Commentary

The Commentary this time begins with a review of the economic situation and the tightening of monetary policy in the second half of July. There is a note comparing indicators of the pressure of demand on page 280 and another on the rise in commodity prices between June 1972 and June 1973 on page 283. The last part of the Commentary, beginning on page 285, provides more detail of financial developments during May to July.

The economic situation

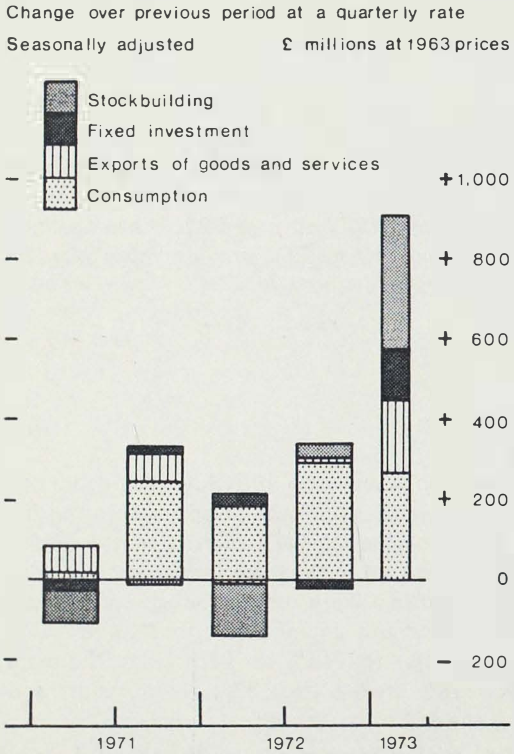
The monetary measures announced on 19th July included a call by the Bank for a further 1% of Special Deposits, bringing the total to as much as 4% of the eligible liabilities of the banks. Arrangements for credit control in the discount market were also revised. These measures led to a sharp rise in interest rates, including a rise in the Bank's minimum lending rate from 7½% to 9% on 20th July and a further rise to 11½% on 27th July. The main banks raised their base rates from 8% to 10% early in August, and then to 11% towards the end of the month.

The measures were prompted primarily by the external situation. In the first quarter the balance of payments on current account moved into heavier deficit, and this has continued: though export performance has been remarkably good, it has been outweighed by the worsening terms of trade as a result of the continued rise in world commodity prices and, to a lesser extent, of the depreciation of the pound. In the first six months of the year this created no problem of external financing; and sterling was never under much pressure in the upheavals that dominated international currency markets. But the rise in interest rates abroad, at a time when interest rates in this country were steady or falling, put sterling at a disadvantage. The effective exchange rate for the pound, which had tended to appreciate since the markets reopened in March, began to depreciate from the middle of May, and more sharply from the end of June. Though the effect of this on domestic costs and prices is likely to be less than might at first appear, it constituted an unwelcome additional pressure.

Activity in the economy has continued to expand, but the pace appears to have slowed markedly. Personal spending during May to July rose very moderately, if at all; and with fixed investment strengthening, and the growth of exports continuing, the balance of demand has improved. Despite the continued rise in prices as a result of past cost increases, wage claims have been settled within the limits set out in the Government's pay code.

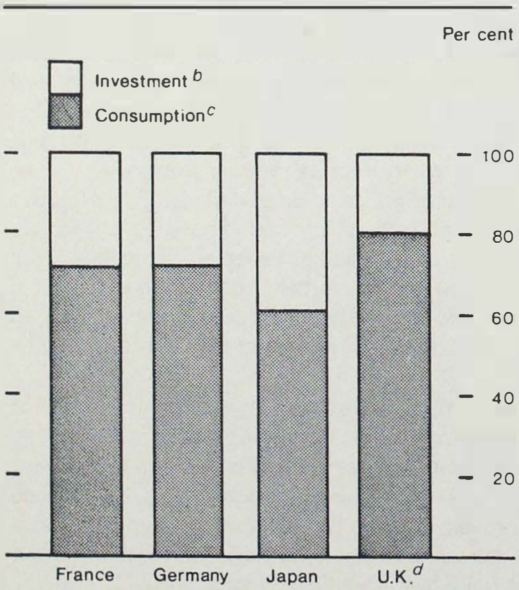
The underlying rate of growth of the money stock in the three months to mid-July was probably much the same as in the previous three months. Rather slower growth up to the middle of June was helped by heavy official sales of gilt-edged stocks. In July the volume of money looked set to rise unduly fast — another factor arguing for the call for further Special Deposits.

The growth of demand



Growth in demand in the first quarter was boosted by stockbuilding, fixed investment, and exports.

Share of resources invested 1968–72 [a]



Compared with other industrial countries, the United Kingdom invests less of its resources.

a Percentage of G.D.P. at current prices. Similar U.S. figures are not available.

b Including stockbuilding.

c Including net overseas trade balance, proportionately small.

d Expressed at factor cost; other countries at market prices.

One effect of the revised arrangements for credit control in the discount market, which accompanied the call for Special Deposits, was that the houses had no longer to compete so keenly for Treasury bills. The bids for bills at the tenders the next day and the following week were greatly lowered. As intended, other interest rates also soon hardened. But because foreign interest rates continued to rise, the pound strengthened only after the second and very large increase in U.K. interest rates had taken place.

Demand and output

In the first months of the year, economic activity grew exceptionally rapidly; since then, the pace has moderated. The balance of demand has shifted too, in that personal consumption has eased and investment is strengthening. What is not clear is exactly how fast the economy has been growing, nor how much slack is left. The difficulty is not just one of 'using last year's Bradshaw' – though comprehensive information certainly takes many months to come through. A greater problem is that the various statistics for the past year or so match much less well than usual. For example, in the last quarter of last year and the first quarter of this, the statistics of expenditure indicate a much faster growth of the gross domestic product than do the statistics of output. Meanwhile, the first estimates for the second quarter, based on the output figures, suggest that G.D.P. then grew at an annual rate of only 3%, compared with 6% in the first quarter. The slowing was doubtless exaggerated by spending shifted into the first quarter to avoid value added tax. The degree of slack in the economy is also a matter of some doubt: for example, the unemployment figures suggest there is a fair way to go before full employment is reached; yet the figures of vacancies have never been higher and, according to the latest survey by the Confederation of British Industry taken in the first half of July, the number of firms still working below capacity was about as low as had been recorded since the surveys began in 1958.[1]

Among the elements of demand, the very large increase in consumption in the first quarter undoubtedly owed much to buying before value added tax was imposed, and something also to buying before the price freeze was lifted. Much of the extra expenditure will have been diverted from savings. A reaction in the second quarter therefore produced a sharp fall in the amount spent. The monthly figures for the volume of retail trade, allowing for seasonal movements, showed little change between June and July; and people generally seemed to be spending no more heavily than at the turn of the year, and probably less heavily on cars. One reason for restraint in personal spending is that prices have risen nearly as fast as wages and salaries so far this year, and so have made for a slower growth of real incomes.

Exports continued to contribute strongly to the growth of demand – they rose by about 4% in volume in the second quarter. By contrast, the amount of stockbuilding in the second quarter was probably much the same as in the first quarter: it had added significantly to demand in the first quarter but, while it may well have remained high in line with economic activity, it is unlikely to have gone on adding to the growth of demand.

1 Some indicators of the pressure of demand are compared on page 280.

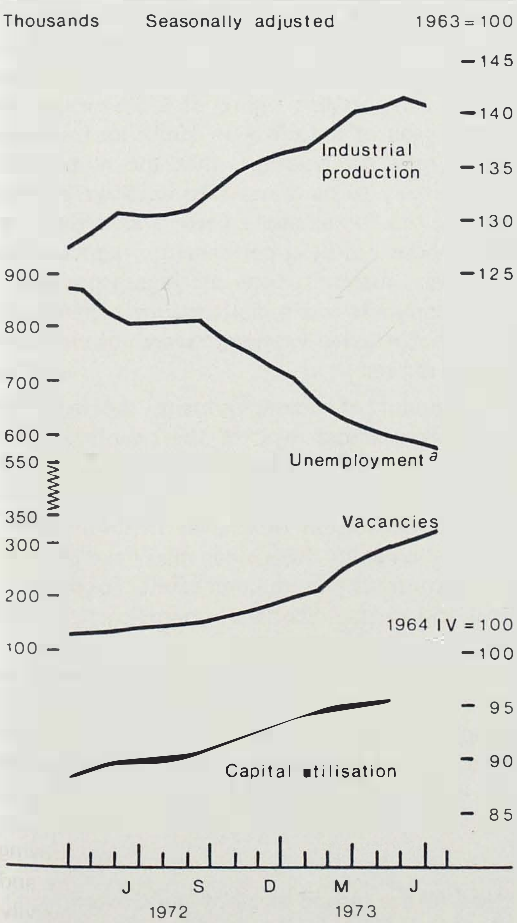
Meanwhile, the figures for the first quarter confirm that fixed investment at last strengthened; substantial rises were recorded for both the public and the private sectors. Further increases will have occurred in the second quarter, though housebuilding was hampered by shortages of men and materials — many fewer houses were started than in the first quarter, and completions were also delayed.

The strong rise in productive investment which now seems under way is welcome, and fears of an early end to the boom, which had been restraining industrial investment, seem largely to have receded. The latest investment intentions survey by the Department of Trade and Industry, held in April/May, pointed to a further strong rise in manufacturers' fixed investment in the rest of this year: the proportion of firms intending to spend more in the coming months was as high as in the 1964 and 1968 upturns. However, the need to encourage more productive investment remains as strong as ever. In recent years, as much as four fifths of the United Kingdom's gross domestic product has been consumed (by persons and public authorities) and about one fifth invested. Most other industrial countries invest a bigger proportion: some comparisons are made in the chart. In 1972 only 18½% of British G.D.P. was invested, a remarkably small proportion bearing in mind that the course of demand was expansionary from the summer of 1971.

During May to July the economy showed further incipient strains, and shortages of men and materials were more frequently and widely reported. Nevertheless, industrial production as a whole continued to grow rather strongly: it rose by some 1¾% (seasonally adjusted) in the second quarter compared with 2¼% in the previous quarter. Within this total, however, manufacturing production rose by only 1¼% compared with nearly 2½% in the first quarter and 4% in the fourth quarter of 1972. Industrial disputes were no doubt partly responsible for the sharp change of pace, particularly in the motor industry and in the steel industry, where shortfalls in production have had repercussions in many other industries. Domestic production of crude steel in the June quarter was less than a year ago, and some customers have bought at higher cost from abroad in order to sustain output. In general, supply difficulties — shortages of labour, especially skilled workers, and of a variety of industrial materials — were becoming more widely cited as likely to limit the growth of output: this was indeed an outstanding feature in the C.B.I. survey in July. In these circumstances there appears to have been over-ordering by some firms in an attempt to guard against shortages, and this may itself have exaggerated them.

These constraints are reflected in the progress of the engineering industry. Production rose no further in the June quarter, after the rapid surge in the previous quarter, though new orders, particularly for the home market, continued to increase. As activity and orders have grown, delivery dates seem to have lengthened. Some cases are reported of offers of nine or twelve months' delivery where the goods could be supplied promptly last year. Delays for capital goods could exacerbate the pressures which the current rate of growth will exert on capacity in the months to come.

Output and the pressure on resources



Output continued to expand strongly and most indicators suggested that little slack remained.

a Excluding school-leavers and adult students.

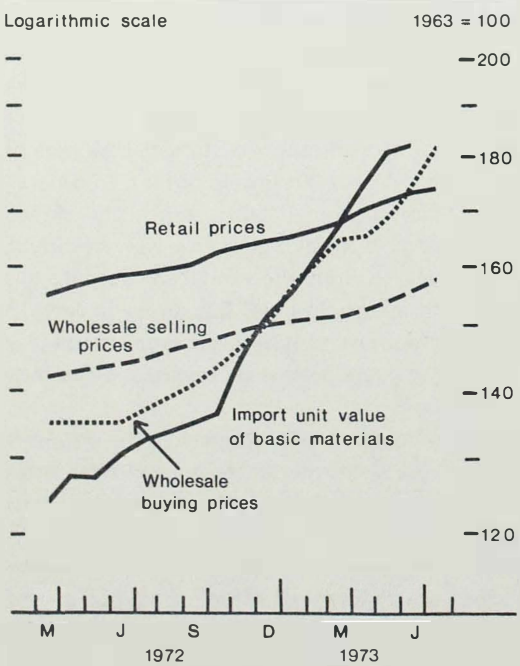
Capital utilisation index [a]

1964 IV = 100

	I	II	III	IV
1970	94·3	92·1	92·4	92·8
1971	90·5	90·4	89·4	88·0
1972	86·9	89·3	89·7	92·7
1973	94·7	95·1		

a The figures for recent quarters have been changed to take account of revisions in the manufacturing output series — principally in the engineering section.

Retail, wholesale and import prices



The rise in import prices has still to make a full impact on retail prices.

The June Commentary suggested that the labour shortages and other supply constraints which had been reported might reflect no more than a failure to adjust immediately to the exceptionally rapid change of pace in the economy. As fairly vigorous activity has since been sustained for some months, but at a slower rate of growth, and as the reports of shortages have increased, this argument looks less likely to be the whole story; and the recent slowing down in the fall of unemployment, though it might well simply reflect the slower rate of growth, could also signify that in many parts of the country there is little labour of the kinds in demand still to be recruited. Certainly, registered vacancies continued to rise strongly, if a little more slowly, for most of the period; however, there is also evidence here for the other interpretation, as the rise at the August count was very slight. Unemployment in Britain early in August stood at 565,000 (2·5%) after seasonal adjustment, a drop of some 30,000 in three months, about half as much as in the previous three months, but still a sharp fall by the standards of the past. The present figure of 2·5% would be historically high for the peak of a cycle — in 1965, for instance, the rate was 1·3%.[1] It may be, however, that the number of unemployed who are unlikely to be drawn into employment has risen in recent years. It has for example been argued that the demand for unskilled labour has been permanently reduced and that people spend longer intervals between jobs (substantial severance pay is more common and social security benefits are larger). It may also be that married women in search of work are nowadays more likely to register.

Despite the total amount of unemployment, shortages of skilled labour were reported across most of the country. Areas such as the south east of England where consumer industries predominate experienced the sharpest falls in unemployment early in the year; and a succession of smaller falls since then suggest that the labour market in these areas may have become quite tight. In areas concentrating more upon capital goods, as in the north of England and central Scotland, unemployment was still falling fairly sharply in the middle of the year, although even here some tightening of the market must have begun, and the falls in August were relatively small. The findings of the C.B.I. survey were comparable in showing that a sharper reduction in spare capacity had occurred in the consumer goods industry than in the capital goods industry.

Costs and prices

Since the introduction of the second stage of the Government's pay and prices policy, efforts to combat inflation have had to face persistent pressures from world commodity prices (see page 283). On the wages side, the implementation of settlements held up by the first stage has added to the pressures on industrial costs.

Manufacturers' average wholesale buying prices were about 24% higher in July than last November when the freeze was imposed, and 33% higher than a year earlier; and in the three months to July they rose by as much as 10%, about twice as much as in the previous three months. These increases are allowable costs for manufacturers in their applications to the Price

1 See the comparison of indicators on page 280.

Inflation since the freeze

Comparing increases over 12-month periods, wages are still ahead of prices.

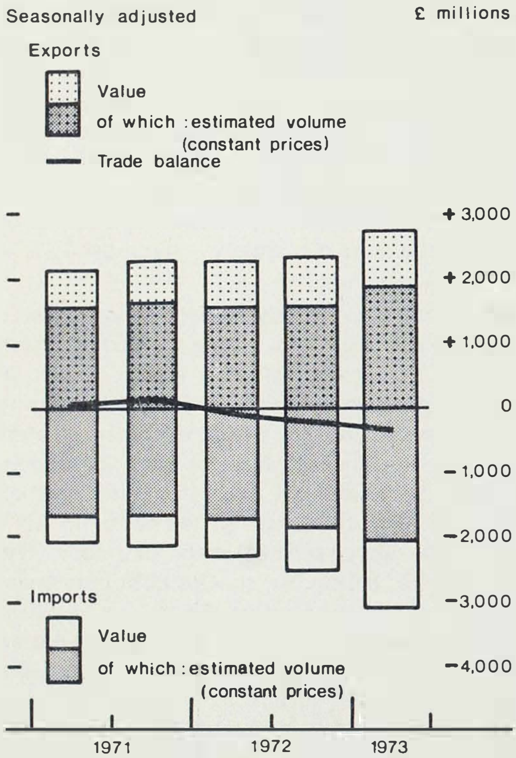
Commission, and as the commission began to deal with the backlog of claims, wholesale selling prices began to rise more strongly too, though much less strongly than buying prices. In the three months to July, selling prices went up by 3¼% compared with only 1¼% in the previous three months, and in July were less than 9% higher than a year earlier. Meanwhile retail prices, benefiting from favourable seasonal movements, rose by 1¾% compared with over 3% in the previous three months, bringing the index in July to 9½% higher than a year earlier. The rising cost of food was again most prominent, and the index for items other than food rose a little more moderately — by under 1½% in the three months.

Labour costs rose sharply as settlements deferred by the freeze came into force. But the rise in earnings during the period, which slowed only a little in June, also reflected greater industrial activity. The amount of overtime worked in manufacturing industry, though less than at previous peaks, was at its greatest for two and a half years. The increase in wage rates slackened a little after the expected boost in April, and settlements reached since the introduction of the second stage of the policy in April have remained within the limits set out in the pay code. The Government's policy has had substantial success both in restraining the rise in incomes and in moderating the extent to which rapidly rising costs, both domestic and external, have been passed on in selling prices. In November average hourly wages were 16½% greater than a year earlier, and in July they were 15¾% greater; retail prices were 7½% up in November and 9½% in July. On a twelve-month comparison, the rise in wages was thus somewhat less than the very high rates of increase in 1972, though in the latest twelve months earnings still outstripped the rise in prices.

Balance of payments

The current account of the balance of payments, which had moved into considerably larger deficit (about £180 million seasonally adjusted) in the first quarter, again showed a large, slightly increased deficit (some £200 million) in the second quarter. The visible trade deficit grew by over £30 million to almost £400 million; but net earnings on invisible account improved somewhat. In value, exports and imports of goods each rose by about 7%. The increase in imports was entirely the result of higher prices. The fact that the volume of imports did not grow despite the brisk rise in output was doubtless largely due, first, to a reaction to accelerated deliveries in March in advance of the introduction of value added tax, and, second, to the big turn-round in stockbuilding having spent most of its force during the first quarter. By contrast, about half the increase in the value of exports in the second quarter was due to greater volume. Comparing the first half of the year with the second half of last year, exporters achieved the remarkably rapid increase in volume of over 12%, which was nearly double the rise in the volume of imports in the same period. British export performance must have outpaced even the rapid upturn in world trade, no doubt helped by the beneficial effects of the depreciation of sterling since June 1972. The improved balance of the volume of trade was, however, offset by the deterioration in the terms of trade, which worsened again in the second quarter.

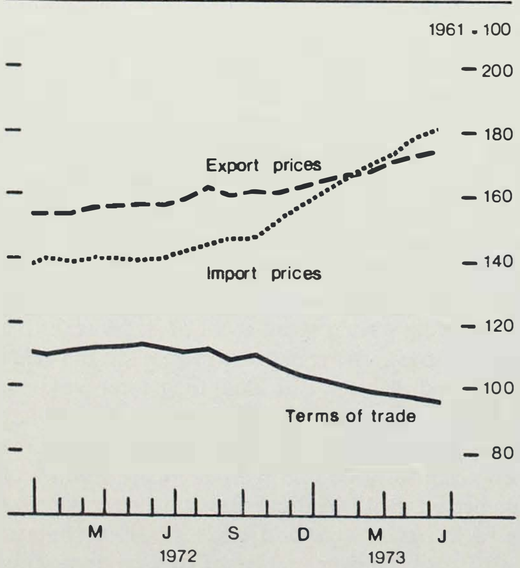
U.K. visible trade [a]



In the first half of 1973 the trade balance worsened despite a better balance in the volume of trade because . . .

a Quarterly average.

Terms of trade



. . . the terms of trade continued to deteriorate as a result of the rise in world commodity prices and the depreciation of the pound.

The scale of the deterioration in the terms of trade can be seen by comparing June 1972 with June 1973: between these dates import prices rose by nearly 30% but export prices by little more than a third as much. Although the effective depreciation of sterling over this period against other currencies increased by about 14%, the main cause of the deterioration in the terms of trade was the rapid rise in world commodity prices. Further increases in commodity prices in the latest months, coupled with a further effective depreciation of sterling of about 3½% in July, suggest that it is too soon to expect an immediate improvement in the terms of trade. But the beneficial effects of the sterling depreciation on the volume of British trade should come through increasingly strongly.

Net invisible earnings, at around £200 million, were somewhat larger than in the first quarter, mainly because of higher income from overseas investments.

Seasonal influences on current transactions are slightly favourable in the June quarter; before adjustment, the net deficit on the current account was some £170 million. Against this, the net structural inflow of long-term capital was perhaps around £100 million, producing a total financing requirement of less than £100 million. In fact, other transactions provided over £450 million; and, in total, the net currency inflow (and increase in reserves) was around £380 million, much bigger than in the March quarter. The largest single element of the inflow was some £290 million borrowed by public bodies under the exchange cover scheme, of which slightly over £200 million was obtained from U.K. banks in euro-dollars and the remainder mainly through bond issues. Other calls for euro-dollar finance were comparatively subdued, with a small net disinvestment of private portfolio investment, after the heavy outflows last year and in the first quarter. Overseas holdings of sterling increased by about £180 million; by contrast with the previous quarter, the holdings of overseas sterling countries fell by nearly £70 million, but the holdings of other countries rose by over £250 million. On the other hand, bank lending to overseas in sterling rose by nearly £150 million, a net repayment of £25 million from borrowers in overseas sterling countries being accompanied by greatly increased lending elsewhere.

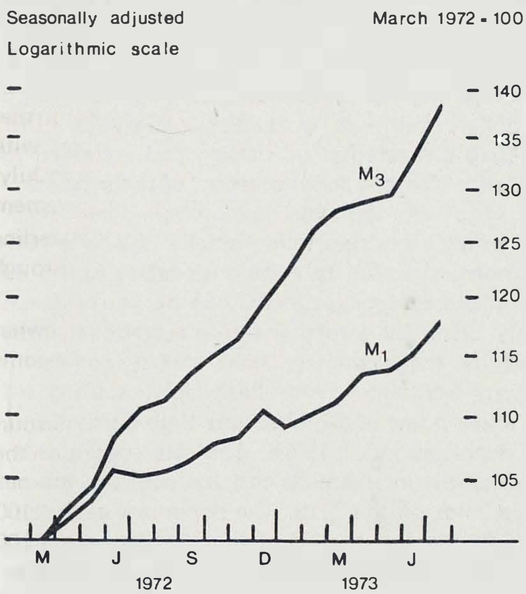
The net inflow of funds in the second quarter increased the reserves by £377 million. At the end of June they stood at £2,422 million valued at the official middle rate of $2·89524. In July, public bodies borrowed about a further £120 million in euro-dollars. The pound was supported on the exchanges towards the end of the month. At the end of July the reserves stood at £2,289 million.

Money stock

During the three months to mid-July, the money stock again expanded fairly strongly, on the figures of M_3 by more than in the previous three months, though the underlying trend was perhaps not very different. After seasonal adjustment, M_3 grew by about 7% and M_1 by over 3¾%; in the three months to mid-April, the corresponding rates were 5½% and 3¾%.

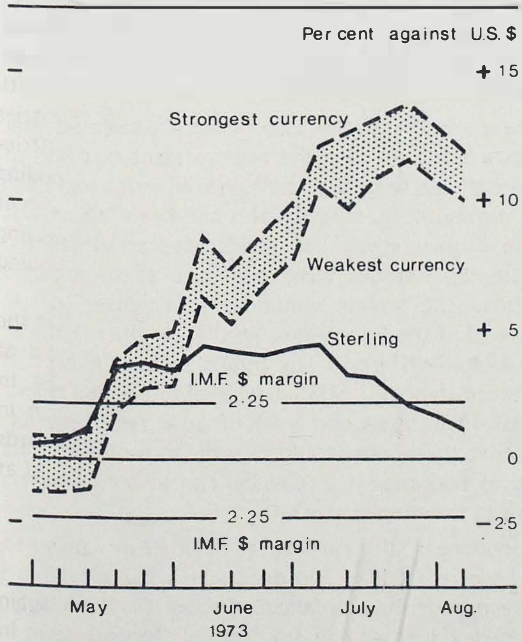
The rise of the money stock over the first half of the year was less rapid than for much of last year. But the rise on either definition was nevertheless substantial, even though not out of

Money stock



The money stock grew strongly, but as the month-to-month changes were still erratic, interpretation remains difficult.

Sterling[a] and the EEC 'snake'[b]



European currencies adhering to the 2¼% band appreciated strongly against the weakened U.S. dollar while sterling changed comparatively little in dollar terms.

a Based on deviations from assumed market rate prevailing prior to reopening of markets on 19 March viz. £1=$2·47.

b Based on deviations of market rates from the dollar equivalents of central rates in terms of SDRs.

line with the growth of G.D.P. in money terms (which was probably of the order of 10% over the same period). The erratic behaviour of both M_1 and M_3 makes it difficult to interpret the month-to-month figures. The largest rises were in the month to mid-July. This period included big payments of half-yearly interest and debiting of quarterly charges. These create problems for seasonal adjustment, particularly during a period of rapidly changing flexible interest rates. At the July make-up, too, several hundred million pounds were probably added to the figures from funds cleared but not yet repaid for partial allotments of subscriptions to the Sainsbury share issue. But, making all allowances, the June and July figures do suggest that the monetary aggregates, after a short pause helped by official sales of gilt-edged stocks and by the reversal of 'merry-go-round' operations,[1] began again to grow rather faster.

Sterling lending to the private sector was considerably larger in the three months to mid-July than in the previous three months – some £1,670 million net compared with some £950 million. This provided a large part of the 'supply side' counterpart to the increase in M_3. The public sector was not a particularly large borrower from the banking system up to mid-June, much of its borrowing requirement being financed by sales of debt to the general public.

Sterling

Sterling came under fairly heavy pressure towards the end of July. Earlier, though not at the centre of the currency storm, it was more affected by developments than it had been in February and March. Up to about 21st May it not only rose rapidly against the dollar, it also appreciated against the European bloc. Thereafter it was generally tending to depreciate, along with the dollar, against other currencies.

Its firmness at the start of May rested mainly on attractive interest rates and the weakness of the dollar. From 9th May onwards, with the dollar under pressure, sterling appreciated strongly against it, and for a while more rapidly than most other important currencies. The dollar rate for sterling was $2·49 at the beginning of May. From $2·50 on 9th May it rose to $2·58 at one time on the 21st. As the rate strengthened some exchange was bought to ensure that the size of the movement in the rate was not out of proportion to the scale of business. At the beginning of May, the effective depreciation of sterling against other currencies since the Smithsonian settlement had been nearly 11%. By 15th May the effective depreciation was about 9¾%.

From 21st May, sterling eased; when the dollar again came under very heavy pressure at the beginning of June, sterling did not appreciate with other leading currencies, although the dollar rate for sterling did reach $2·59 – the highest of the period – on 5th June. Thereafter sterling lagged behind the movement in European currencies, remaining around $2·57–2·58 for most of the month. This reflected the unfavourable May trade figures and the declining attractions of London as short-term interest rates there fell and rates abroad moved up. The stability relative to the dollar masked a further effective depreciation of sterling against foreign currencies in general, which, by the end of June, follow-

1 June *Bulletin*, pages 139 and 197.

ing the deutschemark revaluation, amounted to 14% from Smithsonian rates.

Immediately following the revaluation of the deutschemark, sterling was little changed, but in the very unsettled conditions which preceded the announcement of further support facilities for the U.S. dollar, sterling fell somewhat against the dollar at a time when the dollar itself was weakening rapidly in other centres. The effective depreciation of sterling had increased to over 18% by 6th July. After the announcement of the increase in Federal Reserve swap arrangements there was some slight improvement in sterling's position, and initially this was reinforced by the authorities' action to tighten monetary policy on 19th July. However, the consequent increase in sterling rates was almost immediately offset by a further rise in euro-dollar rates, which was helped by the extremely tight money conditions enforced in Western Germany. From 24th July, sterling fell sharply, to reach a low point of \$2·47 at one time on the 26th, and an effective depreciation of 19½%. The rate subsequently recovered after substantial intervention coupled with the further rise in U.K. interest rates on the 27th. The dollar rate at the end of the month was \$2·51, and the effective depreciation against foreign currencies was a little under 18% since the Smithsonian settlement.

Monetary policy

By the middle of July short-term interest rates in London had become seriously out of line with those in foreign centres. Some funds had perhaps begun to leave London and certainly sterling had again begun to depreciate. The effective depreciation against other currencies of about 6% since the middle of May had brought an unwelcome potential addition to costs.

The fall in domestic interest rates also became associated later in the period with a tendency for the reserve asset position of banks to ease. Since the early spring, their reserve ratios had been near the effective minimum; short-term rates had been falling, but the growth of the money stock had moderated as substantial official sales of gilt-edged stocks were made and as the demand for bank credit from the private sector became lighter (partly because of the reversal of the 'merry-go-round'). By the middle of July the position looked different. The public sector deficit had begun to emerge more strongly, official sales of gilt-edged stocks had virtually ceased since the second week of June, and there was a strong prospect that the banks would become more liquid. The June banking figures had shown a renewed rise in bank lending and a faster growth of the money stock.

In all the circumstances, the authorities decided on action to tighten the position of the banks and produce firmer short-term interest rates more consonant with those abroad. On 19th July, the Bank announced a further call for Special Deposits of 1% from all banks (other than banks in Northern Ireland) and from finance houses within the scheme, ½% to be paid on 6th August and ½% on 15th August, to bring the total of deposits to 4%. At the same time, the Bank also changed the arrangements set up in July 1971 with the members of the discount market under which they observed a 50% public sector lending ratio. The ratio was now replaced by a limit of twenty times their capital and reserves on their holdings of certain assets — mainly private sector debt (see the note on page 306). The need to observe the previous ratio had led to distortions in the structure of short-term interest rates. Most notably, the demand for Treasury bills had kept their yields relatively low, and this in turn had kept down the Bank's minimum lending rate as determined by the outcome of the weekly Treasury bill tender.

The Bank's actions quickly affected interest rates. At the tender the next day bids were very much lower, partly because the authorities clearly wanted rates to rise and partly because the scarcity of bills was of less concern to the market. The authorities were content to see the Bank's minimum lending rate rise from 7½% to 9%, and other interest rates also hardened. Although sterling benefited briefly, overseas rates rose further to leave rates in London still relatively low, and in the following week the pound came under pressure. At the tender on 27th July, when a further sharp rise in rates was widely expected, the minimum lending rate rose to 11½%. A few days later the big banks raised their base rates by 2% to 10%. Interest rates continued to rise, and towards the end of August base rates were raised to 11%.

Conclusion

The sharp tightening of monetary policy in the second half of July was occasioned most immediately by the upward trend of interest rates in foreign centres, but it has to be seen in the broad context of the state of the economy, and more especially the general balance of payments situation and the course of costs and prices, as well as the prospects for internal demand.

The balance of payments on current account moved into heavier deficit in the first two quarters of the year. The continuing net outflow of capital of a structural or long-term character also has to be financed. The reasons for the size of the deficit have been the rapid rate of internal expansion up to the first quarter of this year; the normal delay between exchange rate changes and the full response of the volume of exports and imports; and, above all, the large worsening in the terms of trade due to the rapid and world-wide rise in commodity prices. These factors can be expected to subside or to cease to operate as time goes on. The depreciation in the exchange rate has now put British exports in a highly favourable competitive position. Provided the country maintains a reasonable rate of internal expansion and avoids cost and price increases that undermine the new competitive position, the balance of payments on current account should progressively improve.

In the meantime, there is a need to cover the external position in the intermediate stages. To help meet this requirement, the policy of encouraging borrowing in euro-dollars by public bodies was reintroduced in March. The results have been encouraging.

In the first half-year, despite the deficit on current and structural capital account, total reserves rose as a result of public sector borrowing in euro-dollars. The deficit was largely offset by an inflow of short-term capital, no doubt encouraged by the comparatively high interest rates which prevailed in London for most of the period. During May and June the position began to be undermined by the rise in interest rates in other countries. In all, relative interest rates may go far to explain why, after floating exchange rates were more widely adopted in March, sterling generally depreciated much less than the U.S. dollar against other currencies, and tended to strengthen up to mid-May, but then effectively depreciated by nearly 10% between 15th May and 26th July.

A floating exchange rate for sterling gives protection against certain balance of payments pressures; and the adoption of this system necessarily carries with it the acceptance of a degree of fluctuation in the rate. But the protection is far from complete, notably because of the repercussions on domestic prices of a depreciation. Imports of essential raw materials and of manufactured goods from Japan and Western Europe are likely to bear the main brunt of the recent depreciation of sterling. Especially under present circumstances, any addition to the rise in the cost of living is unwelcome, as is too great an instability in the exchange rate. A floating rate therefore by no means implies that balance of payments considerations can be ignored. It was these considerations which prompted the action taken in July to strengthen the exchange rate, notably by some official intervention on exchange markets, and by the call for Special Deposits, coupled with revised arrangements for credit control in the discount market. As intended, these measures resulted in a big rise in domestic interest rates. The initial change in the Treasury bill rate brought a rise of 1½% in minimum lending rate to 9%. During the following week this increase was overtaken by a further rise in rates abroad, and sterling came under pressure. A further substantial rise in U.K. rates became appropriate on the following Friday; and, with interest rates more in line with those abroad, the pound steadied.

The shift to a tighter monetary policy, though dictated chiefly by external reasons, also appeared appropriate to the domestic situation. Last year the money supply, under the influence of powerful and partly temporary factors, grew rapidly. There was a pause this spring, but there were signs that it might be starting again to grow more rapidly. The figures for June and July indicate that this was in large part due to increased bank lending to the private sector.

A high rate of expansion in demand was desirable as a first stage of industrial recovery. The expansion which occurred at the end of last year and in the first quarter of this year, despite some doubts about the figures, was, however, faster than could have been sustained for long: if it had continued, its later correction would have necessitated harsh adjustments which would have done great damage to industrial confidence in the longer term. Since the first quarter of the year, there have been clear indications that the rate of expansion has been slowing down to a more sustainable rate. The need now is to maintain the momentum of expansion at a reasonable pace. Within the total, there is also need for a relative shift of emphasis, to leave room for greater investment and for the continued growth of exports that the favourable exchange rate should now promote.

At an earlier stage of economic recovery, a rise in interest rates might have risked damaging the recovery of investment demand. But, by now, the expansion of investment in industry seems firmly established; and with the prospect of a continuing growth of exports and of demand at home, this trend should continue. The higher interest rates are therefore unlikely to have great impact on investment plans.

The move to higher interest rates, which the rise in interest rates abroad made it impossible to avoid, has necessitated adjustments by financial institutions and in particular by the building societies. Although it will be important to maintain the flow of mortgage finance, it will also be important that the sums available for house purchase should not again so outrun the supply of houses as to foster another violent rise in prices.

Most industrial countries are suffering from inflation and have found it necessary to tighten monetary policy. But despite these understandable pressures, it would clearly not be desirable that there should be a continuous escalation of international interest rates.

Indicators of the pressure of demand

No single satisfactory measure of the pressure of demand exists, but there are a number of economic indicators that can be used as proxies.

The most commonly used pair are the monthly series of registered unemployment and unfilled vacancies. Up to the mid-1960s, the relationship between output on the one hand and unemployment and vacancies on the other was fairly stable. The latest figures for these series then provided an indication of what the pressure of demand had been some months earlier.

However, as may be seen from Chart A, in 1966–67 and again after 1970, the movements of the two series gave very different readings of the pressure of demand.[1] In both 1966 and 1971 unemployment rose rapidly, indicating a sharp fall in the pressure, but the movement suggested by the fall in vacancies was much less sharp. During 1972 both began to point to a rapidly rising pressure but, up to the present, they have given very different indications of the *level* of the pressure of demand. Unemployment, at 2·5% in August, still indicates a low pressure by comparison with the peaks of past cycles, when it has fallen to half as much. Vacancies, on the other hand, at 328,000 in August, were the highest recorded since the present series of seasonally-adjusted figures began in 1958.

Another labour-based indicator — the amount of overtime being worked — is often used as a measure of the pressure of demand. Monthly statistics are collected for operatives in manufacturing industry, but the interpretation of this series is complicated by the fact that the length of the standard working week has fallen; total hours worked have fallen by less, leading to a rise in overtime. For similar points in two economic cycles between which the standard working week has fallen, overtime would have to be somewhat higher now than earlier to imply a similar pressure of demand; but it is difficult to quantify this effect. Chart B shows overtime per operative (to allow for changes in the number of people covered by the series). The cyclical nature of the series is clearly evident and, on this measure, it would appear that the pressure of demand in mid-1973, though rising rapidly, was still not quite as high as in past cycles.

There are also output-based indicators of the pressure of demand, of which the Bank's own capital utilisation index is one. A second is derived from the Confederation of British Industry's regular surveys of its members in which they are asked if they are working below a 'satisfactorily full rate of operation'; the pressure of demand should be closely related to the percentage who say they are not working below 'capacity' on that formula. These two series are shown in Chart C. The Bank's index suggests that there is still some way to go before the pressure of demand is as strong as it was in the fourth quarter of 1964. However, the way in which this index is constructed[2] means that, while it is useful when assessing changes in capital utilisation over relatively short periods, it is somewhat less reliable for comparisons over longer periods; its present level may, to some extent, underestimate the prevailing pressure on capacity. The C.B.I. index, on

1 The charts are drawn so that an upward sloping line represents a rising pressure of demand; the line for unemployment is therefore inverted.

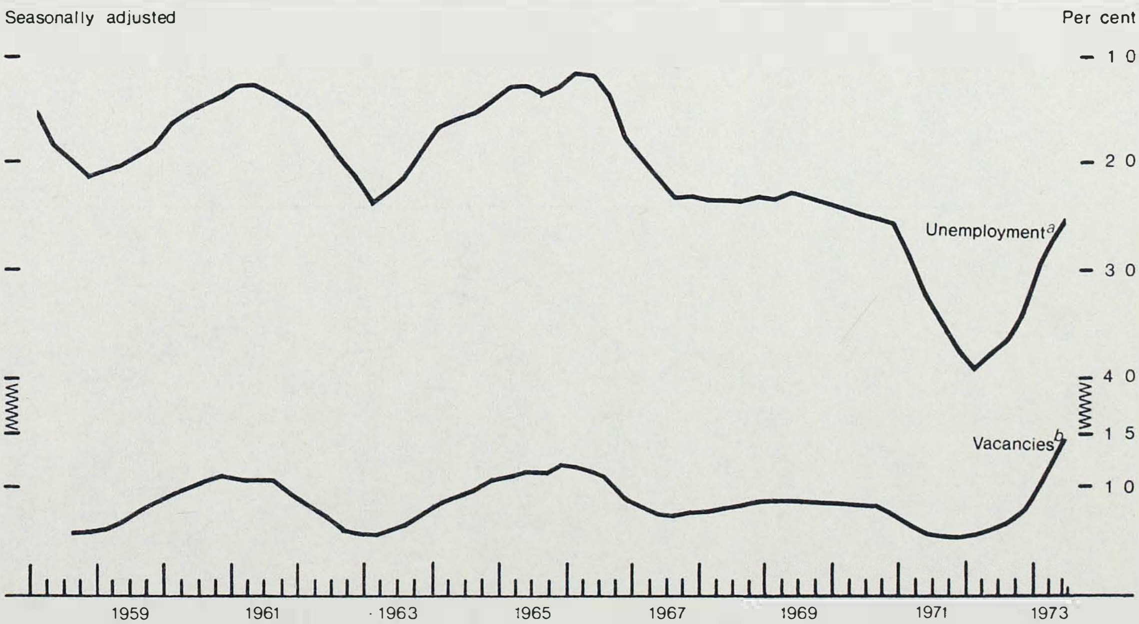
2 The index was described in the December 1971 *Bulletin*, page 490.

the other hand, is a subjective measure, and the relationship between a 'satisfactorily full rate' and working at full capacity may not always be stable; with this qualification, it shows that the country is already very close to the demand pressures experienced in 1964.

A third output-related indicator is sometimes derived by comparing the actual rate of growth of output with the estimated maximum rate at which the economy could grow without increasing the pressure on scarce resources. This, however, provides no indication of how close current output is to full capacity, nor can the maximum rate of growth be measured except as a long-run average. Apart from changes in the size of the labour force, changes in productive potential depend on changes in technology, in capital equipment, and in the productivity of labour. These cannot be presumed to change continuously at uniform rates in the short run; estimates of short-run changes in the pressure of demand cannot therefore be reliably derived in this way.

Chart A

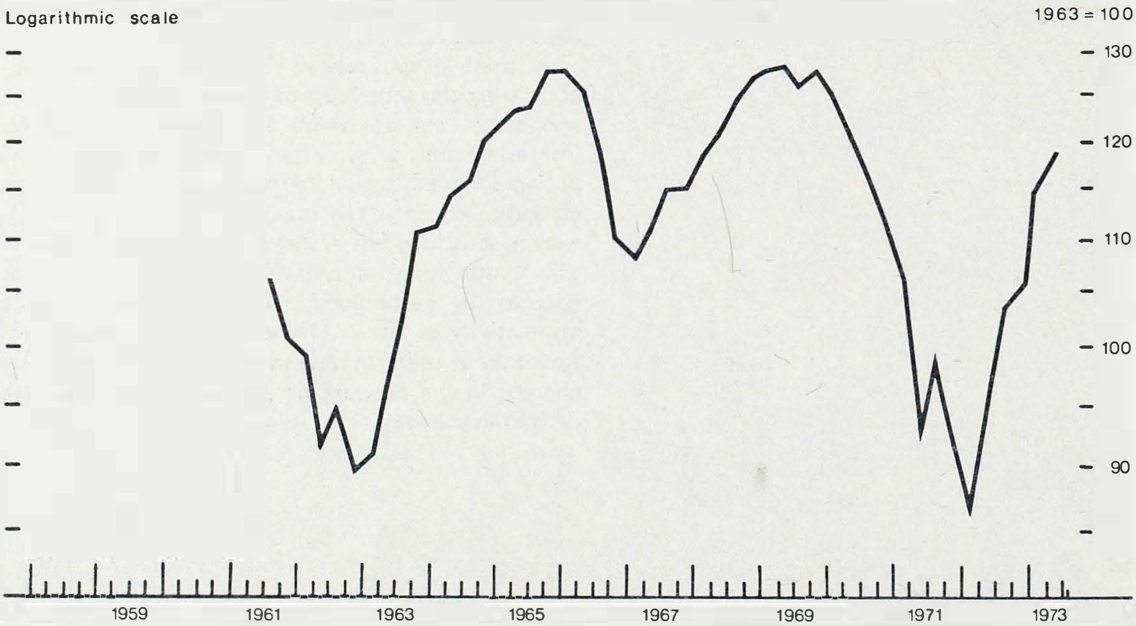
Unemployment and vacancies



a Excluding school-leavers and adult students.
b Adult vacancies.

Chart B

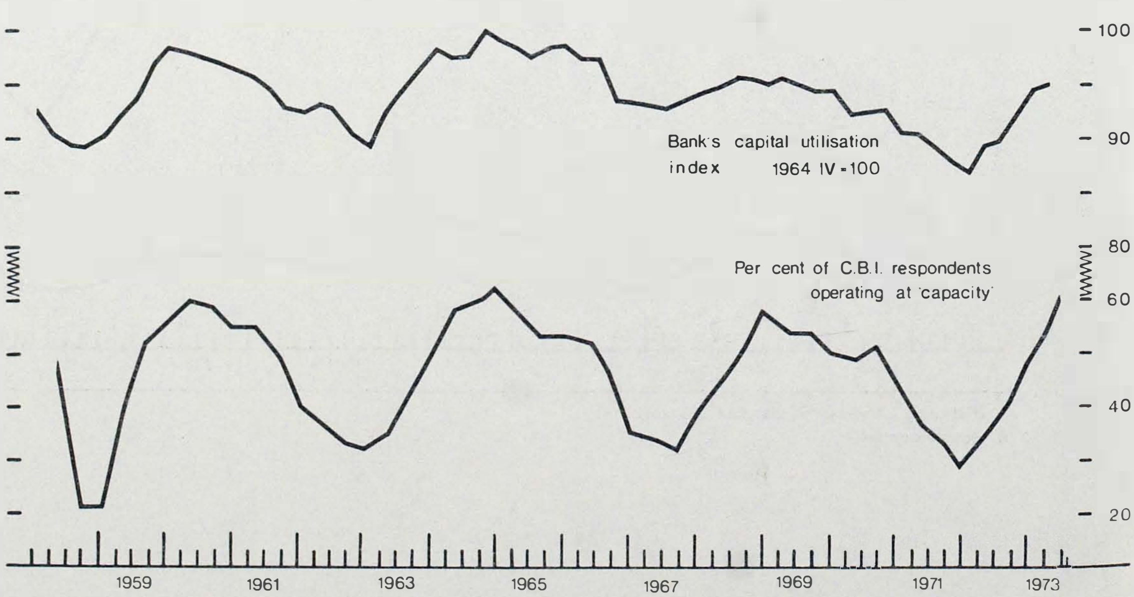
Average weekly overtime per operative in manufacturing industry[a]



a Based on the 1970 Census of Employment.

Chart C

Use of capacity



Commodity prices June 1972–June 1973

During the year to end-June 1973, primary commodity prices increased more sharply than at any time since the Korean War in 1950–51. The dominant influence on the prices of industrial materials was the increase in world activity, sometimes aggravated by supply problems. As well, in a period of rapid world-wide inflation and unsettled exchange rates, buyers will no doubt have added to their holdings of some commodities, so increasing demand. Nearly all agricultural products were also affected by bad weather. The fall in the value of sterling during the twelve months increased sterling prices somewhat further.

The accompanying table shows the rises which took place during the twelve months in the average prices paid by U.K. importers for some of the main commodities, and it illustrates the extent and variety of these changes. (Because the figures are calculated from the trade accounts, which include purchases on long-term contracts, they generally show less steep rises than free market prices.)

Unit values of U.K. imports

Increase per cent

	June 1972 – June 1973
Wool – merino	160
crossbred	120
Lead	80
Cocoa	65
Rubber	65
Maize	60
Bacon and ham	60
Beef and veal	55
Wheat	45
Copper	45

Source: *Overseas Trade Statistics of the United Kingdom.*

Wool was the first commodity to rise rapidly. After several years of depressed conditions, during which flocks were reduced and sheep farmers switched to other activities, the situation changed in 1972. Heavy Japanese buying was followed by generally stronger demand, and stocks in the producing countries were soon exhausted. Prices responded sharply from August 1972 onwards and reached a peak in March this year. By that time, quotations for merino wool in sterling terms were nearly four and a half times what they had been a year earlier. Although still remaining high, prices have since eased.

Supplies of grains were short throughout the period. A combination of poor harvests last year, particularly in the U.S.S.R. and Eastern Europe, and of increasing demand from Japan, China, India, and elsewhere, drew heavily on world stocks. The grain situation will be critical for some time, even though the prospects for this autumn's harvests are generally encouraging.

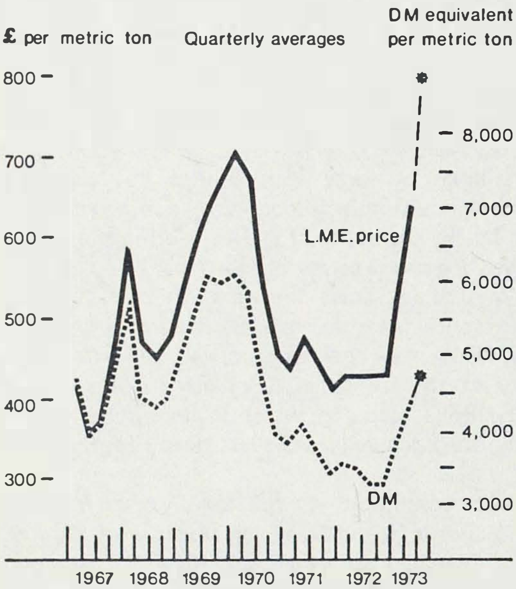
Protein feedstuffs, an essential element in the intensive production of meat, poultry and eggs, were also scarce, and their prices more than doubled. The absence of Peruvian fishmeal from world markets was a big influence from September onward, and demand switched to the already depleted stocks of vegetable proteins, particularly soyabean meal. At the end of the period, the situation was made worse by restrictions on exports of vegetable proteins imposed by the United States and Canadian Governments.

Cocoa prices increased sharply from mid-February this year when it became apparent that the rise in consumption which took place throughout 1972 had outrun production, and that droughts in Brazil and West Africa would reduce the 1972/73 crop and delay that for 1973/74.

Copper prices did not rise in the second half of last year because the market held large stocks which did not begin to run off until January. Thereafter the rise was very steep, apart from a lull in early May. The situation deteriorated considerably in June when major producers in Canada, Chile, and Zambia found themselves unable to meet all their commitments to deliver copper during the following three months.

World prices of primary products (excluding mineral oil), when weighted according to their significance in U.K. imports, rose by

Copper: £ and DM prices



A comparison of the settlement price for copper on the London Metal Exchange with the deutschemark equivalent illustrates the relative cheapness to a West German buyer as a result of movements in exchange rates.

✱ July 1973 averages.

about 37% in sterling terms in the year to the end of June. The effect on the import bill is mitigated by the tendency for demand to be curtailed at the highest prices and by purchases on long-term contracts. Nevertheless, the longer world prices remain high, the more domestic costs and prices will be affected.

Increasingly, this seems to be the prospect for industrial materials. Supplies of both natural raw materials and their substitutes are short, and demand remains strong; and the possibility of further rises cannot be excluded. Moreover, the rise in sterling prices is greater than the underlying rise in world prices because it incorporates the fall in the exchange value of sterling. The chart alongside illustrates, for example, how, for the buyer in Western Germany, the deutschemark equivalent of the London Metal Exchange price of copper has risen more slowly than the sterling price. In foodstuffs the outlook is even less clear. Much depends on this year's harvests; and, although the prospects seem encouraging, a firm assessment will not be possible until later in the autumn. In any event, a series of good harvests is required if world stocks are to be replenished, the continuity of supplies assured, and prices steadied.

Thus the economic causes underlying the rise in commodity prices which took place during last year are largely still present. Widely divergent views about the prospective balance of supply and demand are now held in almost all the markets for major commodities. With continuing uncertainties in the currency markets and weakness in equity markets, commodities have attracted speculative dealing on a scale that has led to unusually large fluctuations in prices.

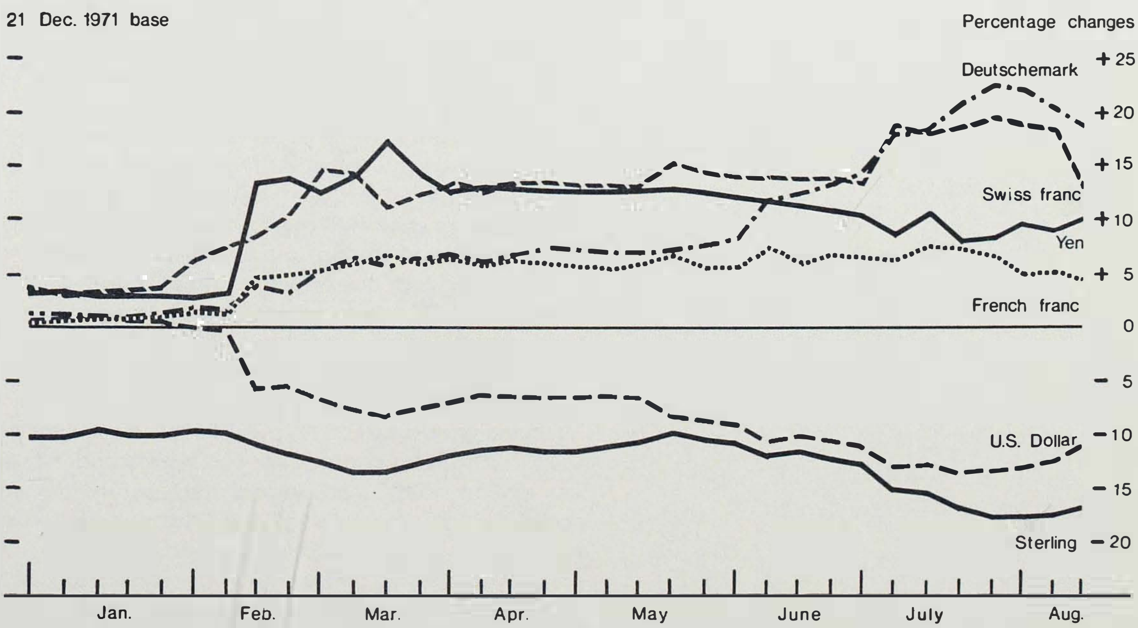
Financial developments during May to July

This part of the Commentary covers, in more detail than in the main part, the financial developments during May to July. It deals first with international currency markets; and the gold market (page 287). It then discusses central government finance, and the banks and discount houses (pages 287 and 288). There follow sections on the course of short-term interest rates (page 289), the bill market (page 290), the gilt-edged market (page 291), government lending rates (page 291), and the equity and debenture markets (page 292). Two final sections discuss the finance houses (page 292) and the building societies (page 293).

International currency markets

The interval of comparative calm since the exchange markets had reopened in the middle of March ended abruptly early in May; and the period to the end of July was dominated by further international currency disturbances. This was primarily because of a sharp break of confidence in the U.S. dollar as the repercussions of the Watergate affair spread wider at a time when the U.S. authorities seemed reluctant to support the dollar and when the dollar, after a long period of stability, had been devalued twice within fourteen months.

Effective changes in exchange rates [a]



During the period, sterling and the U.S. dollar deteriorated against other important currencies, while the deutschemark in particular gained ground.

a The effective change in each exchange rate from the given base date is calculated by estimating the effects on each country's visible trade balance of the actual changes in the main exchange rates since the base date. The effective change in each case is simply equivalent to an estimate of the unilateral change which would have produced the same effect. A number of arbitrary assumptions about the responsiveness of trade flows to price changes have to be made, so there can be no definitive estimates of effective changes. However, in practice, alternative estimates do not differ a great deal. The figures are given in Table 29 in the statistical annex.

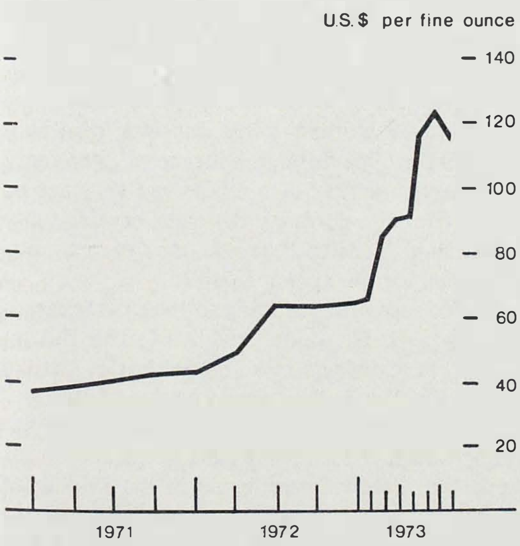
In the first few days of May the dollar began to ease in many centres. It weakened sharply from the 9th mainly because of developments in the Senate's Watergate investigation, and pressure increased in the second half of the month. There was some temporary improvement towards the end of the month after the announcement of the U.S. trade surplus in April and further increases in the main U.S. banks' prime rates, but the dollar again came under very heavy pressure at the beginning of June. In terms of the main Continental currencies, it fell by 4% in the first week of the month and, although there were occasional spells of profit taking by those with bear positions, it continued to be heavily sold. The Administration's price control measures announced in the middle of June did not check the decline, and the dollar continued to weaken despite further increases in U.S. interest rates. Towards the end of the month, extremely tight money in Western Germany attracted a strong flow of funds. The deutschemark rose rapidly, pulling the other currencies in the E.E.C. narrower margins scheme with it. After substantial intervention to keep the 'snake' within its 2¼% limits, the mark was revalued by 5½% on 29th June. Markets were very unsettled after the revaluation, and in nervous trading the dollar weakened further, falling on 6th July to new low points in many centres. Over the week-end of 7th/8th July, increased support facilities for the dollar were arranged at the monthly meeting of central bank governors at the Bank for International Settlements in Basle, and before markets reopened on the Monday a statement was issued that the necessary technical arrangements existed for intervention to maintain orderly markets. This statement, which was followed by an announcement by the Federal Reserve that reciprocal swap arrangements with other central banks had been increased from $11,730 million to $17,980 million, had a calming effect on the markets. Helped by intervention by both the Federal Reserve and the Deutsche Bundesbank, the dollar made a partial recovery.

On the Continent most of the main currencies appreciated sharply against the dollar. At the beginning of May the currencies participating in the Community band had been close to the central rates established against the U.S. dollar in February – the Dutch guilder at the bottom of the 'snake', about 1% below its central rate, and the Swedish krona at the top, 1% above its central rate. During May, only a little intervention was required from time to time to maintain the band within its 2¼% limits. However, from the beginning of June, as the deutschemark moved to the top of the 'snake', the amounts of support increased very substantially; and by far the largest amount since the fixed dollar support points had been abandoned in March was required on 28th June, immediately before the deutschemark revaluation. Subsequently, the Austrian schilling was also revalued, by 4·8%, and Belgium and France tightened monetary policy to reduce inflationary pressures. But West German monetary policy was also kept extremely tight, and the mark was soon back at the top of the 'snake'. At the end of July its dollar rate was nearly 39% over its Smithsonian central rate. By then, most of the other participating currencies were in the lower half of the 'snake', with the Norwegian krone at the bottom.

Other important currencies, with the exception of the Swiss franc, which moved from a premium of 18½% over its central rate against the dollar at the beginning of May to one of 35½% by the end of July, did not appreciate against the dollar to the same extent as those participating in the 'snake'. The Canadian dollar was little changed, around par. The lira improved from 2% to ½% below its central rate, assisted by an announcement of new support facilities and by sizable sales of dollars by the Italian authorities. Sterling (discussed on page 275) appreciated by about 1% against the dollar. And in Tokyo the dollar was firm, the Japanese authorities selling substantial amounts of dollars to maintain the yen about 16% above its central rate.

The result of all these changes was that, although the dollar depreciated sharply against the currencies in the E.E.C. scheme, its effective depreciation against other currencies as a whole was more modest because of the importance in U.S. trade of Canada and Japan, countries whose dollar exchange rates changed very little. In all during May to July its depreciation amounted to about 7%.

London gold price[a]



The gold price rose to still greater heights in May and June but eased in July.

a Last working days.

The gold market

The London gold market was very active during the period, mainly because of the disturbed state of the currency markets. Sharp fluctuations in the price tended to reflect changes in sentiment about the U.S. dollar, and the price passed a series of new records at the fixings, rising by U.S. $25 per fine ounce over the period as a whole. Rumours of central bank sales occasionally set the price back. Investment buying again became an important feature of the market, and this, on top of normal industrial demand and occasional bursts of short-term speculative buying, was more than sufficient to absorb normal production and Russian sales.

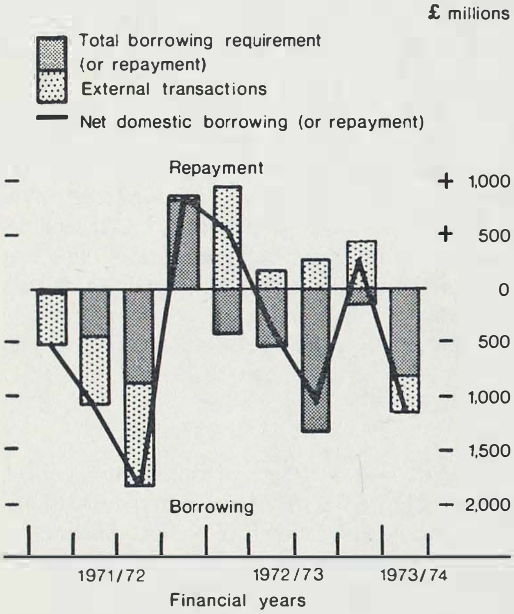
The price had been steady around $90–91 in April. It started to rise once more on 8th May and reached $111 on the 16th. Thereafter the market was steadier for a while, but the price resumed its upward path before the end of the month. The dollar continued to weaken in the wake of the continuing Watergate affair, and a new record price of $127 was reached at the morning fixing on 5th June. Although the price then fell back in a few days to $115, buyers were soon forthcoming at the lower price. On 6th July, with the dollar at a new low point, the gold price once again reached $127, though once again it soon fell back. After further fluctuations, it ended the period around $116.

Central government finance

In the June quarter the Government had an overall borrowing requirement of some £825 million, considerably less than expected at the time of the Budget. Much of the shortfall was attributable to a large amount of euro-dollar borrowing by some nationalised industries and local authorities, most of which probably replaced borrowing from the Government, and which the Government still had to finance domestically (see below).[1] Another part of the shortfall is explained by claims for repayment of value added tax being smaller than expected. Meanwhile, as foreseen, the changeover to value added tax is producing a once-for-all reduction in tax revenue, partly in the June quarter and mostly in the September one; the Chancellor in his Budget speech estimated the total to be about £800 million.

1 The effects of this euro-dollar borrowing in the statistics were described on page 136 of the June *Bulletin*.

Central government's borrowing requirement (–)



The government needed to borrow heavily at home in the June quarter.

The sterling cost of external transactions was some £350 million in the June quarter, largely to finance the surrender to the official reserves of the dollars borrowed by the public sector bodies. Adding this to the borrowing requirement of £825 million meant that the Government had to borrow nearly £1,200 million from domestic sources. The general public provided over £700 million, largely through unusually heavy purchases of gilt-edged stock amounting to nearly £500 million, and partly by holding more notes. Despite the Budget measures, national savings did not bring in very much, doubtless often proving less attractive than gilt-edged stocks or building society deposits. The use of the new tax deposit accounts, announced in the Budget and available from 1st April, was so far limited – to some extent, no doubt, because of unfamiliarity with a new instrument where the yield is not necessarily known but has to be calculated from a formula. In the end, the banks were left to provide some £450 million, and, most notably, they bought over £350 million of gilt-edged stocks.

Banks and discount houses

The banks' balance sheets continued to grow in the three months to mid-July. Some special influences affected the July figures, including, as mentioned on page 275, half-yearly interest payments, quarterly charges, and the Sainsbury share issue. The private sector's holdings of sterling bank deposits rose substantially, while its holdings of foreign currencies grew only slightly. But the euro-dollar market as a whole was very active, and overseas holdings of foreign currency deposits increased substantially. Overseas sterling deposits increased too, even though sterling was generally weak for much of the period.

On the other side of the accounts, lending to the private sector increased more sharply again in June and July. The Budget measures to reduce the attractiveness to some holders of sterling certificates of deposit, and the banks' adjustment of base rates had been successful in reducing arbitrage operations,[1] and the course of bank lending reflected this: sharp falls in the amount of new lending in March and April were followed in the next three months by a return to what may have been an underlying upward trend throughout the half-year. The banks continued to buy gilt-edged stocks in May and June as they rebuilt their holdings from March's exceptionally small total.

Looking at both sides of the accounts, the banks' eligible liabilities rose by £1,860 million between April and July, and their reserve assets rose by £180 million. Their combined reserve assets ratio consequently fell from 14·4% in mid-April to 14·0% in mid-July. However, and in part against the risk that the banks' position would become significantly easier, a call for another 1% of Special Deposits was made on 19th July to be lodged in two equal instalments on 6th and 15th August.

The discount houses bought about another £60 million of gilt-edged stocks over May and June, but sold a similar amount in the month to mid-July. The houses' combined public sector lending ratio fell from 56·0% in April to 53·0% in May, rose to 54·1% in June, and then fell once more to 51·4% in July. The obligation to observe a public sector lending ratio was abolished under the revised arrangements announced on 19th July, and the houses no longer needed to compete so strongly for Treasury bills and other

1 See June *Bulletin*, pages 139 and 197.

public sector debt. A note on the new arrangements appears on page 306.

Short-term interest rates

Interest rates in most overseas centres rose strongly during May to July as a result of widespread attempts to tighten monetary policy and contain inflationary pressures. By contrast, rates in London declined fairly steadily and did not follow the pattern elsewhere until late in July. This reduced the attraction of London for the investment of short-term funds for most of the period.

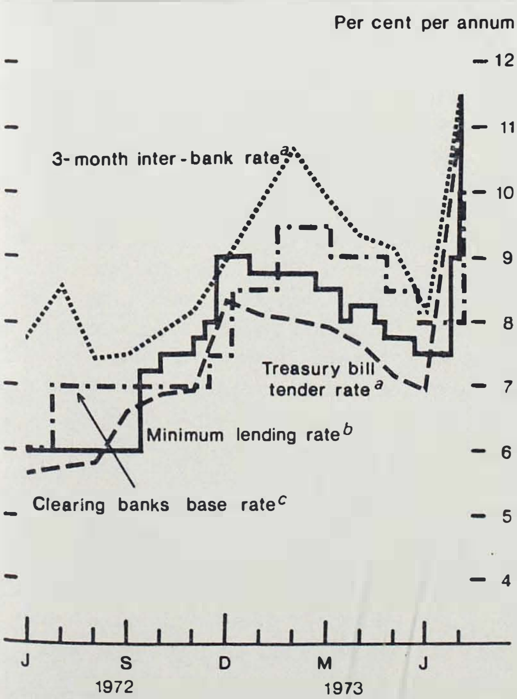
Among changes in continental Europe, the West German discount rate was raised by 1% to 6% at the beginning of May, as the authorities tightened credit; and further measures were reinforced at the beginning of June by another 1% increase. In France, as part of an anti-inflationary package introduced on 5th July, bank rate was increased by 1% to 8½%. In both Belgium and the Netherlands, bank rate was increased in stages to 6%.

In the United States also, tighter monetary policy produced rapid rises in interest rates. The limitation on the interest payable on deposits (Regulation Q) was further relaxed in May; reserve requirements were increased during the three months; and Federal Reserve rediscount rates, which had already been raised several times during 1973, were increased another three times, to bring them to 7%, their highest for over fifty years. The main U.S. banks increased their prime rates on several occasions in an endeavour to keep up with the rise in the market, and by the end of July had raised them to 8¾%. These increases were accompanied by a sharp rise in euro-dollar rates, which went up by some 3% over the period, to reach 11½%.

By contrast, interest rates in London, which had reached a peak in March, continued to decline for much of the period, and throughout the latter half of June and the first half of July they became increasingly out of line with those available in other centres. From the end of April until the authorities acted on 19th July, yields on 91-day Treasury bills fell by about ¾% to just under 7%. At the same time, three-month inter-bank rates, after a small rise early in May, fell by over 1½% to 8% early in July. The banks' base rates were generally lowered towards the end of May by ½% to 8½%, and by a further ½% towards the end of June. Money rates began to rise again after the authorities had signalled their concern after the tender on 6th July; and later, as a result of the measures taken on 19th July (described on page 276), there was a very sharp rise in rates. At the end of July, Treasury bill yields were about 11% and the inter-bank rate was 11½%; and early in August the main banks raised their base rates from 8% to 10%.

For most of the period the cost of forward cover for sterling narrowed, the discount on three-month money falling from 2¼% per annum to ¾% on 24th July. However, as sterling came under pressure in the following couple of days, forward margins widened very sharply as operators sought to roll on their short sterling positions. The discount on three-month sterling increased to as much as 4¼%, before ending the month at 3⅛%. The large rise in euro-dollar rates, which more than offset the rise in sterling interest rates, coupled with the increase in the cost of forward cover, meant that covered interest differentials moved very

Short-term interest rates in London



The sharp rise in the minimum lending rate at the end of July abruptly reversed the downward drift of short-term interest rates.

a Last Friday of month.

b Bank rate before 13 October 1972.

c Changes are recorded when a majority of the big four London clearing banks have moved to a new rate.

sharply against sterling. Thus the discount on the covered comparison between three-month inter-bank money and euro-dollars rose from 1% at the beginning of May to 4% towards the end of July, ending the period around 3%. Similarly, as even uncovered yields on U.K. Treasury bills fell below those for U.S. Treasury bills, the covered comparison in this area was also unfavourable to sterling.

The bill market

Throughout May and during the first ten days of June conditions were extremely tight in the money market, mainly as a result of heavy official sales of gilt-edged stock. The Bank gave help on every day except one. They lent funds on at least two and sometimes on four days during each of the six weeks, generally for terms of seven days but on some occasions for two days or overnight; and they gave substantial help also by purchases of Treasury, local authority, and eligible bank bills.

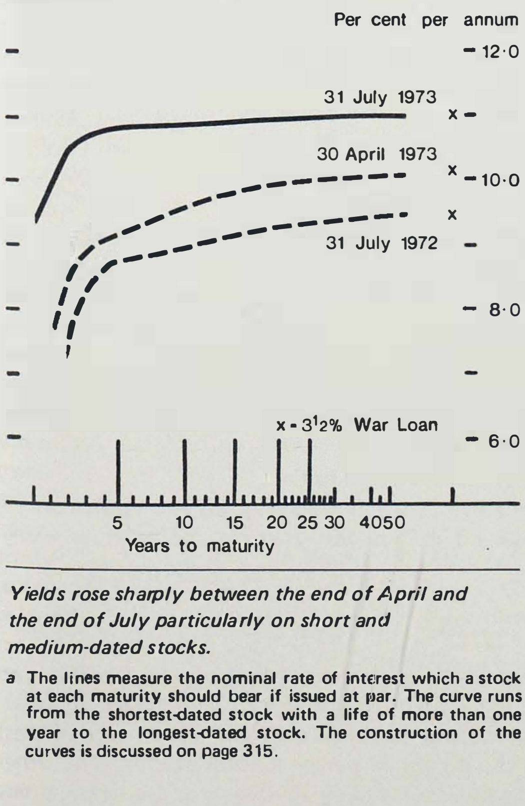
As a result of a change in sentiment in the gilt-edged market (discussed below), and with heavy disbursements on government account, conditions eased from 12th June, and the Bank sold Treasury bills to mop up surplus funds on four consecutive days. Thereafter conditions were generally fairly quiet until near the end of July.

Because the Government were raising large sums in the gilt-edged market, the amount of Treasury bills on offer was limited to £60 million at the first three tenders in May. Bills were very scarce — the amount outstanding in the market on 9th May was under £300 million — and they were in keen demand to help maintain reserve ratios and public sector lending ratios. As a result of the competition for bills, the average rate of discount at the tenders fell steadily, and the Bank's minimum lending rate was consequently reduced from 8¼% to 8% following the tender on 11th May and to 7¾% a week later. At the tender on 25th May, only £50 million of the £100 million bills on offer were allotted; this was followed by three tenders where the offerings were again £60 million. Competition for bills continued and the average rate of discount fell further. With heavy government disbursements to be met, £150 million bills were offered and allotted on 22nd June and £80 million on 29th June; but, despite these larger offerings, the market's appetite for bills remained strong. The average rate of discount continued to decline, and the minimum lending rate fell to 7½% after the tender on 22nd June.

Throughout May and June, the authorities were generally passive toward the decline in interest rates, and the Bank's own dealing rate was regularly lowered in line with the fall in the average tender rate. However, after the tender on 6th July, once again offering only £60 million, the Bank's dealing rate was kept unchanged despite a further decline in the average tender rate, because the possibility of any further fall in the minimum lending rate was unwelcome. The market acted on this signal, and on 13th July lowered their bids a little, even though the amount on offer was yet again only £60 million.

By now it was clear that a rise in at least short-term interest rates was needed; and, as described earlier, on 19th July a further call for Special Deposits was announced. At the same time new arrangements of credit control were instituted for the discount market; these reduced the pressure on the houses to compete for Treasury bills. Consequently, at the tender on the 20th, when as much as £180 million was offered, bids were lowered very sharply. The average discount rate rose by nearly 1½% to 8⅜%, sufficient to lift the Bank's minimum lending rate from 7½% to 9%, where it had been at the beginning of the year. Even so, the rise would have been greater had the authorities not taken up through the tender some of the bills on offer. At the following week's tender, with interest rates abroad still rising and the pound under pressure, the authorities were content to see an even sharper rise in the average rate of discount for the £150 million bills on offer — to over 10⅞%. As a consequence, the Bank's minimum lending rate rose to a record 11½%. With substantial foreign exchange settlements to be met, the money market was very short of funds at the beginning of the following week, and the Bank were able to make the new minimum lending rate effective by enforcing overnight borrowing on three consecutive days. As a result, inter-bank rates rose to a level which more than matched those prevailing in the euro-dollar market.

Time/yield curves of British government stocks[a]



Yields rose sharply between the end of April and the end of July particularly on short and medium-dated stocks.

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 curves is discussed on page 315.

The gilt-edged market

During May and the first ten days of June, the gilt-edged market remained generally firm, and at various times the short, medium and long-dated tap stocks all came into demand. On 2nd May, the short tap stock, 9% Treasury Stock 1978, was effectively exhausted, although the issue, of £600 million, had taken place as recently as 23rd March. Its replacement by £450 million 8% Treasury Stock 1975, offered at £99·75 per £100 nominal, was announced the same day. Of the two new stocks announced in the Budget, 9% Treasury Convertible Stock 1980 sold well to the institutions and 3% Treasury Stock 1979 began to appeal to the private investor for whom it was designed. Towards the middle of June, however, the market weakened markedly, and official sales virtually ceased. Overseas interest rates were rising and the pound was doing less well; and further falls in domestic rates were hardly to be expected. The change in mood was encouraged by the announcement on 13th June of the unfavourable overseas trade figures for May. In the nine weeks of a strong market after the miners' vote on 4th April against strike action, net official sales of stock had amounted to nearly £940 million.

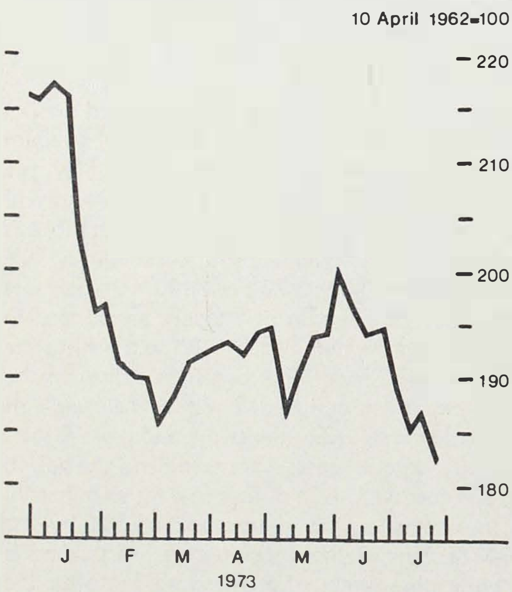
In the whole of the June quarter, the authorities on balance sold almost £950 million. Net sales of short and medium-dated stocks were heaviest. Stocks with between one and five years to maturity accounted for about £600 million, those with between five and fifteen years to maturity for nearly £400 million, and stocks with over fifteen years to run for around £100 million. On the other side of the account, on 1st April three stocks matured of which some £150 million was left to be redeemed from the market.

In July, the market continued to weaken. Prices fell sharply after the authorities tightened monetary policy on the 19th, and nominal yields became much higher. At the end of July undated stocks were yielding over 11%, nearly 1% higher than at the end of April, and high-coupon stocks of all maturities were yielding over 10%.

Government lending rates

On 19th July, the Treasury announced that from the 28th of the month interest charged on loans from the National Loans Fund and Public Works Loan Board was to be calculated by reference to the Bank's new time yield curve for government stocks. The new curve was introduced in an article in the *Bulletin* last December and further modification is described in another article on page 315. The Treasury regard the new method of calculation as more accurately reflecting their obligation under the National Loans Act 1968 to charge interest sufficient to cover the cost of equivalent government borrowing in the market. The effect of the change has generally been to raise rates a little above what would have been charged under the previous system. Local authorities typically borrow for around ten years, and the adjustment in that region has been about ½%.

Industrial share prices[a]



The equity market was generally dull and share prices at the end of July were at their lowest since November 1971.

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

Equity and debenture markets

Turnover in the equity market remained small during May to July. After their slow recovery in March and April, prices fell sharply in early May, and by 11th the F.T.-Actuaries industrial (500) share price index had fallen to 184, from 194 at the end of April. Thereafter, until early June, prices again recovered, helped among other influences by better trade figures and good results for I.C.I.; and the index reached 202 on 8th June, its highest since January. From then until the end of July, prices were generally tending to drift downward, and the index at the end of the period stood at 183.

The number of new equity issues remained small, but the amount of cash raised was bigger because of the flotation in May of Rolls-Royce Motors Holdings Limited for £32 million, one of the largest sums ever raised at one time in the equity market. In total, equity issues in the three months raised some £75 million of new money, compared with £40 million in the previous three, but with £300 million in the same months a year earlier. (Another big issue, heavily oversubscribed, for £15 million of J. Sainsbury Limited, in July, raised no new money for the company itself and is excluded from the statistics.)

Turnover in the debenture market fell away in May and remained low for the rest of the period. Prices in fact rose a little in May, but fell sharply at the beginning of June and generally continued to edge downward until towards the end of July, when they suffered a very sharp fall after monetary policy was tightened. At the end of the month yields on first-class high-coupon debentures were about 11¼%, over ¾% more than at the end of April. Only about £20 million was raised by companies on fixed interest stocks in the three months.

Net sales of unit trust units during May to July amounted to £58 million, about £6 million less than in the previous three months.

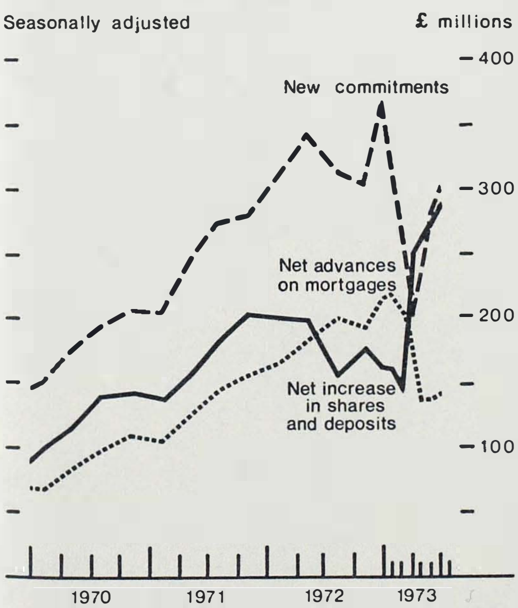
Finance houses

After growing very strongly during the first quarter, the finance houses' hire purchase and other instalment credit business grew more moderately in the second quarter. These movements broadly followed the course of personal consumption. The total rise in instalment debt outstanding in the second quarter, after seasonal adjustment, was just over £50 million, compared with the record increase of more than £130 million in the previous quarter.

The combined reserve ratio of the ten houses observing a minimum ratio of 10% rose from 10·5% at mid-April to 10·8% at mid-June, but then fell back to 10·5% at mid-July. These houses were subject to the further call for Special Deposits of 1% of eligible liabilities which was announced on 19th July.

A typical rate of interest offered by finance houses on three-month deposits fell only slightly from 9½% during May. By the end of June, however, rates had fallen substantially to around 8%, this being in line with the movement of other short-term rates. During July, rates steadied, and then rose after the tightening of monetary policy on the 19th. At the end of the month, the three-month rate was nearly 11½%. The Finance Houses Association's base rate, calculated monthly from the average three-month inter-bank rate during the previous eight weeks, fell by a full 1% to 9½% on 1st June, remained unchanged on 1st July, and fell by a further ½% on 1st August.

Building society funds



Backed by a strong inflow of funds, the societies again committed themselves to a high rate of new lending but remained more cautious than last year.

Building societies

During May to July, the building societies were more comfortable than in the previous period. On 1st May, the Building Societies Association's recommended share rate went up to a record 6·75%, equivalent to 9·64% grossed up at the basic rate of tax. The societies' position was further aided by a general easing in competitive interest rates, and by the failure of national savings to respond as well as the societies might have been expecting to the improvements in terms announced in the Budget. As a result, there was a record inflow of funds to the societies in the three months to the end of July, and net receipts, at £820 million after seasonal adjustment, were 50% greater than in the previous three months.

The net increase in mortgage advances, on the other hand, was some 30% less than in the previous period; and the societies' combined liquidity ratio, allowing for seasonal adjustment, rose from 14·6% at the end of April to 16·4% at the end of July. Lending fell largely because of the sharp reduction in new commitments which had occurred between January and April when the flow of funds to the societies was at its lowest. From May onwards the societies again became keener to take on new commitments, but at a rate well below that in January and much of 1972. The more cautious behaviour of the societies since the new year coincided with and probably contributed to a significant change in at least one aspect of the housing market — the rate of growth of house prices — which, according to the Nationwide Building Society's index, showed a marked and welcome deceleration in the second quarter.

The recommended mortgage rate remained unchanged at 9·5% until the middle of August. The imminent ending of the three-month bridging grant which the Government had made to help borrowers,[1] led the Building Societies Association to reconsider the existing share and mortgage rates on 13th July. At that meeting, they decided to leave the recommended mortgage rate at 9·5% but to reduce the share rate to 6·4% from 1st September. The continuing inflow of funds and the need to help the Government's incomes policy were doubtless the two main influences that decided them against a rise in the mortgage rate. However, the strong rise in other interest rates which developed after the

1 June *Bulletin*, page 146.

authorities tightened monetary policy on 19th July, led the association to reconsider their rates once more on 14th August, and they then decided to leave the share rate at 6·75% after all, and to raise the mortgage rate to 10%.

The Government have not been concerned solely with the short-term problems of a possible rise in the mortgage rate. In the period under review, a number of informal discussions on longer-term problems took place between the Department of the Environment and the Building Societies Association. In initiating these, the Government were anxious to see what could be done to help first-time house-buyers, who have been seriously affected by rapidly rising prices in the last two years. They also wished to explore whether the societies could obtain a steadier inflow of funds; this would help prevent the alternating mortgage 'gluts' and 'famines' which have been one influence behind both the very large cyclical swings in private housebuilding in the last twenty years and the recent explosive rise in house prices.