Commentary

The United Kingdom became a member of the European Economic Community on 1st January. The economic and financial consequences will ultimately be far-reaching but the formal accession, as expected, had little immediate impact. Sterling continued to float and was relatively unaffected by the currency upheaval in February. The outcome will be reviewed in the next issue of the *Bulletin.*
In the period generally covered by this Commentary – November 1972 to January 1973 – inflation remained the chief concern. The Government announced the second stage of their arrangements for the control of prices, incomes and dividends on 17th January. Some concern about the balance of payments also developed as the deterioration in the overseas trade figures in the second half of 1972 ceased to be obscured by the effects of last summer's dock strike. The Government set an unusually early date for the Budget, 6th March; this *Bulletin* went to press before then.

The short standstill on pay and prices imposed on 6th November is to be followed in April by a period, lasting until the autumn, in which annual pay awards for members of a negotiating group are to be limited in sum by a formula allowing £1 a week per head plus 4% of the current pay bill, subject to an overriding limit of £250 a year for anyone. Price rises, rents, dividends, and profit margins will be constrained at the same time. Two statutory agencies – a Price Commission and a Pay Board – will be given powers to enforce a statutory Price and Pay Code. The third phase of the arrangements, from the autumn, will follow consultation in the months ahead and, despite the existence of statutory powers, will, the Government hope, be voluntary.

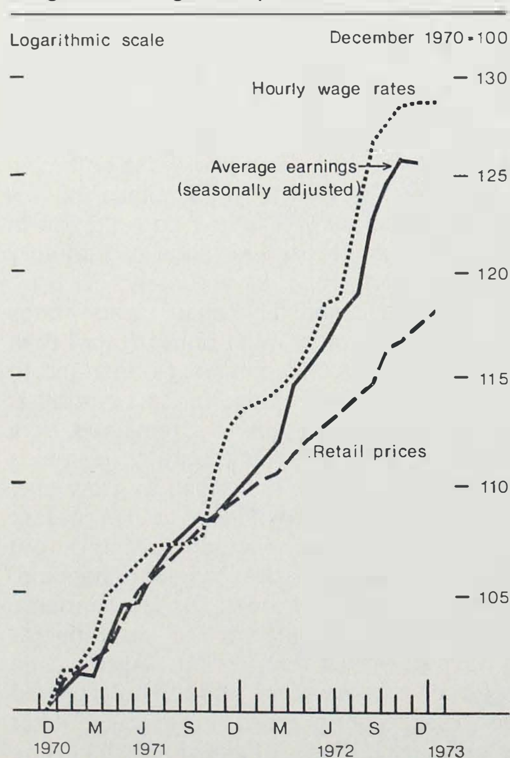
In the period after the standstill began, wage rates understandably rose little and most retail prices (other than food prices) began to steady. Unemployment continued to fall, and output to grow strongly. Demand for cars and other forms of personal consumption generally remained very buoyant, but available statistics suggest that other elements of demand in the December quarter continued to grow only slowly. They may, however, have grown faster than at present indicated. Certainly, the emergence of strongly rising output cannot be reconciled with a more modest growth of demand, for together they would imply the need for less imports. In fact, an increasing amount of consumption – and investment – appears to have been met from imports. At the same time, competition from home demand undoubtedly played some part in the disappointing trend in exports. After allowance for the estimated effects of the dock strike, the visible trade deficit widened, and the current account of the balance of payments was clearly in deficit.

In the foreign exchange markets, once the pay and prices standstill had been introduced, the pound remained mostly fairly steady at around U.S. \$2·35 until near the end of January. It then began to rise as the U.S. dollar came under pressure. In the first few days after the settlement of the

currency crisis on 12th February, when the dollar was devalued by 10%, the pound fluctuated in the region of \$2·45, effectively a slight depreciation in terms of other currencies as a whole. On 12th February, the Chancellor affirmed his intention to refix the rate when conditions permit.

In the domestic money and capital markets interest rates moved upwards, encouraged by the actions of the authorities. The Bank's minimum lending rate, adjusting to the outcome of the Treasury bill tender, rose in a few weeks from $7\frac{1}{2}$% to 9% (later easing to $8\frac{3}{4}$%) and most banks' base rates rose from 7% to reach $8\frac{1}{2}$% early in January (rising again in mid-February to $9\frac{1}{2}$%). A long-dated government stock was issued on 17th January to yield $9\frac{3}{4}$% with a coupon of $9\frac{1}{2}$%, the highest ever offered. The fast growth of money holdings continued, especially in the form of interest-bearing deposits and certificates of deposit. Bank lending increased sharply and the rise in the Government's borrowing requirement – foreseen in the 1972 Budget – began to come through more strongly. On 9th November, the authorities announced a call for Special Deposits of 1% and on 21st December they announced a further call of 2%.

Wages, earnings and prices



Inflation began to moderate after the imposition of the standstill on 6 November.

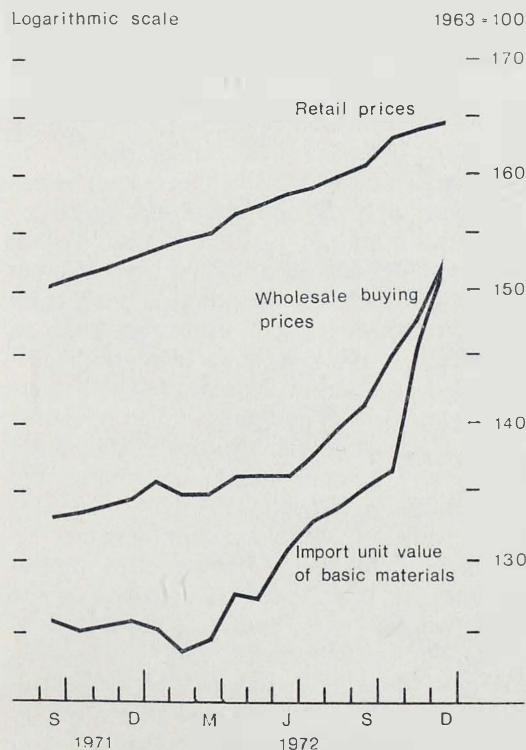
Costs and prices

Concern about the course of costs and prices was still mounting when the Government imposed the standstill in November – and the figures show that retail price inflation was then running at an annual rate of around 7%–8%, and threatening to accelerate, while hourly wage rates were nearly 18% up on a year earlier. After the imposition of the standstill, both price and wage increases were cut back; but the retail price index, which for over twelve months had risen markedly less fast than wages, showed the effects of some exceptionally rapid rises in food prices working through to the consumer.

The trends of costs after 6th November were very mixed. Imported food and raw material prices, which are outside the Government's controls, rose still faster than before. This was largely as a result of specific shortages in world markets, though the further depreciation of sterling in October was a subsidiary influence. In turn, the extra cost of these imports considerably affected manufacturers' wholesale buying prices, which rose by 9% in the three months to January, and exerted significant pressure on firms attempting to keep their selling prices unchanged: overall, these rose by only $1\frac{1}{4}$% over the same period. The effect of the higher import prices may not yet have fully worked through to retail prices; these rose relatively moderately, by $1\frac{1}{2}$%, most items in the index being of course subject to control. The freeze succeeded in holding wage rates steady – the rise in earnings during the period was largely attributable to earlier settlements and to increased industrial activity – and pressures on industry from rising labour costs should have eased.

The first stage of the Government's anti-inflation programme thus largely succeeded in holding down the rise in retail prices and in pay, although price rises of food and imports worked against total success. The proposals of the second stage of measures announced on 17th January

Retail, wholesale and import prices



Price rises of imported materials put pressure on manufacturers' costs, but last year's productivity gains and good profits enabled them to be absorbed rather than working through to retail prices.

will be rather more open to pressures on prices and wages, and it is most important that the limits are kept to. In general, the anti-inflationary measures should benefit the balance of payments on three counts. The absence of any limitation on profit margins on exports should make exporting more attractive. Even so, prices of British goods should grow at a slower pace than otherwise and so benefit the volume of exports in due course. Thirdly, the check to wage and salary increases should moderate the rise in consumer spending, and the exceptional demand for imported products, which has been such a feature of the consumer boom, should ease. A very important long run advantage of the policy is that productivity increases are now to be used to hold prices down rather than to boost wage packets.

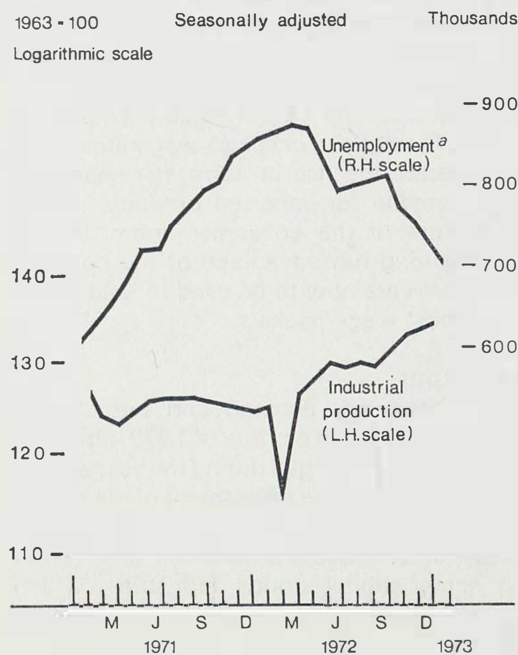
Expenditure and output

The growth of both consumer demand and output was certainly strong during the closing months of 1972, although the large discrepancies which emerged during the year among measures of economic activity make assessment of the overall situation exceptionally difficult. The pick-up in output began to spread from consumer goods production into other sectors, including some capital goods industries, which implies that the thrust of demand has begun to broaden too, if not yet by much.

Personal consumption was on the whole even more buoyant in the fourth quarter than in the third. It was again led by car buying, though expenditure on other goods grew strongly as well. Although the volume of total personal consumption rose faster than in the third quarter (by about $2\frac{1}{2}$% compared with $1\frac{1}{2}$%), the volume of retail sales through the shops rose less fast (by $1\frac{1}{2}$% compared with 3%), and the demand for some durable goods was relatively subdued; even the spate of new car registrations slackened a little in December. But it is too soon to say that the consumer boom is easing, since the figures are subject to revision and erratic fluctuations in the monthly figures are common.

Other elements of demand began to show signs of an upturn during the December quarter, although the overall picture was one of only slight improvement since the summer. There is some indication that stocks – particularly of finished goods, and raw materials and fuel – at last ceased to be run down, which is consistent with the recent rapid increases in imports of these items.

Fixed investment by private industry probably started to recover too, after the sharp fall in the third quarter. Commercial vehicle production for the home market certainly turned up sharply, which suggests some increase in spending on this category of investment; and there was a substantial rise in imports of capital goods in the second half of the year. The latest investment intentions survey taken by the Department of Trade and Industry in November and December indicated that the long overdue recovery in private investment is expected to be only modest in 1973, but the Confederation of British Industry's latest survey taken in January was more optimistic than for some time. Private housebuilding rose strongly in the December quarter, partly perhaps in recovery from the builders' strike in the previous quarter and



As domestic demand strengthened, industrial production rose and unemployment continued to fall sharply.

a Excluding school-leavers and adult students.

Capital utilisation index[a]

1964 IV = 100

	I	II	III	IV
1969	94·9	95·5	95·0	94·3
1970	94·3	92·1	92·4	92·8
1971	90·5	90·4	89·4	88·0
1972	87·3	89·4	89·9	91·2

a The figures have been revised because of a recalculation of the seasonal adjustments in the light of more up-to-date output statistics.

doubtless mostly because underlying demand remained strong. Housebuilding for the public sector also rose in the aftermath of the builders' strike, from which it had suffered severely.

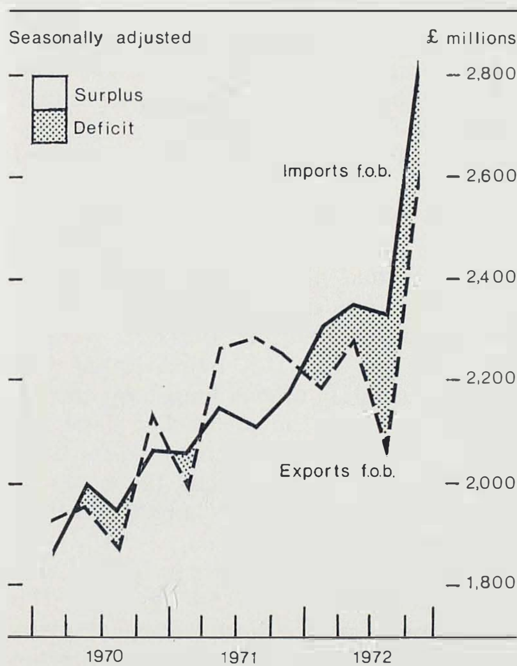
Indicators of the growth of output during the December quarter suggest some acceleration. The first estimate of gross domestic product, measured at constant prices from output data, shows an increase of $1\frac{1}{2}$%–2% on the September quarter. Industrial production rose rapidly, by $2\frac{1}{2}$%, because of a rise in manufacturing production and also through the construction industry's recovery from the builders' strike. Within manufacturing, the strongest rises were no doubt in consumer durables and vehicles, but there were signs that production was picking up in some capital goods industries, such as machine tools and metal manufacture; some heavy engineering, however, remained stubbornly depressed. There have been a few reports of shortages of materials and components as a result of the rise in industrial activity; but these are not sufficient to indicate any general supply constraint, and capital utilisation, even though it rose for the third successive quarter, remained relatively low. All told, a continued fast rise in output should not be immediately hampered by bottlenecks. But the scope for prolonged fast growth in the economy as a whole will be limited until it is supported by a strong growth in productive investment.

Equally, there ought to be little risk of general labour shortages rapidly developing to constrain supply, though there are reports already of shortages of particular skills, and these could become a serious problem. Unemployment fell steadily in the closing months of last year and the total for mid-February, at 660,000 after seasonal adjustment, or 2·9% of the estimated total of employees, stood some 220,000 below the peak last March. This total was still very high compared with the same stage of previous cycles. The number of recorded vacancies continued to climb; it did so in every month of 1972, partly, it seems, as a result of the Government's drive to secure more registrations; however, the increase was particularly marked in the last quarter as production accelerated.

Balance of payments

The aftermath of the dock strike (which ended on 21st August) continued to affect the current account of the balance of payments in the December quarter. The backlog of goods helped to swell the quarterly totals of both imports and exports; the effect on the latter was the more marked, and the visible trade deficit fell slightly, to about £230 million after seasonal adjustment, compared with some £280 million in the third quarter. Accurate assessment of underlying trends is difficult. However, from a comparison of the second half of 1972 with the first half, it is clear that a marked deterioration occurred. The average monthly deficit widened from about £30 million to about £85 million. A small part of this worsening can be attributed to once for all losses of exports during the strike, another part to the boom in consumption, and most of the rest to the initial adverse effect of the floating of sterling. Almost half of the 10% rise in the value of imports in the half-year was a result of higher import prices, which

Balance of U.K. visible trade



The balance of visible trade continued to be affected by the dock strike, but a marked underlying deterioration undoubtedly occurred in the second half of the year.

mainly followed from the depreciation of sterling since June, though some stemmed from rises in world commodity prices. At the same time, the volume of exports in the half-year increased only slightly (perhaps by about 1%), and the greater part of the rise in value of some 4% was caused by rising prices.

The net invisibles surplus, meanwhile, was rather larger than in the third quarter, and somewhat above the average of earnings in the first and second quarters. In total, the current account was in deficit in the second half of the year, roughly offsetting the modest surplus earned in the first half. The deterioration from a surplus of over £1,000 million in 1971 to a position of approximate balance in 1972 was mainly accounted for by the swing in visible trade. The steep decline reflected partly some apparent lack of competitiveness and partly changes in circumstances which had favoured U.K. trade to an unusual extent during 1971. Domestic consumption had then been unusually subdued, for example, and the growth of domestic demand in 1972 helped to produce sharp rises in many categories of imports – industrial materials (up 12% in value, largely in the second half-year), capital goods (20%) and consumer goods (50%). The terms of trade had also continued to improve considerably during 1971 as export prices increased more rapidly than those of imports; but they deteriorated slightly in 1972, as sterling depreciated in the second half of the year and as world commodity prices responded to shortages. The visible trade balance in 1972 must also have suffered from erosion of the country's competitive position as a result of export prices in previous years having risen more rapidly than those of other countries. Another handicap was the slower growth of world trade, particularly in the markets of the overseas sterling area, where U.K. exports in the year actually fell. Finally, home production was badly disrupted by strikes in 1972, leading to some loss of exports and extra demand for imports.

At the same time net invisible earnings in the year fell after rising rapidly for five years. There were several reasons for this: in particular, oil companies' earnings abroad fell, profits of foreign companies in this country rose, the Government's military costs in Western Germany increased, and the travel account worsened. However, private services generally continued to do well.

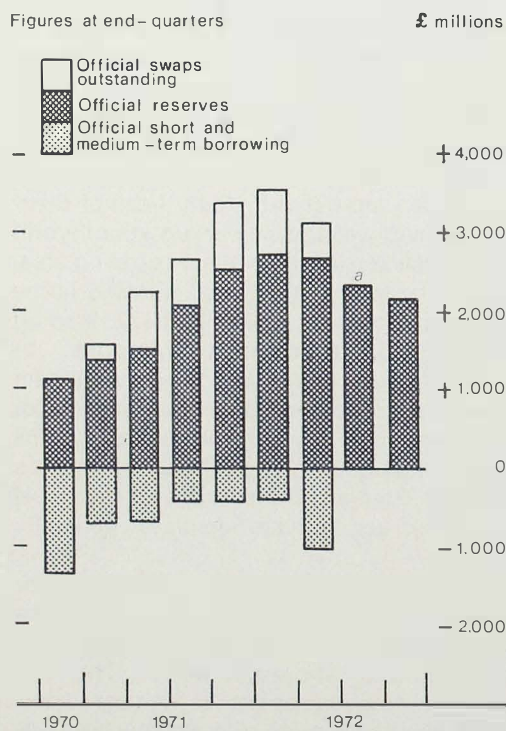
Identified capital movements during the fourth quarter produced a sizable net inflow of about £200 million. Overseas exchange reserves in sterling increased by about £165 million and private sterling balances by about £80 million. The total of bank lending in sterling to overseas (other than for export credit) contracted very slightly as more of the heavy borrowing that had taken place in the first half of the year was repaid. Net external borrowing by the banks in foreign currencies contributed over £300 million; as in earlier quarters, a large part of this was used to finance outward private investment – particularly by investment trusts, unit trusts, and pension funds. Other private investment was in broad balance. The amount of both inward and outward direct investment was larger than for over a year. Against this, there was a sizable outflow of official long-term capital, partly because of the usual end-year payments of North American

long-term debt. The balancing item swung from a positive figure of £190 million in the third quarter to a negative figure of about £400 million. Some of the swing represents a reversal of the effects which the dock strike had had in the third quarter on the normal timing relationships between movements of goods and payments for them. As well as this, currency uncertainties towards the end-year may have contributed to some leading of import payments and lagging of export receipts.

Over 1972 as a whole there were net capital outflows in excess of £1,200 million, of which about half remains unidentified and probably resulted mainly from the impact of several periods of exchange rate uncertainty, particularly in the second quarter. The major identified outflows were in overseas borrowing in sterling from U.K. banks (other than for export credit) and, as usual, in official long-term capital. There was a fall in other countries' private sterling balances, but an increase of over £300 million in exchange reserves in sterling more than offset this. Borrowing by the banks in foreign currencies rose by over £450 million, largely offsetting the net outflow in private investment.

The total currency outflow in the December quarter was about £200 million, met entirely from the reserves. The annual debt service payments on the North American loans accounted for £111 million. At the end of December the reserves stood at £2,167 million,[1] and no special transactions affecting the total were outstanding; £259 million drawn from the U.K. reserve position in the International Monetary Fund last July is due to be repaid within three to five years but, as the reserve position is now included as part of the reserves,[2] repayment will affect only the composition of the reserves and not their total.

Reserves and official financing



The reserves fell slightly in the fourth quarter after the usual end-year debt service payments to the United States and Canada.

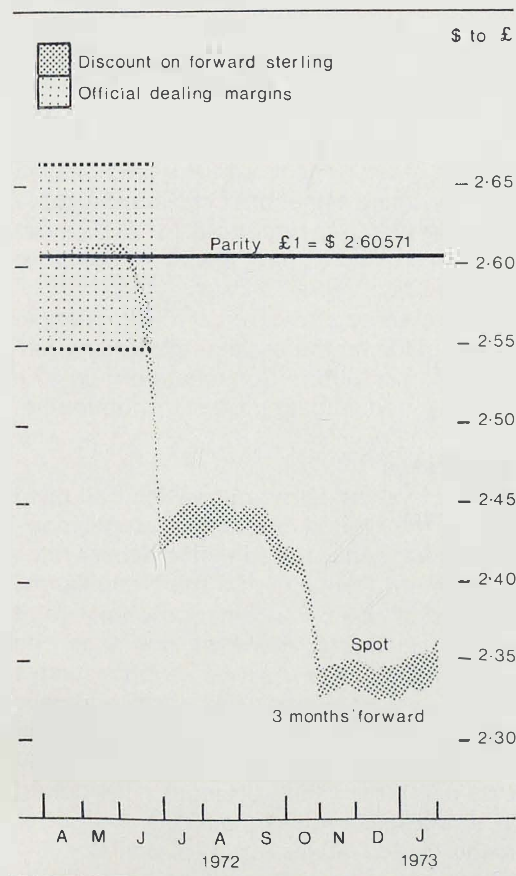
[a] From July 1972, the reserves have been redefined to include the U.K. reserve position in the I.M.F.

Foreign exchange and gold markets

Following its sharp fall from U.S. $2·42 during October, sterling steadied at around $2·35 after the announcement of the prices and incomes standstill early in November. Uncertainty about the Government's strategy for combating inflation after the initial freeze, and some pessimism about prospects for the balance of payments, imparted a weaker undertone to sterling in the first half of December. In the expectation of a further sharp fall in the rate and then of a refixing of sterling at the time of the U.K. entry into the E.E.C., some continental operators had been building up large short positions in sterling. When the Italian lira came under speculative pressure at the beginning of December, sterling was marked down in sympathy, and further selling drove the rate down to touch $2·3365 on the 12th. Further falls were prevented by some official intervention, which served both to increase the cost of carrying these short positions forward, and to convince the market that sterling was unlikely to be allowed to fall further without resistance. The technical strength given to sterling by the earlier overselling was reinforced by the rise in sterling interest rates at Christmas and by the decision to continue floating in the New Year; and, despite disappointing trade figures

1 Valued at the official parity of U.S.$2·60571. Movements into and out of reserves are valued at the rates at which transactions took place.
2 See September 1972 *Bulletin*, page 309.

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



Sterling generally remained steady after the introduction of the pay and prices standstill, gaining strength when the dollar weakened at the end of January.

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

and unofficial forecasts of a rapidly deteriorating balance of payments, sterling continued firm at around $2·35. The rate rose when the dollar came under pressure towards the end of January and ended the month at $2·3825. On the whole, however, sterling was only marginally affected by the international currency upheaval which led to the devaluation of the dollar by 10% on 12th February. In the first few days after the realignment sterling fluctuated rather widely, mostly between $2·43 and $2·48.

In November and December the U.S. dollar was steady against most continental currencies, as it had been since the last period of pressure in July. Indeed, a number of central banks were able to sell some of the dollars they had accumulated earlier. Only in Japan did the central bank have to intervene to prevent its currency appreciating against the dollar; its support was heavy, but ceased to be necessary at the end of December. Meanwhile, the lira remained weak, and continued to need substantial support to keep it within the limits against other E.E.C. currencies agreed under the Community's narrower margins scheme. The dispensation given by the Council of Ministers to the Italian authorities, allowing them to intervene in U.S. dollars, expired at the end of December,[1] and in January the lira had at times to be supported against the Danish krone and the Belgian franc. To discourage the outflow of private capital, and so check the pressure on the rate, the Italian authorities announced that from 22nd January capital transactions in lire would have to be conducted in a separate market, the rates in this market being allowed to move outside the official intervention limits.

The Italian recourse to a two-tier market unsettled foreign exchange markets generally, and the Swiss franc, already very near its ceiling, came into heavy demand; not wishing to receive large inflows of foreign exchange, the Swiss authorities withdrew their official buying rate for U.S. dollars on the 23rd January, and the franc rose swiftly. Expectations that other currencies might appreciate against the dollar were soon strengthened by the publication of figures showing a $6–7 billion U.S. trade deficit for 1972 and by the absence of any sign of improvement in the position, and the pressure on the dollar was resumed. In early February, sales of dollars became huge – $6 billion went into deutschemarks and over $2 billion into other currencies, of which more than half went into Japanese yen. Urgent discussions were initiated among the countries most concerned. On 12th February, the London market was closed, the New York market was closed in any case (because of a holiday), and European and the Japanese central banks withdrew from the market; agreement was reached that the dollar would be devalued by 10%, that a number of major currencies would not follow, and that the yen would be allowed to float. The Italian authorities announced that the commercial lira, like the financial lira, would also be allowed to float. The London market was reopened on 13th February.

Under very active conditions, the price of gold on the London market moved mostly between $60 and $65·50 per fine ounce during the three months, much as it had since

1 See September 1972 *Bulletin*, page 311.

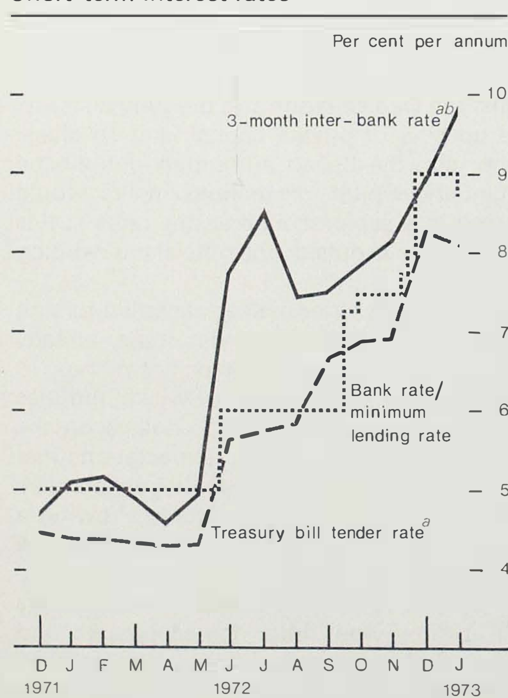
the I.M.F. meeting in September, when the prospects of a rise in the official price of monetary gold had been thought to be negligible. Nervousness about the possibility of further Russian sales depressed the market early in November. The price later recovered as the prospects for the Vietnam peace talks temporarily worsened, and as the swing to the left reported by opinion polls in France produced a temporary rise in domestic French demand for gold to hoard. During January the market was quieter again, and the price stayed around \$65. In February, the international crisis and subsequent devaluation of the dollar against gold to \$42·22 per fine ounce led to the price rising to new peaks. At the close on the 22nd it was at \$87.

Payments to sterling area countries under the guarantee arrangements are being made on the basis of the closing rate on 23rd November of \$2·3506.[1] Consultations on the techniques for settlements under floating rates are continuing.

Short-term interest rates

The upward movements in short-term rates which had been initiated in Europe and the United States in October continued into January. Central banks raised their discount rates in Belgium, France, Western Germany and the Netherlands, following the agreement of the E.E.C. Finance Ministers at the end of October to use tighter monetary policy as one weapon in the fight against inflation. As a result, interest rates in these countries, and also in Switzerland, were generally around 1% – 1½% per annum higher at the end of January than they had been three months earlier. The central banks of Denmark and Austria also raised their discount rates during the period. In general, European rates rose further and faster than U.S. rates. In the United States, on 12th January, the Federal Reserve Board announced that all member banks' rediscount rates were being raised by ½% to 5% from 15th January – the first change since December 1971. This move was in line with market trends during the previous two months, when yields on 91-day U.S. Treasury bills rose from 4¾% to 5¼% per annum. The rise in interest rates in the United States and elsewhere did not produce much reaction in the euro-dollar market until the New Year, when rates hardened a little against their normal tendency to ease. As a result the three months' deposit rate ended the period at 6⅝%, compared with 6% at the end of October.

Short-term interest rates



Short-term rates rose sharply, although Treasury bill rates eased in January as bills became scarce.

a Last Friday of month.
b Middle closing rate.

Sterling interest rates rose much more sharply than euro-dollar rates during the three months, and rates on inter-bank deposits exceeded the peaks seen late in July. After the introduction in October of the arrangements for determining the Bank's minimum lending rate by the results of the weekly Treasury bill tender, rates in the parallel sterling markets and in the Treasury bill market kept rather more in line for a while. Previously bill yields had shown a wide disparity with other rates at times when Bank rate was out of line with conditions in other markets. Yields on 91-day Treasury bills rose by nearly 1½% per annum to over 8¼% between the end of October and the end of December, while rates on three months' inter-bank deposits rose by over 1% to 9%. Thereafter, however, as reserve assets became less plentiful, competition for Treasury

1 See December 1972 *Bulletin*, page 441.

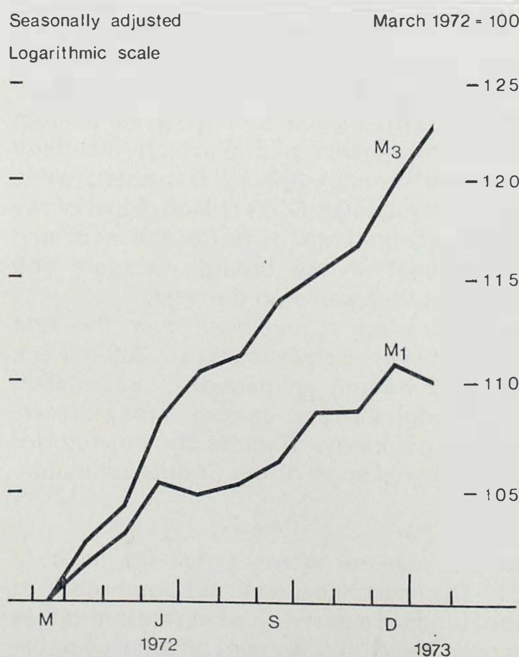
bills caused yields to ease while inter-bank rates continued to rise. By the end of January the rate on three months' inter-bank deposits had reached 10%, but the yield on Treasury bills was only just over 8%.

Over this period as a whole, the cost of forward exchange cover rose rather less than the difference between sterling and euro-dollar interest rates, the discount on three months' sterling widening from $2\frac{3}{4}$% per annum to $3\frac{7}{8}$%. This left the covered interest differential on three months' inter-bank sterling compared with euro-dollars at around $\frac{3}{8}$% per annum against sterling at the end of January, under half as much as three months earlier. In mid-December, sales of forward sterling and borrowing of sterling on a swap basis had briefly widened the differential to over 1%, but the rapid rise in sterling interest rates around Christmas reversed the position, and covered differentials virtually ran off for a short time in the New Year, before returning to a discount. At the same time the corresponding covered differentials on one-year funds moved to a discount of $\frac{1}{4}$%, having been around zero since sterling floated in June.

Money stock

Seasonally adjusted — March 1972 = 100

Logarithmic scale



The money stock grew faster during November to January on the figures for the broader version (M_3) but slower on those for the narrower version (M_1).

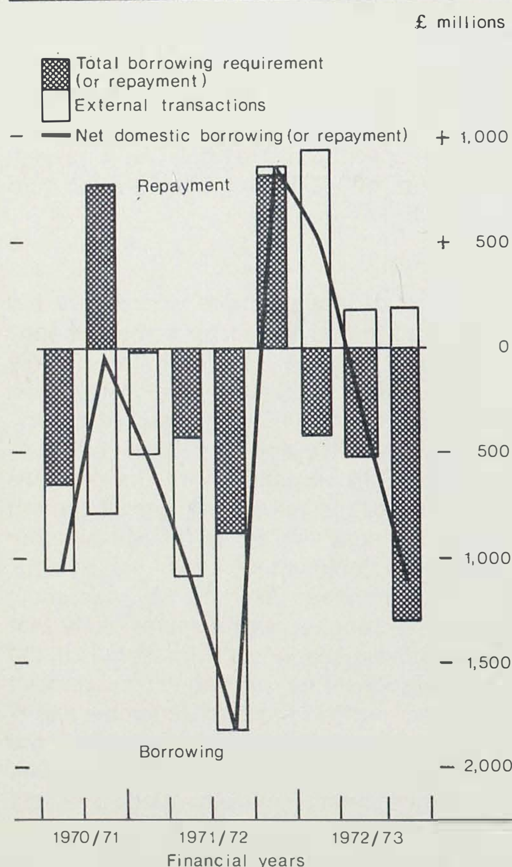
Money stock

In the three months to mid-January there was a very big increase in bank lending to the private sector and the money stock continued to expand strongly. However, the broadly defined category of money (M_3) rose much more sharply than the narrowly defined category (M_1). After seasonal adjustment, the former grew by $6\frac{3}{4}$% and the latter by $1\frac{1}{2}$%, compared with $4\frac{1}{4}$% and $3\frac{1}{2}$% respectively in the previous three months. Assessment of the underlying rate of growth of M_1 is more difficult because the series for M_1 is rather erratic and the seasonal adjustment of it is less reliable. However, the divergence between M_1 and M_3 was most acute in the month to mid-January, and it seems likely that special end-year factors were responsible for some of the disparity. The half-yearly crediting of interest to deposit accounts will have tended to offset the end-December debiting of bank charges within the total for M_3 but not within the total for M_1, which excludes deposit accounts. However, because the banks' balance sheets have expanded so rapidly and because interest rates are historically high, the amounts credited and debited to accounts will probably both have been much larger than in the past, and the effects may not have been fully taken into account in the normal seasonal adjustments. Allowing for these factors, the underlying rates of growth of the two series are likely to have been less in conflict than the figures suggest.

The rise in M_3 also reflected the further rapid rise in the amount of sterling certificates of deposit held outside the banking system. As in the early summer, the pattern of rates was such that it was possible for those who borrowed from the banks at the best rates to employ the funds at a profit in the parallel markets. This is one reason for believing that the relationship between M_3, interest rates, and incomes has been changing. The increase in money held by companies in particular has exceeded the increase that would have been predicted from estimates of the previous relationship; and the excess is probably greater, and has continued longer, than

could be attributed just to the initial shift of funds into deposit accounts and certificates of deposit consequent upon the introduction of the new arrangements for credit control in September 1971.[1] While this difficulty continues, the demand-for-money relationship is uncertain; M_3 is probably, at present, a less reliable indicator of the thrust of monetary policy, and assessments of monetary stringency must rest more than usually on a wider range of indicators.

Central government's domestic borrowing requirement (–)



The substantial increase in the borrowing requirement in the December quarter was largely met from domestic sources, especially the banks.

Central government finance

During the three months under review, the big increases in public expenditure foreshadowed in the 1972 Budget estimates began to come through more strongly and the central government's borrowing requirement in the December quarter was swollen to a record amount of over £1,300 million. Local authorities were responsible for a proportion of the increase. This was, however, not simply a result of greater expenditure: they also borrowed heavily from the Government (around £375 million against some £165 million in the September quarter) in order to comply with the requirement that an authority, if it wishes to take up its full quota for the financial year, must draw 75% of it by the end of December.

The fall in the foreign exchange reserves in the December quarter provided nearly £200 million of sterling finance for the Government's borrowing requirement, and other external transactions (such as foreign buying of stocks and Treasury bills) provided another £80 million, but most came from domestic sources, the banks meeting £635 million (including £325 million channelled through Special Deposits), while other sectors contributed just over £400 million. Most of the last came from increased holdings of notes and coin and gilt-edged stocks. National savings brought in some £60 million, considerably less than earlier in the year.

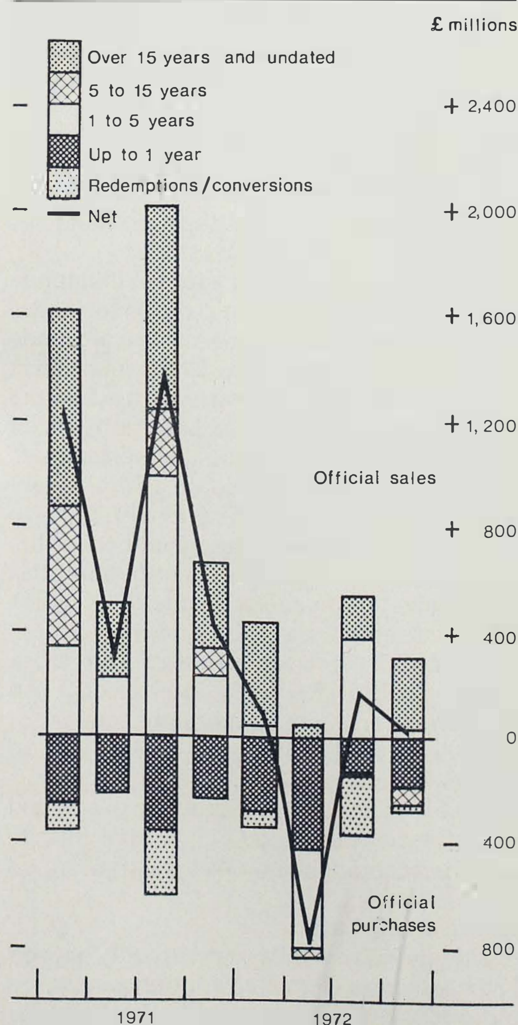
The cumulative borrowing requirement over the first nine months of the financial year was some £2,260 million, compared with the 1972 Budget estimate of £2,930 million for the whole year. Although the revenue quarter may not see, as in past years, a large net inflow of funds, the out-turn for the year is certain to fall well short of the Budget estimate.

Bill markets

Conditions in the bill markets were normal for most of November – that is, the market experienced some days of moderate shortage of funds in each week which the authorities relieved by buying bills. The announcement on 9th November of a call for 1% of Special Deposits had no significant impact. On 22nd November, the authorities indicated some concern at the relatively low level of rates and, for the first time since the new arrangements for the Bank's minimum lending rate began, lent for seven days – as opposed to lending overnight for smoothing purposes. Interest rates edged upward in response, though not by much. Further lending at seven days on 30th November, when the first tranche of the call for Special Deposits was paid, brought a sharper reaction, and the average rate at the Treasury bill tender next day rose further, by nearly $\frac{1}{4}$%. As a result, minimum lending rate (at

[1] See December 1972 *Bulletin*, page 444.

Official transactions in gilt-edged stocks by maturity



The authorities sold only a very small net amount of stock in the fourth quarter, sales of medium and long-dated stock being largely offset by purchases of next maturing stocks.

$\frac{1}{2}$% above the average tender rate, rounded to the nearest $\frac{1}{4}$% above) moved up from $7\frac{1}{2}$% to $7\frac{3}{4}$%. The following week, further lending by the Bank and a bigger offer at the tender (to help to meet the fast growth of the Government's borrowing requirement) led to another sharp rise of $\frac{3}{8}$% in the tender rate and a further increase in the minimum lending rate; many tenderers lowered their bids steeply and the average tender rate rose to almost $7\frac{1}{2}$%, taking the minimum lending rate to 8% but not beyond. On 12th and 13th December most banks raised their base rates from 7% to $7\frac{1}{2}$%.

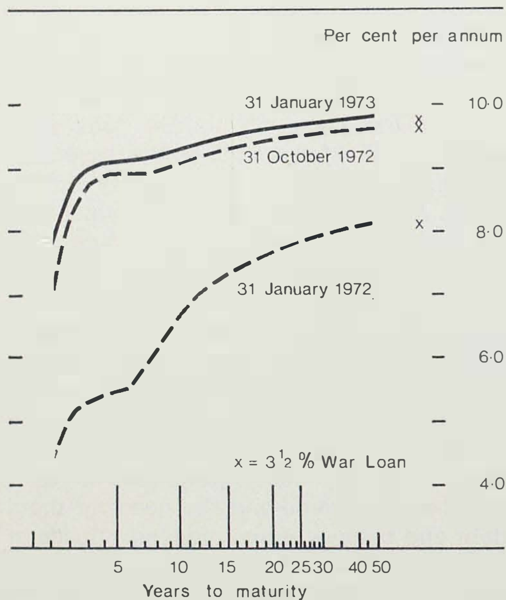
On the 15th of the month conditions were very tight – among other special factors, the second tranche of the call for Special Deposits had just been paid – and the authorities bought exceptionally large amounts of bills. The announcement on 21st December of a second call for Special Deposits took much of the market by surprise, while others had not expected so large a call. At the next day's tender – for another large amount – the price of bills fell very sharply indeed. The minimum lending rate was pushed up to 9%; and most banks' base rates moved up to $8\frac{1}{2}$% in the first days of January. From Christmas to the end of the first week of January, conditions were generally easy. Thereafter, the usual pressures associated with the large tax payments due in January and February began to be felt, money was generally short, and money rates rose. But demand for Treasury bills, which are reserve assets for the banks and public sector debt for the discount houses, was such that the average rate of discount fell at each tender, especially as the offerings were small. Caution induced by official lending for seven days on 8th January and the payments of Special Deposits helped to moderate the fall; but at the tender on 19th January the average rate went below $8\frac{1}{4}$% and the minimum lending rate fell to $8\frac{3}{4}$%.

Another factor had strengthened this movement. The first reaction to the announcement on 17th January of the second stage of pay and price controls was a widespread feeling that government borrowing rates would now decline, and buying of gilt-edged stock led to a severe shortage of cash, which the authorities relieved by very heavy purchases of bills. Thereupon bills became very scarce and the need for them as public sector debt and reserve assets induced houses to bid up prices, although, because funds were scarce too, money market interest rates in general were still rising. On 25th January the Bank signalled for moderation in the fall in the bill rate by again lending at seven days, and at the next day's tender the average rate fell only slightly.

The gilt-edged market

The gilt-edged market remained fairly weak or barely steady until the end of the year; it began to strengthen in January in anticipation of the second stage of the pay and prices policy; and became much firmer after the measures were announced. At the beginning of November, the reduction of uncertainty after the announcement of the first stage – a short standstill – helped the market considerably, and the long tap stock ($7\frac{3}{4}$% Treasury Loan 2012/15) was in good demand. The call for Special Deposits on 9th November, however, interrupted the return of optimism, and the market remained quiet until the

Time/yield curves of British government stocks[a]



Yields throughout the range rose just a little during the period.

a The lines measure the nominal rate of interest which a stock at each maturity should bear if issued at par. The curve runs from the shortest-dated stock with a life of more than one year to the longest-dated stock. The construction of the curve is discussed in an article in the December 1972 *Bulletin*, page 467.

end of November, when demand for both the medium and long tap stocks briefly revived. The news of bank rate increases in France and Western Germany, and of seven-day borrowing by the discount houses at home, caused a sharp fall around the turn of the month as the market anticipated a general rise in domestic money rates. The rise in the minimum lending rate to 8% on 8th December had little further effect itself, because the market was waiting to see whether the banks' base rates would be raised – and the first announcement of such a change was not made until the 11th. The market then turned up again briefly until the 13th, when discouraging trade figures and a pessimistic balance of payments forecast published in the *National Institute Economic Review* unsteadied it once again. Expecting further rises in interest rates, the market remained nervous for much of the month, and the announcement on 21st December of a further call for Special Deposits caused prices to fall sharply.

During the December calendar quarter, the authorities sold net some £20 million of stock. Redemptions of 4% Funding Loan 1960/90 and purchases of 6¾% Exchequer Stock 1973, together with purchases of other near maturing stocks, amounted to almost £220 million, but the authorities offset these by selling about £35 million of other short-dated stocks and making net sales of over £200 million of medium and longer-dated stocks. Domestic holders outside the banking system bought substantial amounts, and their net holdings rose by some £115 million over the quarter.

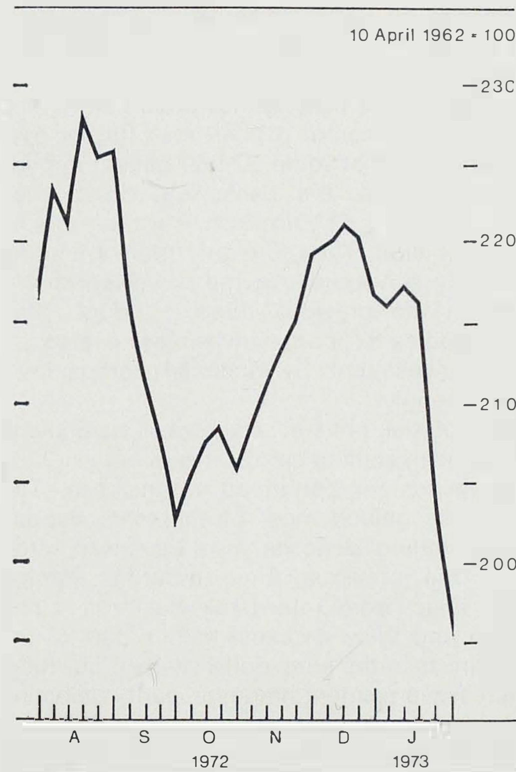
In January, the market opened firm, after a temporary set-back when the first of the clearing banks raised their base rates by a further 1%, and further substantial sales were made of all tap stocks. On 15th January, 6¾% Exchequer Stock 1973 was redeemed; about £140 million was held in the market at maturity. On 12th January, it had been announced that the long tap stock had run out and that the replacement, 9½% Treasury Loan 1999, would be issued on 17th January at £97·50 per £100 nominal, to yield a record 9¾% to redemption. On that day the Government introduced the second stage of their pay and prices policy; and around this time the market, notably the financial institutions, again bought stocks heavily, especially the short and medium tap stocks. The exhaustion of the medium-dated tap stock (7¾% Treasury Loan 1985/88) was announced on 22nd January. The market remained steady until the end of the month, when prices eased, influenced by the rise in money and parallel market interest rates.

In all, during November to January, yields in the gilt-edged market, already exceptionally high, rose only a little further, as may be seen from the accompanying chart.

Equity and debenture markets

Equity prices rose strongly in November, and broadly paused thereafter until 17th January. Then the announcement, as part of the pay and prices arrangements, of further controls on profits and dividends led to a series of sharp falls which continued until the end of the month. The F.T.-Actuaries industrial (500) share price index fell by over 10% in less than two weeks to 194 on 29th January. This was its lowest

Industrial share prices[a]



Share prices had recovered a lot of ground, but fell very sharply indeed after the introduction of the second stage of the prices and incomes policy on 17 January.

a F.T.-Actuaries (500) share price index: Wednesdays.

point since the end of 1971, and about 15% below the peak of 228 reached in August.

Prices had moved ahead from the beginning of November on reported progress in the tripartite talks on pay and prices, but eased after the breakdown of the talks and, especially, the first call for Special Deposits. The market went ahead again in the latter part of November, encouraged by improved unemployment figures, the strength of Wall Street, and good company results. Turnover fell in December, and up to Christmas the index fluctuated within a point or two of 220. From then until 17th January – when the index stood at 217, the impact of the further tightening of monetary policy was generally offset by encouraging profits figures from large companies and by the effects of take-over bids.

Yields on first-class high-coupon debentures and other company loan stocks rose steadily in November and passed the 10% point by the end of the month. They fell back after the end of December, and at the end of January were just under 10%, slightly higher than at the end of October. Yields on comparable gilt-edged stocks rose by nearly $\frac{1}{4}$% in the period, and the differential between them fell to less than $\frac{1}{4}$%.

New issue business was rather subdued again in the three months to January. In particular, equities brought in only £60 million, compared with £100 million in the previous three months and £300 million in the three months before that. Loan stocks brought in some £80 million, a little more than in the same previous periods. The queue of prospective borrowers continued to shrink, following further cancellations and postponements of planned issues.

Net sales of unit trust units during November to January were fairly steady at around £25 million in each month, much the same as in October. The figures followed the market to some extent: the inflow to the trusts rose a little in November and December; and then fell rather more sharply in January because of a sizable increase in repurchases.

Banks and discount houses

After the slower growth of bank deposits and bank lending in the previous three months, they both grew more rapidly again in the three months to mid-January. The main feature was a very big increase in lending to the private sector.

Much of the expansion in sterling advances was still to personal and commercial customers, but it is reported to have included more lending to manufacturers than for some time. It may be that this was the beginning of the long-awaited general revival in borrowing by manufacturers to finance the expected upturn in their stockbuilding and fixed investment. On the other hand, as borrowing costs are higher, many companies may prefer to finance such an upturn by running down their liquid assets. These assets are likely to be augmented, if only temporarily, by the extra funds which will be retained in the system – because of the arrangements for collecting the new tax – on the changeover from purchase tax and selective employment tax to value added tax.

To provide for their increase in lending, the banks continued to run down their holdings of gilt-edged stocks for much of the three months under review, and these then formed a

smaller proportion of their assets than for a very long time: by mid-January, their holdings stood at £1,930 million, a decline of £850 million on a year earlier. At the same time, their holdings of stocks of under one year to maturity were augmented in December when 5¼% Treasury Stock 1973 moved into the one-year band. Among their other assets, their holdings of sterling certificates of deposit rose further over the three months, and stood at some £2,960 million in mid-January. During the period, the banks ran down their holdings of Treasury bills by £110 million, but their money at call rose by £120 million. Their foreign currency lending expanded at a slightly slower rate in the three months to mid-January than in the previous three, although their lending to U.K. companies to finance investment overseas – especially portfolio investment by financial companies – continued to grow strongly.

Sterling deposits of the private sector rose particularly rapidly, and the volume of sterling certificates of deposit held outside the banking system continued to increase. The London clearing banks gained most of the extra deposit business. Overseas sterling deposits also increased, after changing little in the previous three months. Foreign currency deposits, apart from inter-bank business, came largely from abroad and were as usual mainly part of the banks' entrepôt business in the euro-dollar market, but there was also a big increase in resident holdings, partly reflecting funds awaiting investment abroad.

The banks' total eligible liabilities rose in the period by over 6%, but their holdings of reserve assets grew rapidly too. As a result, their combined reserve ratio at mid-January was 14·6%, the same as in October. It had, however, risen to 15·7% in December, when their holdings of 5¼% Treasury Stock 1973, mentioned above, had just become reserve assets. There were calls for Special Deposits of 1% on 9th November and 2% on 21st December; each call was in two equal instalments, which had to be lodged by 30th November and 14th December, and by 3rd January and 17th January respectively. The purpose of the second call was, like the first, to absorb increases in liquidity which were flowing from the growth of public spending; and it was aimed at reinforcing the upward pressure on interest rates. In this way it would assist the policy of restraint in the growth of the money supply.

The discount houses' total borrowed funds rose by £80 million in the period. The houses further reduced their holdings of gilt-edged stocks, and by mid-January these had fallen to £104 million from £131 million in October, already an historically low total. Their holdings of sterling certificates of deposit rose by about £25 million. In the month to mid-November, they increased their holdings of public sector bills and their average public sector lending ratio rose from 55·4% in October to 58·7%; but by mid-January they had reduced their holdings and their combined ratio had fallen to 54%.

Finance houses

The finance houses' hire purchase and other instalment credit business continued to grow rapidly. In the December quarter, the amount of debt outstanding rose by a record

of nearly £100 million, after seasonal adjustment, following two already exceptional increases of around £75 million in each of the previous two quarters. This fast growth could perhaps ease, if the present signs of a slackening growth in demand for some durable goods are confirmed. Credit extended for the purchase of new and used cars was responsible for a large share of the increase, while lending in the form of personal loans is likely to have remained buoyant.

In November, another finance house joined the ten already observing a minimum reserve ratio of 10%. Eligible liabilities of these eleven houses stood at £294 million by mid-January, a rise of £33 million over the previous three months. Reserve assets rose by £5 million to £32 million in the three months to mid-January and, as in the previous period, mainly in the form of money at call. The finance houses' aggregate reserve ratio was 10·9% in the middle of January, compared with 10·4% three months earlier.

Interest rates on finance house borrowing and lending followed the pattern of other short-term interest rates and rose markedly. The rates on three months' deposits rose from 7⅞% at the end of October to 9% at the end of December; and stood at 9⅝% at the end of January. Similarly, the Finance Houses Association base rate (calculated monthly from the three months' inter-bank rate and from which charges to some industrial borrowers are in turn calculated) rose from the 7½% set at the beginning of October, to 8% on 1st December, 8½% on 1st January and 9% on 1st February.

Building societies

The net inflow of funds to the societies had recovered after it had been agreed that higher rates would be offered from 1st October, but the recovery proved short-lived as the competitiveness of the new rates was eroded by the sharp rise in other short-term interest rates towards the end of the year. The net inflow remained healthy in November, but in December the situation worsened markedly – new funds came in more slowly and withdrawals increased, together resulting in a 10% fall in net receipts.

In a very prompt effort to restimulate investment in the societies, the Building Societies Association on 12th January recommended a further increase in the tax-paid rates to take effect from 1st February. The interval of only four months since the last change was the shortest in the post-war period. The rise in the rate on share accounts from 5·25% to 5·6% brought it to the equivalent of 9·14% when grossed up at the standard rate of income tax, though it would be worth only 8% under the new unified tax arrangements due to come into force from 1st April. The association recommended no corresponding increase in mortgage rates, for which the recommended rate remained 8·5%, because the new tax régime would also reduce the composite rate of tax paid by the societies. For the time being, therefore, it was thought that they would have a margin from which to finance the higher deposit rates. The latter achieved some response and there was a somewhat larger gross inflow in January even before the new rates generally became operative; but withdrawals continued to increase and the net inflow was little changed.

Both new mortgage commitments and actual net advances by the societies appeared to be falling back a little at the end of the year, but both were again very large in January. Their liquidity ratios continued to run down and had reached 15·6% on average at the end of January, compared with 16·4% at the end of October.

Industrial management and the institutional investor

In March 1972, the President of the Confederation of British Industry, with the support of the Governor of the Bank, announced the formation of a committee to enquire into aspects of the structure and practice of public companies. The appointment of the Working Party was described in the June 1972 *Bulletin*, page 178. Their report was published on 1st December and is reprinted on page 20.

Conclusion

The period November to January covered by this Commentary saw new action by the Government to curb the rate of wage and price inflation. The short standstill on pay and prices was announced on 6th November and the second stage in the programme on 17th January. The pace of inflation has already eased somewhat, and the programme should secure a further slowing down in the rise in prices and incomes throughout 1973. The period was again one of rising output and rapidly falling unemployment brought about by a strong growth in demand led by personal consumption. The results of the latest survey of industrial trends, taken in January by the Confederation of British Industry, gave further evidence of the sharp increase in industrial activity; but, although there was a substantial rise in the proportion of companies expecting to authorise more capital expenditure, this must be seen in relation to the very low level to which such spending had fallen last year. For the time being the contribution to demand of stockbuilding and fixed investment has been only modest, but if a faster rate of growth is to be achieved and sustained then clearly it must be supported by much more productive investment than hitherto. Partly because of supply difficulties, including strikes, too much demand has been met from imports, so contributing to a disturbing deterioration in the balance of payments. Some of the weakness in the accounts reflects the initial adverse impact on the terms of trade of the depreciation of sterling since June, and this should be reversed by the longer-term benefits to the volume of trade. But exports also seem to have been hit by some weakening of competitiveness and by a diversion of resources to meeting home demand, though the figures for December and January are more encouraging.

The money stock continued to grow rapidly, and action to contain it was taken. The rise has to be associated partly with the growth in government outlays, which had hitherto lagged somewhat behind the Budget estimates, and partly with a further expansion in bank lending to the private sector. The calls for Special Deposits have helped to prevent the Government's expenditure adding undesirably to bank liquidity; and the strong rise in interest rates should help to reduce the demand for money, and so induce a somewhat

slower rise in the money stock.

It is too soon to assess the full implications of the currency crisis in February. However, an important degree of realignment was achieved. The beneficial effects on patterns of trade will take time to develop, but there is good reason to believe that imbalances of international payments will thereafter be significantly reduced. None the less, the need for international monetary reform has become more evident than ever: yet another upheaval has had to be resolved by sizable adjustments to currency values, while for as many as five major currencies the authorities have resorted to a floating exchange rate. Because of the unsettled conditions prevailing both at home and abroad, it has not been prudent to refix the value of the pound, though it remains the Government's intention to do so when conditions permit.