rising again, even before the news of another large trade surplus in September and of the reduction in the West German bank rate. On 13th October, the authorities stated that their sales of the long tap stock were at an end but that a new issue was likely very soon. News of this came on 15th – £600 million of 8% Treasury Loan 2002/06. At the issue price of £95 per £100 nominal this carried a yield to redemption of just under $8\frac{1}{2}$%. It was quickly followed by the announcement of a £50 million issue for the Greater London Council. Faced with these two new issues, the market became much quieter and prices fell back for a time, only to resume their increase in November.

The marked fall in yields continued during the three months to the end of October and the spread between yields on short-dated and long-dated stocks remained wide. Yields on the shortest dated stocks were down by $\frac{7}{8}$%–$1\frac{1}{8}$% to some $4\frac{3}{8}$%–$4\frac{7}{8}$% but on other short stocks, some falls were only $\frac{1}{2}$%–$\frac{3}{4}$% and yields were between $5\frac{1}{4}$% and $6\frac{1}{4}$%. Medium yields were lower by up to $1\frac{1}{8}$% and long-dated stocks fell by $\frac{3}{4}$%–$1\frac{1}{8}$% leaving high coupon stocks standing at around $8\frac{3}{4}$%.

Time/yield curves of British government securities[a]



All yields fell in the three months to October, particularly on the shortest-dated and long-dated stocks.

a The continuous lines begin at Bank rate and pass through the yield on 91-day Treasury bills to those of dated British government stocks: the broken lines connect the calculated yield for the longest-dated stock to the flat yield on $3\frac{1}{2}$% War Loan.

Banks and discount houses

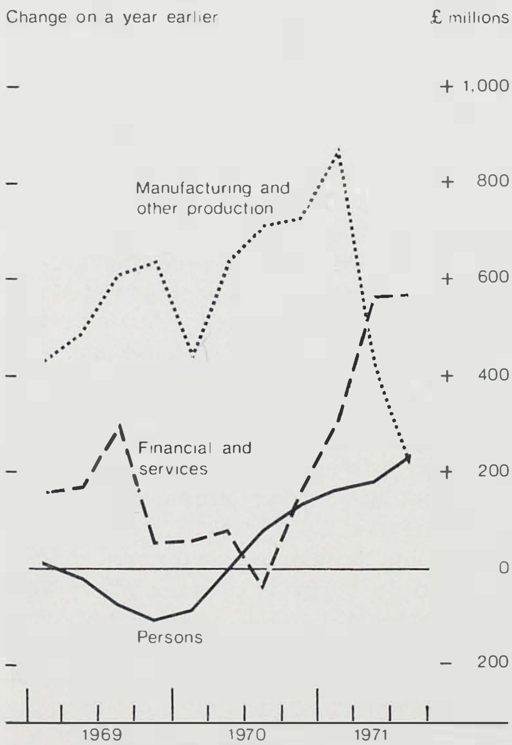
The new arrangements for credit control[1] agreed with the banking associations and individual banks formally came into effect on 16th September. They replaced the quantitative and qualitative guidance on bank advances which had been the principal means of control in the last few years.[2]

In the two months up to 15th September before the changeover, net deposits with the *London clearing banks* rose by £230 million, after seasonal adjustment, in spite of substantial official sales of gilt-edged stocks to the pub-

1 The main features of the new scheme were made public on 10th September in a paper *Reserve ratios and Special Deposits* the text of which was issued as a supplement to the September 1971 issue of the *Bulletin*. Further details are set out on page 482 and some background is provided on pages 477–481.

2 The last notice which the Bank issued to banks and finance houses on lending ceilings was dated 30th June and appeared on page 316 of the September 1971 *Bulletin*.

Banking sector's advances to U.K. residents



Lending to industrial companies continued to decline in recent months but other domestic borrowers again took more.

lic. As in earlier months, the effect of these seem to have been more than outweighed by the continuing large inflow of funds from abroad and, latterly, by a more rapid growth of bank lending.

Advances other than to the nationalised industries rose by £110 million, after seasonal adjustment. Part of this increase was again attributable to personal borrowing and part to loans for property development and house purchase. Advances to manufacturing industry remained slack and, apart from some increase in applications for facilities, there were few signs of a recovery. The London clearing banks' restricted lending in mid-September finished just within the ceiling – 110% of the amount outstanding at mid-March 1970 – which they had been asked to observe.

Other changes took place in the balance sheets of the London clearing banks which were directly associated with the introduction of the new arrangements for credit control. As part of the ending of the old arrangements, all their Special Deposits (£395 million) were repaid on 15th September. In order to absorb these funds, and also to ensure that the banks did not begin the new era with disproportionately large holdings of reserve assets, they agreed concurrently to subscribe for some £750 million of the three new gilt-edged stocks described on page 443. To the extent that the stocks were not financed from the repayment of Special Deposits, the banks ran down their liquid assets, mainly their money at call with the discount houses. Over the two months, total liquid assets fell by £92 million, and the combined liquidity ratio, which had risen from 32·0% in mid-July to 33·6% in mid-August, dropped to 30·7% in mid-September.

The outstanding Special Deposits of the *Scottish clearing banks* were repaid at the same time as those of the London clearing banks on 15th September. The amount involved – £20 million – was comparatively small and did not increase the banks' holdings of reserve assets disproportionately. These banks were not, therefore, asked to subscribe to the special issues of funding stocks.

In August, the Government announced an increase from £700 million to £1,000 million in guaranteed loans for the purchase of ships built in U.K. yards for U.K. shipowners. The London and Scottish clearing banks agreed to make the necessary additional finance available under the arrangements for fixed rate lending for exports and for home shipbuilding. The interest rate on the finance provided for exports (except exports of ships) under these arrangements was reduced from 7% to 6½% on 1st November but the rate on finance for sales of ships remained at 7%.

Sterling deposits with the *accepting houses, overseas and other banks,* excluding inter-bank funds, rose by £475 million during the period from the end of June to the middle of September. The increase in domestic deposits – £49 million – was modest, but overseas holdings, reflecting the very substantial inflows from abroad, rose by a further £207 million. The amount of sterling certificates of deposit in issue also increased, by £221 million, though as before the greater part was taken up by other banks within this group. Part of these additional resources were used to build up the banks' holdings of reserve assets in preparation for the new reserve ratio requirements; money lent at call to the discount houses rose by £243 million, and holdings of Treasury bills by £65 million.

The funding operation which accompanied the introduction of the new arrangements for credit control had a considerable impact on the *discount houses.* As already described, the London clearing banks financed part of the funding by withdrawing over £220 million of money lent at call to the market, which the houses met mainly by reductions in their holdings of Treasury bills. Nevertheless, in the whole period from the end of June to mid-September, there was a rise of £123 million in the discount market's borrowed funds. These additional funds were employed mainly in local authorities' securities and in certificates of deposit; holdings of commercial bills were reduced.

The banks under the new arrangements

At mid-October, the combined reserve ratio for all the banks stood at 15·9% compared with the minimum of 12½% required under the new arrangements. Ratios for individual banks varied widely, partly, no doubt, because some of them were still adjusting to the new requirements. Eligible liabilities and assets both rose, to some extent perhaps because of seasonal influences. The largest part of the increase in liabilities was in those of the London clearing banks. More than half of the reserve assets was in call money with the discount market.

In the five weeks to mid-October, some of the *London clearing banks* started to do business in areas where they had not previously competed in their own names. This included issuing about £80 million of sterling certificates of deposit and increasing their currency liabilities by well over £100 million. These movements helped to raise net deposits by nearly £500 million. The banks used these funds to buy some £75 million of sterling certificates of deposit, to place over £100 million in the sterling inter-bank market, and to increase their currency business by a similar amount. In all, their advances rose by nearly £330 million.

These changes have complicated comparisons with the banks' balance sheets up to 15th September and have made it inappropriate to apply the usual seasonal adjustments to the figures affected. However, after taking into account the new business and making some allowance for seasonal influences, it seems that advances as previously defined may have risen by around £50-100 million. This was large, given the continued slackness of industrial demand on these banks, but the total is believed to have included a substantial further increase in lending to persons. Meanwhile, eligible liabilities increased by only £190 million, the difference compared with the much greater increase in net deposits being explained largely by the deduction, in arriving at eligible liabilities, of claims on other banks and foreign currency deposits. Reserve assets rose by £60 million; call money and holdings of bank bills were increased but holdings of Treasury bills were run down. The aggregate reserve ratio for the London clearing banks was 16·5% compared with 15·9% for all banks.

By 17th November, the London clearing banks had further expanded their new business. Among their liabilities, certificates of deposit rose by about £75 million, sterling inter-bank business by nearly £100 million, and currency deposits by £40 million. Total net deposits were £185 million higher. Advances also continued to increase substantially, by £349 million, but here again the banks' new activities were important, with increases of £140 million in sterling inter-bank loans, £65 million in holdings of sterling certificates of deposit, £25 million in local authority temporary loans, and more than £60 million in foreign currency business. There was a reduction of over £120 million in call money with the discount market, which helped to reduce the banks' reserve assets by nearly £140 million. Eligible liabilities fell by £60 million, and the combined reserve ratio was 15·3%.

As part of the new arrangements for the control of credit, the London and Scottish clearing banks agreed to abandon their collective agreements on interest rates. Barclays Bank announced a reduction in its base rate from 5% to $4\frac{1}{2}$% on 15th October. The remaining London clearing banks and some other banks did the same on 25th November, and also reduced the rates paid on seven-day deposit accounts from 3% to $2\frac{1}{2}$%. Some banks have also publicised their willingness to negotiate rates for deposits outside the traditional clearing bank rate of Bank rate less 2% for deposits at seven days' notice.

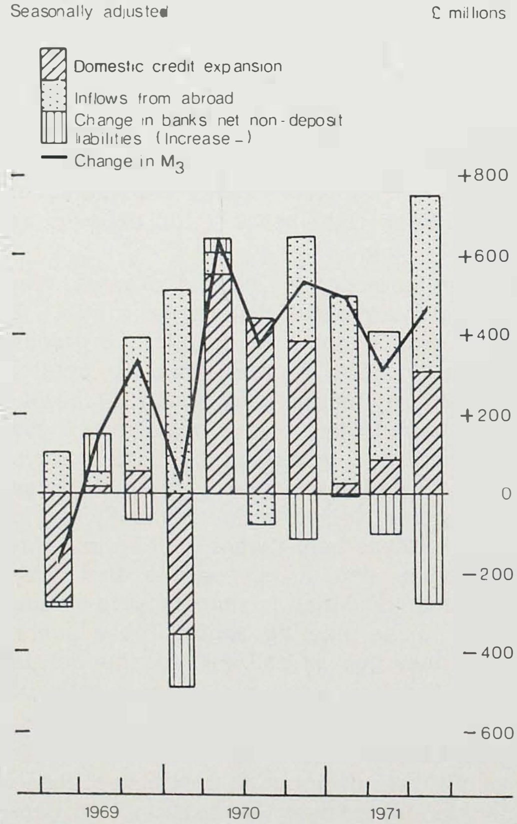
Sterling deposits with the *accepting houses, overseas and other banks,* excluding inter-bank balances, rose by £232 million in the month to mid-October. Deposits from overseas continued to increase, in spite of the exchange control restrictions on payment of interest, and issues of certificates of deposit were much higher. Mainly because of these movements, eligible liabilities increased by £312 million. These new resources helped to finance a sharp increase of £170 million in advances to U.K. residents, partly to the finance houses. Some of these banks were offering loans at relatively attractive rates, and it is possible that they provided funds to some industrial customers who would normally have looked to the clearing banks. These banks also increased their money held at call, and reserve assets rose by £70 million, giving an aggregate reserve ratio of 14·9%.

New arrangements for control of credit extended by the *discount market,* which were designed to supplement those agreed with the banks, also came into effect on 16th September. From that date the houses were required to maintain a minimum of 50% of their funds in eligible public sector debt. The discount market's borrowed funds rose by about £90 million in the month to mid-October. The houses reduced their holdings of commercial and other bills by £66 million, but increased their holdings of sterling certificates of deposit by £87 million. They also purchased £41 million of gilt-edged stocks and smaller amounts of local authority bonds. In total, their holdings of eligible public sector debt rose by £32 million.

A particular feature in recent months has been the growth in the market for sterling certificates of deposit. In the three months of the September quarter, the total amount in issue rose by £338 million, or nearly a quarter, to £1,778 million and the total continued to grow in October. Some of this increase may be associated with the new monetary arrangements. Since they were introduced, banks and their customers have become more rate conscious and funds have been moved from time deposits into higher-yielding sterling certificates of deposit. As a result, the total of these certificates held outside the banks has increased markedly. At the same time the banks themselves have found certificates more attractive as a means of maintaining an adequate cushion of marketable liquid assets against unforeseen fluctuations in reserve assets.

Changes in money stock[a]

Seasonally adjusted £ millions



The rise in money stock was broadly the same as in recent quarters (apart from the effect of the postal strike) but domestic credit expanded more than in the first half of 1971.

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

Money stock and domestic credit[1]

The money stock rose by some £470 million, after seasonal adjustment, or $2\frac{1}{2}$%, in the September quarter. This compares with a revised increase of £317 million[2] in the previous three months. The increase in the June quarter was significantly reduced – by perhaps as much as £150 million – by tax payments delayed from the previous quarter as a result of the postal strike. If allowance is made for these, there was probably little change in the rate of increase in the money stock during the first two quarters of the current financial year.

The inflow from abroad once again contributed to the rise in the money stock but the expansion of domestic credit – by £311 million – was a more important influence in the three months to September than in the previous three months. Bank lending in sterling to the private sector rose substantially, the central government was in deficit, and other public sector borrowing, although considerably less than in earlier quarters, remained fairly large. These expansionary influences were partly matched by heavy official sales of gilt-edged stocks to domestic investors other than the banks and by a further increase in national savings.

Bill markets

In the first half of August, conditions in the money market were generally easy because of substantial inflows of funds from abroad. In the middle of the month, however, heavy official sales of gilt-edged stocks created shortages. The authorities bought large amounts of bills and occasionally lent overnight. During the second and third weeks of September, they used their assistance to the market to smooth out the different pressures exerted by gilt-edged redemptions and by the funding issues made in connection with the new arrangements for control of credit. Because of the funding issues the authorities allotted only half of the bills on offer at the preceding tender. Thereafter, shortages

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 J of the analysis of financial statistics (see page 468). To supplement the present quarterly series of statistics on the money stock, it is hoped to begin publication of a monthly series in the next issue of the *Bulletin*. The new series will not be available until March 1972 because of difficulties of seasonal adjustment.

2 The revisions to earlier quarterly figures reflect the changes in the treatment of items in transit explained on page 484.

occurred from time to time, particularly when official sales of gilt-edged stocks exceeded such foreign exchange inflows as took place, and the authorities provided assistance through the purchase of bills, sometimes on a very large scale.

During August, the amounts of bills on offer at the weekly Treasury bill tender varied between £160 million and £220 million. The discount houses reduced their bids in each of the first three weeks and the tender rate rose altogether by some $\frac{3}{16}$% to just over $5\frac{3}{4}$%. The houses received allotments averaging nearly half of the bills offered. Thereafter, they paid successively more, particularly after the reduction in Bank rate on 2nd September, and the tender rate fell to $4\frac{7}{8}$% before the new arrangements for the control of credit were introduced in mid-September.

As part of the new arrangements, the discount houses informed the Bank that they would no longer tender for Treasury bills at an agreed price; but that they would continue to apply for a total of bills which would at least cover the amount on offer. At subsequent tenders in September and October, the amounts of bills offered were small, because sales of gilt-edged stocks to the market had kept pace with the Exchequer's needs. Nevertheless, the totals of bills applied for from all sources in this period were unusually large. The lowest rate at which applications were accepted fell at each tender to 29th October when it was under $4\frac{5}{8}$%.

This movement reduced Treasury bill rates relatively more than other money market rates. It may have been due partly to the end of the joint bid and partly to a shortage of Treasury bills. Otherwise, since the new arrangements, banks appear to have been more rate-conscious when placing their liquid funds and this has tended to make money in the discount market more expensive than it would have been under the old arrangements. The members of the discount market have not been agreeing rates for fine bank bills since 6th August, with the result that margins have become narrower. Selling rates for these bills fell from $6\frac{5}{16}$% at the end of July to about $4\frac{7}{8}$% at the end of October.

Over the three months from August to October, the average cost of the houses' borrowed funds appears to have reflected the general decline in interest rates. The cost was fairly steady during August but dropped after the reduction in Bank rate on 2nd September. It continued to fall in the following weeks as money taken previously at higher rates was repaid. By the end of October, the average cost of borrowed funds is estimated to have been down to about $4\frac{7}{8}$%. Since the new arrangements, the market has taken a smaller proportion of its funds than before from the clearing banks, as the other banks began to adjust to the requirements for reserve assets.

On 22nd October, the Bank announced a modification of the facilities provided to the market. At their option, individual houses which were short of funds would henceforward be able to borrow from the Bank, as an alternative to selling bills. The loans would be limited in total to each house and confidential. They would normally be for one week and rates would take into account not only the cost of the houses' borrowing from the banks but yields on their other assets. The purpose of this innovation was to give the houses a limited time in which they might respond more flexibly to shortages of money arising in the normal day-to-day functioning of the market. It would not affect the Bank's ability to require the houses to borrow in the traditional way either to smooth market fluctuations or as an act of monetary policy.

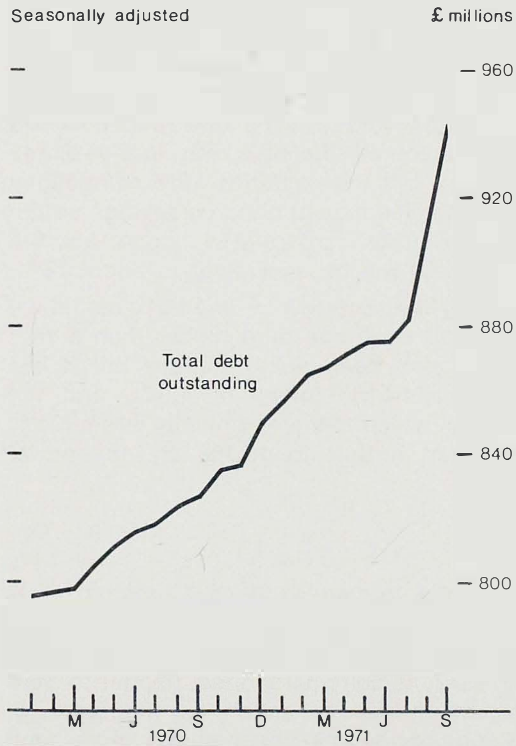
Local authorities

In the three months to the end of October, longer-term borrowing by local authorities was less than the exceptionally large amounts taken in the June quarter. This may in part reflect a temporary decline in their capital expenditure. Local authorities in development and intermediate areas may perhaps have been seeking to transfer resources into capital projects eligible for grants under the additional public works programmes announced in July and augmented in September. Projects, of which some £160 million have already been submitted, must be essentially completed by March 1973. The start of some housing work may also have been delayed by uncertainties about the Government's proposals, published on 3rd November, for a radical reform of the methods of housing finance.

Borrowing from the Public Works Loan Board was somewhat higher than in the June quarter but the proportion of their quotas which authorities have so far drawn has been smaller than normal. Since authorities may not draw more than 25% of their quotas in the last quarter of the financial year, the Board has restricted the proportion that may be drawn in December, in an attempt to smooth out a possible sudden rise in borrowing should the authorities attempt to catch up on their drawings. There were few new stock issues and, with only 10% of the £50 million Greater London Council issue falling due for payment in October, these were exceeded by redemptions. There was, however, a strong demand for negotiable bonds, which, under the new credit arrangements, the discount market may include in its eligible assets, and the rate of interest has been running below that asked for mortgages of a similar term.

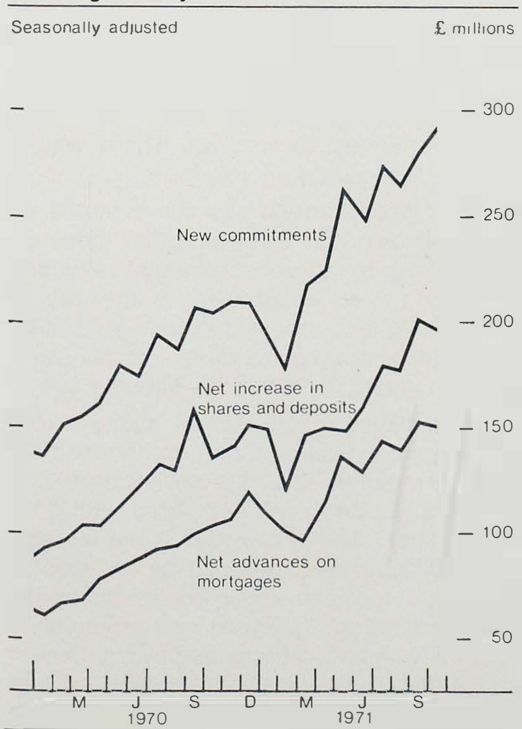
The cost of all forms of local authorities' borrowing declined during the three months. There were several reductions in P.W.L.B. rates and, at the end of October, quota rates for 10–15-year loans stood at $7\frac{7}{8}\%$ compared with $8\frac{1}{2}\%$ at the end of July. Market mortgage rates fell steadily, the rate on mortgages of over five years coming down from 8%–9% at end-July to $7\frac{1}{4}\%$–8% in October; and on one-year mortgages from $6\frac{7}{8}\%$ to $5\frac{5}{8}\%$. The cost of negotiable one-year bonds fell from $6\frac{1}{2}\%$ to $5\frac{1}{2}\%$. Temporary money rates were also down over the three months, at first because of the foreign exchange inflows and then because of the reduction in Bank rate at the beginning of September. The rate paid on three months' deposits was 5%–$5\frac{1}{8}\%$ compared with $6\frac{1}{8}\%$ at the end of July, and seven-day money cost some 1% less at 5%.

Finance house lending



Instalment debt expanded very rapidly after the removal of terms control in July.

Building society funds



Building societies' lending continued to rise but the increase in receipts was even more marked.

Finance houses

The removal of terms controls on hire purchase, credit sale and rental agreements on 19th July led to a vigorous expansion in the amount of credit extended by the finance houses. Although repayments in the September quarter were also somewhat larger than in the previous three months, total instalment debt outstanding rose, after seasonal adjustment, by as much as £66 million, or $7\frac{1}{2}$%.

Rates offered by finance houses for three-month deposits fell by about $\frac{1}{4}$% to around 6% during August and were cut by a further $\frac{1}{2}$% following the reduction in Bank rate on 2nd September. They continued to ease throughout September and October, to close the month at about $5\frac{1}{8}$%. The Finance Houses Association's base rate, to which charges for some long-term lending are related, was reduced from 7% to $6\frac{1}{2}$% on 2nd August, to 6% on 1st October and to $5\frac{1}{2}$% on 1st November.

The new credit control arrangements for instalment credit finance houses which take deposits,[1] agreed by the Bank with members of the Finance Houses Association and with certain houses outside the Association, formally came into operation on 16th September. They replaced the previous requests from the Bank to restrict lending within given ceilings, under which the houses had been asked that their outstanding lending at end-September 1971 should not be more than 10% higher than at end-March 1970. Partly because of the abolition of terms control in July and the subsequent rapid expansion in new credit, the houses were in aggregate well above their ceiling when the old scheme came to an end. The new scheme provides for a transitional period of twelve months during which the participating houses must build up their holdings of reserve assets by stages to the prescribed proportion. Smaller houses – those with eligible liabilities of less than £5 million – are exempted from the arrangements so long as their liabilities remain below that limit. As a result of this, the scheme has started with fourteen participating finance houses. A number of these have applied, or are understood to be contemplating applying, to be recognised by the Department of Trade and Industry as banks under the Protection of Depositors' Act 1963. If successful, they will subscribe instead to the credit control scheme for banks.

Building societies

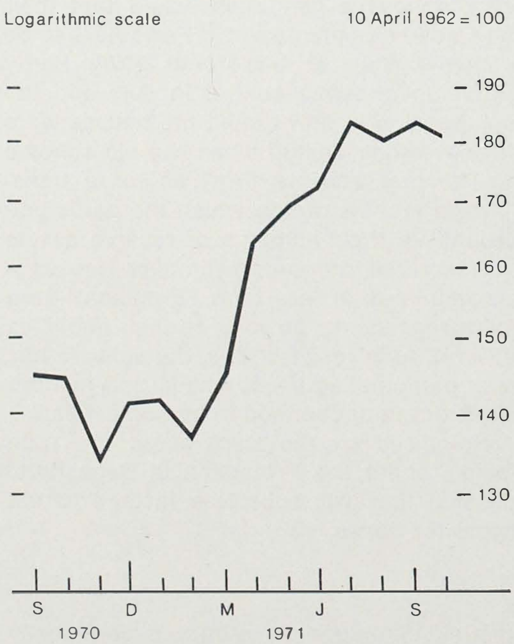
The building societies continued to attract exceptionally large sums in the period August to October, and despite an appreciable increase in withdrawals – possibly reflecting in part the recent upsurge in instalment credit business as well as initial deposits for house purchase – net receipts, seasonally adjusted, totalled a record £573 million. This was £87 million more than in the previous three months and over £150 million, or 36%, greater than in the corresponding period last year. The societies probably benefited to some extent from the reduction in Bank rate on 2nd September which had the effect – temporarily at least – of widening the already favourable differential between their own and

1 The details of the agreed arrangements are reproduced on page 488.

alternative interest rates. However, on 8th October, the Building Societies Association recommended a reduction in the mortgage rate from 8½% to 8%, to take effect from 1st November on new mortgages and from 1st January next year for existing loans. This reduction was the first change in mortgage rates since 1969. It was accompanied by a cut – also effective from 1st January – in the rate recommended to be paid on share accounts; the new rate was 4¾% tax paid instead of 5% but left the societies fully competitive with all the main alternatives except national savings certificates. Grossed up at the standard rate of income tax, the rate of interest on shares will be equivalent to about 7¾%.

New commitments by the societies to lend have continued to increase strongly and were one third higher than a year ago. Net lending has also been rising steadily but it has not quite kept pace with the inflow of funds, and the societies' liquidity ratio, which at the end of July was already high at 18%, increased further to 18·3% at the end of October.

Industrial share prices[a]



Share prices changed little between the end of July and October . . .

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

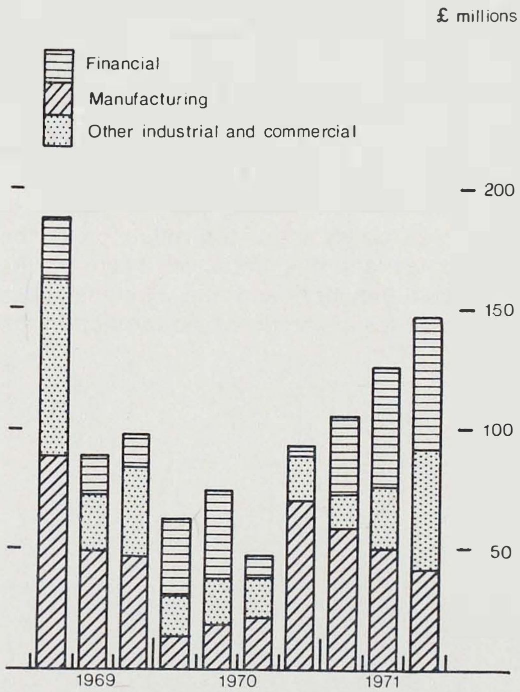
Company securities

The disturbances in the foreign exchange markets, fears about the effects of the U.S. import surcharge on the profits of important exporting companies, and concern about the size of certain wage claims being submitted, appear to have influenced the equity market as much as the signs of recovery in some kinds of personal consumption, more good trade figures, and increases in prices on the New York stock market for a time after the U.S. measures. Prices did respond to these last two influences for a while in the first part of September but drifted down again thereafter. By the end of October, the F.T.-Actuaries industrial share price index (181) was down slightly compared with the end of July (184). At the end of October and early in November, the market was depressed by falls on the New York stock exchange and prices continued to weaken. There was a recovery, however, after the middle of November.

In common with other fixed interest securities, yields on company debentures fell over the three months: those on first-class high-coupon stocks of about twenty-five years' maturity came down by 1% to about 8⅞% at the end of October. As yields on gilt-edged securities of similar maturity fell by a somewhat smaller amount – some ¾% – the differential between them narrowed to about $\frac{3}{16}$%.

Although there was a pause in the rise in equity prices during the period, the new issue market maintained its recent recovery. U.K. companies raised a net total of £115 million (of which equities £38 million) compared with £139 million (equities £35 million) in the previous three months. The figure for August-October was reduced by £27 million through a partial redemption of five debenture stocks by the Receiver of Rolls-Royce Limited. Financial companies were again prominent but the largest part was as usual taken by industrial and commercial companies. The 'queue' of borrowers yet to announce their issues shortened over the period, following the announcement of a large rights issue by the British Petroleum Company. If this is not taken into

Capital issues by quoted U.K. public companies



. . . but the gradual increase in capital issues by companies has continued.

account, however, there was a modest lengthening in the 'queue' of other intending borrowers.

Repurchases of units by unit trusts were a record during the September calendar quarter. It appeared that investors who had bought units at the high prices ruling in 1968 and early 1969 took the opportunity offered by the recovery in the equity market during the June quarter to withdraw without loss. As gross sales fell, net sales – at £7 million – were the lowest since 1962. In the month of September, however, there was a modest increase in sales. This continued in October, when gross sales expanded further and repurchases declined, giving net sales of £8 million.

Conclusion

It is still too soon to judge how much the recent uncertainties in foreign exchange markets may be affecting world trade. The longer the uncertainties last, however, and the greater the fluctuations in market rates, the more chance there is of individual countries introducing restrictions on trade and other international transactions. Many governments have shown that they are aware of the dangers and steps have been taken in a number of industrial countries – including the United Kingdom, Canada, Italy and Japan – to stimulate output and a fuller employment of resources. Together with a widespread reduction of international interest rates, this should help to make up for any contraction of trade which might otherwise have developed. Nevertheless business confidence remains weak in a number of countries and the rate of investment is low. Governments' efforts to maintain activity would be more sure of success and the prospects for world trade would be improved by an early settlement of outstanding international questions, including a realistic realignment of exchange rates and the removal of the U.S. import surcharge. Such a settlement would be in the interests of developed and developing nations alike.

Against this international background, the measures which have been taken at home in the Budget and subsequently to revive a sluggish economy are already having effect. Monetary relaxations have helped to stimulate a pronounced increase in personal spending on cars and other durable goods and on housing, as credit from banks, finance houses and building societies has become more easily available and, in some instances, cheaper. Past experience has shown that it takes some time for a recovery in personal spending to affect demand for capital goods and labour. This helps to explain why manufacturing investment has continued to decline and unemployment to rise. Unemployment may also no longer be responding in the same way as in the past to changes in demand, partly perhaps because of the effect of inflation on firms' profits and liquidity and the repercussions of this on business confidence. However, it should not be too long before the growth in consumers' demand, which has so far been concentrated mainly on durable goods, extends to other goods and helps to stimulate production in other industries besides those supplying consumer goods. An end to the recent rundown in industries' stocks will add to the expansion. All this should be assisted by the current combination of lower interest rates and spare lending resources available to the banks under the new arrangements for control of credit. The transition to the new system has progressed satisfactorily and banks have already begun to take advantage of the opportunities to compete more freely.

Much has been done by means of monetary and fiscal relaxations to lay the foundations for a period of strong economic growth. It is still true, however, that these measures may not succeed for very long unless the pressure of rapidly rising prices and wage costs can be reduced. There is encouraging evidence that the rate of growth in prices has begun to slow down under the influence of the July cuts in purchase tax and the initiative taken by the Confederation of British Industry; and the circumstances should now be favourable for a significant moderation in the growth of wage costs.