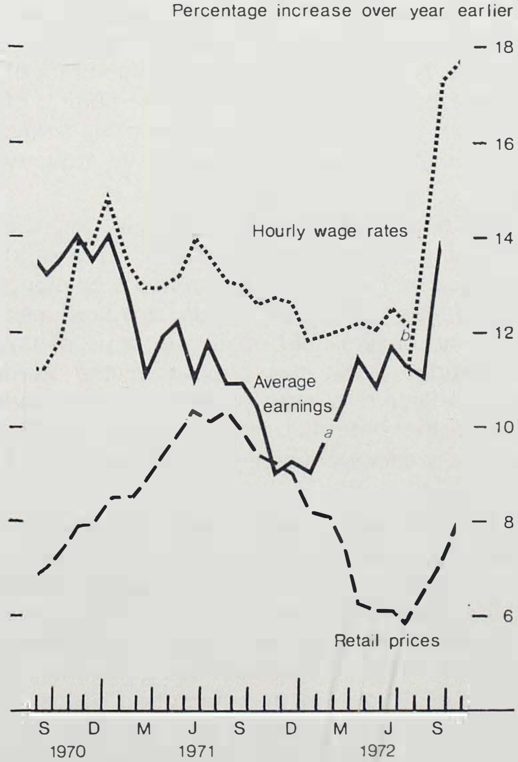
Commentary

The main concern of economic policy and the preoccupation of financial markets in the three months from August to October discussed in this Commentary was the growing domestic wage and price inflation. Unemployment was falling and output rising, though the development of the main forms of demand and output was uneven, with personal consumption buoyant and suppliers of consumer goods busy, while fixed investment was sluggish and manufacturers of capital goods were short of work. The effect of all these influences on the balance of payments was obscured by the U.K. dock strike. In the foreign exchange market, the floating sterling rate was fairly steady during August and the first half of September, but then fell sharply. The domestic money stock rose less quickly than in the previous quarter. The increase in bank lending to the private sector was also smaller, and the central government deficit showed no signs of reaching the amount expected in the Budget. But on 9th November the Bank called for Special Deposits from the banks and finance houses observing reserve ratios to help to moderate the effects on their liquidity of an anticipated sharp increase in the government deficit later in the year. Short-term interest rates fell back a little after the end of July but were still well above those prevailing in the first five months of 1972; and they rose again at the end of October. In the discount market, increases in Treasury bill rates took them above Bank rate, and, in October, the Bank linked their minimum lending rate directly with market rates.

After the breakdown early in November of discussions with the Confederation of British Industry and the Trades Union Congress, the Government announced a short statutory standstill on prices, incomes and dividends, as a holding measure to allow time for the preparation of longer-term and preferably voluntary arrangements.

Wages, earnings and prices



Wage and price inflation began to accelerate sharply after July.

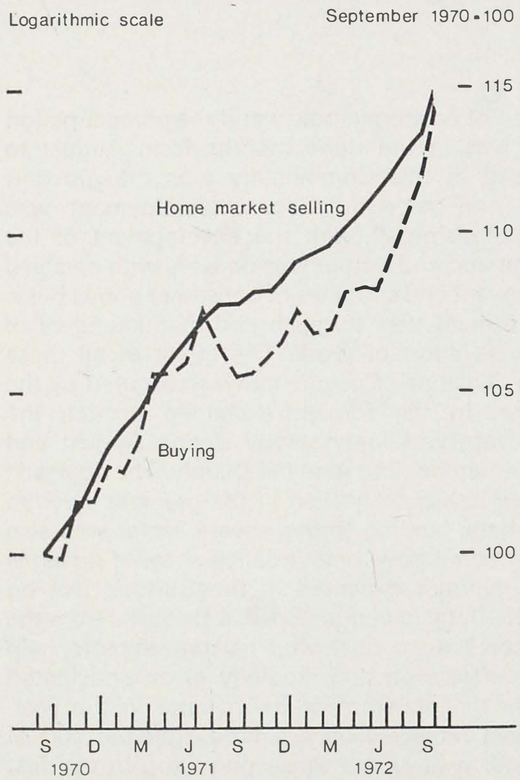
a Not available.
b Series reweighted according to the pattern of industry in 1970.

Costs and prices

In the three months August–October, discussions between the Government, the C.B.I. and T.U.C. continued against the background of an accelerating increase in domestic costs and prices.

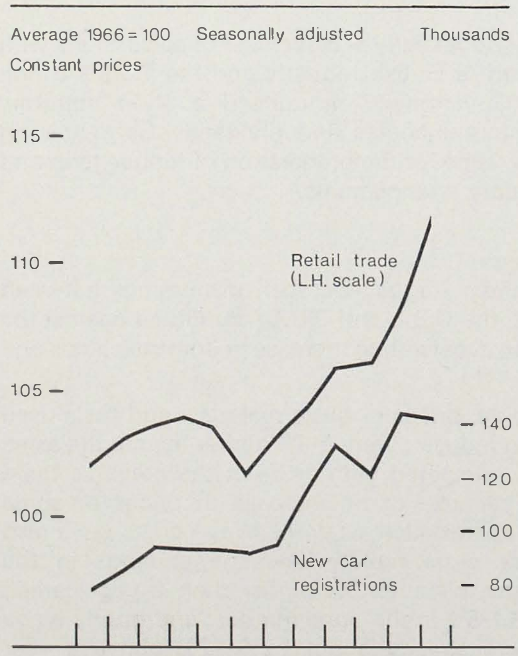
On the cost side, prices of basic materials and fuels used in manufacturing industry were 6·4% higher than in the same period of 1971, compared with 1·9% in the previous three months, partly because of an increase in prices of some imported commodities such as wool. Wage costs were also moving upwards more rapidly. Average earnings in the September quarter were 12·1% higher than a year earlier, compared with 11·3% in the June quarter; and hourly wage rates, which were already about 11%–12% above a year earlier in May–July, rose to 16·5% above in August–October. Some workers, including large numbers in the engineering industry, were covered in this period by settlements which gave

Manufacturers' prices



Buying prices turned sharply upwards and began to be followed by selling prices.

Retail trade and new car registrations



Retail sales continued to rise rapidly in the third quarter and new car registrations remained high.

them a second substantial increase in minimum rates within twelve months. Several large claims were also outstanding.

Though the rate of increase in productivity so far this year has been fast – output per head in production industries was at a rate of some 7½%–8% greater than a year earlier – the quickening of the rise in costs was beginning to affect selling prices. Wholesale prices of manufactured goods in the home market were 5·4% higher in the three months August–October than in the same quarter of 1971, as against 4·3% in the previous three months; and retail prices moved up to 7·1% in August–October compared with a year earlier, as against 6% in May–July.

When the series of talks between the Government, C.B.I. and T.U.C. ended without agreement early in November, the Government announced a standstill on increases in prices (including rents), wages and salaries, and dividends. The standstill was to take effect immediately and to last for ninety days from enactment of the enabling bill, with provision for an extension of sixty days if required. Special allowance was made for changes in the cost of imported raw materials and unprocessed agricultural products; and for increases in earnings from higher output, incremental scales or promotions. Pay settlements reached before 6th November but which would otherwise have taken effect during the standstill were to be deferred until it had ended.

Expenditure and output

The development of the main forms of domestic demand and output in the September quarter was uneven. Personal consumption continued to grow strongly and manufacturers of consumer goods were busy, but this welcome beginning of an expansion was slow to work through; some other forms of demand were still subdued and much of heavy industry was under-utilised.

Consumers' expenditure grew quite strongly for the second quarter running. Some of the 2¾% increase in volume in the June quarter may have represented a catching up after the low first quarter, when the miners' strike reduced output and when some buyers held off in the hope of tax reductions in the Budget; but the growth in the third quarter presumably reflected a rise in real incomes and lower tax rates. The volume of retail sales increased by 3%, and registrations of new cars were again very high, as in the previous quarter.

Other forms of demand taken together were less buoyant than consumption. There was no improvement in stocks, which had been run down in 1971 and again very markedly in the first half of 1972 when they were affected first by the miners' strike and power shortages and later by the strong growth in consumption. They continued to fall quite sharply in the third quarter, especially in manufacturing industry, perhaps partly because of the continued rise in output and partly reflecting supply shortages caused by the dock strike.

Current spending by public authorities on goods and services has been rising in real terms at an annual rate of some 3% since the end of 1970. But investment in housing by the public sector was down temporarily in the September quarter and private sector spending on housing, though high, was probably little more than maintained. Work in both sectors was curtailed by a strike of construction workers but, to judge from advances by the building societies, demand for private housing remained strong. Other fixed investment by private industry in the September quarter may have edged upwards again, after the recovery in expenditure by the distribution and service industries in the June quarter, but capital spending by manufacturers alone probably failed to show any improvement after falling sharply in the previous three months. The C.B.I. survey taken in October pointed to some increase in investment in the next twelve months, and broadly confirmed the most recent official survey of intentions taken in August–September. This suggested that manufacturing investment may not start to pick up until 1973. These surveys have in the past been less reliable when the trend in investment has been changing; but there has normally been a substantial lag before changes in output are reflected in investment, and the rise in manufacturing production in the second and third quarters of this year was the first substantial upward movement since as long ago as 1968. Much investment is financed out of profits which, though they have recovered in the last two years, were still historically low; and manufacturers were also unlikely to be planning large increases in investment while capital utilisation remained relatively slack.

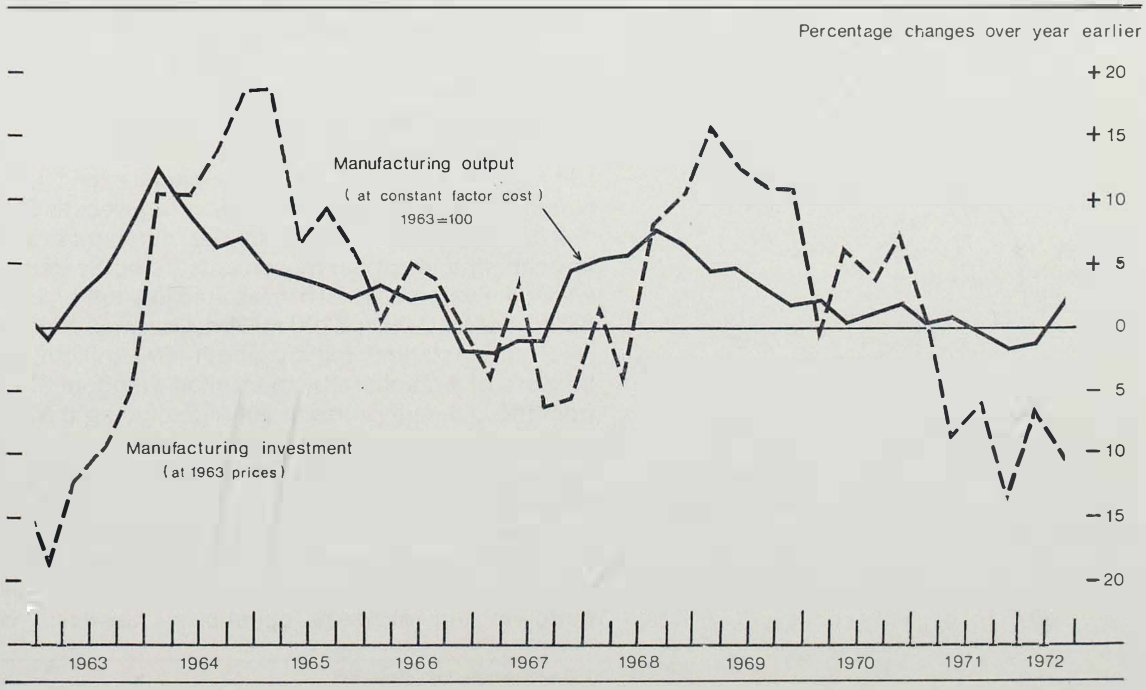
Capital utilisation index [a]
1964 IV = 100

	I	II	III	IV
1969	94·7	95·6	94·8	94·3
1970	94·3	92·2	92·2	92·5
1971	90·7	90·5	89·2	88·1
1972	86·9	89·7	90·3	

a After adjustment for revised estimates of the capital stock.

In fact, capital utilisation in the September quarter continued to recover from its low point in the first quarter of 1972, reflecting a further increase of 1% in industrial production. The rise in total production was smaller than in the June quarter because of the builders' strike; but manufacturing production was up by 2·3% in the quarter, and the trend in industrial output seemed to be broadly consistent

Changes in investment and output



Past changes in manufacturing investment have tended to lag behind changes in output.

with the Government's aim of an annual growth rate of 5%. In line with the pattern of demand, production by consumer goods manufacturers and by the motor industry continued to be high, but order books in heavy industry remained low. Meanwhile, the falling trend in unemployment continued. In the four months to the November count, the number out of work fell by 48,000 after seasonal adjustment to 3·3% of the total number of employees. Some shortages of certain kinds of labour were beginning to be reported from some areas, but not on a scale consistent with the recently apparently rapid growth in recorded vacancies.

Balance of payments

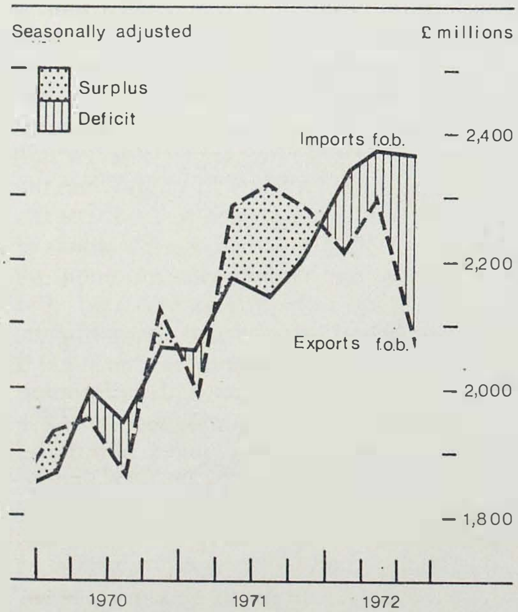
The current account of the U.K. balance of payments will have been influenced in the September quarter by the growth in domestic consumption, by the effect on the cost of imports of the depreciation of sterling since June, and by an increase in world commodity prices. These influences may to some extent have been matched by recovering demand in several important export markets. But the U.K. dock strike in July and August makes it difficult at this stage to assess the underlying trends. The strike affected exports in the September quarter much more than imports, so that the total value of exports fell by some £220 million to £2,055 million but imports, at £2,335 million, were only slightly down. As a result the visible trade deficit after seasonal adjustment widened from around £75 million in the June quarter to some £280 million.

In October, exports and imports were large, as the backlog of goods delayed by the strike was made good, and the trade deficit fell to £47 million after seasonal adjustment compared with a monthly average of £93 million in the September quarter. By the end of October, it was likely that most of the delay in imports had been recovered, but that some remaining backlog of exports was still to come. The strike will have meant, however, a permanent loss of some exports as foreign buyers who were unable to obtain goods ordered from the United Kingdom turned to other suppliers.

Meanwhile the net invisibles surplus in the third quarter was a little higher than in the second at £174 million, but still slightly below the quarterly average for 1971; and the current balance swung into a deficit of just over £100 million.

After the large outflow in the June quarter, identified investment and capital movements in the September quarter were relatively modest. They resulted in another, but small, net outflow of just under £100 million. Other countries' exchange reserves in sterling fell by about £90 million, but largely because of a purchase by the United Kingdom of £83 million from the U.S. authorities in July.[1] Excluding this transaction, there was little net movement in either official exchange reserves held in sterling or in private sterling balances. Overseas borrowing in sterling from U.K. banks (other than for export credit) rose by only £13 million, as some of the exceptionally high borrowing of over £200 million recorded in the previous quarter was repaid. The banks' net external borrowing in overseas currencies, however, was again

Balance of U.K. visible trade



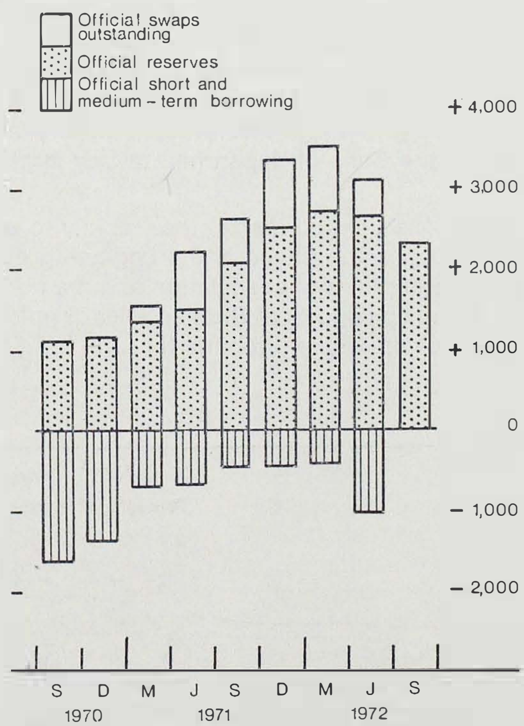
The overseas trade deficit in the third quarter was increased by the dock strike.

1 September *Bulletin*, page 309.

substantial in the third quarter, rising by over £200 million. As before, a large proportion was used to finance investment overseas by U.K. investment and unit trusts. Other private investment produced a modest net inflow. The balancing item swung from a large negative figure of nearly £400 million in the second quarter to a positive figure of £150 million in the third quarter. Although it is possible that this may signify some reversal of the large unidentified outflows in the June quarter, the main influence was probably the dock strike, which must have upset the normal timing relationships between movements of goods (as shown in the balance of payments accounts) and payments for them.

Reserves and official financing[a]

Figures at end-quarters £ millions



The reserves fell sharply, largely because of the repayment of short-term liabilities to E.E.C. central banks.

a From the third quarter of 1972, the reserves have been redefined to include the U.K. reserve position in the I.M.F.

Reserves and official financing

The total currency outflow in the September quarter of 1972 was £79 million. The short-term liability of £1,001 million to E.E.C. central banks (which had arisen because of the run on sterling towards the end of June) was also repaid in the period.[1] Of the total £1,080 million, £441 million was financed from the outstanding amounts previously swapped forward with overseas monetary authorities. The remaining £639 million was provided from the reserves, including £259 million from the U.K. reserve position in the International Monetary Fund, the full £292 million of which was taken into the reserves during July. At the end of September the reserves stood at £2,337 million.[2]

Foreign exchange and gold markets

Sterling was floating during the three months August–October. It remained fairly steady until the second half of September, but then depreciated sharply.

By the middle of July it had become clear that, with the pound at around U.S. \$2·45, the market's day-to-day transactions in sterling were for the time being in balance. News which might normally have affected confidence had little effect on the rate. The pound rose to \$2·4550 when the docks dispute was settled but soon returned to \$2·45. At the beginning of September, dealers' concern about the effects of domestic inflation increased, but sterling was protected by some demand for spot funds from those who had sold forward in June and now wished to meet their commitments. The demand fell away on the 22nd, three months after sterling had been floated. The movement coincided with unfounded reports that a new parity would be fixed at the meeting of the I.M.F. the following week, and with anxieties about the repercussions of the Scandinavian referenda on E.E.C. entry. For the first time for over two months there was some fairly heavy selling of sterling, and the rate fell to around \$2·43. Several days later the Trades Union Congress's rejection of the Government's initial proposals on prices and incomes set off another fall. While the discussions between the Government, C.B.I. and T.U.C. continued during October, a number of reports suggested that sterling might be refixed at points below \$2·40. Some overseas holders sought protection against these possibilities and the rate fell sharply, touching around

1 September *Bulletin*, page 309.

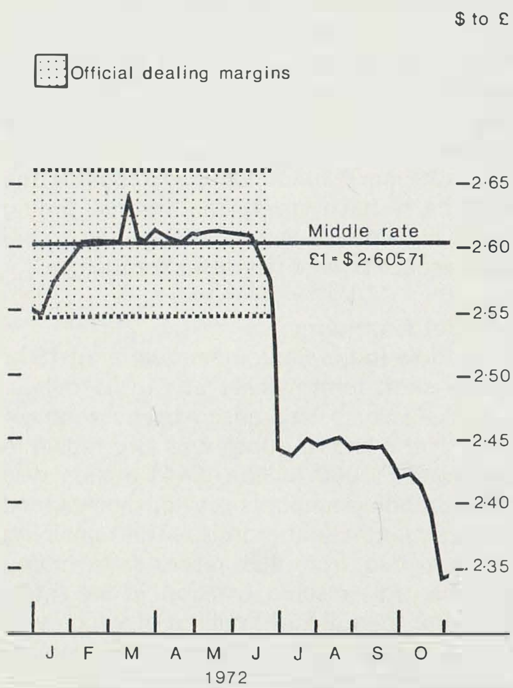
2 Valued at the official middle rate of \$2·60571. Movements into and out of the reserves are valued at the rates at which transactions took place.

$2·3225 before closing at the end of October at over $2·34. This represented an effective devaluation against all other currencies of about 10½% compared with the middle and central rates agreed in December 1971. After the announcement of the prices and incomes standstill in November, sterling settled around $2·35 for most of the rest of the month.

The U.S. dollar continued to improve in most markets during August and early September. The improvement reflected rising U.S. short-term interest rates, interventions in the foreign exchange markets by the Federal Reserve Bank, and the slower growth of U.S. prices. At the end of September, confidence in the dollar was helped by the co-operative atmosphere at the I.M.F. annual meeting, so that the West German and Swiss authorities were subsequently able to make some modest sales of dollars. But towards the end of October the sharp fall in sterling led briefly to some reappraisal of other currencies: the French franc, the Italian lira and the Scandinavian currencies eased and the improvement of the dollar was checked in terms of deutschemarks and Swiss francs. Meanwhile there continued to be a strong feeling in foreign exchange markets that the Japanese yen might be revalued and the Bank of Japan had to buy large quantities of dollars.

The price of gold on the London market rose rapidly to a new record of U.S. $70 per fine ounce at the beginning of August, largely because of renewed speculation about a rise in the official price. But the prospects of Russian sales of gold to finance large grain purchases, and reports that the I.M.F.

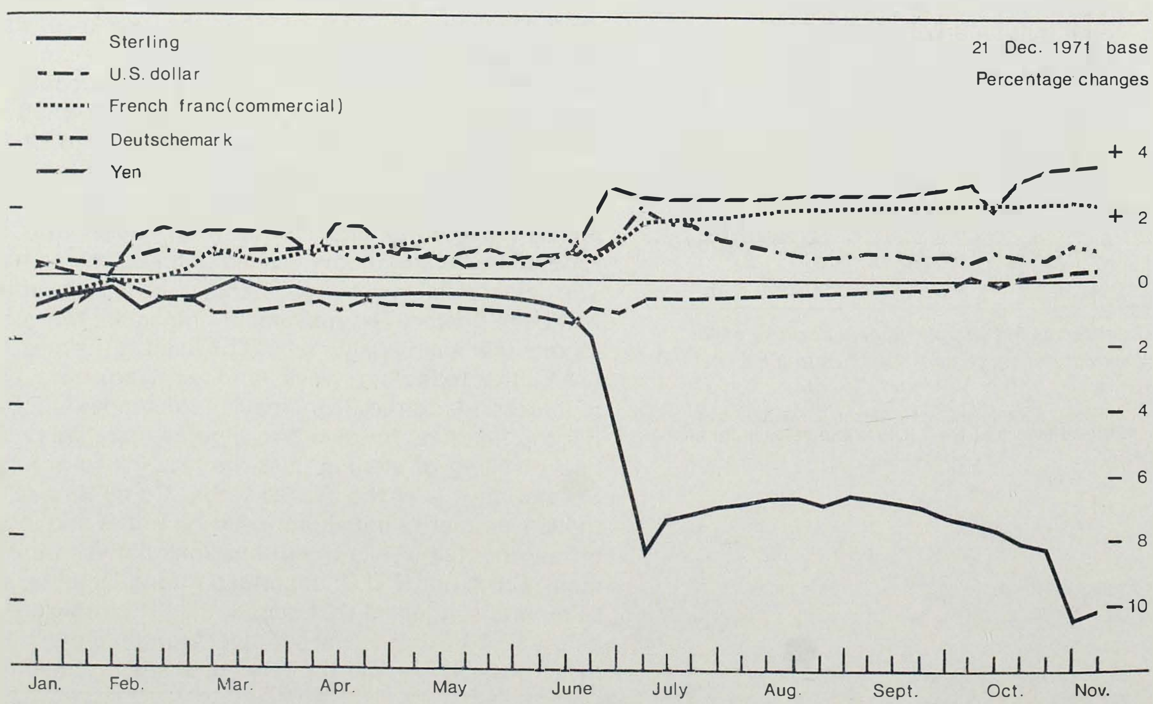
Spot rate for U.S. dollars in London[a]



After seeming fairly settled for over two months, sterling depreciated sharply against the U.S. dollar from mid-September.

a Weekly middle closing rates, Fridays, except for Thursday, 22 June.

Effective changes in exchange rates[a]



The U.S. dollar and the yen strengthened in the three months to the end of October while sterling depreciated sharply.

a Each line represents the appreciation/depreciation of a currency against all other exchange rates, based on the position at 21 December 1971.

were considering the possibility of gold sales led subsequently to a gradual decline in the price. It fell momentarily to \$61·25 in the middle of September but quickly returned to around \$64 and was little changed up to the end of October. In the first half of November, the feeling that prospects of a rise in the official gold price were receding, coupled with the continued fear of substantial Russian gold sales, appeared to inhibit demand, and the price fell back to under \$61.

Sterling guarantee agreements

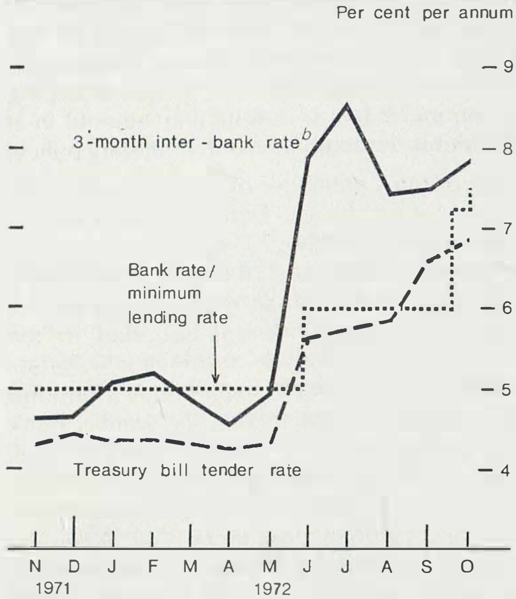
The fall in sterling during October and November brought into play the U.K. guarantee arrangements in the sterling agreements. Under these agreements, made originally in 1968 with individual overseas sterling countries and subsequently renewed with most of them in September 1971, each country undertook to hold a minimum proportion of its official reserves in sterling, in return for a U.K. guarantee in terms of the U.S. dollar for any official sterling held in excess of 10% of total reserves. The guarantee is to be implemented if the middle sterling/U.S. dollar rate in London falls, and remains for a period of thirty consecutive days, below \$2·3760 (*i.e.* 1% below the parity of \$2·40 ruling when the agreements were concluded). The payment then to be made in sterling from the Exchange Equalisation Account is determined by the difference in dollar terms between \$2·40 and the closing middle rate in London on the last working day of the thirty-day period, applied to eligible balances on the day preceding the thirty-day period. The closing middle rate first went below \$2·3760 on 25th October, and was still below on 23rd November when it stood at \$2·3506. The agreements were concluded in a régime of fixed rates, and consultations are taking place on the techniques for settlements under floating rates.

European Economic Community

After the Danish referendum in favour of joining the European Economic Community, the Danish authorities announced on 10th October that they would again maintain the krone within $2\frac{1}{4}$% of the rates for other E.E.C. members' currencies (inside the 'snake').

At a summit conference of the enlarged Community in Paris on 19th and 20th October, it was agreed to set up before 1st April 1973 a European monetary co-operation fund to be administered by the Committee of E.E.C. central bank Governors. The fund may develop in time into the nucleus of a Community central bank. Initially the fund will organise concerted action under the existing narrower margins scheme, and arrange settlement of positions arising from interventions in Community currencies, which will be expressed in units of account. It will also administer the central bank arrangements for short-term monetary support. Moreover, it was decided at the conference that the Community should draw up reports on the adaptation of the short-term support arrangements and on conditions for progressive pooling of external reserves by 30th September 1973 and 31st December 1973, respectively.

Short-term interest rates[a]



After the Treasury bill rate moved above Bank rate in September, more flexible arrangements were introduced for the Bank's minimum lending rate.

a Last Friday of month.

b Middle of spread at close of market.

Short-term interest rates

Short-term interest rates in continental Europe were generally little changed in August and September. But they began to move upwards in the second week of October, and the West German bank rate was raised on the 9th. It was raised again early in November, together with bank rates in France and the Netherlands. Yields on U.S. Treasury bills, however, rose quite quickly during the second half of August and U.S. banks' prime lending rates were increased at about the same time, and again at the beginning of October. Rates continued firm, and at the end of October 91-day U.S. Treasury bills were yielding $4\frac{3}{4}$% per annum, compared with $3\frac{7}{8}$% three months earlier.

Euro-dollar rates did not share in the rise in domestic U.S. rates. Yields on most maturities were little changed over the period but, as the maturity date for three months' and shorter deposits passed over the end of the year, they were marked up by about $\frac{1}{2}$%, three months' deposits yielding 6% per annum at the end of October.

In domestic sterling markets, most interest rates were at a peak in late July when three months' inter-bank money at one time reached nearly 9% per annum. They fell in August, however, and by the third week rates in the inter-bank and parallel deposit markets had declined by around $1\frac{1}{2}$% for three months' and by around 2% for one month's money; but they were still very substantially higher than the 5% recorded before the events of June. Thereafter, movements in sterling deposit rates were fairly small, but they rose to $8\frac{1}{8}$% per annum for three months' inter-bank funds at the end of October when the sterling rate was under pressure.

The fall in sterling deposit rates in the inter-bank and parallel markets during August was reflected in a fall in the cost of forward cover, so that covered interest differentials with euro-dollars continued at around $\frac{1}{2}$% per annum against sterling on three months' money, and around par on the one-year comparison. But the movement out of sterling at the end of October caused one-month and three months' forward margins to widen appreciably for a few days to discounts of $3\frac{1}{2}$% and 3% per annum respectively. Covered differentials were only a little wider, however, because the increase in the cost of forward cover was partly matched by the rise in sterling interest rates. Movements in the six months' and one-year forward margins were less marked, since most of the borrowing to finance sales of sterling was concentrated in the shorter dates.

Bank rate

Meanwhile U.K. Treasury bill rates, after a sharp rise in the middle of June, moved up only gently from under $5\frac{5}{8}$% for three months' bills in mid-June to $5\frac{7}{8}$% at the end of August. As described in the next section, however, in the first half of September they jumped by $\frac{7}{8}$% almost to $6\frac{3}{4}$%, which was well above the ruling 6% Bank rate.

With the introduction in September 1971 of the new arrangements for the control of credit, the significance of Bank rate as a conventional reference point for other rates was reduced. In particular the clearing banks ceased to tie their lending and deposit rates to it. But the function of Bank rate as a market instrument remained, being the minimum at which the Bank would normally lend to the discount market. The increased flexibility of interest rates envisaged by the changes of September 1971, however, requires a last resort lending rate which can respond flexibly to changing conditions in the money market, without movements in it being interpreted as signalling major shifts in monetary policy.

With the approval of the Chancellor of the Exchequer, the Bank accordingly published on 9th October new arrangements for determining and announcing their minimum rate for lending to the market. From 13th October, the lending rate was to be $\frac{1}{2}$% above the average rate of discount for Treasury bills at the most recent tender, rounded to the nearest $\frac{1}{4}$% above. The rate would be automatically determined by this formula and announced each Friday afternoon with the results of the Treasury bill tender, the weekly Bank rate announcement on Thursday being discontinued. A change in the lending rate independent of these arrangements, however, was not to be excluded if, for example, it was required to signify a shift in monetary policy. When the Bank decided, with the approval of the Chancellor, to make a special change of this kind, the announcement would normally be made on a Thursday at mid-day and the operation of the minimum lending rate formula would be suspended until market rates had moved into line.

Bill markets

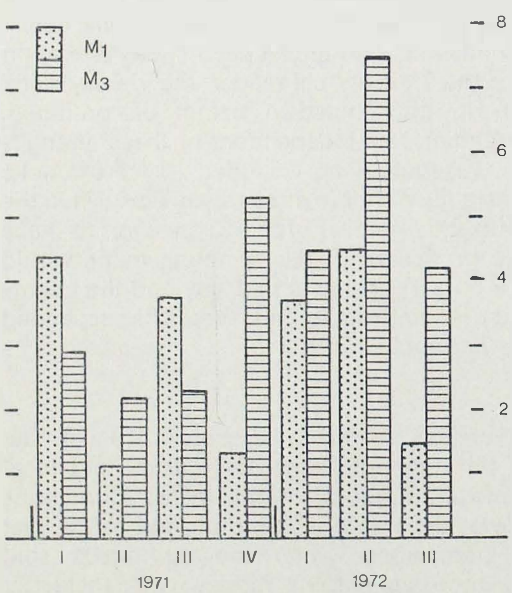
Funds in the bill markets tended to be short in August. The Bank gave help through purchases of Treasury and local authority bills and through overnight loans. Conditions eased for a while at the end of the month and in the first two weeks of September, when the authorities sold Treasury bills to mop up surplus money; but thereafter markets were tighter, and the Bank again relieved shortages by buying bills. No lending to the market was undertaken by the Bank from the time that Treasury bill rates moved above Bank rate early in September until 18th October, five days after the new minimum lending rate had been introduced. The lending undertaken then was overnight only, to cover fluctuations in the supply of funds to the market.

At the first five Treasury bill tenders in the three months August–October, the amounts of bills on offer were modest (averaging less than £90 million a week) and the average rate of discount was little changed at $5\frac{3}{4}$%–$5\frac{7}{8}$%. The tender on 8th September, however, was for a much larger amount of bills (£200 million) and the discount houses increased their rates sharply, the average rate rising to $6\frac{3}{8}$%. At the next tender, when £160 million bills were on offer, it rose again, though less sharply, to nearly $6\frac{5}{8}$%. The rate remained between $6\frac{5}{8}$%–$6\frac{3}{4}$% for the next five weeks, during which the Bank discouraged an incipient downward drift in rates by holding their own dealing rate for long-dated bills at over $6\frac{5}{8}$% for three successive weeks.

After the tender on 13th October, when the average rate of discount was over $6\frac{5}{8}$%, the Bank's minimum lending rate (at $\frac{1}{2}$% above, rounded to the nearest $\frac{1}{4}$% above) was

Relative growth rates in M_1 and M_3

Seasonally adjusted Percentage changes



Since the third quarter of 1971, the broader version of money, M_3, has grown much faster than the narrower version, M_1.

$7\frac{1}{4}\%$. It rose to $7\frac{1}{2}\%$ on 27th October when the average tender rate was more than $6\frac{7}{8}\%$.

The average cost of the discount houses' borrowed funds was probably little changed until towards the end of October when it reached around $6\frac{3}{8}\%$. Selling rates for fine bank bills rose a little from 7% to $7\frac{1}{2}\%$. The margin between eligible and ineligible bank bills, which had grown to some $1\frac{1}{4}\%$ in the second half of June and July,[1] narrowed during August and September to about $\frac{1}{4}\%$.

Money stock[2]

The money stock rose less rapidly in the September quarter than in the June quarter, and the increase in bank lending to the private sector was smaller than in the first two quarters of 1972.

The broader version of the money stock (M_3) rose by some £970 million or $4\frac{1}{4}\%$ after seasonal adjustment in the September quarter, much less than the increase of £1,620 million or $7\frac{1}{2}\%$ in the June quarter and about the same as in the preceding two quarters. The narrower version (M_1) rose even more slowly, by $1\frac{1}{2}\%$, compared with $4\frac{1}{2}\%$ in the June quarter.

Over the twelve months since the end of September 1971 – just after the introduction of the new arrangements for the control of credit – the broader version of the money stock increased by $23\frac{3}{4}\%$, almost twice as fast as the increase of about 12% in the narrower version. This difference illustrates how successfully under the new arrangements the banks have attracted larger time deposits including certificates of deposit. During these twelve months, private sector current account deposits in sterling (which, with notes and coin, comprise the narrower version of the money stock) rose by £815 million or some 11%, while other domestic sterling deposits (which are included with current accounts in the broader definition) rose by £3,135 million or about 39%. The rise in interest rates in the summer of 1972 may well have helped to exaggerate the disparity between movements in the broader and narrower versions in the September quarter by attracting funds into deposit accounts from current accounts and other assets.

The more modest growth in the broader version of the money stock (M_3) in the September quarter than in the June quarter owed much to an easing in the pace of bank lending to the private sector, which rose by £1,075 million after seasonal adjustment compared with £1,840 million. The rise in lending to persons was more than halved compared with the previous quarter.[3] Some moderation after the recent rapid rates of growth was perhaps not surprising, and may have occurred partly because the first impact of the Budget concession allowing interest payments against tax was beginning to wear off and partly in consequence of the rapid increase in banks' base rates (and, therefore, their lending rates) between May and July. In line with the Governor's letter of 7th August to the banks,[4] the rate of growth in bank

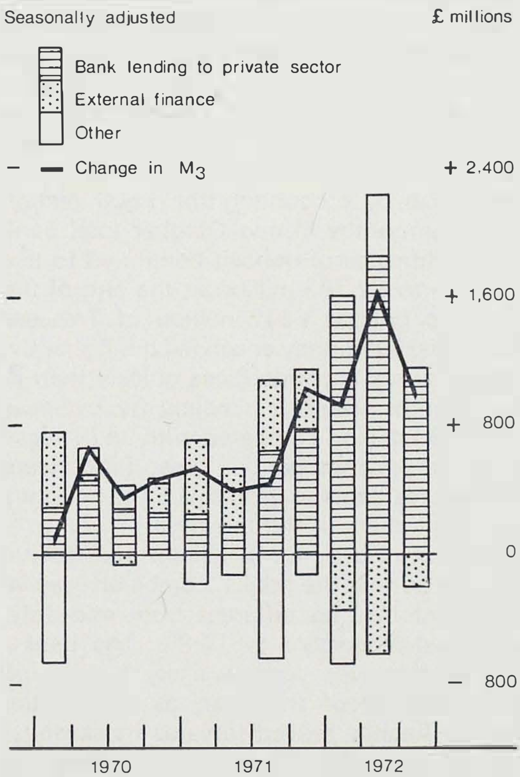
1 September *Bulletin*, page 322.

2 A note on page 512 describes revised money stock tables in the annex.

3 See also page 459 for a further discussion of lending to persons.

4 September *Bulletin*, page 327.

Changes in money stock



The rise in the money stock was less rapid than in the June quarter and about the same as in the previous two quarters.

lending to property companies and other financial institutions also began to slacken.

Of the other sources of domestic credit, the public sector does not appear to have had such an expansionary influence as the Budget forecasts suggested. The central government borrowing requirement was much the same after seasonal adjustment as in the previous quarter, and the borrowing requirement of the rest of the public sector (after taking account of its sales of debt to the general public) was somewhat less. The smaller requirement by the public sector as a whole was, however, matched by smaller (though still substantial) purchases of gilt-edged stock and national savings by the general public. Once again there was a net outflow of funds overseas, though much less than the large movement in the previous quarter associated with the pressure on sterling.

In the four weeks ending on 18th October, the broader version of the money stock (M_3) rose by £300 million after seasonal adjustment or $1\frac{1}{4}$%, compared with an increase of £220 million or 2% in the narrower version (M_1). The faster rate of growth in the narrower version reflected a larger rise in the U.K. private sector's sterling current accounts than in deposit accounts. Bank lending to the private sector, which had slackened in the previous two months, quickened again; but the central government's need for finance was reduced by purchases of gilt-edged stocks by the general public towards the end of September.

Banks and discount houses

Bank lending, though still growing relatively rapidly, rose less in the three months to mid-October than in the previous three months.

Total sterling deposits rose by £1,297 million in the three months to mid-October compared with £3,046 million in the previous period. The London clearing banks took the greatest part of the increase, but after August were less active in issuing certificates of deposit.[1] Overseas sterling deposits were little changed, after a substantial fall of £200 million in the previous period associated with the selling of sterling in June.

Sterling advances to U.K. residents other than the banks rose by £662 million, compared with £1,798 million in the three months to mid-July. This slowing down affected most of the groups who had previously been large borrowers, and the rate of growth in borrowing by manufacturing companies was still only quite modest. Company liquidity in general was relatively high: new issues earlier in the year had been substantial and, with no marked revival yet in manufacturing investment expenditure, increases in output had thus far been financed without extensive recourse to bank facilities. Companies may also have been running off the borrowing undertaken in the previous quarter to profit from the sharp fluctuations in market interest rates towards the end of June. Another consideration which may have affected all borrowers was the raising of the banks' base rates in June and July. Most clearing banks kept their base

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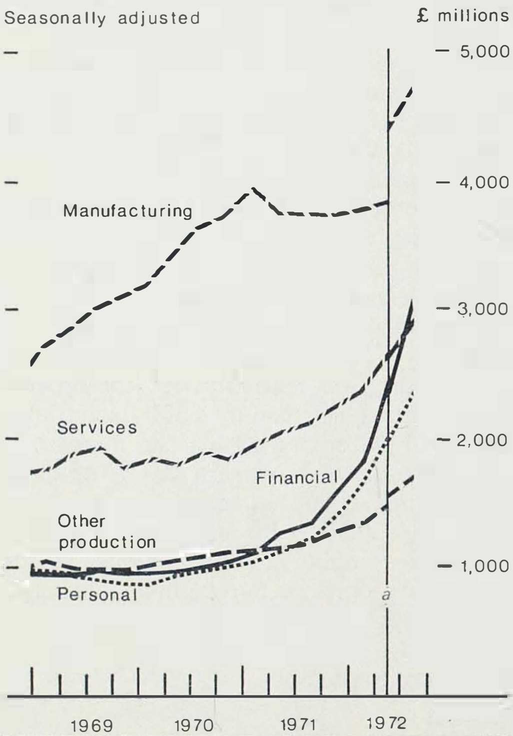
1 See the article on sterling certificates of deposit on page 487.

Distribution of bank advances to U.K. residents



Loans to manufacturing industry began to rise in the three months to mid-August but the main increases were again to financial companies and persons.

a Figures for mid-May are shown before and after the transfer to advances of certain fixed rate credit for exports and domestic shipbuilding, and short-term export finance.

rates at 7% from the end of July for the rest of the period under review. Ordinary deposit rates were also unchanged at between 5% and 5½%.

Of the banks' other sterling assets, sales of gilt-edged stocks continued (though at a slower rate than in the previous three months) until well into August, but thereafter modest purchases were made. Nevertheless, by mid-October, the banks' holdings of gilt-edged stood at £2,054 million, a decline of £702 million since the previous mid-October, the London clearing banks accounting for £500 million of this fall. In the three months to mid-October total bank holdings of sterling certificates of deposit continued to rise rapidly by £466 million to £2,793 million at the end of the period. The banks also bought £442 million of Treasury bills and commercial bills, but money at call fell quite sharply.

Foreign currency business expanded less quickly than in the previous three months. Deposits, mainly by overseas residents, rose by £2,530 million compared with an increase of £3,268 million in the previous period. These funds were lent mainly to overseas residents, with the U.S. banks once more taking a prominent share of the business.

Total eligible liabilities rose by £648 million and reserve assets by £101 million, so that the banks' combined reserve ratio was 14·6% in October, no different from mid-July. It fell somewhat in mid-November to 14·3%. The banks' reserve asset position, however, seemed likely to become easier during the remainder of the year, as the central government's need for finance moved towards its seasonal peak. To lessen the possibility of a reversal of the progress which had been made since the summer in reducing the rate of monetary expansion, the Bank called on 9th November for Special Deposits from banks (other than in Northern Ireland) and finance houses subject to reserve ratios, equivalent to 1% of their eligible liabilities on 15th November. Half the call was met by 30th November, and the remaining ½% is to be completed by 14th December.

The discount houses' total borrowed funds fell by £299 million in the three months to mid-October. The houses substantially reduced their holdings of gilt-edged stocks in August and September but made small purchases in October; over the three months, however, their holdings fell by £143 million to £131 million. They also ran down their holdings of sterling certificates of deposit by £82 million. With total borrowed funds falling, the houses were able to reduce their holdings of public sector assets by £80 million and still increase the average public sector lending ratio to 55·4% in mid-October, compared with the low point of 52·8% reached in mid-July, after they had come under pressure during the withdrawal of funds from London.

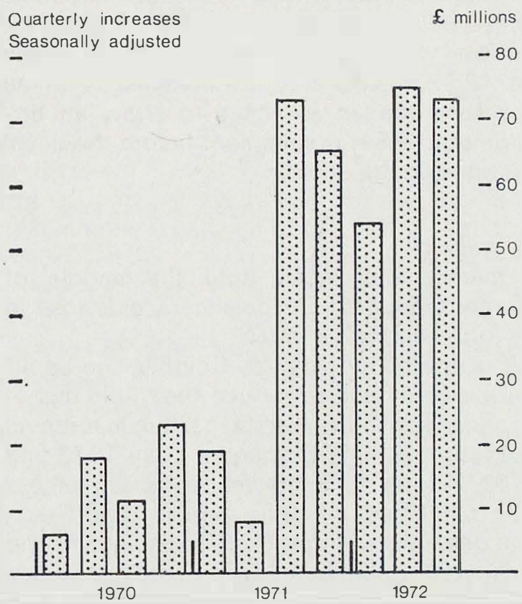
In the context of entry into the E.E.C., some modifications of the Bank's rules on banking mergers and participations were announced on 16th November.[1]

Finance houses

There was no slackening in the very fast rate of growth in the finance houses' instalment credit business. Hire purchase

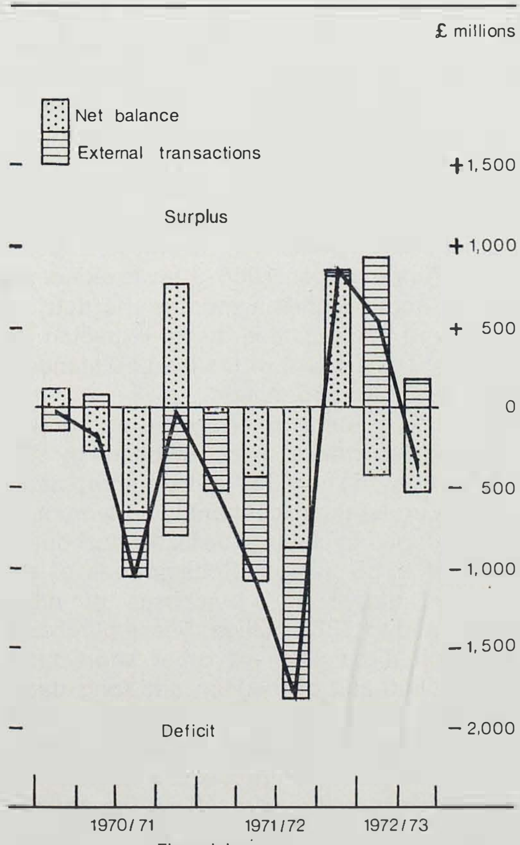
1 See the press notice at the end of this Commentary.

Finance house lending



The increase in finance house lending was about the same as in the previous quarter.

Central government's domestic borrowing requirement (—)



The central government deficit increased a little, but the external outflow fell and the government had to borrow from domestic sources.

and other instalment debt owed to the finance houses continued to rise very rapidly in the September calendar quarter, by £73 million after seasonal adjustment compared with £75 million in the previous quarter. This was well in line with the buoyant growth in consumer spending on durable goods since the first quarter of the year. Lending in the form of personal loans probably continued to grow faster than other instalment credit business.

The ten finance houses which are observing reserve ratios increased their eligible liabilities by £25 million in the three months to mid-October to £261 million. Their reserve assets, particularly money at call, rose by £7 million to £27 million, and their combined reserve ratio was 10·4% compared with 8·4% in mid-July. Under the new arrangements for control of credit introduced in September 1971 the houses had undertaken to build up their reserve ratios to 10% of eligible liabilities within twelve months. By mid-September 1972 their combined ratio had reached 10·1%.

In line with most other short-term rates, those on three months' deposits quoted by the finance houses fell from 8½% at the end of July to 7½% at the end of October. The Finance Houses Association increased their base rate for calculating charges for certain industrial and commercial lending from 6% to 7½% from 1st August and 8% from 1st September, but reduced it to 7½% from the beginning of October.

Central government finance

The central government's borrowing requirement increased seasonally in the September quarter but it was still low in relation to the Budget forecast for the financial year as a whole.

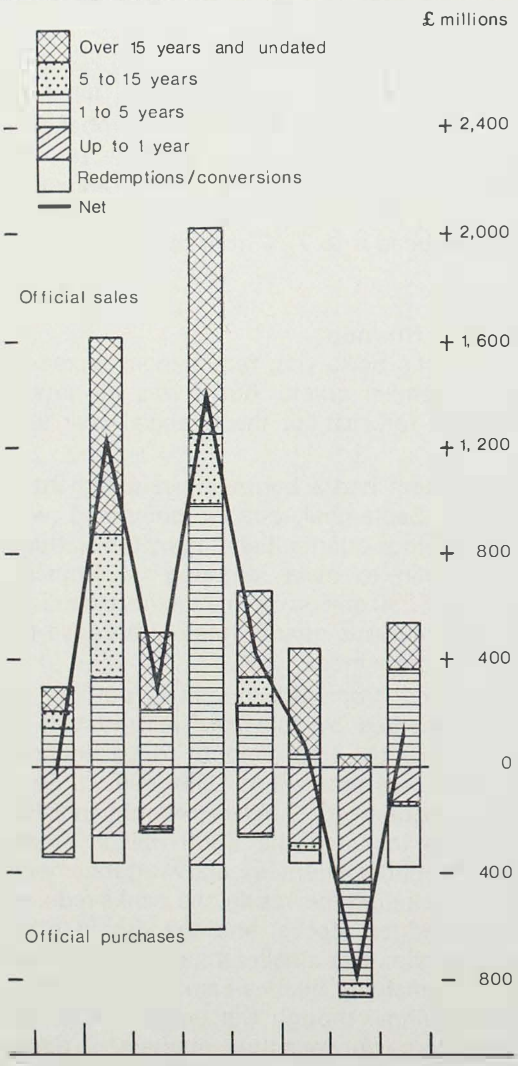
The central government had a borrowing requirement of £527 million in the September quarter compared with £416 million in the previous quarter. Lending by the National Loans Fund (other than to meet maturing government-guaranteed stock) was £230 million more than the exceptionally low figure in the previous quarter, mainly because the nationalised industries drew more.

The sterling acquired from the currency outflow of £79 million was augmented by sales of Treasury bills to overseas holders, so that the total amount to be financed from domestic sources was reduced to £354 million. Sales of gilt-edged stocks to domestic holders brought in £195 million, but this figure included the £360 million stocks resold to the banks under the temporary arrangements announced in June. Excluding this resale, the banks reduced their holdings of gilt-edged stocks, and the rise in other domestic holders' portfolios was smaller than in the previous quarter. Some of the remaining finance came from a further growth in national savings, though the amount was less than half the average of the previous three quarters, no doubt partly because the general rise in interest rates during the summer had made the return on other assets more competitive.

Over the first half of the financial year, the cumulative borrowing requirement was about £950 million, as against

£460 million in the corresponding period last year. Although the increase in the deficit undoubtedly reflected the effects of the Government's reflationary measures, the outcome for the half year compares with a Budget estimate for the whole financial year of £2,933 million. If this forecast is to be realised the December quarter will have to show an unprecedentedly large borrowing requirement before the usual inflow of taxes in the revenue quarter.

Official transactions in gilt-edged stocks by maturity



The total of net sales by the authorities in the September quarter was entirely due to the resale of stock to the banks under the exceptional arrangements made in June.

The gilt-edged market

The gilt-edged market was weak until the middle of September but firmer thereafter. On balance, yields rose in the three months to the end of October.

In the first half of the period August–October, the banks and discount houses continued to reduce their holdings of gilt-edged stock, and yields in the market rose while turnover fell. A moderate amount of $6\frac{1}{4}\%$ Exchequer Loan 1972 and 4% Gas Stock 1969/72 was still in market hands when these two stocks were redeemed on 8th August. Short-term interest rates were generally thought likely to rise again, and these expectations were confirmed early in September when the Treasury bill rate rose sharply; statistics were also published showing that the rate of growth of U.K. wages and prices was increasing, and that the money stock had been rising very rapidly. In the last week of September, however, the announcement of the Government's proposals on prices and incomes, for discussion with the C.B.I. and T.U.C., brought a marked improvement in sentiment, and accumulated funds flowed into the tap stocks ($6\frac{1}{4}\%$ Treasury Stock 1977, $7\frac{3}{4}\%$ Treasury Loan 1985/88 and $7\frac{3}{4}\%$ Treasury Loan 2012/15). Although this period of active buying did not last long, the market thereafter in general remained quietly firm (apart from some weakening towards the end of October), with a brief period of substantial buying early in November after the announcement of the prices and incomes standstill. On 1st November, 4% Funding Loan 1960/90 was redeemed at par, anticipating by about eighteen months the date on which the sinking fund might have been expected to complete its operations. The amount of the loan outstanding had been reduced to less than £35 million.

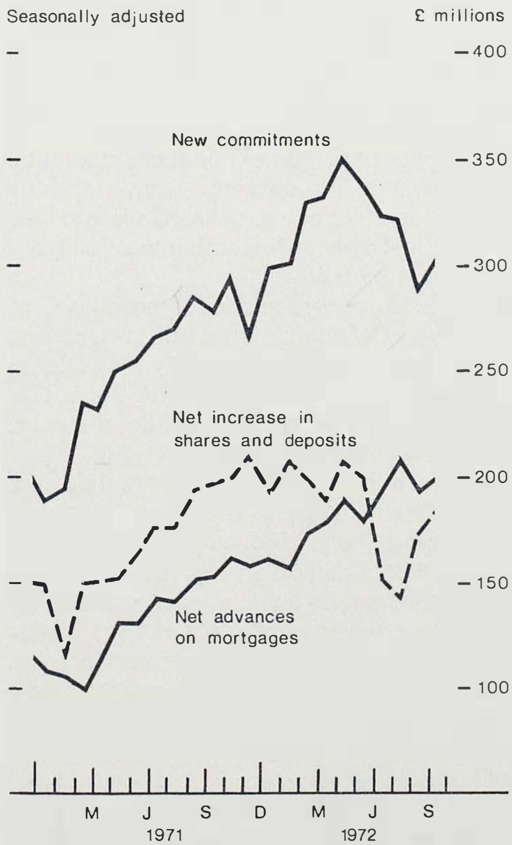
During the September calendar quarter, the authorities' transactions in gilt-edged stocks were swollen by the resale to the banks in July of the £360 million short-dated stocks taken from them under the exceptional and temporary facilities announced in June.[1] Excluding these, the authorities made net purchases of £188 million. Redemptions of the two stocks mentioned above and purchases of next-maturing stocks amounted to £363 million. These purchases were only partly matched by sales of other short-dated stocks of some £13 million and of medium and long-dated stocks amounting to some £160 million, largely to domestic holders other than the banks. Overseas holdings of gilt-edged stocks fell by some £25 million over the quarter.

Yields on all maturities rose by up to $\frac{1}{4}\%$ in the period.[2]

1 September *Bulletin*, pages 317–18.

2 A separate article on the construction of yield curves for gilt-edged stocks, and including charts showing recent movements, is on page 467.

Building society funds



After falling sharply, the net inflow of funds into the building societies picked up in September, but new commitments continued to fall.

By the end of October yields on short-dated stocks ranged from 7%–8½%, while yields on the longest-dated stocks were almost 9¾%. Yields on some other longer-term public sector debt were also higher. Over the three months to the end of October, P.W.L.B. quota rates for five to ten-year local authority loans repayable in half-yearly instalments went up from 8% to 8⅝%; but local authority mortgage rates fell slightly from 9%–9½% for six to ten years at the end of July to 9⅛%–9¼% at the end of October.

Building societies

An increase in rates announced by the building societies in September reversed the previous decline in the net inflow of funds.

After the sharp fall in net receipts in July, the building societies had another relatively lean month in August. Gross receipts were much the same as the low figure recorded in July and withdrawals were higher than ever, reducing the net inflow for the month to £143 million after seasonal adjustment. This compared with an average net monthly inflow of almost £200 million a month in the first half of the year.

On 8th September, therefore, the Building Societies Association announced that it was recommending that its members should increase the tax paid rate on share accounts from 4¾% to 5¼%, to take effect from 1st October. Grossed up at the standard rate of income tax, the new rate of interest on shares is equivalent to about 8½%. It restored some of the differential which the societies had enjoyed until rates on other short-term investments started to rise in the middle of the year. The Association also announced that the rate of interest on mortgage lending would be raised from 8% to 8½%. New borrowers would be affected almost immediately and all existing borrowers were expected to be paying the new rate by January 1973.

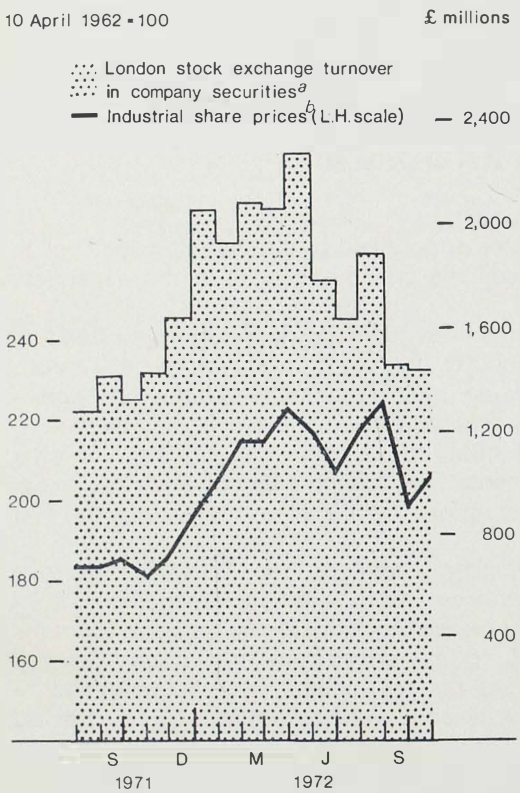
There was an immediate improvement in the deposit situation, as net receipts rose in September (even before the new rate took effect) and again in October. Despite this recovery the net inflow in the three months to October was less than in the previous three. Gross receipts were £1,438 million after seasonal adjustment, withdrawals were £942 million and the net inflow was £496 million compared with £558 million in May–July.

Mortgage advances in August to October were larger than in the previous three months. They were a monthly record in August and still substantial thereafter. Nevertheless there were signs that the societies might be adopting a less liberal attitude towards lending in the light of their problems in attracting new funds and new commitments fell by 10%, while the rise in house prices seemed to moderate around this time. Repayments rose substantially, however, and helped to prevent the societies' liquidity ratio falling more rapidly than from 17·6% at the end of July to 16·4% at the end of October.

Company securities

Equity prices reached a new peak in mid-August, but dropped back quite sharply later.

Industrial share prices and turnover



Industrial share prices reached a new peak early in August but fell later, and turnover was much reduced.

a Monthly total.

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

The F.T.-Actuaries industrial (500) share price index stood at 206 at the end of October, 5% down on the end of July; and turnover was much lower than in the previous quarter. Prices were rising at the beginning of August. Hopes of a settlement in the docks dispute and of some form of agreement on prices and incomes between the Government, the C.B.I. and the T.U.C. took the F.T.-Actuaries industrial index to a new peak of 228 on 16th August, just higher than in May. Prices then began to drift downwards, influenced by fears that the dock strike settlement might be thwarted by unofficial action; and the decline accelerated early in September when the market became dominated by concern over the course of price and wage inflation, and doubts were expressed about the value of equities as a hedge against inflation. It was not until the beginning of October that equity prices rallied modestly, when buyers were cheered by the publication of further evidence on the growth of industrial production. Thereafter there was little change as the market awaited the outcome of the tripartite discussions on prices and incomes. The Government's announcement of a standstill early in November was followed by a further modest gain in prices.

Yields on company fixed interest securities continued to rise in the three months to October. By the end of October, first-class high-coupon stocks of 25 years' life were yielding over $9\frac{3}{4}$%, some $\frac{1}{4}$% more than at the end of July. This rise was more than yields on comparable gilt-edged stocks, so that the differential between them rose to over $\frac{1}{4}$%.

With both the equity and debenture markets hesitant, new issue business declined sharply in the three months to October. Net issues during the period amounted to £191 million, compared with £368 million in the previous three months; industrial and commercial companies accounted for the major part. Because of the declining market the queue of prospective borrowers was reduced by around a third. This shortening was also helped by the arrangements introduced on 1st September under which the issuing limit for companies obliged to join the queue was raised from £1 million to £3 million.[1]

The change in sentiment in the equity market during the September quarter was reflected in unit trust sales. Gross sales fell by £24 million compared with the June quarter, to £107 million. Repurchases also fell, by £13 million to £44 million, so that the decline in net sales was relatively modest – from £74 million in the June quarter to £62 million in the September quarter. These figures disguise the sharpness of the change within the September quarter, however, when net sales plunged from £30 million in July to only £9 million in the month of September. But in October, net sales of units revived. Gross sales rose to £34 million and repurchases fell to £11 million, giving a much increased monthly net sales figure of £23 million.

Conclusion

Discussions between the Government, the C.B.I. and the T.U.C. on prices and incomes marked the whole period covered by this Commentary. The dangers of failing to reach

1 September *Bulletin*, page 324.

a consensus were concurrently underlined by several large wage claims and settlements, and by a sharp depreciation of the pound; at the same time a further strong recovery in output and a falling trend in unemployment emphasised the prospects of expansion.

When the discussions were broken off early in November, the Government introduced a temporary statutory standstill for prices, pay, rents and dividends, to allow time for the preparation of longer-term arrangements. There were few large wage claims pending when the standstill took effect, and pressure for immediate increases in minimum rates should not be widespread. The growth in output this year will have made it less difficult for companies to hold prices down and, all in all, there is a good prospect that the standstill will lessen the general expectation of continuing inflation.

Concern to accelerate the recovery in demand for labour had led, in the first half of 1972, to a very expansionary monetary policy. As the trend in unemployment improved during the summer, it became possible to bring about a gradual moderation in the growth of the money stock; but an over-sharp change in the monetary climate might well have been damaging at the present stage of economic recovery. In the coming months, the emergence of the very large government deficit will be working against any further moderation of the increase in money. But the call for Special Deposits in November will help to neutralise the effect of the fiscal deficit; and this and the standstill on prices and incomes, with the helpful influence of both on inflationary expectations, should make possible continued monetary restraint with less risk to the planned growth in real output and employment.