Commentary

After a very heavy outflow of funds in the third week of June, sterling was allowed as a temporary measure to float and the United Kingdom withdrew from the intervention arrangements of the European Economic Community. Thereafter the outflow was halted, but by the end of July sterling had effectively depreciated on average against other currencies by some 6¾% on the rates agreed in December 1971. This sudden pressure on sterling together with its causes and effects was one of the chief features of the three months May to July with which this Commentary is mainly concerned. It reflected growing anxiety about the prospects for the U.K. balance of payments. In fact, the balance on current account remained in moderate surplus in the second quarter. But the volume of exports had fallen and the volume of imports was growing; and the markets considered that this trend was likely to continue as domestic demand and output grew, and that inflationary pressures appeared to be increasing again. Unsettled industrial relations also added to anxieties about the future.

The rapid outflow of funds before the decision to float had a sharp effect on U.K. financial markets. During the preceding months private sector demand for bank credit had been heavy and, though the money stock had been increasing very rapidly, interest rates had been moving up. Bank rate itself was increased by 1% to 6% on 22nd June during the run on sterling. The outflow caused an acute shortage of funds in London and short-term interest rates rose further. The banks' reserve assets fell sharply and, to provide temporary help and to avoid wild fluctuations in interest rates, the Bank announced on 28th June special arrangements for the purchase from the banks and subsequent resale to them of short-dated gilt-edged stocks. This news steadied the gilt-edged market, which had been weak for much of the period, partly because the banks had already been selling stocks to finance their advances. It also smoothed the impact of the shortage of funds on interest rates. These resales were made and the arrangements terminated on 14th July. By the end of that month, rates for three months' inter-bank and local authority money were in the region of 8½% compared with just over 4½% at the end of April. Early in August, the banks were reminded by the Bank that demand from industry for bank finance was growing more broadly than in recent months, and they were asked as necessary to make credit less readily available to property companies and for financial transactions not associated with the maintenance and expansion of industry.

Domestic demand and output

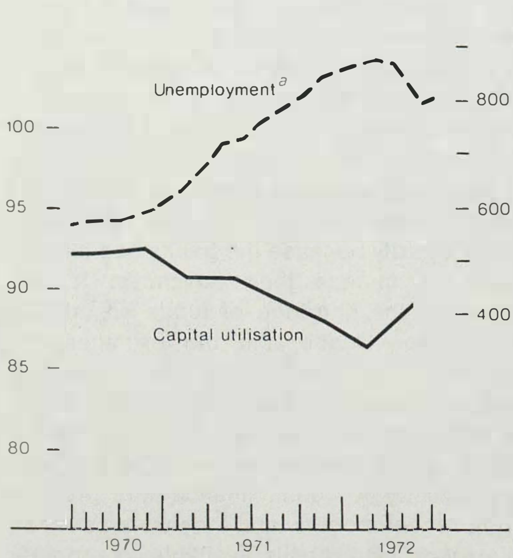
Much of the anxiety which led to the heavy selling of sterling in the second half of June arose from concern about the development of the domestic economy, particularly about the outlook for the growth of cost and price inflation and about the effects of this, and of the expected rise in domestic output, on the balance of payments. After a sharp fall in activity in the first quarter of 1972 – the fall, at some 2½%, was greater than had at first been thought – demand and output both recovered quite strongly in the second. Although some of this growth must have been a rebound from the effects of the miners' strike and consequent power stoppages in the first quarter, it was also probably a response to the succession of reflationary measures which had been taken since the middle of 1971.

As had been expected at the time of the Budget, the increase in demand was at this stage very largely due to personal consumption, which may have increased by as much as 2¾% in volume after having changed little in the previous quarter. Among the main components, the volume of retail sales rose by some 2½% and, as the biggest increase was in sales of durable goods, it may be that people had delayed spending in the first quarter in anticipation of reductions in purchase tax. The growth in registrations of new cars in the second quarter was even more marked, with an increase of 18%. Though sales of cars were also probably affected by Budget expectations, they had been held down in the first quarter by the consequences of labour disputes, especially in the mines.

Apart from personal consumption and some improvement in stocks, all the other main forms of demand taken together were probably little changed in the second quarter. The public sector's spending on goods and services continued to rise, but public expenditure on new houses may well have fallen back, probably offsetting an increase in private housebuilding. Other fixed investment by private industry had been little changed in the first quarter and, on the evidence of the Department of Trade and Industry's May survey of intentions, probably did not rise much in the second quarter. After the sharp fall in stocks in the first quarter (which must have been very largely a consequence of the power shortages) a much smaller reduction, or even some rebuilding, seemed likely to occur in the second; but early information suggests that the turnround may have been slower to take place than might have been expected. As regards overseas demand, the volume of exports recovered a little in the second quarter; but the volume of U.K. imports went up more and the ratio of imports to home demand continued to rise. Over the four and a half years since the devaluation of sterling in the last quarter of 1967, the volume of imports rose by 28% while domestic industrial production was up by only just over 11%.

Although several forms of domestic demand were still sluggish, industrial output recovered strongly to rise by 6¼% in the second quarter of 1972, with increases in most industries. The greater part of this recovery was almost certainly to make good the output lost from the miners' strike and, taking the first two quarters of 1972 together, production was about the same as in the second half of 1971. Similarly, the amount of spare capacity in manufacturing industry in the second quarter was less than in the first – when it had been the largest for ten years – but still showed little if any improvement compared with the second half of last year.

Capital utilisation and unemployment



Unemployment fell sharply in the June quarter and capital utilisation recovered from the effects of the miners' strike.

a Excluding school-leavers and adult students.

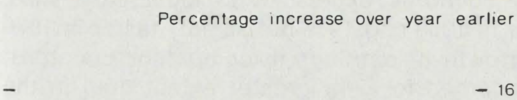
Capital utilisation index

	I	II	III	IV
1969	94·8	95·7	94·9	94·4
1970	94·4	92·3	92·3	92·6
1971	90·8	90·7	89·4	88·1
1972	86·4	89·1		

The fall in unemployment since March 1972 was greater than might have been expected from the behaviour of output: in the five months to the August count, the number out of work fell by 72,000, after seasonal adjustment, from 3·9% to 3·6% of the total number of employees. But the large increase which had earlier taken place between the winters of 1970/71 and 1971/72 was similarly much sharper than would have been consistent with previous experience, and unemployment may not at the moment be a good indicator of demand for labour. The slow but steady increase in adult vacancies in each of the first eight months of this year was probably a better guide; the number of vacancies outstanding in August was the highest for eighteen months.

Meanwhile industrial relations were again generally very unsettled in the June quarter and, although the number of stoppages in the first half of the year was a little less than in the first half of 1971, more workers were involved, and the number of working days lost substantially exceeded the already very large figure of a year earlier. The settlement of some stoppages, such as those in the coal mines and on the railways, led to large increases in wages; and a dispute over the allocation of container work between dockers and other workers developed in the latter part of July into a national dock strike which continued until after the middle of August.

Wages, earnings and prices



The recent slowing in the rate of growth in prices continued in the second quarter, though it was less marked; but earnings began to accelerate.

a Not available.

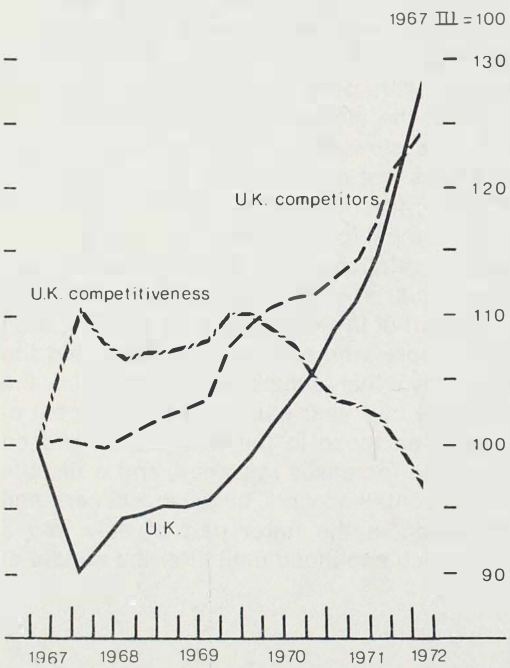
Costs and prices

The progress made in reducing unemployment was reassuring; but the recent trends in costs and prices suggest further deterioration of the competitive position of the United Kingdom. There is no single economic series that satisfactorily measures performance in comparison with international competitors; but some idea of the change in the United Kingdom's relative position, at home and abroad, can be gained by examining a number of indicators of costs and prices.

Looked at in isolation, the figures for the United Kingdom in the second quarter had shown that the rate of increase in domestic prices had diminished, thanks partly to the reductions in purchase tax in the Budget, but that the rate of increase in wage rates had accelerated. The year-on-year increase in retail prices was down to 6% in the three months to July; but the year-on-year increases in both average weekly earnings ($11\frac{1}{4}$% in the second quarter) and hourly wage rates ($12\frac{1}{4}$%) were again edging upwards. And with the decline in the exchange rate since 27th June, and other factors tending to push domestic prices up again, the current rate of price increase may prove lower than can be expected in the immediate future. The July survey of industrial trends by the Confederation of British Industry – which was, however, taken before the decision was announced to seek a continuation for a further three months of the agreement on price restraint – showed that a rapid rise in costs and prices was expected.

The important question is whether this recent and current rate of inflation at home is undermining the United Kingdom's competitive position in manufacturing. Two kinds of international comparison can be made; but neither is free from doubt. Changes in U.K. export prices can be compared

Manufacturing export prices (in dollars)



A comparison of manufacturing export prices suggests that the U.K. competitive advantage achieved by devaluing in 1967 had been largely if not completely eroded by the end of 1971 . . .

with changes in those of the main competing countries; and changes in unit costs can be compared, where they can be adequately measured.

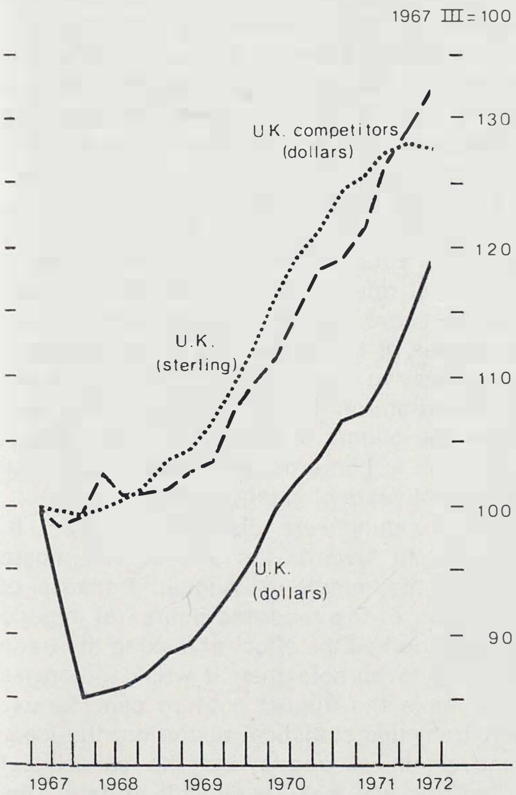
The international comparison of export prices is not reassuring to the United Kingdom. The comparison is full of difficulty both because the kinds of goods exported are different for each country, and because the comparison tells only of the prices of those goods that have been successfully sold abroad and not of those that were priced out of the markets; but the lesson of the figures is not in doubt. In the two years following the 1967 devaluation U.K. export prices rose roughly in line with those of other major exporting countries,[1] retaining for this country most of the competitive advantage achieved by devaluing. Since then they have risen much faster than competitors' prices; and by the end of 1971, after the currency realignment, that competitive advantage, at least in so far as it appeared in relative price changes, must have been largely, if not completely, eroded. This trend continued in the first half of 1972; but some relief for U.K. export prices will have been gained with the floating exchange rate.

The second kind of comparison should look at total costs per unit of output in manufacturing; but the nearest possible approach to this is to compare unit labour costs, and even this approximation rests on figures derived from statistics of earnings – in the currency of the exporter – and output. Earnings in the United Kingdom over the past few years, expressed in sterling, have risen no faster than earnings in the main competing countries expressed in local currencies; somewhat slower in 1968 and 1969 but slightly faster in 1970 and 1971. The growth of earnings in competitor countries, however, was absorbed to a far greater extent than in the United Kingdom by rises in labour productivity. Average annual increases in U.K. productivity between 1967 and 1970 were some 3½% compared with almost 7% in major competitor countries. Then in 1971 U.K. productivity rose by 4½%, much faster than abroad (2¾%). However, this marked acceleration did not recover all the ground lost in the preceding three years; and, over the whole period to the end of 1971, unit manpower costs in manufacturing industry (earnings per unit of output) rose more in the United Kingdom than abroad.

This direct comparison between exporting countries based on earnings expressed in the various currencies of the exporters needs to be adjusted to allow for changes in exchange rates. But the simple conversion of domestic currencies into dollars at current rates of exchange only serves to expose a fundamental defect of the comparison. Labour costs are not the only cost of manufacturing; where the other manufacturing costs have a substantial import content, this component of total unit costs must also be affected by changes in exchange rates, and in the opposite direction to the effect on export prices. Thus for the United Kingdom, where the import content of exports may be more than 20% of total sterling unit costs, a devaluation will increase the cost of the import content as well as reducing the dollar-equivalent of unit labour costs; so a comparison in dollar

1 The United States, France, Western Germany, Italy, Canada and Japan.

Unit manpower costs in manufacturing



. . . even though U.K. unit manpower costs in terms of dollars retained most of the advantage from the devaluation. However, as explained in the text, manpower costs are only part of total unit costs of manufacturing.

terms based on nothing but unit labour costs must give a misleadingly favourable indication of the United Kingdom's competitive performance.

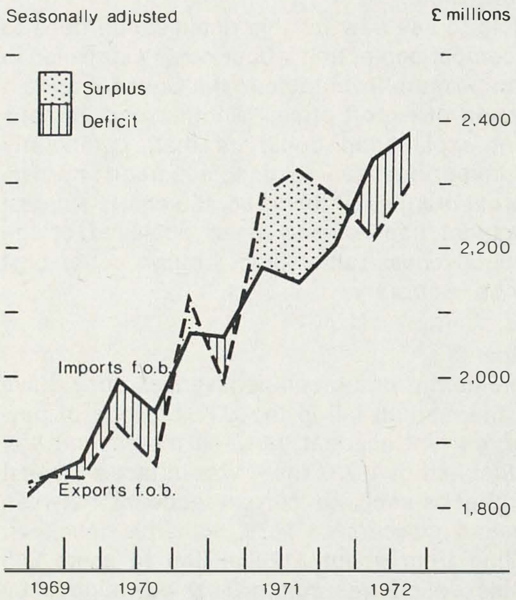
It is not possible to say how far this qualification goes to explain why the comparison of unit labour costs expressed in dollars appears to be more favourable to the United Kingdom than the comparison of export prices. Another and perhaps equally important explanation could be that, particularly during 1971, U.K. exporters have obtained a marked improvement in export profit margins. If this is so, the charts suggest that the improvement has recently been achieved at the expense of competitiveness rather than through better cost control, and may be temporary.

Balance of payments

These developments in price competitiveness may have played a part in the marked fall in the U.K. balance of payments surplus on current account between the second half of 1971 and the first half of 1972. There was in fact a modest improvement in the balance on current account between the first and second quarters of 1972, with the deficit on visible trade falling from about £120 million to some £85 million. The visible deficit was comfortably outweighed by the surplus earned on invisible transactions. Some of the improvement on visible trade was probably no more than making good the export business delayed by the miners' strike and power cuts in the first quarter and, because of this, the half-yearly figures provide a better indication of recent trends. Between the second half of 1971 and the first half of 1972, the balance on visible trade changed from an exceptional surplus of £250 million to a deficit of about £200 million. The decline was the result of a number of unfavourable influences. Probably the most important so far as exports were concerned was a fall in the volume of world trade in manufactures towards the end of 1971 and only slow growth in the early part of 1972. This hit U.K. exports severely and there was a sharp decline in demand from overseas sterling countries, which customarily take an important share (about 25%) of total U.K. exports. The decline reflected a variety of influences, including slack demand in Australia and New Zealand, import restrictions and devaluation in South Africa and other African countries, and the Indo-Pakistani War. U.K. imports were increased by the timing of trade in goods such as ships and aircraft, whose deliveries tend to vary erratically: and both exports and imports were adversely influenced by the effect of industrial unrest on domestic output, and by the decline in price competitiveness already mentioned. Finally imports, particularly of finished manufactures, were beginning to show the consequences of the rise in consumer demand which followed the reflationary measures taken in the last year or so.

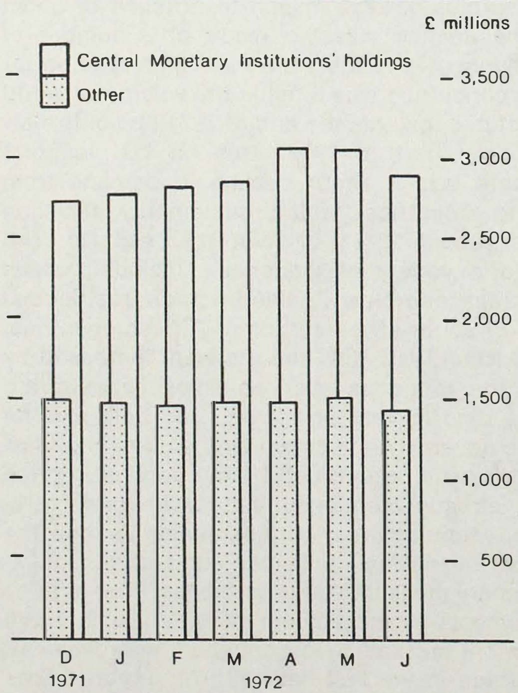
Adverse movements in the volume of U.K. visible trade were to some extent masked by a continued 'improvement' in the terms of trade in the first half of 1972: export prices rose by about 3% in the period while import prices rose by only around 1%. After making approximate adjustments to allow for these movements and for changes in trade in the erratic categories of ships and aircraft, there appears to

Balance of U.K. visible trade



The balance of visible trade remained in substantial deficit in the second quarter.

Sterling holdings of overseas sterling countries



After rising in the first part of the year, official and private holdings of sterling by overseas sterling countries fell sharply in June.

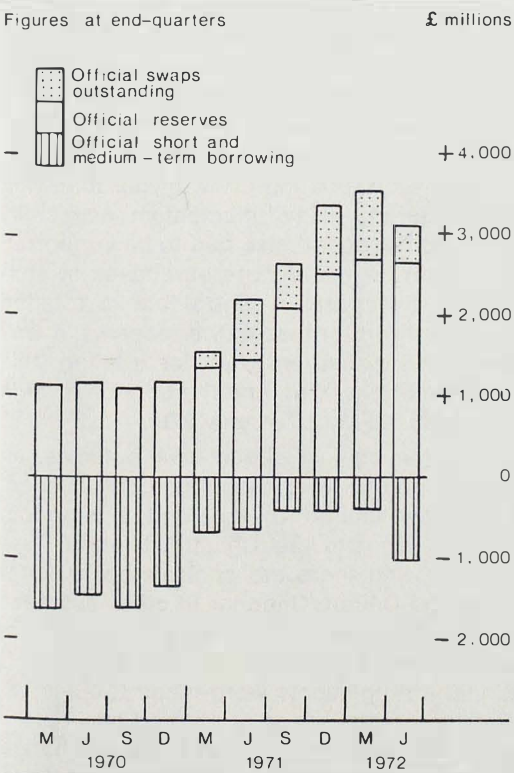
have been a fall of about 5% in the underlying volume of exports, and a broadly similar rise in the underlying volume of imports. In value, imports in the first half of this year rose by 8%. Increases of 7% in machinery and of 3% in industrial materials excluding precious stones were relatively modest, but imports of consumer goods rose very sharply indeed, by 20%, with cars up by a half. The foreign share of the U.K. car market in this period grew to about 26% at the end of June compared with some 19% in 1971 and 14% in 1970. At the same time the U.K. surplus on overseas trade in cars fell very sharply from about £245 million in 1970 to about £200 million in 1971 and to about £25 million at an annual rate in the first half of this year. A rise in the foreign share of the U.K. car market from the relatively low figures of the 1960s was to be expected, particularly after successive reductions in tariffs in recent years. But a deterioration on this scale may also have been due in part to the effects of industrial unrest and in part to a sharp increase in home demand, which had been encouraged after several years of steady sales.

The trade figures for July were distorted by the U.K. dock strike, which began towards the end of that month and lasted until after the middle of August. Because of differences in the timing of the recorded figures of imports and exports, the stoppage had the effect of making the trade balance for July more favourable than it would otherwise have been and will make the August out-turn considerably worse. Quite apart from this statistical distortion, the interruption to the movement of goods and the subsequent clearance of the backlog will make it difficult to detect the underlying trend of overseas trade for some months.

The surplus on current account in the second quarter was greatly outweighed by a very large investment and capital outflow associated mainly with the pressure on sterling in June. Overseas sterling holdings fell by some £130 million, a small rise in official balances having been offset by a substantial fall for other holders. These quarterly figures disguised the extent of the change in sentiment about sterling which took place in June. Official and private holdings of sterling had risen substantially during 1971 and, in the first quarter of 1972, official holdings continued to grow while private balances were unchanged. These trends were little different in April. Exchange reserves in sterling rose sharply as overseas sterling countries continued in seasonal balance of payments surplus, and private holdings also rose a little. After a pause in May, however, official and private holdings in June were reduced by some £200 million each, reflecting the decline in confidence in sterling – though seasonal influences also normally become unfavourable at this time. Of the total fall of £400 million in June, about three fifths was in the holdings of overseas sterling countries.

Further evidence of the pressure on sterling was provided in the second quarter, first, by an increase of over £200 million in overseas borrowing of sterling from U.K. banks, largely in June (some borrowers were hoping that, if sterling was devalued, they would have correspondingly less to repay in terms of foreign currency); and second, by a fall of about

Reserves and official financing



Despite an increase in short-term borrowing, the reserves fell in the June quarter for the first time for a year and a half.

£130 million in net borrowing by the banks from abroad in overseas currencies. In fact, the banks' net borrowing declined by some £310 million in the June quarter after allowing, as in the first quarter, for sizable lending in currencies to domestic borrowers, mainly investment and unit trusts, to finance investment overseas. As well as these identified transactions, the balancing item swung from a modest positive figure in the first quarter to a sizable negative figure. This was consistent with an unidentified outflow of funds, and suggests that payments for U.K. imports might have been accelerated, and those for exports delayed, as confidence in sterling declined.

Reserves and official financing

The total currency outflow requiring official financing in the second quarter of 1972 was £1,045 million. Final repayment of outstanding U.K. liabilities of £405 million to the International Monetary Fund had also been completed during April,[1] so that the total finance needed from other sources was £1,450 million. The greater part was obtained by means of special transactions with overseas monetary authorities. The amount of foreign currency placed with them under earlier official swap arrangements was run down by £403 million, leaving £441 million outstanding at the end of the quarter. £1,001 million was also borrowed from E.E.C. central banks during the second half of June under the provisions of the E.E.C. intervention arrangements to restrict fluctuations in cross rates between the currencies of participating countries. After these transactions, the reserves were reduced by only £46 million, (valued at the rates at which the transactions took place) to £2,673 million (valued at the middle rate of \$2·60571) at the end of June. There was also the U.K. reserve position of £292 million in the I.M.F., which was incorporated in the reserves during July in line with the practice of many other countries.

At the end of July the liability of £1,001 million to E.E.C. central banks was settled in accordance with the terms of the intervention arrangements. £259 million of the U.K. reserve position in the I.M.F. was used for this settlement, together with the remaining £441 million of funds swapped forward. In the same month, £83 million of sterling was bought from the U.S. authorities, who had drawn it from the I.M.F. in April in connection with the U.K. repurchase. After taking into account all these transactions, the reserves were reduced by £339 million to £2,334 million.

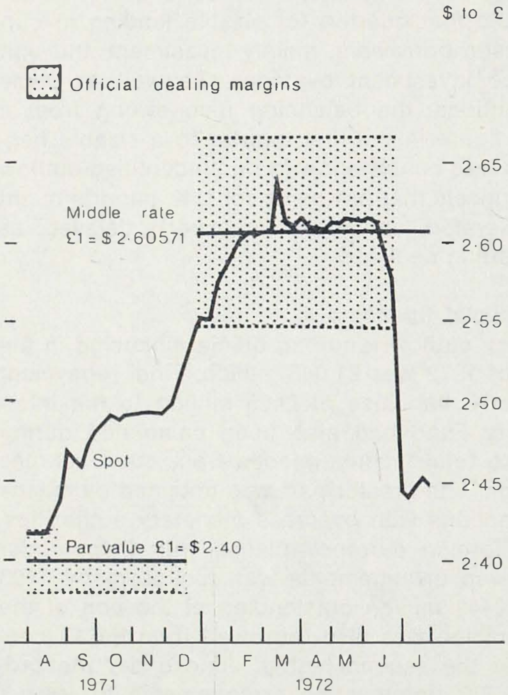
The Federal Reserve Bank of New York's forward liability under the reciprocal swap facility was reduced by £21 million in the three months to the end of June, to stand at £274 million. The whole of this outstanding liability was settled by mid-August.

Foreign exchange and gold markets

During May and the early part of June sterling continued fairly steady between \$2·61 and \$2·6150, although it did touch \$2·6170 at one stage when the U.S. dollar weakened on news of an intensification of the conflict in Vietnam. Generally, however, sterling failed to share in most other

1 For details, see June *Bulletin*, page 167.

Spot rate for U.S. dollars in London[a]



After the suspension of official dealing margins, sterling fell sharply to about $2·45.

a Middle closing rates: weekly, Fridays, except for Thursday, 22 June.

currencies' improvement against the dollar during this period. There was growing uneasiness about prospects for the U.K. balance of payments in the light of persistent industrial strife and the continuing high rate of domestic cost and price inflation.

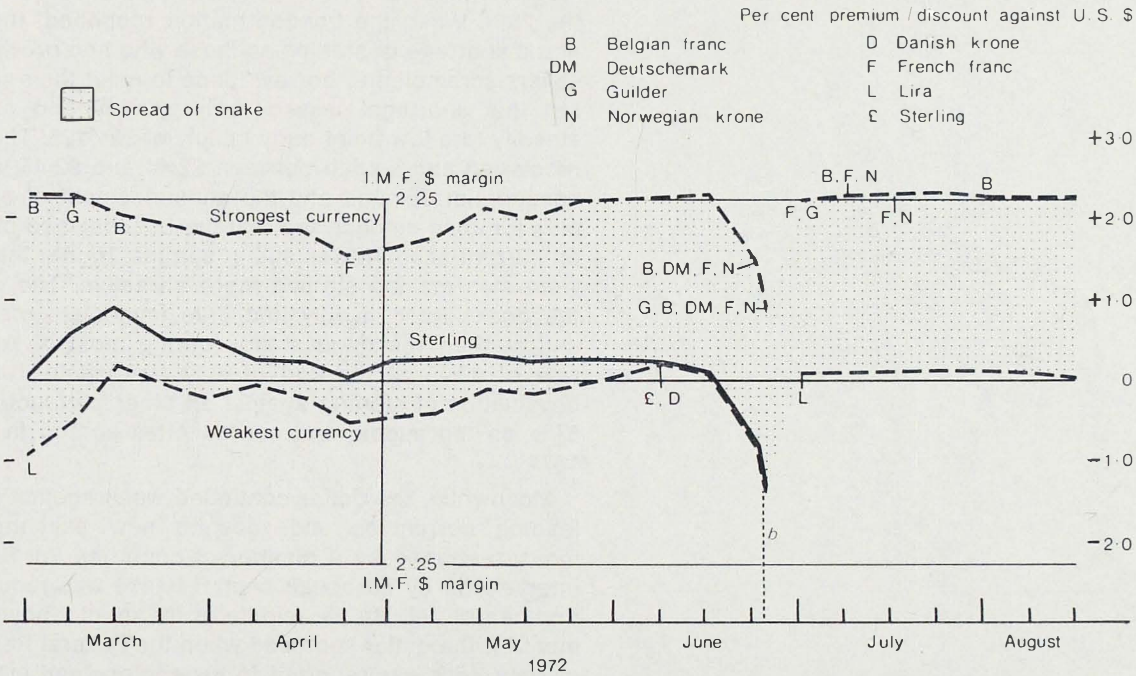
These worries were crystallised on 15th June when a national dock strike seemed imminent. There was talk of devaluation, and a substantial move out of sterling began. In keeping with the E.E.C. intervention arrangements to which the United Kingdom had subscribed since the beginning of May,[1] support was given to sterling when the agreed intervention rates were reached against first the Belgian and then the French franc. This was the first occasion on which central bank intervention had been necessary to keep the currencies concerned within the limits of the Community band of 2¼% (the "snake"). The next day the continuing weakness of sterling caused the Community band to move lower against the dollar (*i.e.* it pulled the whole "snake" lower in the "tunnel"), and support for sterling against the deutschemark and Norwegian krone was also required. Although sterling stood at $2·59, or well above its dollar floor of $2·5471, talk of a devaluation grew. In the following week, the move out of sterling gained momentum, especially into deutschemarks, and the pound also had to be supported against the Dutch guilder. By 22nd June purchases of sterling by the Bank and five partner central banks totalled £1,001 million. To prevent further loss to the reserves, it was decided to suspend all intervention rates for sterling; this was announced early on Friday 23rd, and the London foreign exchange market was closed until Tuesday 27th.

As a further precaution against speculative outflows, an extension of exchange control was announced. The Scheduled Territories are now limited to the United Kingdom (including the Isle of Man and the Channel Islands) and the Republic of Ireland, and there are controls on resident capital outflows from the United Kingdom to other overseas sterling countries.[2] The Republic of Ireland subsequently imposed similar controls on its residents. As part of the U.K. measures, transitional arrangements were made to allow all payments due under contracts issued or entered into before 23rd June 1972; and in some other respects the exchange control rules applicable to these countries differ from those which apply to transactions with other countries. The most important differences are, first, that existing loan and overdraft facilities given as at 23rd June to companies and branches in the United Kingdom and Ireland which are controlled by residents of overseas sterling countries may continue without formality. Applications for new or increased facilities are being dealt with under the same rules as for E.E.C.-controlled companies, which means that they will normally be allowed. Secondly, the "25% requirement" (under which U.K. residents selling foreign currency securities are obliged to convert 25% of the sales proceeds at the official rate of exchange) does not apply to sales of securi-

1 See June *Bulletin*, page 169.

2 *i.e.* the countries of the Commonwealth (except Canada and Rhodesia), Bahrain, Iceland, Jordan, Kuwait, Maldive Islands, Oman, Pakistan, Qatar, Sikkim, South Africa and South West Africa, the United Arab Emirates, and the People's Democratic Republic of the Yemen.

Sterling and the E.E.C. "snake" in the "tunnel"[a]



The selling of sterling in June pulled other E.E.C. currencies down against the dollar, but they recovered after the United Kingdom withdrew from the E.E.C. intervention arrangements.

a Middle closing rates: Tuesdays, except for Thursday, 22 and Wednesday, 28 June.
b Sterling after leaving the "snake".

ties payable solely in the currency of an overseas sterling country or payable in such a currency and sterling. Thirdly, U.K. residents may normally make direct investments in overseas sterling countries without limit through the official market at the current rate. Fourthly, U.K. banks may make credit available to their branches and to customers in overseas sterling countries under lines of credit established before 23rd June. They may also grant new facilities to residents of these countries as if they were still Scheduled Territories, provided the facilities are linked to the movement of goods. Lastly, the ceiling for emigrants' remittances and gifts from the United Kingdom to the overseas sterling countries is higher than for other external account countries.

As a consequence of the floating of sterling, the United Kingdom withdrew from the E.E.C. intervention arrangements. Denmark withdrew at the same time (although retaining the intervention limits against the U.S. dollar agreed in December 1971) but Italy, whose currency had been close to or at the bottom of the Community band for several months, remained in the scheme after it had been agreed in Luxembourg on 26th June that until the end of September the Italian authorities could, when necessary, support the lira by intervening in U.S. dollars rather than in other E.E.C. currencies.

Immediately after sterling had been allowed to float, speculative attention was directed against the U.S. dollar, and other currencies rose to their dollar ceilings. Support for the dollar by European central banks on the morning of the

23rd was very large, and they all soon withdrew from their markets, most of them not resuming normal dealings until the 28th. When the London market reopened, there was at first a shortage of sterling as those who had previously been sellers scrambled to borrow funds to meet their settlements; but this shortage passed fairly quickly and sterling fell steadily to a low point early in July of \$2·4125. The rate then recovered and settled between \$2·44 and \$2·45, as reviving commercial demand and the announcement of a trade surplus for June emphasised that the U.K. balance of payments on current account was still in surplus. Higher interest rates were also making sterling more attractive. The disputes in the docks later in July had little immediate market effect and sterling remained steady during most of August. The rate of \$2·45 at the end of July represented an effective devaluation of sterling against all other currencies of about 6¾% on the middle and central rates agreed in December 1971.

Meanwhile, the dollar continued weak against most other leading currencies and, despite new exchange control measures taken by a number of countries, further massive intervention by European central banks was required in the first half of July. In the middle of the month, however, sentiment for the dollar improved when the Federal Reserve Bank of New York was reported to have intervened in the market in support of the dollar, its readiness to do so was confirmed, and it was announced that the suspension on 15th August 1971 of the swap network would be lifted. By the end of July the U.S. dollar was above its support point in most markets.

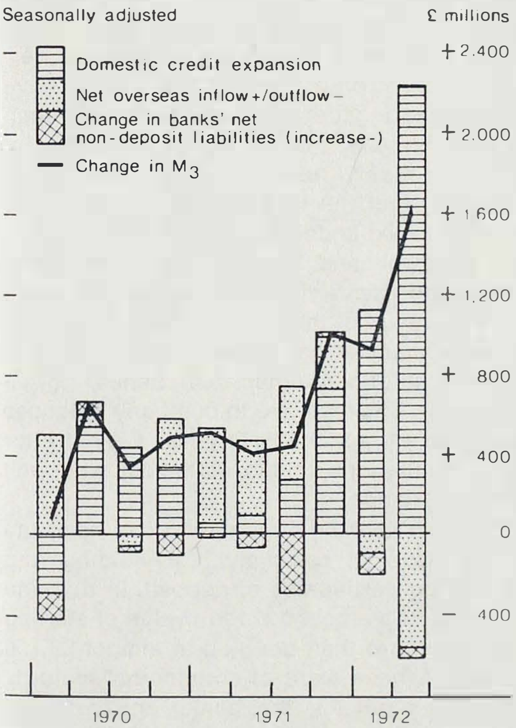
Before the upheavals in foreign exchange markets in the second half of June, the main speculative interest had been concentrated on gold. The market price in London rose from around \$50 per fine ounce at the beginning of May to reach a record \$66·75 on 8th June. This increase owed something to the normal reduction in sales of newly-mined gold as South Africa's balance of payments moved into surplus, but it was also aided by renewed speculation on the possibility of a much enhanced official price. Profit-taking took the price back to around \$61, where it stayed during the sterling crisis; but later the weakness of the dollar, and reports that some E.E.C. countries could be contemplating an increase in the price at which gold would be valued in settling certain debts among themselves, led to a fresh surge in the market price to \$70 at the beginning of August. The increase was stemmed by reports that Russia would be needing to sell gold to finance purchases of wheat, and the price fell to \$65-66 in the face of some profit-taking, but subsequently recovered somewhat.

Money stock and domestic credit

The rise in the money stock in the second quarter was even more rapid than in the previous two quarters, despite the currency outflow towards the end of June.

The money stock (M_3) in the June calendar quarter rose by some £1,650 million or 7¾% after seasonal adjustment. This was much greater than the increase of about £900

Changes in money stock



The money stock and domestic credit expanded even more rapidly in the June quarter than in the previous two quarters.

million or 4½% in the March quarter, and of £1,010 million or 5¼% in the last quarter of 1971. The increase was in fact moderated by the large currency outflow. However, part of this outflow consisted of a reduction in overseas holdings of public sector debt, and part reflected the banks' net overseas lending in foreign currencies, neither of which directly affected the size of the money stock. Only about half the total currency outflow of over £1,000 million thus had any contractionary effect on the money stock in this period. Other restraining influences were purchases of some £110 million of gilt-edged stocks by the general public, mainly in the last two weeks of the quarter, and continued heavy subscriptions to national savings.

These movements were, however, entirely submerged by a further large expansion in the other main components of domestic credit. The expansion was mainly the result of an even greater increase in bank lending to the private sector than in the previous quarter (£1,660 million as against £1,430 million), some of which may have been associated with the large currency outflow towards the end of June. Once again, the largest part (about half) of this increase was taken by non-financial companies; property and construction companies were still borrowing heavily although, towards the end of the quarter, there were some signs that lending to manufacturers might be beginning to pick up. Accordingly, on 7th August, the Governor wrote to the banks reminding them of the need to meet this industrial demand, and asking them as necessary to make credit less readily available to property companies and for financial transactions.[1] In the second quarter, financial institutions other than banks borrowed little more than in the March quarter, but lending to the personal sector (which includes unincorporated businesses and non-profit-making concerns) continued to rise very rapidly, and had accounted for about two fifths of the total rise in bank lending to the private sector in the twelve months to the end of June 1972. A further contribution to the expansion of domestic credit in the June quarter came from the central government borrowing requirement, which amounted to some £400 million after seasonal adjustment.

The increase in recent quarters in the money stock on the broader definition most frequently used in this country (M_3), has been considerably faster than on the narrower definition (M_1). In the four quarters ending in June 1972, M_3 rose by over 20%, compared with a rise of some 14% in M_1, and in the June quarter alone the increases were 7¾% and 4½% respectively. Both measures leave little doubt that the money stock has recently been rising very rapidly, and more rapidly than previous relationships with other economic variables would have suggested. Past experience both in the United Kingdom and in a number of other countries indicates that the rate of growth in a broader monetary aggregate like M_3, incorporating time deposits and certificates of deposit, generally tends to exceed the rate of expansion of a narrower measure including only currency and demand deposits like M_1. Thus no different judgment about the pace of expansion of the money stock can necessarily be drawn from the less

1 The text is reproduced on page 327.

rapid rate of growth of the narrow definition in recent months.

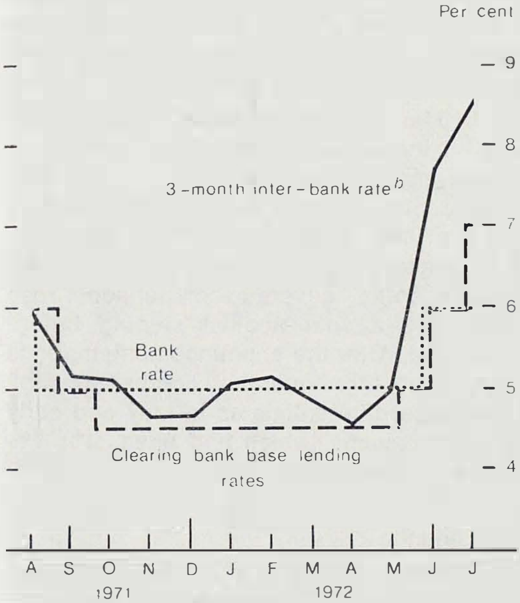
There is a particular reason for paying attention to the comparison between the two versions of money stock in the United Kingdom just now; since the introduction of the new arrangements for the control of credit, the banks have competed for interest-bearing deposits more strongly than previously, especially in the market for certificates of deposit. This would probably have attracted funds from other markets, perhaps from the local authority market for example, and would have expanded the banks' role as intermediary between borrower and lender. The banks have tended to bid most aggressively in the market for large deposits. Probably as a result of this, the sharpest expansion in holdings of money balances has been in those of companies and financial institutions other than banks, particularly in the June quarter. The increase in company balances in the June quarter was exceptionally large and, even after allowing for erratic fluctuations in the statistics, was well out of line with past experience.

A further aspect of this banking competition has been the rapid growth in the issue of relatively high-yielding and easily marketable sterling certificates of deposit. In the nine months since the end of September 1971 the value of sterling certificates outstanding more than doubled to almost £3,750 million, and over half of these were of six months' maturity or less. Certificates held outside the banks and discount houses, mainly by companies and other financial institutions, more than doubled over the same period from £480 million at the end of September 1971 to some £1,050 million at the end of June 1972. In recent conditions of rapidly moving interest rates, it seems likely that there were times when some borrowers would have found it advantageous to borrow from the banks in order to use the funds in the certificates of deposit market.

In summary, there are some grounds for believing that the more competitive approach of the banks since the introduction of the new arrangements may account, particularly in conditions of rapidly changing interest rates, for a considerable part of the faster growth in the broad definition of the money stock, and that attention should be directed in recent quarters to the movements in both monetary aggregates. On either measurement, however, the money stock has recently been rising very fast.

In the month to mid-July, the broad version of the money stock (M_3) rose by some £480 million, or 2%, after seasonal adjustment. There was a further substantial rise in bank lending to the private sector, although some of this was no doubt connected with the large external outflow. The rise in M_3 was smaller than in the previous month, but the average monthly increase over the latest three months was still about $2\frac{1}{2}$%. The rise in the July banking month largely took the form of additions to the private sector's sterling deposit accounts and certificates of deposit, which are not included in the narrower measurement (M_1). This version of the money stock fell by about £60 million ($\frac{1}{2}$%) after seasonal adjustment; over the latest three months, however, M_1 has grown at an average monthly rate of about $1\frac{1}{4}$%.

Short-term interest rates[a]



Short-term interest rates rose sharply in June and July.

a Last Friday of month.
b Middle of spread at close of market.

Fridays	Clearing bank base lending rates	3-month inter-bank rates	3-month £ C.D. rates
Jan. 28	$4\frac{1}{2}$	$5\frac{1}{16}$	$5\frac{1}{16}$
Feb. 25	,,	$5\frac{3}{16}$	$5\frac{3}{16}$
Mar. 30	,,	$4\frac{7}{8}$	$4\frac{7}{8}$
Apr. 28	,,	$4\frac{9}{16}$	$4\frac{9}{16}$
May 26	,,	$4\frac{15}{16}$	5
June 2	,,	$4\frac{15}{16}$	$4\frac{15}{16}$
9	$4\frac{1}{2}$ or 5	$5\frac{5}{16}$	$5\frac{3}{16}$
16	5	$5\frac{11}{16}$	$5\frac{11}{16}$
22a	,,	$7\frac{1}{2}$	$7\frac{11}{16}$
30	6	$7\frac{3}{4}$	$7\frac{3}{4}$
July 7	,,	$7\frac{3}{4}$	$7\frac{5}{8}$
14	,,	8	8
21	6 or 7	$8\frac{1}{2}$	$8\frac{7}{16}$
28	$6\frac{3}{4}$ or 7	$8\frac{9}{16}$	$8\frac{9}{16}$
Aug. 4	,,	$8\frac{3}{16}$	$8\frac{3}{16}$

a Thursday.

Short-term interest rates

Short-term interest rates rose in both the United Kingdom and the United States in the three months May to July. The rise in U.K. rates reflected increasing domestic economic activity and was particularly sharp when pressure on sterling led to an acute shortage of domestic funds. Rates in continental Europe, however, continued to fall.

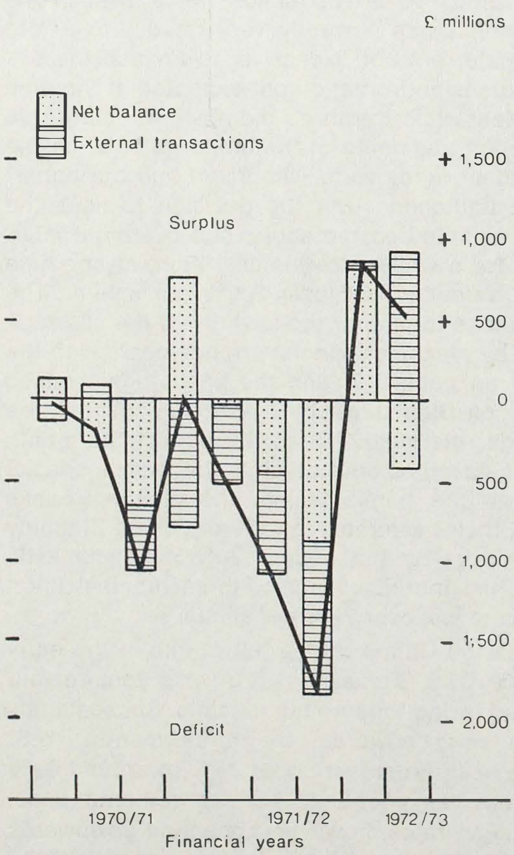
In the United Kingdom, market rates started to move up during May as the economy recovered from the effects of the miners' strike, the three months' inter-bank rate rising from over $4\frac{1}{2}$% per annum to over 5% in the month. By early June, Treasury bill rates had moved only a little, but they started to rise sharply after the authorities had raised their dealing rates in mid-week, the first time that such a signal had been given since the new arrangements came into effect last September. Between 9th and 15th, the London and Scottish clearing banks raised their base rates from $4\frac{1}{2}$% to 5%, and in the middle of the month Treasury bill rates went above Bank rate to stand at over $5\frac{1}{2}$% per annum for three months' bills. On the 22nd Bank rate followed other short-term domestic rates upwards. It was increased from 5% to 6%, restoring its normal position above Treasury bill rates. The move was seen as consistent with the official monetary policy objective of restraining the growth in the money stock – which was currently very rapid – to a rate which was adequate, but not excessive, to finance the 5% annual rate of expansion in real output expected at the time of the Budget. Meanwhile the three months' inter-bank rate rose from 5% at the beginning of the month to $7\frac{1}{2}$% on the 22nd as non-resident funds were withdrawn and the banks' liquidity position tightened. After the decision to float, the shortage of liquid funds became acute, and overnight inter-bank rates were for a while exceptionally high, at one time reaching the equivalent of well over 200% per annum. The authorities took steps to temper the severity of the shortage of bank liquidity by means of special arrangements with the banks described on page 317, and the banks again raised their base rates on 30th June by 1% to 6%. The three months' inter-bank rate was $7\frac{3}{4}$% at the end of the month and, though rates eased somewhat while the Bank's special arrangements with the banks lasted, the clearing banks further increased their base rates to $6\frac{3}{4}$% or 7% on 21st July or shortly afterwards. By the end of July most domestic short-term rates had increased again, three months' inter-bank money rising to just over $8\frac{1}{2}$% per annum.

Interest rates in the United States fell a little in the early part of May as the U.S. Treasury's borrowing requirement was much reduced owing to large tax receipts. Subsequently rates started to edge upwards, the three months' U.S. Treasury bill rate rising from just under $3\frac{1}{2}$% to around $3\frac{7}{8}$% by the end of July, as economic activity gathered pace. Continental European rates, however, continued downwards as internal measures were taken by several governments to offset the effects of foreign exchange inflows.

Euro-dollar rates continued to ease in May, the three months' rate falling from 5% to $4\frac{5}{8}$% per annum, in line with U.S. rates. Euro-dollar rates were mostly firmer in the first two weeks of June and rose quickly in the week before the floating of sterling, the three months' rate hardening from $4\frac{7}{8}$% to $5\frac{3}{4}$%. It reached 6% on the 26th, as operators were seeking to finance their sales of dollars and central banks absorbed funds from the euro-dollar market. In early July, the three months' rate eased a little to $5\frac{1}{2}$%.

Despite the rise in sterling interest rates in May, there was little narrowing in the covered interest comparison of about $\frac{1}{2}$% per annum against three months' sterling seen in April, because the cost of forward cover increased. This differential narrowed a little in the first half of June but, as forward sterling weakened sharply in the second half of the month, three months' covered comparisons rose briefly to more than 7% a year against sterling before announcement of the float. After the announcement, markets settled down and covered three months' comparisons returned almost to the same differentials as in May and early June; but one-year comparisons, which had been over 1% against sterling, moved to around par.

Central government's domestic borrowing requirement(—)



The sterling acquired from the exchange outflow was more than sufficient to finance the borrowing requirement in the June quarter.

Central government finance

The sterling which had been acquired from the substantial outflow of foreign exchange in the June quarter more than covered the central government's borrowing requirement, and a large amount of domestic debt was repaid.

In the June quarter, the central government had a borrowing requirement of rather more than £400 million (or some £375 million after seasonal adjustment).[1] This compared with a requirement of only £25 million in the same period last year (or some £175 million after allowing for the effects of the postal strike in the March quarter of 1971). Although the requirement was higher than a year ago, it was still low in relation to the requirement of £2,933 million for the financial year as a whole expected at the time of the Budget. Lending by the National Loans Fund to local authorities proved to be relatively modest, but only slightly less than in the same quarter of 1971. In contrast, borrowing by the nationalised industries was under £70 million compared with about £215 million in the same quarter of the previous year, partly because of the £100 million emergency grant to the National Coal Board in March, the bulk of which was not utilised until the June quarter when it was used to repay borrowing from the Fund.

The amount of sterling acquired from the outflow of foreign exchange over the quarter was more than enough to finance the borrowing requirement, the net total of external transactions amounting to some £930 million. This allowed the authorities to repay a large amount of domestic debt, for the first time other than in a revenue quarter for three years. This reduction was more than accounted for by sales of debt by the banking sector, including some £910 million of gilt-edged stocks – though this figure includes amounts of short-dated gilt-edged securities purchased temporarily from the banks and referred to in more detail

1 The definition of the borrowing requirement has been changed since the last *Bulletin*. Issue Department transactions in local authority bills and commercial bills are now being treated as items financing, rather than contributing to, the borrowing requirement (see annex Table 1).

later. Other domestic holders, however, continued to buy gilt-edged stocks though, as in the March quarter, at a more modest rate than in the second half of 1971. The inflow of funds into national savings, at over £150 million, remained very high. These accruals continued to be largely shared between national savings certificates, British savings bonds and deposits in the trustee savings banks' ordinary departments.

Local authorities

Longer-term local authority borrowing fell back further in the three months May to July compared with the previous three months. Borrowing from the Public Works Loan Board was lower than in the three months to April. Borrowing on market mortgages was also down and there were net redemptions of stock issues, including substantial redemptions of stocks by the Corporation of London and the Greater London Council. Net receipts from bond issues fell in the three months to July compared with the previous three months. Temporary borrowing by local authorities seems to have continued to rise for most of the period, but there were net repayments at the time of the pressure on sterling. In line with the movement in other short-term interest rates, the cost of temporary borrowing by local authorities rose from $4\frac{1}{2}$% per annum for three months' deposits at the end of April to nearly $8\frac{1}{2}$% at end-July. Local authorities' long-term borrowing rates also rose steeply: P.W.L.B. quota rates for 5–10 year maturity loans repayable in half-yearly instalments were increased from $6\frac{3}{8}$% at the end of April to 8% at the end of July, and one-year mortgage rates rose from $5\frac{1}{4}$% to over $8\frac{3}{4}$% between the same dates.

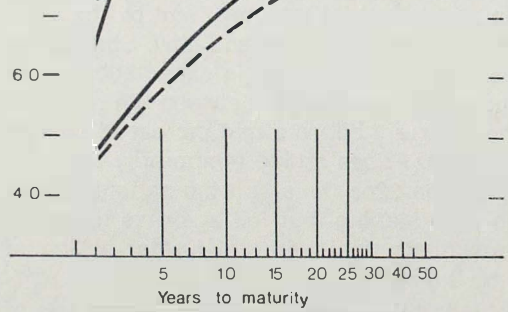
The gilt-edged market

In the three months from April to July the gilt-edged market was generally weak and yields rose sharply, particularly for short-dated stocks.

May and early June was a period of distinct weakness. Shorter-dated stocks were affected by the banks' substantial selling as they sought to finance the continuing rise in their advances, and the longer end of the market was probably influenced by the high rate of company new issues. The market was also affected by repeated bad news on wage and price inflation and industrial relations, and by the large visible trade deficits recorded in April and May. Short-dated stocks in particular were marked down in expectation of the rise in the clearing banks' base rates between 9th and 15th June and after the Treasury bill rate had increased sharply at the next two tenders. Prices rallied temporarily after the increase in Bank rate on 22nd June and the announcement of the decision to float sterling, but fell again as the availability of short-term funds tightened and further selling of gilt-edged stocks by the banks was anticipated.

The outflow of funds brought about an acute shortage of reserve assets among the banks (which are required to maintain a minimum ratio of $12\frac{1}{2}$% of these assets to their "eligible liabilities"). To meet this situation, the Bank announced on 28th June that they would exceptionally make

Time/yield curves of British government securities[a]



Yields rose sharply before the floating of sterling.

a The lines have been fitted to the gross redemption yields on dated British government stocks with coupons of 5% or higher: the dotted lines connect the calculated yield for the longest-dated stock to the flat yield on 3½% War Loan.

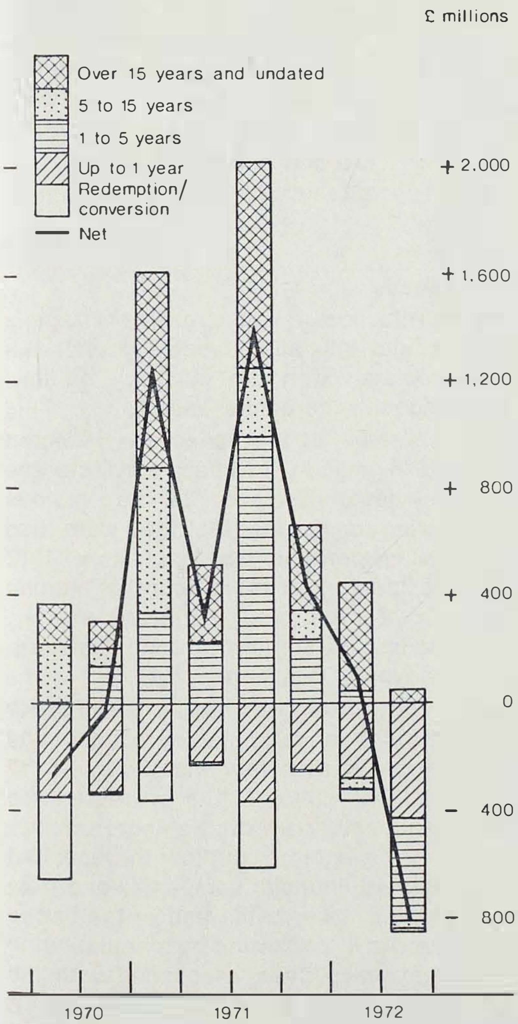
available to the banking system, should the need arise, temporary sale and repurchase facilities in short-dated gilt-edged stocks at a rate of interest of 6½%. These arrangements were designed to avoid excessive reactions in both the money and gilt-edged markets to the consequences of the outflow and particularly to obviate unduly sharp fluctuations in interest rates. Under the arrangements, the Bank bought some £360 million of stocks which were resold to the banks on 14th July. As a result, the banks obtained a breathing space in which to correct the balance of their portfolios, though the pressure on them was still such that they felt it necessary to make some increase in their base rates immediately and a further increase after the special arrangements had come to an end.

Prices fell sharply in the gilt-edged market before the special arrangements were announced, but a rally followed and the market was much steadier in the first half of July, when the authorities were able to make some sales of the long tap stock (7¾% Treasury Loan 2012/15). Disputes in the docks culminating in a strike towards the end of the month led to a renewed fall in prices, but the market was steadier early in August. On the 8th, 4% British Gas Guaranteed Stock 1969/72 and 6¼% Exchequer Loan 1972 were redeemed with only a moderate amount in market hands.

During the three months to the end of June, official transactions in short-dated gilt-edged stocks were swollen by the special purchase and resale facilities with the banks, which were reversed when the facilities expired in July. Excluding these special transactions, the authorities purchased a net total of £442 million stocks in the quarter. Almost all of this (£435 million) was accounted for by next maturing stocks – including the Gas and 6¼% Exchequer stocks redeemed on 8th August. There was a small net purchase of other stocks in the period amounting to £7 million. The authorities engaged in some limited purchases during the quarter of stocks with maturities over one year. It will be recalled that in the original proposals for *Competition and credit control*, paragraph 13(ii), it was stated that the Bank "reserve the right to make outright purchases of stock with more than a year to run solely at their discretion and initiative". During the quarter the authorities bought a net £17 million of stocks with over one year and up to five years to maturity and a net £40 million of medium-dated stocks. They sold a net £50 million of long-dated issues. These figures reflect switching by the authorities between stocks in different maturity groups as well as the outright purchases. The banking sector reduced its holdings of gilt-edged by some £550 million and other holders continued as net buyers, taking a further £111 million.

From the end of April until the floating of sterling, yields on all stocks rose sharply, on short-dated by 2%–2½% and on long-dated by about 1%. Afterwards yields fell at first by up to ½% but subsequently rose again, leaving all yields substantially higher at the end of July than three months earlier, but with the largest increases in the shorter-dated stocks.

Three firms of jobbers have recently withdrawn from the gilt-edged market, one after only a few months' operations, Official transactions in gilt-edged stocks by maturity



After a long period of substantial net selling of stock, the authorities were net buyers in the second quarter, mainly of next maturities (but also including other short-dated stocks under the special arrangements with the banks).

but taken together these firms only accounted for a small part of the business in British government stocks. These withdrawals were no doubt due in some part to the general fall in prices in the market in recent months. After the modification of the Bank's operations in May 1971, it was recognised that a period of falling prices would subject the market to some difficulties as they adapted to the new conditions. But on the whole the market has continued to function satisfactorily; there is little evidence that it has at any time been seriously impaired, and turnover continues on occasions to be exceptionally high. During the first four and a half months of 1971, before the Bank's changes were introduced and when yields were falling, turnover in all sections was large. In the four weeks immediately after the announcement, turnover in medium and longer-dated stocks declined, but it thereafter increased and was unprecedentedly high in January 1972. Turnover in shorter-dated stocks was large throughout 1971. After January 1972, when yields stopped falling and then began to rise, turnover was lower in all maturities, though still higher than before 1971, and much higher than in the first half of 1969, the last period when yields had risen substantially. As might have been expected, after May 1971 the official share of turnover declined – from 25% in the first quarter of 1971 to 11% in the first quarter of 1972. The discount houses and "other holders"[1] were the main groups to increase their shares.

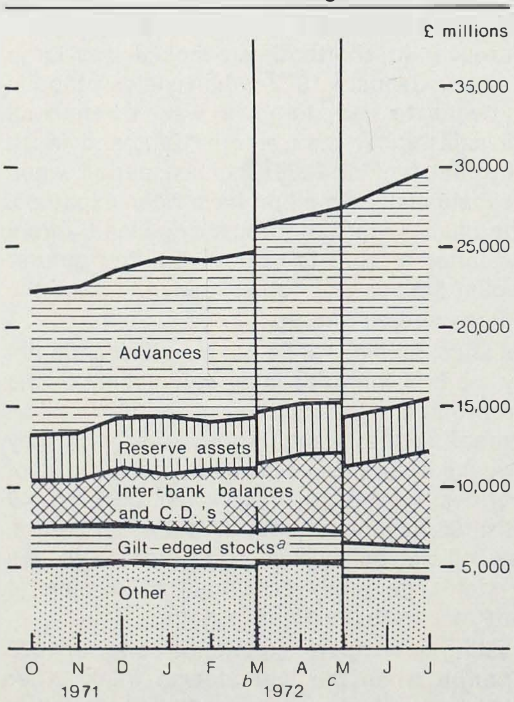
Preliminary statistical studies, while not conclusive, do not indicate any very marked increase in price volatility in the period immediately after the introduction of the new policy. For example, comparing the twenty weeks after 14th May with the twenty weeks before, the Financial Times index of government securities moved by more than 0·20 on 40 working days out of 98, compared with 37 out of 95 before. However, the new official policy was hardly tested in this period, because yields generally continued to decline at much the same rate as before the policy change.

It is more interesting to compare experience so far in 1972 with an earlier period when the market was weak. After January 1972 yields moved up slowly until mid-May, and then rose very sharply indeed. As already explained, the weakness of the market in this period reflected growing anxieties about inflation, depressing industrial news, and the outlook for the balance of payments; and the steepness of the rise in yields cannot be ascribed solely to the change in the authorities' policy towards the market. Nevertheless the new official tactics were no doubt among the influences behind an increase which occurred at this time in the size of fluctuations in the Financial Times index. The index moved by more than 0·20 on 61 days (on 13 of which the movement exceeded 0·60) out of the 127 working days of February to July 1972, compared with 46 days (and 2 days) out of the 124 working days of the first six months of 1969, the last period in which there had been a substantial and sustained rise in the yield on gilt-edged stocks. Wider swings in interest rates were always expected to be a consequence of the new system.

1 As shown in Table 14 of the annex. This group includes jobbers but excludes banks and other financial institutions.

The Bank announced on 14th July that they had recognised three more firms of stockbrokers as money brokers able to borrow money or stock from financial institutions in order to assist jobbers in making a market in gilt-edged stocks and company securities. The three firms were James Capel & Co.; Hoare & Co., Govett; and Rowe and Pitman. Previously, the only three authorised money brokers were Cazenove & Co.; Laurie, Milbank & Co.; and Sheppards & Chase. These recognitions are consistent with the encouragement of competition generally under the new arrangements for control of credit.

Distribution of banks' sterling assets



The banks continued to expand their advances strongly in the three months to mid-July, and reduced their holdings of gilt-edged stocks with over one year to maturity.

a Excluding those with less than one year to maturity (held as part of reserve assets).
b Five finance houses, now banks, added to series.
c Fixed rate export and shipbuilding business in "other" transferred to advances.

Banks and discount houses

Bank lending to the private sector again rose very rapidly in the three months to mid-July and, especially after the liquidity pressures associated with the currency outflow, there were marked changes in the banks' assets.

The growing competitiveness of the banks was reflected in an increase of £3,046 million in their total sterling deposits, a considerably faster rise than in the previous three months, even allowing for the fact that they were then affected by payments of corporation tax. Deposits of U.K. banks and other U.K. residents and the amount of sterling certificates of deposit outstanding all increased sharply. Largely reflecting the selling of sterling in June, however, overseas deposits fell by over £200 million.

On the assets side (and allowing as far as possible for some breaks in the statistical series[1]), sterling advances to U.K. residents other than banks rose very sharply, by £1,817 million, compared with £1,249 million in the previous three months. As already mentioned, part of the increase was probably associated with the external outflow in June. But demand from commercial and financial companies and from persons was again high, and towards the end of the period there was also some increase in borrowing by manufacturing industry. Part of this may have been associated with the recovery in output which began in the second quarter but it is also possible that some companies may have drawn on unused facilities with the banks to relend the funds at the exceptionally high rates obtainable in the money markets during and after the run on sterling. The London and Scottish clearing banks had already raised their base rates for loans and deposits by $\frac{1}{2}$% between 9th and 15th June and, as the pressure on sterling developed, they increased them by a further 1% on 30th June, so that the base rate for lending then stood at 6% and the rate for ordinary deposit accounts at 4%. The banks increased their base rates again on and after 21st July to 6$\frac{3}{4}$% or 7% and their ordinary deposit rates to 5%, 5$\frac{1}{4}$% or 5$\frac{1}{2}$%. As already mentioned, the Governor wrote to the banks on 7th August, conveying some qualitative guidance on the direction of their lending.

Many of the banks' other sterling assets fell in the three months to mid-July. Even before the June currency outflow, they had sold a considerable amount of gilt-edged stocks, and the reduction in overseas deposits in June increased the pressure on their reserve ratios, inducing

1 See additional notes to Table 8(1) of the annex.

further sales. By mid-July, when the special transactions with the authorities had been completed, their holdings of gilt-edged stocks were £2,127 million, a fall of £364 million in the three months, of which sales by the London clearing banks were £273 million. The amount of call money lent to the discount market was also reduced in the period to mid-June but recovered sharply in July after the squeeze on the banks' reserve assets. Holdings of Treasury bills and commercial bills were not so much affected, and sterling certificates of deposit rose sharply by £552 million to stand at £2,327 million by mid-July.

The banks' foreign currency business continued to expand rapidly; deposits rose by £3,270 million, of which the American banks accounted for about one third. The bulk of these funds was lent abroad but, as in the previous three months, there was also a substantial rise, this time of nearly £250 million, in lending in foreign currencies to U.K. residents, largely for portfolio investment overseas.

Total eligible liabilities rose by £1,693 million in the three months to mid-July but reserve assets rose by only £12 million; the banks' liquidity came under pressure, especially after the currency outflow towards the end of June. The banks' combined reserve ratio thus fell from 15·7% to 14·6%, and in June and July was at its lowest since the new arrangements for control of credit were introduced last September. The ratios of most of the main groups of banks fell markedly, the exception being the London clearing banks which restored theirs by sharply increasing the funds placed at call with the discount market in the month to mid-July. This caused the main change in the composition of all banks' reserve assets in the three-month period, money at call rising by £249 million while gilt-edged stocks maturing within one year fell by £190 million.

The discount market was seriously affected by the events in June, for the banks withdrew substantial amounts of funds at call, and much official help had to be given. In May, the discount houses' total borrowed funds were reduced by £249 million but recovered slightly in June as they borrowed outside the banking system and again in July as the banks switched out of other short-dated assets. On the assets side, the houses' holdings of Treasury bills and gilt-edged securities fell by £27 million and £178 million respectively over the three months to mid-July. Altogether, the houses reduced their portfolio of public sector assets by £174 million and, by mid-July, their average public sector lending ratio had fallen sharply to 52·8% from 60·2% at mid-April.

Bill markets

Bill markets were quiet in May. To relieve modest shortages of funds, the Bank bought bills (including corporation and bank bills because of a shortage of Treasury bills) and made overnight loans. In the first half of June, the Bank sold bills on several occasions to mop up funds when government spending exceeded revenue. In the third week, however, the market began to be affected by the selling of sterling, as funds were withdrawn in settlement of foreign exchange purchases. On 26th June, the settlement day for the sales of sterling which had occurred just before the closure of the foreign exchange market and for the official sales of gilt-edged stocks on the day the decision to float was announced, the money market experienced unprecedented shortages. The Bank bought an exceptionally large amount of bills and lent an exceptional sum for seven days. On the next day, help was again given on a large scale, but conditions then eased. At the end of the week, when the Bank bought stock from the banks under the special purchase and resale arrangements, the resultant funds placed in the market were absorbed through official sales of bills. These bills were due to mature on the date when the banks would have to take back their stocks. As a result the repurchase on 14th July caused little disturbance to the markets.

At the Treasury bill tenders in May, the highest rate at which tenders were accepted was unchanged at just over $4\frac{1}{4}$%. It rose to $4\frac{3}{8}$% on 2nd June in acknowledgement of the increase which had already taken place in other short-term rates. But the Bank raised their own dealing rate unusually in the middle of the next week and, partly in response to this signal, the rate rose sharply at the next two tenders to nearly $5\frac{5}{8}$%, substantially above Bank rate. At the tender on 23rd June, only £60 million of the £240 million bills on offer were allotted because it was known that, with large foreign exchange settlements to be made, the market would be short of funds. For the same reason the authorities did not allot the full amount at the next tender when the highest rate accepted reached $5\frac{3}{4}$%, in line with the Bank's own dealing rate since the increase in Bank rate. In July, bidding was keen for the small quantities of bills on offer and the tender rate fell to $5\frac{1}{2}$% on the 14th. The Bank maintained their dealing rate, however, at $5\frac{3}{4}$% and, by the end of the month, the highest rate accepted at the tender had moved into line.

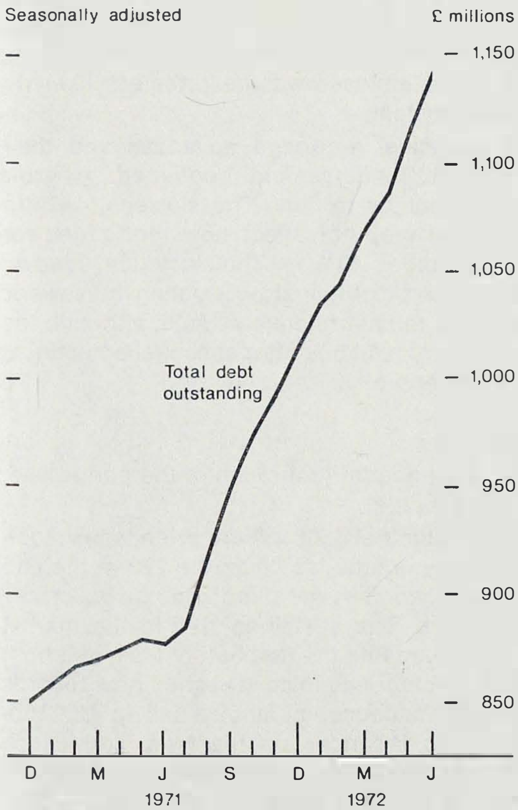
The average cost of the discount houses' borrowed funds increased quite sharply in the three months to the end of July to around $5\frac{5}{8}$%. Selling rates for fine bank bills, which stood at about $4\frac{1}{2}$% at the end of April, rose to 7% at the end of July. For most of the time since the introduction of the new arrangements for control of credit, rates for bank bills not eligible for rediscount at the Bank had moved only some $\frac{1}{8}$%–$\frac{1}{4}$% above rates for eligible bills. When pressure on the discount houses' public sector lending ratios and the banks' reserve ratios became intense in the second half of June, however, the marketability of ineligible bank bills declined rapidly, market buying rates rising to some $1\frac{1}{4}$% above eligible bills and even exceeding rates for trade bills. A broad margin between eligible and ineligible bank bills persisted to the end of July.

Finance houses

The finance houses' instalment credit business expanded rapidly between April and July. The eleven reporting finance houses continued to build up their ratio of reserve assets.

At the middle of July, the eligible liabilities of the eleven reporting finance houses stood at £236 million. With reserve assets at £20 million, the houses' combined reserve ratio was 8·4%, compared with 6·6% in mid-April. The finance

Finance house lending



Finance house lending continued to rise strongly in the June quarter.

houses have been asked to build up their reserve ratios to 10% by 20th September.

At the end of the June quarter, the seasonally adjusted total of outstanding hire purchase and other instalment debt owed to the finance houses stood at £1,144 million. This was £75 million higher than at the end of the March quarter, and was a record increase for one calendar quarter. In May alone, finance house outstanding debt rose by £31 million – a monthly increase exceeded only once before, in August last year, the first full month after the removal of hire purchase terms control. The growth in instalment debt had appeared to be slowing down at the end of last year and in the first few months of 1972, and the recent revival seems to have been due partly to further purchase tax cuts in the Budget and partly to the Budget measure allowing tax relief on interest payments of more than £35 a year on personal loans. New credit extended to finance purchases of new cars rose to £59 million and was comparable with the high figures recorded in the preceding three quarters, while credit extended for other goods (which includes personal loans not identified with specific purchases in the statistics) rose sharply to £117 million against £86 million in the previous quarter.

The rates on three-month deposits quoted by finance houses rose from $4\frac{3}{4}$% at the end of April to $8\frac{1}{2}$% by the end of July. The Finance Houses Association base rate, which is used to calculate charges for some longer-term industrial and commercial lending, was lowered from $5\frac{1}{2}$% to 5% on 1st May. It was raised to 6% at the beginning of July and further increased to $7\frac{1}{2}$% at the beginning of August.

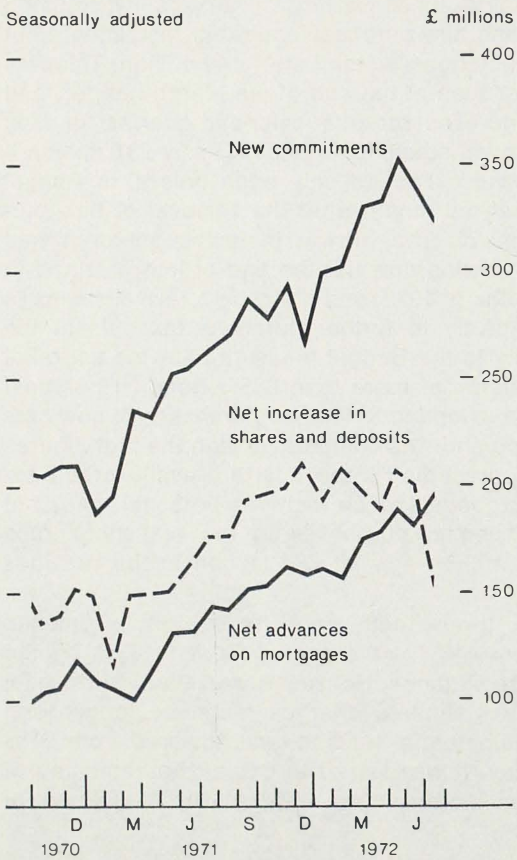
Building societies

The net inflow of funds into the building societies slowed down in the three months to July, while mortgage advances and future lending commitments increased further.

The societies' gross receipts in the three months May to July were considerably higher, after seasonal adjustment, than in the previous three months; but withdrawals were also much higher, particularly in June and July. The trend of withdrawals has been rising rapidly since early in 1971, and they were about 65% of the gross inflow in May to July compared with an average of some 58% in 1971. As a result net receipts were less in total than in the previous three months and were declining month by month.

There were various reasons why the net inflow of funds into building societies was being reduced. Consumers may have been withdrawing money to spend; at the same time, interest rates on alternative investments had risen, especially those on short-dated gilt-edged stocks and bank deposits. Investors are fairly sensitive to changes in interest rate differentials between building society accounts and other liquid assets, and significant amounts are commonly moved within the twelve months or so after such changes in relative rates. This substitution may have become more important recently if, as the more rapid turnover of building society accounts may suggest, these accounts are increasingly

Building society funds



The net inflow of funds into the building societies fell sharply in July; advances continued to rise, but new commitments were rather lower.

being used as short-term banking deposits. The societies may well continue to lose funds, given the narrowing of the interest rate differential in June and July. The Building Societies Association decided, at a meeting early in August, not to recommend an increase in rates for the time being, but indicated that some increase was nevertheless likely to be inevitable before very long.

Meanwhile the societies' mortgage advances and their commitments to future lending both continued to grow strongly in the three months to July. The slower growth in the net inflow of funds may not affect new mortgages for some time, because about 40% of the societies' lending comes from repayments of principal by existing borrowers. Moreover, the societies remain relatively liquid, although the liquidity ratio dropped from 18·5% after seasonal adjustment in April to 17·6% at the end of July.

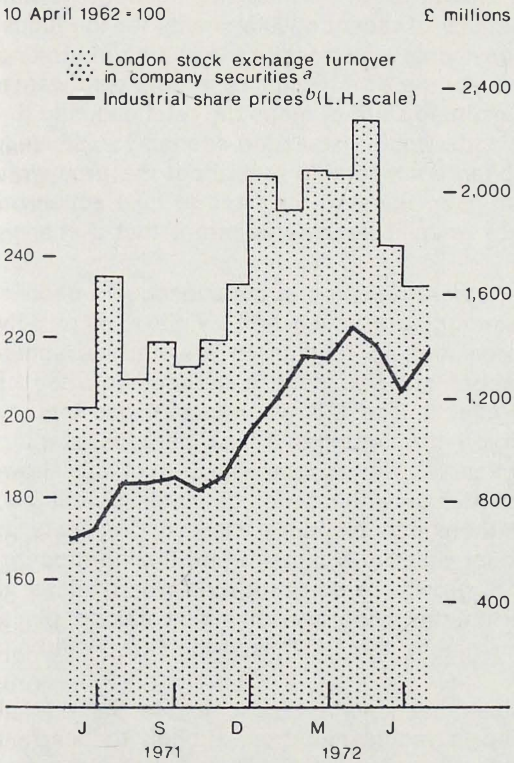
Company securities

The equity market was uncertain for much of the period and, on balance, prices fell a little.

The F.T.-Actuaries industrial (500) share price index stood at 218 at the end of July, a little less than the 223 at the end of April. These three months were marked, however, by some sharp fluctuations. The sustained rise in the market since December continued into the first half of May, and both the F.T.-Ordinary and Actuaries indices reached new records on 19th May after the announcement of a fall in U.K. unemployment and a rise in prices on the New York stock exchange. The market subsequently dropped quite sharply, nervously awaiting the outcome of renewed industrial action on the railways and in the docks and depressed by the poor May trade figures. The rise in Bank rate in June and the floating of the exchange rate were at first well received, but prices then fell further, to some extent perhaps reflecting the pressures in money markets and rising interest rates at the end of June. By mid-July, however, a recovery was taking place as evidence became firmer of an acceleration in economic growth in the second quarter. The recovery paused as disputes in the docks led to strike action but, by the middle of August, prices were rising, and the F.T.-Actuaries index had regained the high point reached in mid-May.

Although the market was uncertain for much of the period, many companies were still very keen to make new issues of shares, and the queue of prospective borrowers lengthened still further. On 10th August, it was announced that, from 1st September, companies need only join the queue if they wished to raise £3 million or more. The previous limit of £1 million had been in force since 1959. It is hoped that this change will materially reduce the waiting time for new issues coming to the market, which has recently been about six months. In the three months to the end of July, net issues totalled £368 million, a rise of £90 million over the previous three months. Within this total, only a small proportion was taken by manufacturers, the largest part, £224 million, being raised by financial companies, of which £172 million was by investment trusts.

Industrial share prices and turnover



The equity market was unsettled, with prices falling slightly and turnover also down.

a Monthly total.

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

Both capital issues and foreign currency borrowing by investment trusts have recently risen sharply. Their net capital issues amounted to a record £116 million in 1971; already in the first seven months of 1972 they have raised £291 million, and they still account for an appreciable proportion of the queue of prospective borrowers. This resurgence in investment trust issues was helped by the recovery in equity prices during 1971 both in London and Wall Street, and falling dividend yields which reduced the cost of equity issues as a form of finance. The 1972 Finance Act, by halving the capital gains tax payable by investment trust shareholders, increased their attraction for potential investors, especially the less highly taxed. The trusts have traditionally been heavy buyers of foreign currency securities, partly financed by foreign borrowing; and borrowing in foreign currencies has been given a new impetus this year, to some extent because of fears that the investment currency premium might be sharply reduced for E.E.C. securities after U.K. entry. Several large new domestic issues have been made recently by trusts specialising in E.E.C. and Japanese shares. Foreign currency borrowing from U.K. banks to finance portfolio investment abroad rose substantially and accounted for a large part of the recent rise in bank advances to the financial institutions.

Yields on company fixed interest securities rose sharply in the three months to the end of July, but rather less quickly than those on gilt-edged stocks. At the end of July, first-class high-coupon stocks of about 25 years' maturity were yielding over $9\frac{1}{2}$%, about $\frac{3}{4}$% more than at the end of April. The rise in yields on comparable gilt-edged securities was nearly 1%, so that the differential between them narrowed to less than $\frac{1}{4}$%.

Unit trust sales continued to increase in the June quarter. Gross sales amounted to £131 million and, with repurchases at £56 million, net sales were £74 million – substantially more than the £32 million in the March quarter. These results were helped by the launching of several new trusts. In July, gross sales increased slightly to £44 million, while net repurchases fell. Net sales, at £30 million, were the highest since February 1969.

Conclusion

The decision to float sterling on 23rd June was taken after a loss of reserves of over £1,000 million in six working days. The speed with which the selling of sterling developed once again emphasised the increasing size and volatility of the movements in short-term funds which can be generated in the foreign exchange markets. Such large and rapid movements create difficult problems of monetary management in the many countries involved, and bring home the pressing need to seek solutions through reform of the international monetary mechanism and the establishment of a more stable system.

On this occasion, the loss of confidence in sterling reflected less the present position than expectations about the U.K. economy – the balance of payments surplus on current account, though heavily reduced in the first half of the year, was still running at an annual rate of some £300 million a year, a figure which would have been considered adequate by the standards of the last two decades. It was rather the implications of recent developments for the future U.K. balance of payments which led to the selling of sterling – in particular the course of movements in domestic wages and prices; the unsettled state of industrial relations; and the likelihood that imports would rise as the economy expanded. There had also been considerable talk about the prospects for the balance of payments and the need to take action on the exchange rate when it became apparent that a change was necessary.

These influences were reflected in the subsequent decline in the floating sterling rate which had by the end of July produced a depreciation in relation to the parities established last December of 6¾%. Such a depreciation has its own inflationary effects. The U.K. Government has already declared its intention of returning to a fixed parity for sterling as soon as practicable. The accomplishment of this, however, and the maintenance thereafter of stable conditions, will be easier if there can be more assured prospects at home than in recent years of a marked and lasting moderation in the rate of growth in domestic costs and prices. It must be hoped that the tripartite talks now taking place between the Government, the T.U.C. and the C.B.I. will help towards this.

There has indeed been some slackening in the rate of increase in prices in recent months – though the current pace obviously remains unacceptably high. But earnings are, if anything, accelerating again and there is a great danger that prices will soon do likewise. Now that the expansionary fiscal and monetary policies of the past twelve months have clearly begun to produce the strong growth in activity which they were intended to achieve, the highest priority must be given in all aspects of policy to the reduction in the rate of inflation.