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No. 81

FEDERAL RESERVE BANK
OF RICHMONDCAPITAL MARKET DEVELOPMENTS ABROAD

- I. United Kingdom
II. Nine Charts on Financial Markets Abroad

I. United Kingdom: Money and Capital Markets in September

A continuing decline in interest rates took place in British money and capital markets in September and early October. In the last two weeks of September, yields on medium dated-securities fell by about 50 basis points and those on undated securities by about 20 basis points. (See Table 6.) The continued distrust of equities at a time when the domestic business situation remains sluggish and the prospects for short-term capital gains encouraged private investors to buy gilt-edged securities. With liquidity ratios high and with private loan demands somewhat restrained, reductions in Special Deposit requirements of the London clearing banks supported the rise in gilt-edged prices.

However, gilt-edged prices fell by 1 per cent on October 9 and failed to regain the lost ground during the following week. This setback in bond prices "reflects an element of sheer exhaustion and ... a correction of some overextended positions," in the opinion of The Economist (October 13, 1962, p. 165).

The downward trend in money rates was evident outside financial markets. The Public Works Loan Board reduced lending rates by 1/8 per cent in late August, in mid-September and in early October (from 6-5/8 to 6-3/8 per cent). Home mortgage rates were also affected. Some independent building societies lowered their rates on household mortgages but the Council of Building Societies (comprising most of these institutions) decided that they would hold their rates at 6-1/2 per cent but that they might recommend lower rates before Christmas if current trends continue.

On October 3, the British authorities took cautious steps in the direction of further relaxations of the July 1961 program of fiscal and monetary restraints. The Special Deposits of the banks were again reduced (from 2 to 1 per cent for the London clearing banks following a reduction from 3 to 2 per cent on May 31, 1962), and the Bank of England has informed all financial institutions that existing qualitative controls on lending have now been withdrawn. In addition, the Chancellor announced that public sector investment in 1963 is to be raised by £175 million to offset any fall in private investment and some postwar credits to the elderly are to be released.

On foreign exchange markets, the pound fell fractionally below the end of August level, probably as a result of seasonal influences. (See Table 5.) Reserves declined in September, again reflecting seasonal international payment factors. The foreign trade returns for August showed no rise in exports and imports at the high levels recorded for June and July. Exports rose in September.

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DECONTROLLED AFTER SIX MONTHS

Money market. Interest rates continued their decline during the month of September and the first half of October. The Treasury bill rate fell steadily from 3.69 per cent on August 31 to 3.53 per cent on October 11. (See Table 5 and Chart 2.) Covered arbitrage opportunities in favor of the United Kingdom bill rose from 0.29 per cent on August 31 to 0.34 per cent on September 14, but declined during the remainder of the period; however, there were no reports of foreign funds moving in response to this differential. (See Table 5).

On the local authorities funds market, the rates sagged somewhat in the middle of September, and money was diverted to other uses. However, at the end of September, funds were short, and the rate on 30-day money was bid up to 4.56 per cent (See Table 5). By the middle of October, the short-term borrowing requirements of local authorities were reduced by tax receipts, central government grants and by funds raised from bond issues.

There was no opportunity for covered arbitrage movements from the Euro-dollar market in London to local authorities loans, except at the end of September, when demand for funds there was strong. During the first three weeks of September and again in the second week of October, the high Euro-dollar rate (see Table 5) induced some withdrawals from short-term loan markets. The covered yield in favor of local authorities loans compared with Euro-dollar deposits in London for recent weeks was as follows (in percentage per annum):

Aug. 3	+0.05	Aug. 31	-0.03	Sep. 28	+0.19
10	+0.01	Sep. 7	-0.06	Oct. 5	-0.07
17	-0.01	14	-0.13	12	-0.13
24	+0.05	21	-0.20		

Gilt-edged market. October 9th, saw a break in the continuous rise in the prices of government securities, which began late in June. After rising rapidly during the last two weeks in September, the government securities price index dropped by 1-1/2 per cent on October 9th (from 86.8 to 85.8). (See Table 6 and Chart 6.) Prices recovered somewhat in the following week, but the index only reached 86.7 on October 15. This break in the gilt-edged market came after two weeks of rapid price rises concentrated in medium-term issues. For example, the yield on the 3 per cent Savings Bonds of 1965-75 fell by 27 basis points from September 13 to 20, by 24 basis points in the following week, and by 19 basis points between September 27 and October 4 (See Table 6). In the week from September 13 to 20, the yield on the war loan and 2-1/2 per cent consols declined by 13 and 18 basis points, respectively; but in the following week their yields declined by only a few points as contrasted to the large decline in yields on the 3 per cent 1965-75 issue. Likewise, the fall in bond prices on October 9 was felt more in the long-term and undated sectors of the market than in the medium-term sector.

Two new Treasury issues came on to the market during the period under study. At the end of August, an additional \$500 million tranche of the 5-1/2 per cent Treasury bonds of 2008-12 was offered at 1/2 a point above the market price. This issue supplied the authorities with a tool for keeping control over the long-end of the market. On September 28, a 4 per cent

Treasury bond maturing in 1965 was issued to replace a medium-dated tap issue, the Exchequer 5 per cent 1967 bond. The new issue was not made available for a week after the 5 per cent 1967 bond was sold out, so the medium and short-dated sectors of the market were uncontrolled. The £100 million cash portion of this new issue was subscribed entirely by non-official funds, presumably including substantial purchases by commercial banks.

Foreign holders of the £13 million portion of the War Loan that is in bearer form were relieved to learn that the Bank of England will issue new coupons to replace the final outstanding coupons which expire on December 1. There had been some fear that the bonds would be converted into registered form rather than recouped. Bearer bonds are preferred by foreign investors, who are willing to pay up to a 2 per cent premium to acquire them.

London clearing banks. On September 27, the Bank of England reduced the Special Deposit requirements from 2 per cent to 1 per cent for the London Clearing Banks and from 1 per cent to 1/2 per cent for the Scottish banks. On October 3, it was announced that the qualitative controls over bank lending imposed in July 1961 were completely repealed. The banks are now free to finance personal consumption and property development. However, a substantial immediate increase in advances is not expected since the London clearing banks' liquidity ratio had already stood at 33.7 per cent in mid-September. The Economist reported that the banks plan "... to earmark part of the coming release of Special Deposits for the new Treasury 4 per cent 1965 issue/ and the rest for the 6 per cent 1972 - the division depending partly on assessment of likely demands for advances over the next few months." (October 6, 1962, p.70.) From mid-August to mid-September, bank advances declined by £38 million, and the banks increased their holdings of government securities and Treasury bills. (See Table 1, page 4.)

Installment credit. Installment credit issued by shops increased slightly in August, reflecting the rise in consumer spending on clothing and footwear. The business of finance houses declined by £4 million, but the Board of Trade believes this to be merely a seasonal movement.

Table 2. United Kingdom: Changes in Hire Purchase Credit
(in millions of pounds)

	<u>C h a n g e s 1 9 6 2</u>						<u>Outstanding August 1962</u>
	<u>Jan.- Mar.</u>	<u>Apr.- June</u>	<u>May</u>	<u>June</u>	<u>July</u>	<u>Aug.</u>	
Shops	-13	-2	-1	+2	+1	+2	297
Finance houses	-26	+1	+3	--	+4	-4	593
	-39	-1	+2	+2	+5	-2	890

Table 1
London Clearing Banks: Net Deposit Liabilities and Selected Assets, 1962

(In millions of pounds)

	C h a n g e s						Out- standing September p/
	Jan.- Mar.	Apr.- June	June	July	Aug.	Sep. p/	
Net Deposits	- 90	+142	+132	+81	--51	p/+38	p/ 6,460
Liquid Assets							
Cash	- 16	+ 16	+ 25	--	+10	-13	623
Call money	+ 33	- 29	- 19	+15	-24	- 9	692
Treasury bills	-287	+124	+ 57	-18	- 4	+72	968
Other bills	+ 21	+ 3	+ 13	+ 9	+ 2	-11	276
Loans and other investments							
Gilt-edged	- 23	+ 91	+ 74	+27	+ 1	+20	1,123
Other market investments	--	--	--	--	--	--	112
Advances:							
Nationalized industries	- 3	- 29	- 20	+19	+ 6	- 6	55
Other (net)	+169	+ 54	+ 54	+46	- 9	p/-38	p/ 3,363
Special deposits with Bank of England	- 1	- 71	- 72	+ 1	+ 1	- 1	150
Selected assets as percentage of gross deposits (end of period)							
Total liquid assets	32.6	33.4	33.4	33.1	33.1	33.7	
Cash	8.2	8.3	8.3	8.2	8.4	8.2	
Special deposits	3.0	2.0	2.0	2.0	2.0	2.0	

p/ Preliminary.

Foreign trade. The trade returns for August were regarded in Britain as very disappointing. Imports remained at the high level reached in July, mainly because the high level of food imports was sustained. Exports (seasonally adjusted) declined by 5 per cent. This was accounted for almost entirely by a fall in exports of engineering products, particularly railway rolling stock, ships, and aircraft. The area distribution of the decline in August exports was evenly divided among the overseas sterling area, Western Europe, and Latin America. However, exports showed a substantial pick up in September and the trade deficit was substantially lower.

Table 3. United Kingdom: Seasonally Adjusted Foreign Trade
(monthly, or monthly averages, in millions of pounds)

	Jan.- Mar.	Apr.- June	July- Aug.	June	July	Aug.	Sep.
Imports c.i.f.	-367	-369	-385	-369	-390	-387	-378
Exports f.o.b.	306	319	320	328	327	309	325
Re-exports	12	14	13	14	14	12	12
Trade balance	- 49	- 36	- 52	- 27	- 49	- 66	- 41

Foreign exchange reserves. In August, gold and foreign exchange reserves fell by \$67 million. However, this figure should be adjusted upwards by \$50 million for the unwinding of the swap arrangements with the Federal Reserve System and by \$28 million for repayments of former EPU debt. Reserves fell in September by \$56 million; this figure should be adjusted upwards by \$16 million gold subscriptions to the IMF by three overseas sterling area countries (Kuwait, Tanganyika, and Sierra Leone). Hence, on an adjusted basis, reserves increased \$11 million in August and declined \$40 million in September. The British authorities say that the adjusted loss of reserves for the third quarter reflect seasonal weakness in the balance of payments.

Stock market. Trading was dull from late August through early October, mainly as the consequence of intensive activity in the gilt-edged market. The Financial Times industrial ordinary index fell from 283.5 on August 28 to 269.8 on September 27 (4.8 per cent). (See Chart 7.)

With the rapid rise in bond prices and the sluggish state of the stock market, the yield gap (the rate of return on 2-1/2 per cent consols less the rate of return on industrial stocks, as compiled by the Financial Times) diminished from late August through September, and became reversed in the third week in September. The yield on stocks fell relative to bonds between September 27 and October 4 as the result of the rise in stock prices. In the following week, bond prices declined at a slightly more rapid rate than stock prices. The yield gap during this period was as follows:

Aug. 2	0.01	Aug. 30	0.11	Sep. 27	-0.27
9	0.14	Sep. 6	0.01	Oct. 4	-0.03
16	0.28	13	0.04	11	-0.04
23	0.29	20	-0.11		

Foreign exchange market. The spot rate declined from mid-August until early October (See Table 5). This reflects the normal seasonal weakness of sterling, which had been disguised earlier in the summer by pressure on the dollar. According to The Economist foreign exchange dealers in London and on the Continent interpreted the weakening of sterling in the last half of September to the strengthening of the dollar rather than to lack of confidence in the pound. (September 22, 1962, p. 1130) In the second week of October, sterling showed renewed strength in the market, climbing to 280.24 on October 11.

Security sterling remained steady at 279.875 throughout September and early October.

Bullion market. There was a strong demand for gold on September 13 and 14 which was associated with press reports about the forthcoming IMF annual meeting. Gold was also in moderate demand on September 20 and 21, but this was offset, to some extent, by Russian sales, according to market reports.

Table 4. United Kingdom: Fixing Price for Gold Bullion
(in U.S. dollars per ounce)

Aug. 3	35.105	Aug. 31	35.127	Sep. 28	35.126
10	35.126	Sep. 7	35.129	Oct. 5	35.130
17	35.140	14	35.138	11	35.137
24	35.127	21	35.138	19	35.138

Europe and British Commonwealth Section.

II. Nine Charts on Financial Markets Abroad

- Chart 1 - Interest Arbitrage, United States/Canada
- Chart 2 - Interest Arbitrage, New York/London
- Chart 3 - Interest Arbitrage for German Commercial Banks
- Chart 4 - Interest Arbitrage, Frankfurt/London
- Chart 5 - Short-term Interest Rates
- Chart 6 - Long-term Bond Yields
- Chart 7 - Industrial Stock Indices
- Chart 8 - Spot Exchange Rates -- Major Currencies
Against U.S. Dollar
- Chart 9 - 3-month Forward Exchange Rates

Table 5. United Kingdom: Treasury Bill Yields and Exchange Rates

	3-mo. Treasury bill arbitrage calculation					Spot pound (U.S. cents)	London deposit rates	
	U.K.	U.S.	Difference	3-mo. pound ^{a/}	In favor U.K. bill		U.S. dollar (3-mo.)	Local authority
1961 - High	6.74	2.74	4.05	-0.79	1.13	281.62	4.00	7.50
	Low	4.17	2.16	1.88	-4.36	278.47	3.13	6.00
July	13	3.81	2.96	0.85	-0.88	280.75	3.94	4.50
	20	3.88	2.91	0.97	-0.85	280.78	3.72	4.50
	27	3.81	2.88	0.93	-0.66	280.55	3.94	4.62
Aug.	3	3.75	2.82	0.93	-0.76	280.56	3.81	4.62
	10	3.69	2.83	0.86	-0.77	280.51	3.78	4.56
	17	3.69	2.83	0.86	-0.73	280.48	3.72	4.44
	24	3.69	2.82	0.87	-0.61	280.26	3.72	4.38
Sept.	31	3.69	2.80	0.89	-0.60	280.18	3.81	4.38
	7	3.66	2.79	0.87	-0.60	280.14	3.84	4.38
	14	3.63	2.78	0.85	-0.51	280.12	3.93	4.31
	21	3.63	2.73	0.90	-0.57	280.11	3.94	4.31
	28	3.56	2.74	0.82	-0.56	280.11	3.81	4.56
Oct.	5	3.55	2.76	0.79	-0.57	280.10	3.81	4.31
	11	3.53	2.77	0.76	-0.66	280.24	3.91	4.25

^{a/} Spread between spot and 3-month forward rate in per cent per annum. Discount equals (-).

Table 6. United Kingdom: Selected Capital Market Yields

	U.K. Government bond yields					Share yield ^{a/}	Yield gap ^{b/}	Share prices ^{c/}	
	4-1/2% 1964	3% 1965-75	5-1/2% 2008-12	3-1/2% War Loan	2-1/2% Consols				
1961 - High	6.65	6.68	--	6.92	6.78	5.48	1.90	365.3	
	Low	5.15	5.95	--	5.95	5.70	4.22	0.86	287.7
June 21	4.62	6.22	6.20	6.36	6.21	5.98	0.23	261.4	
July 26	4.23	5.79	6.00	6.09	5.95	5.88	0.07	265.3	
Aug.	2	4.26	5.77	6.05	6.11	5.97	5.96	0.01	261.9
	9	4.20	5.76	6.05	6.10	5.97	5.83	0.14	267.4
16	4.12	5.68	5.95	5.97	5.82	5.54	0.28	281.5	
23	4.12	5.65	5.95	5.92	5.79	5.50	0.29	283.8	
30	4.10	5.64	5.85	5.83	5.70	5.59	0.11	279.4	
Sept.	6	4.03	5.52	5.85	5.80	5.65	0.01	276.4	
	13	4.03	5.49	5.85	5.88	5.73	0.04	274.0	
	20	4.02	5.22	5.80	5.75	5.55	5.66	-0.11	275.3
27	3.98	4.98	5.80	5.70	5.51	5.78	-0.27	269.8	
Oct.	4	4.03	4.79	5.75	5.75	5.56	5.59	-0.03	278.7
	11	4.10	4.80	5.75	5.80	5.61	5.65	-0.04	275.8

^{a/} Financial Times.

^{b/} Difference between yield on 2-1/2 per cent Consols and share yield.

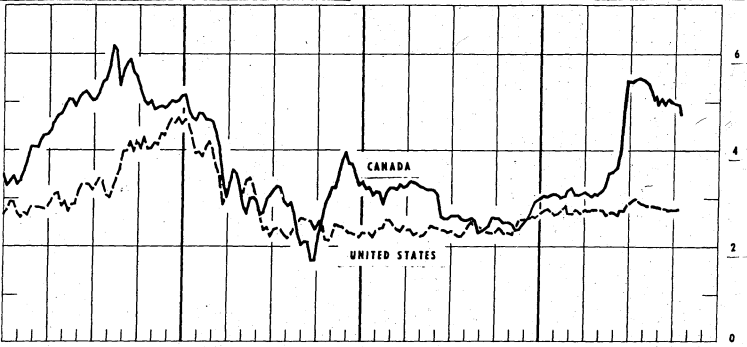
Chart 1

INTEREST ARBITRAGE, UNITED STATES / CANADA

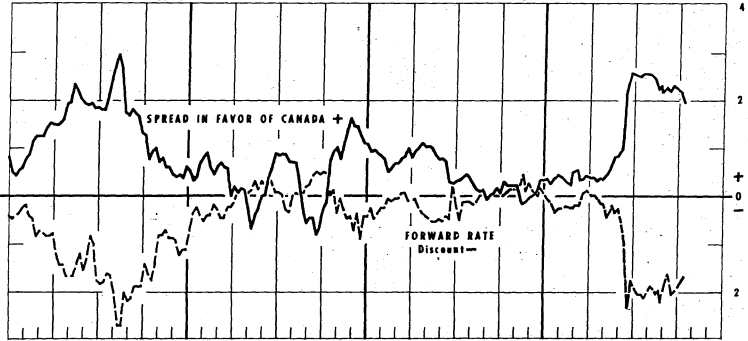
Thursday figures

THREE-MONTH TREASURY BILL RATES

Per cent per annum



RATE DIFFERENTIAL AND FORWARD CANADIAN DOLLAR



RATE DIFFERENTIAL WITH FORWARD EXCHANGE COVER

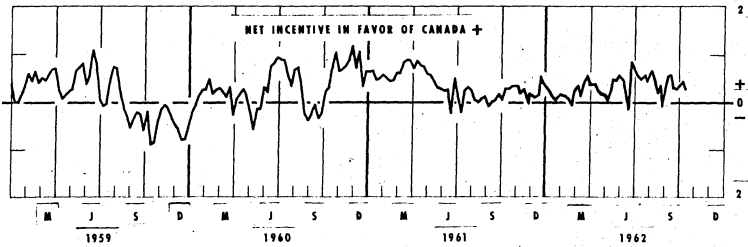


Chart 2

INTEREST ARBITRAGE, NEW YORK/LONDON

Friday figures

Per cent per annum

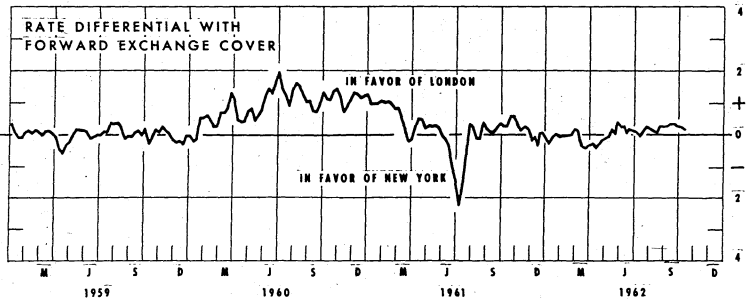
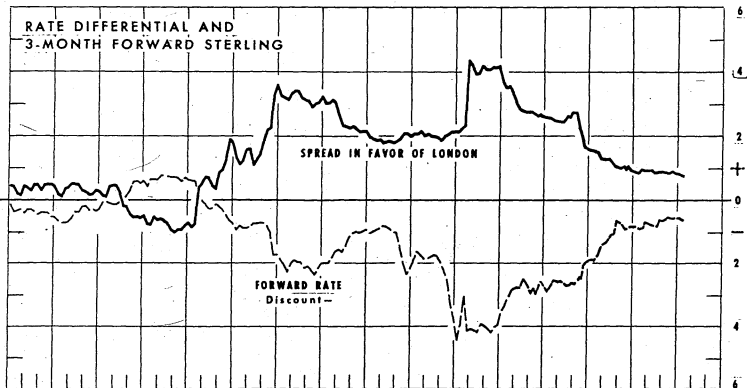
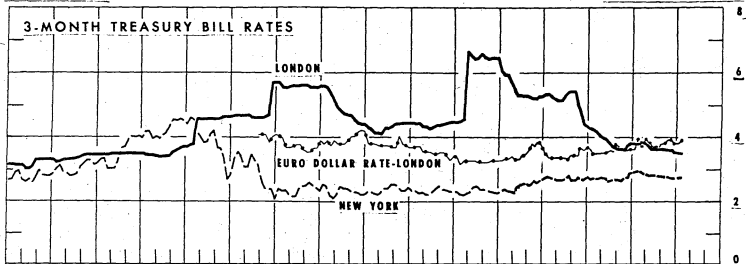
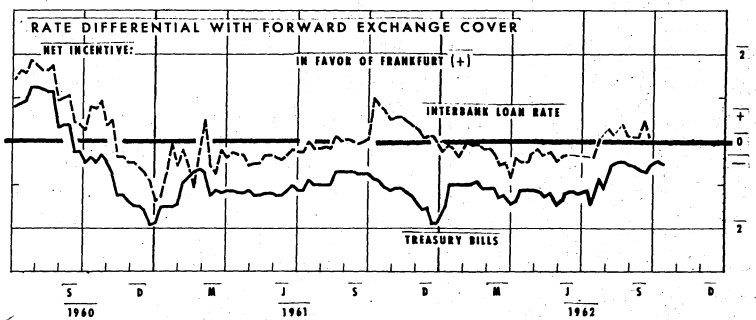
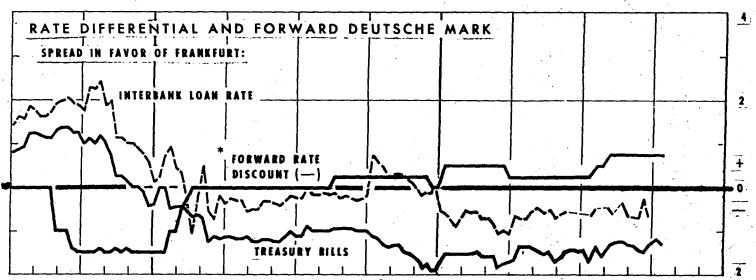
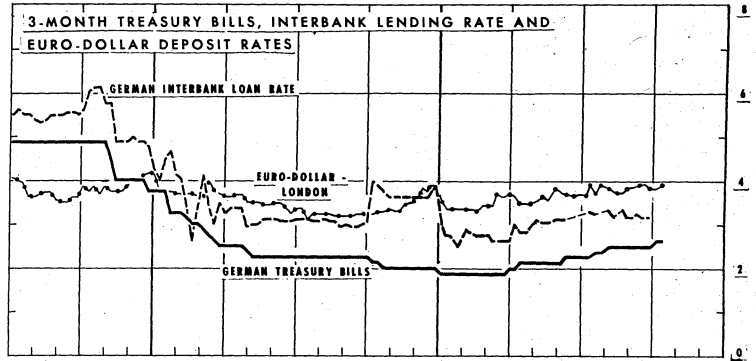


Chart 3
INTEREST ARBITRAGE FOR GERMAN COMMERCIAL BANKS

Friday figures Per cent per annum



Note: Special forward rate available to German commercial banks.

Chart 4

INTEREST ARBITRAGE, FRANKFURT / LONDON

Friday figures

Per cent per annum

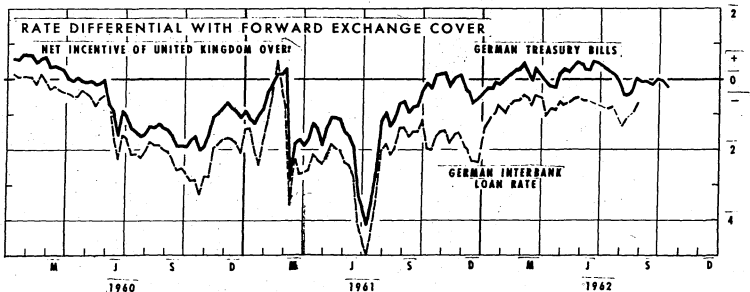
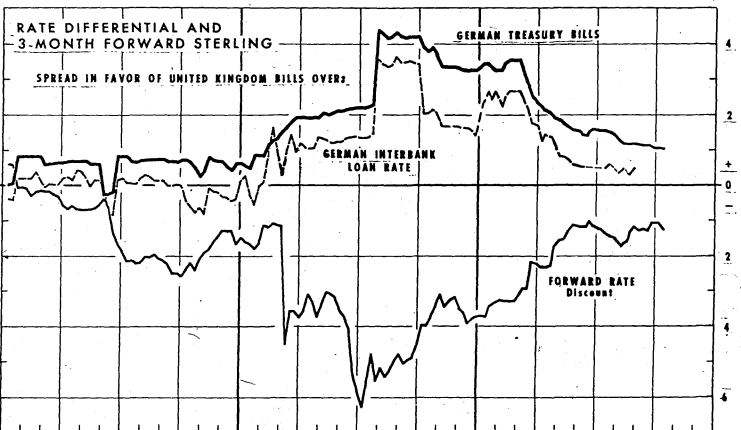
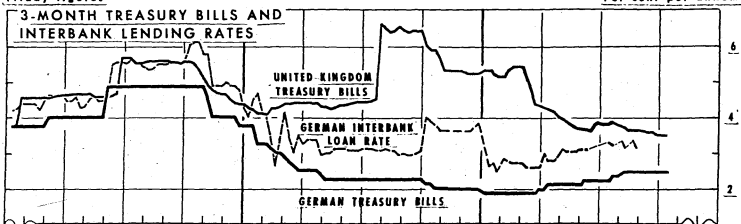
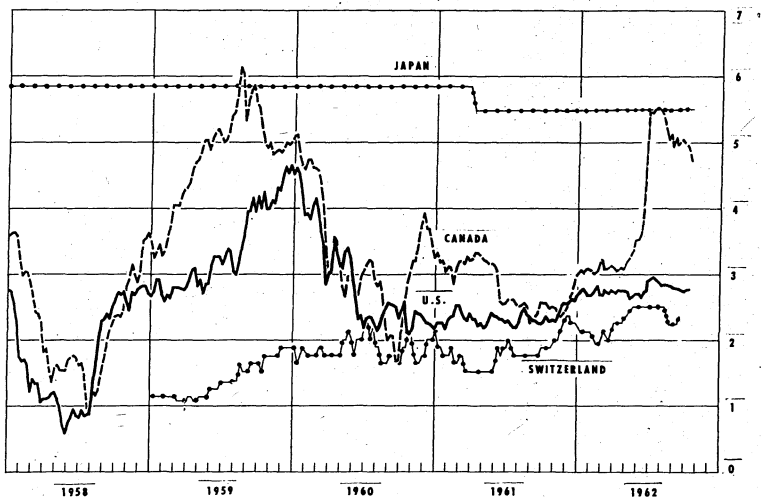
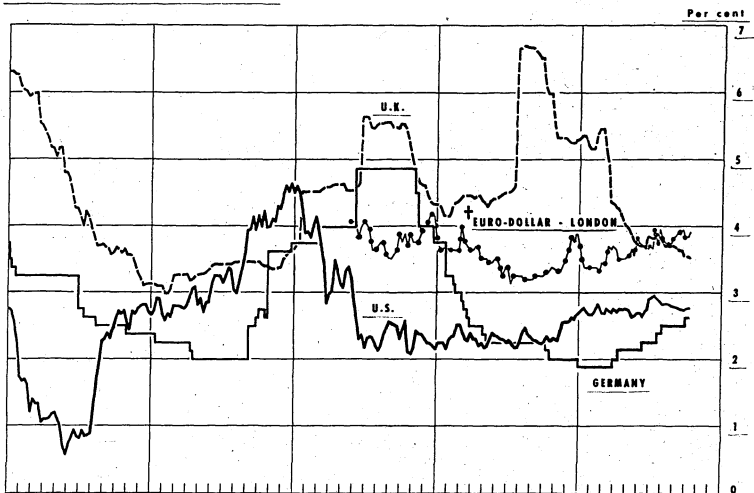


Chart 5
SHORT-TERM INTEREST RATES *



* 3-month treasury bill rates for all countries except Japan (3-month interbank deposit rate) and Switzerland (3-month deposit rate).
 † 3-month rate for U.S. dollar deposits in London.

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Chart 6

LONG-TERM BOND YIELDS

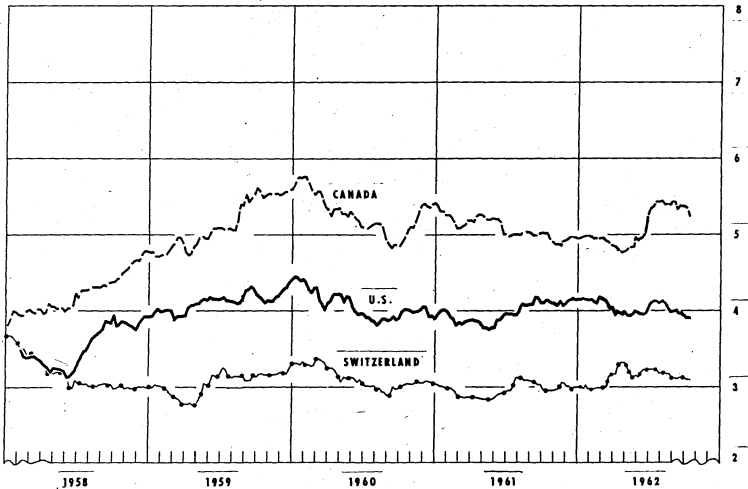
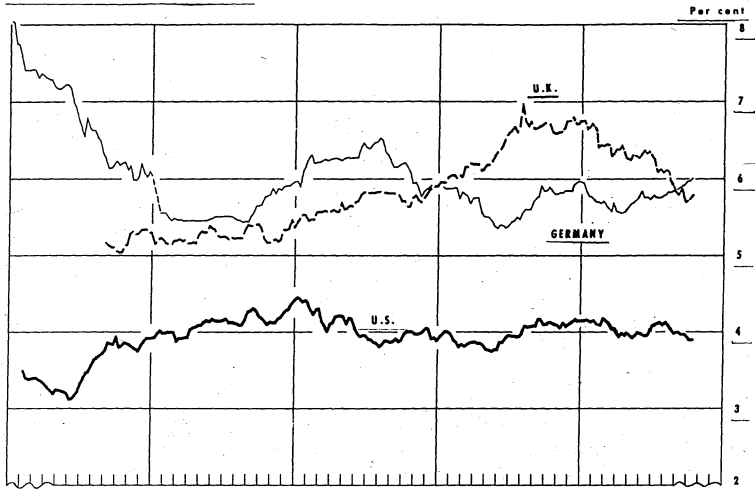
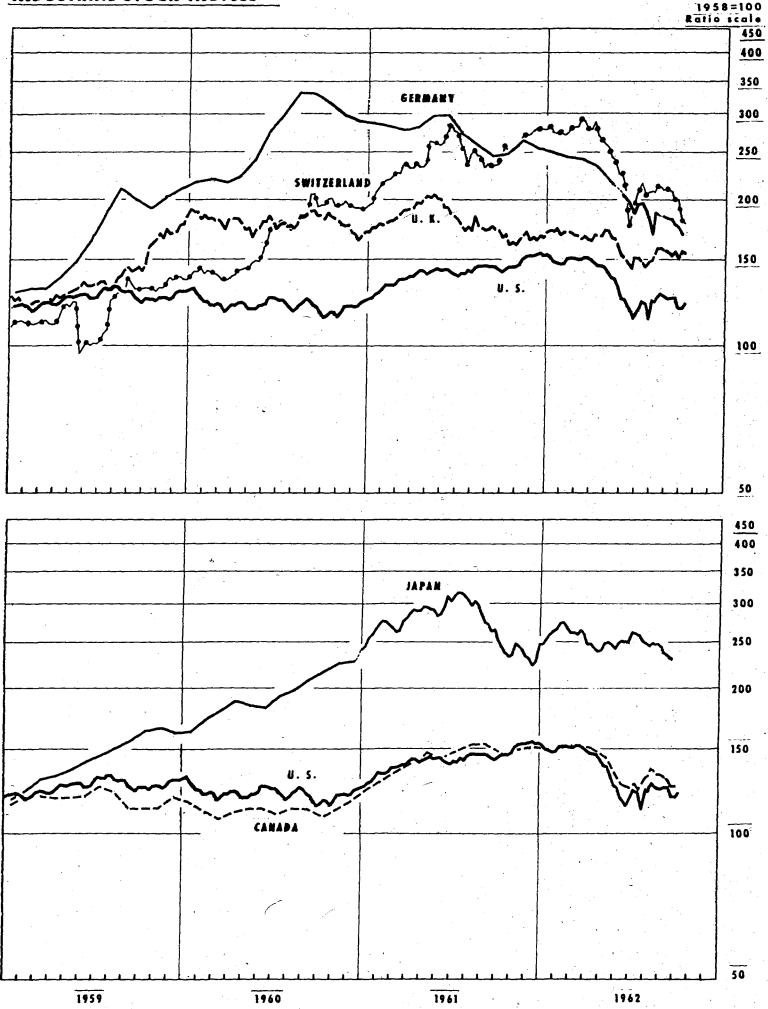


Chart 7

INDUSTRIAL STOCK INDICES*



* Note: Japan: Index of all stocks traded on Tokyo exchange

Chart 8

SPOT EXCHANGE RATES - MAJOR CURRENCIES AGAINST U.S. DOLLAR

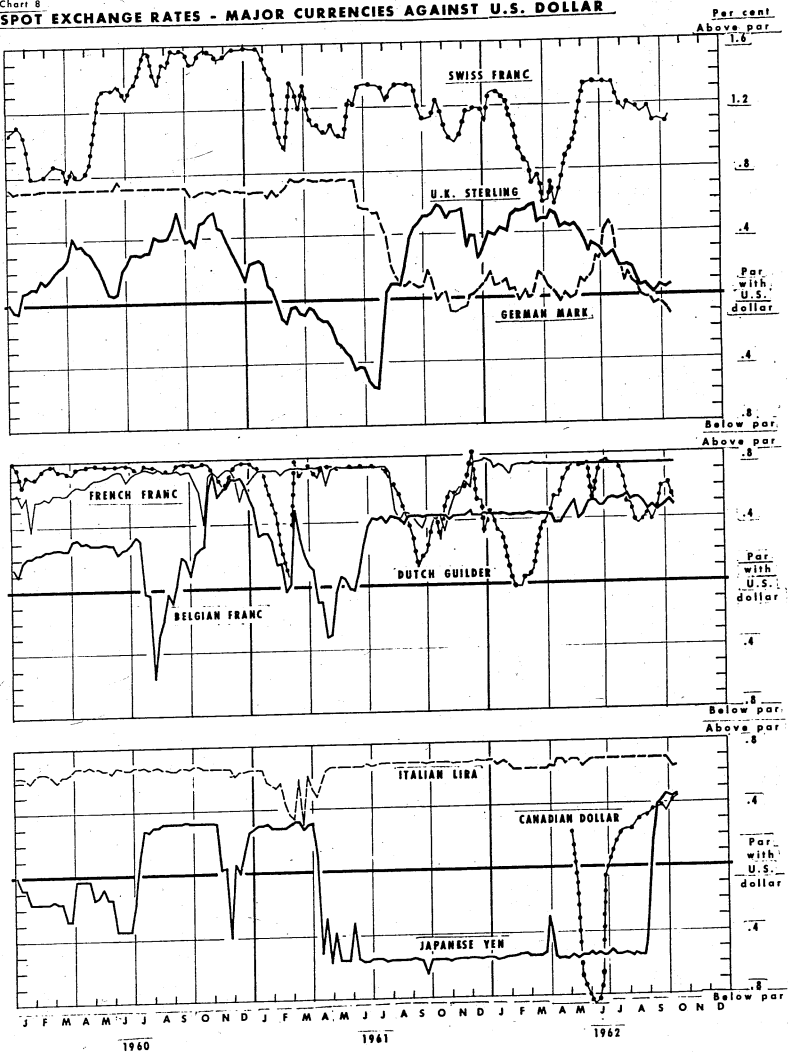


Chart 9

3-MONTH FORWARD EXCHANGE RATES

