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October 20, 1965

Recent Economic Developments in the United Kingdom:
July-October 1965

24 pages

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Summary

Economic developments in the United Kingdom took a turn for the better during the period under review.[1/] In the second quarter the balance of payments improved markedly and the growth of domestic demand eased; in September-October the sterling exchange rates moved up sharply. At the same time, the Labor government continued in its efforts to strengthen the balance of payments program. On July 27, the British authorities took further steps to curtail domestic spending and to tighten exchange control regulations.[2/] On September 2, Labor officials announced plans to obtain Parliamentary approval for a compulsory "early warning" system on price and wage increases. Then, on September 10, the Bank of England announced that an additional package of international central bank credits had been arranged.

Prior to the July measures, there was some evidence that the growth of domestic demand eased in the three months April-June. Between the first and second quarters, retail sales fell about 1-1/2 per cent and fixed investment outlays in manufacturing dropped 5.3 per cent. (See Table 1.) Press reports also suggest that automobile registrations fell off and that private housing starts decreased substantially.

1/ For a review of earlier developments see "Recent Economic Developments in the United Kingdom: June-July 1965" dated July 30, 1965.
2/ Ibid., pp. 2-3.

On the other hand, some of the adverse economic trends of earlier months continued during the second and third quarters: import volume increased sharply; retail prices and money wages continued to climb; and labor market pressures became very intense in April-June, although they eased a little in the third quarter. (See Table 1.)

Table 1. United Kingdom: Selected Economic Indicators, 1964-1965
(monthly average or monthly)

	1964	1965						
	IV	I	II	April	May	June	July	Aug.
Volume indices a/								
Industrial prod.	131	132	131	131	132	130	131	n.a.
Retail trade	107	108	106	107	107	105	107	n.a.
Exports	113	115	113	115	113	111	124	116
Imports	119	114	120	118	125	118	123	126
Capital outlays in manufacturing (£m) a/ b/	294	318	302	--	--	--	--	--
Unemployment rate	1.5	1.6	1.3	1.5	1.3	1.2	1.2	1.5
Prices								
Retail prices	108.0	109.7	112.4	112.0	112.4	112.7	112.7	112.9
Weekly wage rates	141.9	144.1	145.2	144.8	145.3	146.3	147.5	147.7

a/ Seasonally adjusted.
b/ Quarterly totals; 1958 prices.
Source: Monthly Digest of Statistics.

Britain's external position improved in both the second and third quarters. For the second quarter, balance of payments statistics showed a current and long-term capital account surplus of £28 million compared to a £130 million deficit in the first. (See Table 7.) In the third quarter exports jumped sharply, reducing the trade deficit, on a seasonally adjusted basis. (See Table 8.)

The lower level of private domestic demand in the second quarter and the better export position in the third were not entirely due to the government's balance of payments program. On the domestic side, severe restraints on consumer spending were not imposed until the middle of 1965, and attempts to limit investment outlays were not made until the end of July.[3/] Hence, the second quarter shortfalls in spending in these two areas may have been, to a significant extent, a reaction to the increases in spending which preceded the expected restrictive measures of the April budget.

Spending patterns for the third quarter are not yet available, but a survey of investment intentions taken by the Board of Trade in August and September suggests that investment outlays in manufacture over the last half of 1965 will not be seriously affected by the measures of July 27. The new survey, just like the one taken at the beginning of the year, indicates that the expected increase in expenditures between 1964 and 1965 is 10 per cent and that for 1966 the spending will at least hold to the 1965 level.

As for exports, the sharp third quarter jump in value (and volume--see Table 1) seems to have been due to a bunching of deliveries of specialized equipment--machinery, ships and aircraft--rather than a more broadly based swing of goods and resources into export channels. Taking a longer view, over the first 8 months of 1965 the value of

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3/ *loc. cit.*

exports has risen much more rapidly than the volume of foreign sales. Comparing average monthly figures for January-August 1965 with all of 1964, the value of exports has risen 5.2 per cent while volume increased only 3.6 per cent.

Despite the mixed tendencies in the British economy, sterling exchange rates improved markedly during the period under review. In early September the spot rate began to move up from the 279.00 (U.S. cents) level that had been in effect since mid-June: on September 29 it moved above 280.00 cents and by October 18 it reached 280.27 cents. Between September 1 and October 18 the forward discount narrowed from 2.55 per cent per annum to 1.25. For the month of September, Britain reported official reserve gains of $170.8 million--after repayment of an unspecified amount of central bank credits--indicating the significant change in market sentiment for the pound.

The decision to obtain Parliamentary authority to introduce an "early warning" system on price and wage increases, which was announced on September 2, contributed to the change in sentiment. At the next session of Parliament, Labor Party leaders will introduce legislation giving the government power:

(a) to require notification of intended price advances and to require notification of claims relating to pay, hours or other major improvements and prospective terms of settlement;

(b) to refer such proposed price or wage increases for review by the National Board for Prices and Incomes; and

(c) to require that such proposed price or wage increases be deferred until after the Board has reported its findings.

In addition, the National Board for Prices and Incomes is to be placed on a statutory basis with powers to subpoena witnesses and information relating to price and wage claims. Labor government officials made it clear that they did not intend to invoke these powers unless, in their opinion, it became absolutely necessary. On this basis, both the Trade Union Congress and the Labor Party Annual Conference gave majority votes in support of the government program.

The announcement by the Bank of England on September 10 of substantial additional international central bank credits to support the pound in the event of a future sterling crisis provided the push needed to alter materially exchange market sentiment about the pound.

In other developments, credit conditions generally remained tight during the period under review; new borrowing by the private sector proceeded at a decidedly slower pace than in the same period a year earlier. However, in August-September bond yields dropped sharply in a period of about six weeks, shaking off nearly all of the increases recorded in the 36 weeks since the change in Bank Rate in November 1964.

Finally, Labor government officials announced on September 16 a National Plan for economic performance for the years 1965 to 1970. The Plan--essentially a statement of obtainable objectives--calls for:

(a) National output to be raised by a total of 25 per cent;

(b) Productivity to increase at an average rate of 3.4 per cent per year compared to 2.75 per cent per year in 1960-64;

(c) Export volume to grow by 5.25 per cent per year compared to only 3-1/2 per cent per year in 1960-64;

(d) Import volume to grow at the 4 per cent average annual rate of recent years despite the anticipation of accelerated growth in Britain; and

(e) The trade deficit to be reduced from £450 million in 1964 to only £45 million per annum.

Concrete policies for the attainment of these objectives have not as yet been spelled out.

Industrial output stops growing

After a substantial upsurge between September 1964 and January 1965, the rate of industrial output in Britain dropped off in February and March and remained at the lower level through July. (See Table 2.)

During the earlier period, output in all major industrial sub-groups--except mining and textiles--experienced production growth. The lower aggregate output levels since January came from broadly based shortfalls in most industries; the principal exception has been the chemicals group where output has remained at the January peak.

The easing of private sector demand and the stagnation of foreign sales in the second quarter contributed to the lower level of total output. A rash of wildcat strikes and a significant increase in the number of working days lost due to industrial stoppages in the second quarter also led to the cessation of output growth this year.

Table 2. United Kingdom: Indices of Industrial Output 1964-1965
(seasonally adjusted: 1958=100)

	1964			1965			
	July	Sept.	Nov.	Jan.	Mar.	May	July
All industries	128	128	130	133	131	132	131
Mining	95	94	95	97	94	93	n. a.
Manufacturing	129	129	132	135	131	134	133
Food	118	121	121	121	122	118	119
Chemicals	154	152	154	157	158	153	158
Metals	129	123	133	138	132	136	133
Engineering	126	127	130	136	130	132	133
Textiles	118	119	119	120	116	122	119
Other	139	140	141	144	140	142	140
Construction a/	--	136	137	--	139	n. a.	n. a.
Gas, electricity, water	136	134	139	143	148	139	n. a.

a/ Quarterly totals: entered under September for third quarter, November for fourth quarter, and March for first quarter.
Source: Monthly Digest of Statistics.

(See Table 3.) Pressures on plant and equipment, on the other hand, apparently eased in the second quarter, perhaps because of the large investment outlays in 1964. In the June survey of industrial trends by the Federation of British Industries, there were fewer firms reported to be operating at full capacity than there were four months ago.

Pressures on labor market ease in third quarter

The demand for labor remained at a very high level during the period under review despite a slight easing in the third quarter. The number of unemployed rose slightly in July-September and total job vacancies fell. As a result, the unemployment rate moved up from 1.3 to 1.4 per cent. (See Table 3.) The third quarter increase in the number of unemployed and decrease in job vacancies was greater than would have been expected on seasonal grounds alone. (See Table 3.)

Table 3. United Kingdom: Labor Market Indicators, 1964-1965 [a]
(monthly average)

	1964				1965		
	I	II	III	IV	I	II	III
Unemployment rate	2.1	1.6	1.5	1.5	1.6	1.3	1.4
Total unemployed	465	367	342	348	372	308	311
Total vacancies	258	334	357	318	332	429	421
Ratio of vacancies to unemployed	0.55	0.91	1.04	0.91	0.89	1.39	1.35
Changes in:							
Unemployed;							
Actual b/	-11.3	-32.6	0.0	- 5.6	+ 1.4	-24	+ 6.0
Seasonal b/	+ 8.0	-25.0	+ 2.0	+15.0	+ 8.0	-25.0	+ 2.0
Vacancies;							
Actual	+27.8	+23.8	-10.0	- 9.0	+15.4	+30.3	-19.2
Seasonal	+ 1.9	+18.6	- 8.3	-12.3	+ 1.9	+18.6	- 8.3
Total working days lost due to industrial stoppages	246	215	169	129	302	364	n.a.

a/ All data in thousands accept unemployment rate and ratio of vacancies to unemployed.
b/ Excludes school leavers.
Source: Monthly Digest of Statistics.

Although business concerns released some employees as a result of the reduced demand, they also shortened the work week. Time lost due to a shorter work week in manufacturing rose to 956,000 hours for the week ending August 14, from 220,000 for the week ending July 17. This increase does not appear to be due solely to seasonal factors for in 1963 and 1964 the amount of hours lost during the August reporting week was about the same as those during the reporting week for July.

Prices and wages move steadily upward

Through the first six months of 1965, British prices and wages rose at about the same rate as they did in the same period in 1964. By the end of September, there was still no clear sign of abatement in the wage-price spiral.

Table 4. United Kingdom: Basic Price Indices, 1963-1965

	Level	Percent changes			Level			
	Dec. 1963	Dec. 1963- June 1964	June 1964- Dec. 1964	Dec. 1964- June 1965	June	June	Aug.	Sept.
Retail prices	104.2	+3.1	+1.6	+3.2	112.7	112.7	112.9	113.0
Wholesale prices								
Manufactured goods (domestic market)	121.0	+2.8	+1.7	+2.7	129.9	130.0	130.1	130.2
Basic materials	106.3	-0.2	+1.7	-0.6	107.2	106.8	106.6	107.2
Wage rates (weekly average)	137.6	+1.7	+2.1	+2.4	146.3	147.5	147.7	n.a.
Export prices	105.0	+1.0	+1.0	+1.0	108.0	108.0	109.0	n.a.
Import prices	106.0	0.0	+0.9	0.0	107.0	106.0	106.0	n.a.

Source: Monthly Digest of Statistics.

In addition, new labor contracts signed in July and August have granted wage increases of 6 per cent per year on the average--much the same as during the first half of 1965 and far in excess of the government's guide line of from 3 to 3-1/2 per cent.

Largely because of these developments, the Labor government proposed, on September 2, a compulsory "early warning" system for price and wage increases.[4/] At that time, Labor officials made it clear they would invoke the powers they were seeking only if it became absolutely necessary; they suggested that labor and management organizations establish "early warning" systems on a voluntary basis. On September 8, the Trades Unions Congress (T.U.C.) voted to create such a voluntary system (5.2 million to 3.3 million votes) and on September 22 it established a committee to examine wage claims before they were submitted to employer groups.

On September 30 the Labor Party Annual Conference endorsed the government's program by 3.6 million to 2.5 million votes.

The Confederation of British Industries (C.B.I.)--the largest of Britain's management associations--agreed with the principle of an early warning system, but has not yet taken steps to establish one. C.B.I. officials claim that the main efforts toward slowing the wage-price spiral must be aimed at wages. In this connection it is now considering a plan whereby all agreements between companies and unions on wage hikes will be submitted to the Department of Economic Affairs for consideration before the extra money will be paid.

New orders position weaker at mid year

Net new orders from domestic and foreign buyers for engineering goods and ships fell off sharply in the second quarter. (See Table 5.) For the engineering group, this marks the second consecutive

4/ See above pp. 4-5.

quarterly decline: revised figures for the January-March period show an 8 per cent decline from the peak reached in the final months of 1964.

Table 5. United Kingdom: Net New Orders, Domestic and Export 1964-1965

	1964				1965	
	I	II	III	IV	I	II
Engineering industries (index: 1958=100) a/						
Domestic	145	154	147	164	152	139
Export	137	147	155	163	153	140
Shipbuilding b/ (Ths. gross tons)						
Domestic	269	294	60	n.a.	250	200
Export	30	16	53	c/	207	168

a/ Seasonally adjusted.
b/ All vessels 100 gross tons and over.
c/ Modifications and cancellations exceeded new orders for this period.
Source: Monthly Digest of Statistics.

Despite these declines, both industries still have substantial order backlogs. In the engineering industry, for example, total export orders on hand in the second quarter averaged 7 per cent higher than during the last three months of 1964.

New private sector borrowing beginning to rise

The rate of new borrowing by the private sector picked up in the third quarter of 1965, in marked contrast to developments during the first half of the year. However, for the nine months ending in September, total new lending by major groups of financial institutions is still appreciably less than during the same period in 1964. (See Table 6.)

Table 6. United Kingdom: New Borrowing by the Private Sector 1964-1965
(£ million)

	1964				1965		
	I	II	III	IV	I	II	III
Bank advances a/							
Actual	231	76	135	105	174	-12	-31
Seasonally adj.	50	105	210	210	-35	15	103
Installment credit b/	31	57	41	31	24	54	d/ 15
New issues by U.K. corp. c/	175	137	126	71	87	62	135
Advances by building societies	227	272	285	273	234	220	d/137

a/ London clearing banks.
b/ Debt owed to finance houses and department stores.
c/ Net of gross redemptions.
d/ July and August.

Source: Financial Statistics.

In the July-September period, net new issues by U.K. corporations rose £135 million compared with £159 million for the six months from January through June, and bank advances (seasonally adjusted) increased by £103 million as opposed to a £20 million decline during the previous six months. Bank advances (seasonally adjusted) totalled £4,678 million at mid-September. Thus, the banks can expand their advances another £110 million in the six months to March 1966, before reaching the 5 per cent ceiling imposed by the Bank of England last May.

Installment credit extensions increased only marginally in July and August--after a sharp rise in the second quarter--reflecting the tighter controls imposed by British authorities in June and July. (See Table 6.)

Data on the lending activities of the building societies are not available for the entire third quarter. However, through August the decline in the rate of growth of new loans (which began late in 1964) was no longer as rapid as it was early in 1965. (See Table 6.)

Balance of payments improves further in the second quarter

Britain's current and long-term capital account, which had shown diminishing quarterly deficits between September 1964 and March 1965, swung sharply into surplus in the April-June period. (See Table 7, item C.) However, a short-term capital outflow of about £151 million more than offset this small surplus: as a result, Britain's financing requirements for the second quarter were the same as those for the first. (See Table 7, items E and F.)

A number of factors contributed to the noticeable improvement in the current and long-term capital account. First, strong seasonal factors reduced the deficit on trade account to only £59 million. Secondly, the surplus on non-merchandise transactions (invisible balance) increased to £84 million. Thirdly, the long-term capital account showed a small surplus; there were deficits of about £90 million in the previous two quarters. (See Table 7, items A and B.)

Table 7. United Kingdom: Balance of Payments, 1964-1965
(£ m)

	1964 I	1964 II	1964 III	1964 IV	1965 I	1965 II
A. Current account						
Imports	1,249	1,254	1,217	1,285	1,227	1,270
Exports and re-exports	1,126	1,153	1,030	1,162	1,141	1,211
Visible balance	-123	-101	-187	-123	- 86	- 59
Invisible balance	+ 67	+ 38	- 5	+ 22	+ 45	+ 84
Current balance	- 56	- 63	-192	-101	- 41	+ 25
B. Long-term capital	- 86	-107	- 57	- 94	- 89	+ 3
C. Current and long-term capital	-142	-170	-249	-195	-130	+ 28
D. Balancing item	+ 58	+ 7	+ 2	- 32	--	- 19
E. Short-term capital	- 83	+174	+122	-355	- 43	-151
F. Overall balance	+ 1	+ 11	-125	-582	-143	-142
G. Financing a/						
Central bank assistance	--	+ 5	+ 66	+137	+148	-207
Swiss loan	--	--	--	+ 28	--	+ 14
I.M.F. drawing	--	--	--	+357	--	+500
Reserves	- 1	- 16	+ 59	+ 80	- 5	-165
Total	- 1	- 11	+125	+582	+143	+142

a/ Assets: increase -; decrease +.
Liabilities increase +; decrease -.
Source: Economic Trends, September 1965.

According to the Board of Trade, the turnaround in the long-term capital account was confined to private transactions. The Board reported that there was: (1) a substantial net disinvestment in portfolio holdings by U.K. residents; (2) a reduction in overseas direct investment; and (3) a sharp rise in direct investment in the U.K. (principally from the U.S.).

Despite this improvement in the current and long-term capital account, Britain recorded on overall payments deficit of £142 million in the second quarter, largely because of a £151 million short-term capital outflow. (See Table 7 and item E.) Much, if not all, of this outflow reflected speculative pressures against the pound which were particularly intense in early April and late June.

The overall deficit was financed from the proceeds of an IMF drawings and a Swiss loan, which together totalled £514 million. Of the remaining borrowed funds, £165 million were added to reserves and £207 million were used to repay central bank credits. (See Table 7.) However, by the end of June, central bank credits outstanding still totalled about £50 million.5/

Third quarter trade outturn--seasonally adjusted--quite favorable

Britain's foreign trade performance improved noticeably in the third quarter--on a seasonally adjusted basis--as exports rose and imports remained close to the second quarter level. The trade deficit (estimated on a balance of payments basis) was reduced to a monthly average of only £26 million compared to £40 million per month in the preceding quarter. (See Table 8.)

5/ For the two months (April and May) Bank of England data show a net repayment of about £364 million with no Central bank credits outstanding at the end of May. (Bank of England, Quarterly Bulletin, June 1965, p. 109.) Board of Trade quarterly data show a net repayment of only £207 million for the entire second quarter. Hence, the Bank of England must have used £57 million of central bank assistance in June to meet the speculative attacks upon sterling in that month.

Table 8. United Kingdom: Foreign Trade, 1964-1965
(£ m: monthly or monthly average; seasonally adjusted)

	1964	1965					
	Year	I	II	III	July	Aug.	Sept.
Imports (c.i.f.)	475	458	483	486	484	500	475
Exports and re-exports (f.o.b.)	381	396	393	414	434	406	402
Surplus/deficit	-94	-62	-90	-72	-50	-94	-73
Trade balance a/	-46	-13	-40	-26	- 1	-53	-23

a/ Adjusted to balance of payments basis.
Source: Board of Trade.

The wide month-to-month swings in the trade figures make it difficult to assess the underlying trends. However, for the January-September period, exports and re-exports in 1965 averaged 5 per cent above, and imports remained at about the same level as, the averages for 1964 as a whole. In 1965, exports moved to a high plateau in the first quarter, held steady in the second and jumped to a higher level in the third. Imports, on the other hand, dropped sharply in the first quarter, rose strongly in the second and held at this higher level in the third. (See Table 8.)

The main thrust behind higher exports this year is in increased sales of machinery and transportation equipment and "other" manufactured goods. Quarterly movements in these two items closely parallel those of total exports. (See Table 9.) Movements in total imports, on the other hand are broadly based, reflecting changes in items not covered by the surcharge--food, beverages and tobacco--as well as changes in items that are covered--industrial materials and finished manufactured goods. (See Table 9.)

Table 9. United Kingdom: Foreign Trade by Commodity Classes, 1964-1965
(£ m: seasonally adjusted; monthly or monthly average)

	1964				1965			
	I	II	III	IV	I	II	July	Aug.
Imports (c.i.f.)								
Food, beverages and tobacco	151	147	152	143	132	144	141	159
Industrial materials	197	206	204	209	200	211	206	212
Finished manufactures	68	71	70	69	65	73	80	78
Other	53	53	50	57	61	57	57	51
Total	469	477	476	478	458	485	484	500
Exports (f.o.b.)								
Manufactures								
Machinery and transport equipment	157	150	148	154	159	157	175	169
Chemicals	33	33	35	35	36	36	39	36
Textiles	22	23	23	24	23	23	25	22
Other manuf.	92	99	100	101	104	107	114	108
Other	63	60	57	63	65	56	64	56
Total	367	365	363	377	387	379	417	391

Source: Board of Trade.

Official reserves fell by $36 million in the third quarter

Official British holdings of gold and foreign exchange fell sharply in July and August, but a reported $170.8 million gain in September kept the third quarter loss to only $36.4 million. (See Table 10.)

This loss does not, however, reflect Britain's overall balance of payments position (as defined by item F in Table 7) for the third quarter because U.K. Treasury officials revealed that central bank assistance was utilized in July and August while some repayment of these credits was made in September. The amounts involved were not made public.

Table 10. United Kingdom: Official Reserve Position, 1965
($ m)

	Changes in:				Total holdings
	June	July	Aug.	Sept.	Sept. 31
Official holdings of gold and foreign exchange	-67.2	-140	-67.2	+170.8	2,755.2

Source: U.K. Treasury.

Money market conditions still tight

Credit conditions in British money markets generally remained on the tight side during the period under review, although the cost of short-term funds did fluctuate modestly. Local authority deposit rates and the Treasury bill yield tended to rise between July and August, but eased thereafter; Euro-dollar deposit rates, on the other hand, edged off in July-August, only to move up in September and October. (See Table 11.)

In the call money market, rates fluctuated a great deal during the period under review, but money has been generally in short supply and the Bank of England was quite active in making funds available. For the most part, this was accomplished through open market purchases of bills, although upon occasion the discount houses were forced to borrow at Bank Rate.

The most recent cause for such borrowing was the September-October slide in the Treasury bill rate. The discount houses, as they did repeatedly in the past, raised their bidding price for new bills

Table 11. United Kingdom: Selected Money Market Rates, July-October 1965
(per cent per annum)

	July 2	July 16	Aug. 6	Sept. 3	Sept. 24	Oct. 8	Oct. 15
Call money	5.38	5.44	5.38	5.56	5.50	5.56	5.53
Local authority deposits							
2-day	6.13	5.94	6.31	6.31	6.00	5.88	5.81
90-day	6.38	6.38	6.69	6.56	6.44	6.19	6.12
Euro-$ deposits							
Call	4.38	4.25	4.13	4.00	4.12	4.25	4.25
90-day	4.88	4.75	4.63	4.38	4.50	5.00	5.06
Treasury bill (market rate)	5.42	5.54	5.54	5.54	5.43	5.31	5.37

at the weekly tender in order to secure a larger percentage of the unseasonally low weekly offerings. Another reason for the higher price (lower yield) was the expectation of a cut in Bank rate. The Bank of England, in order to squelch these expectations and to put upward pressure on short-term rates, forced the houses to borrow at Bank Rate upon several occasions in September and October. The discount houses responded to this pressure by lowering their bidding price on October 15 and the market yield on Treasury bills rose to 5.37 per cent. (See Table 11.)

The upward movement in local authority deposit rates in late July and August seems to have resulted from the fact that the authorities became active bidders for deposit funds because alternative sources of cash were drying up. First, tax revenues (which reach a seasonal high in April-June) dropped to a seasonal low in July-September. Secondly, borrowing from the Public Works Loan Board was reduced appreciably in July and August to a monthly average of £35 million compared to about £60 million for April-June. Thirdly, capital issues totalled only £14.1 million in July-August compared to £64.5 million in the previous three months.

The fall in deposit rates during September-October is more difficult to explain because alternative domestic supplies of cash were still quite meager. At least loans from the PWLB totalled only £3 million in September.[6/] However, capital issues totalled £16 million in September--£2 million more than in the two preceding months combined; as a result, local authorities could have become less active in bidding for deposit funds. On the other hand, the strong showing of sterling during the last two months coupled with substantial official reserve gains in September strongly suggest a capital flow from Euro-dollar deposits into local authority deposits. On a covered basis, local authority deposits earned more than Euro-dollar deposits in late September and early October. (See Table 13.)

6/ The substantial reduction in the rate of borrowing in the third quarter--£72 million compared to £180 million for April-June--represents an attempt by British officials to space out such loans through March of 1965. One-half of the amount allotted in the April 1965 budget had been used by the end of June.

<u>Capital market conditions strengthen sharply in August-September</u>

After months of very light trading activity in British capital markets, buyer interest finally picked up in August--especially in long-term government bonds. In the six weeks from August 5 to September 16, government long-term bond yields recouped all of the losses recorded in the preceding 36 weeks after the change in Bank rate in November 1964. Since mid-September, bond yields have fluctuated around these lower levels. (See Table 12.) This change in sentiment broadened into a major reversal of trends in other financial markets during September and October. By October 14, the <u>Financial Times</u> index of 500 industrials was slightly above the level recorded on November 29, 1964. (See Table 12.)

The increased demand for long-term bonds after August 5 probably reflected the anticipated effects of the special measures announced by the authorities on July 27--designed to slow the growth of public and private investment spending--and the very favorable July trade returns.

The recovery of stock prices, on the other hand, began after the Labor government announced on September 2 plans to establish a statutory "early warning" system on prices and wages. (See Table 12.)

Conditions in financial markets continued to strengthen after the September 10 announcement of central bank credits by the Bank of England.

Table 12. United Kingdom: Selected Capital Market Yields, November 1964-October 1965
(in per cent per annum)

	1964	1965					
	Nov.	Aug.	September			October	
Government bonds	26	5	2	16	30	7	14
5% 1967	6.02	6.60	6.67	6.57	6.62	6.55	6.55
5% 1971	6.02	6.92	6.64	6.55	6.57	6.52	6.50
5-1/2% 1982-84	6.17	6.82	6.58	6.26	6.29	6.33	6.31
5-1/2% 2008-12	6.27	6.77	6.55	6.30	6.27	6.30	6.32
3-1/2% War Loan	6.32	6.84	6.58	6.35	6.33	6.37	6.39
Stocks a/							
Price index	109.80	101.62	101.22	104.59	107.19	108.31	110.28
Dividend yield	5.05	5.86	5.90	5.71	5.58	5.52	5.43

a/ *Financial Times*, 500 industrials.

Sterling rates recover sharply in September-October

Beginning in early September, the sterling exchange rates began a steady and dramatic improvement after two-and-one-half months of recurring, and at times quite heavy, speculative pressure. Between August 27 and October 15, the spot rate rose from 279.02 (U.S. cents) to 280.27 cents and the forward discount narrowed from 2.49 to 1.25 per cent per annum. (See Table 13.)

This substantial improvement in market tone seems to be related to two factors: (1) the September 2 announcement by government officials of plans to establish a statutory early warning system on prices and wages; and (2) the international support operation announced by the Bank of England on September 10.

Table 13. United Kingdom: Exchange Rates and Arbitrage Calculations, July-October 1965

	July	August		September		October	
	23	6	27	3	24	1	15
Exchange rates							
Spot (U.S. cents)	279.01	279.02	279.02	279.18	279.95	280.27	280.27
Fwd. (p.c. p.a.)	-1.98	-2.54	-2.49	-2.59	-1.73	-1.38	-1.27
3-month yields and yield spreads							
Treasury bills							
U.K. (covered)	3.48	2.92	2.90	2.93	3.63	3.89	4.03
U.S.	3.79	3.82	3.83	3.84	3.94	3.99	3.99
Spread	-0.31	-0.90	-0.93	-0.91	-0.31	-0.10	+0.04
Deposit rates							
Local authority (covered)	4.46	4.15	4.14	3.97	4.71	4.93	4.85
Euro-dollar	4.56	4.75	4.44	4.38	4.50	4.88	5.06
Spread	-0.10	-0.60	-0.30	-0.41	+0.21	+0.05	-0.21
Euro-dollar a/	4.75	4.69	4.50	4.44	4.50	4.88	5.00
New York C.D.'s a/b/	4.28	4.29	4.28	4.31	4.34	4.37	4.45
Spread	+0.47	+0.40	+0.21	+0.13	+0.16	+0.51	+0.55

a/ Previous Wednesday.
b/ Negotiable New York time certificates of deposit.

The significant narrowing of the discount on forward sterling had a marked impact upon arbitrage calculations. The covered differentials on Treasury bills actually favored London by 4 basis points on October 15 compared to an average of 90 basis points for the month of August in favor of New York. In the market for 90-day deposit funds Euro-dollar deposits earned as much as 50-60 basis points more than covered local authority deposits in August; by early September the covered differential had swung in favor of local authority deposits. (See Table 13.)

In other developments, the differential between Euro-dollars and New York C.D.'s narrowed considerably between late July and early September owing to a rise in C.D. rates and a fall in Euro-dollar rates. More recently, however, Euro-dollar rates have moved up again, and the differential favoring these deposits has widened out to over 50 basis points. (See Table 13.)