DIVISION OF INTERNATIONAL FINANCE

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

H. 13
No. 176 A

December 23, 1964

CAPITAL MARKET DEVELOPMENTS ABROAD

I. United Kingdom
II. Nine Charts on Financial Markets Abroad
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I. United Kingdom: Money and Capital Markets in November and December

In the period under review, British financial markets were unsettled by events surrounding the recent major sterling crisis. On November 23, Bank rate was raised from 5 to 7 per cent to halt the speculative attack; however, through mid-December financial markets remained quite weak and the forward pound was under continuous selling pressure. Prior to November 23, the Treasury bill and other government bond prices held firm, but stock prices fluctuated widely, and the pound weakened steadily in both spot and forward markets. The Bank rate action and the announcement on November 25 of the $3 billion support package brought only temporary relief. Sterling weakened again in December, and stock and bond prices continued to decline. (See Tables 1 and 3 and Charts 5, 6 and 7.)

Table 1. United Kingdom: Selected Financial Market Indicators, October-December, 1964

		Actual October 16	Changes from previous week to: November 20	November 27	December 4	December 11	Change from October 16 to December 11
Interest Rates (per cent per annum)							
Treasury bill maximum tender		4.73	+0.07	+1.89	n.c.	n.c.	+1.84
Government bonds a/							
5%	1967	5.50	+0.10	+0.60	+0.03	+0.17	+0.72
5%	1971	5.64	+0.05	+0.30	+0.05	+0.11	+0.54
3-1/2%	1979-81	5.88	+0.03	+0.20	+0.02	+0.08	+0.37
5-1/2%	2008-12	6.15	+0.02	+0.15	+0.03	+0.05	+0.20
3-1/2%	War Loan	6.23	+0.02	+0.17	+0.01	+0.07	+0.17
Stock Price Index a/b/		364.9	-15.3	+6.7	-9.9	-3.2	-29.9
			(Actual Values)				
Exchange Rates							
Spot rate (U.S. cents)		278.28	278.27	279.13	279.15	279.04	+0.76
Forward rate (per cent per annum)		-0.96	-1.01	-2.65	-2.54	-2.68	-1.72

a/ Previous Thrusday.
b/ Financial Times 30 industrial stock index.

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Background to the sterling crisis. The run on sterling began shortly after the announcement in late October of a 15 per cent surcharge on imports and an average 1-1/2 per cent rebate on exports. In its special autumn budget presented on November 11, the government announced an increase in the tax on oil and gasoline used by road vehicles, and disclosed some of its tax and expenditure plans for 1965. The expenditure plans related solely to increases in welfare benefits. The tax plans envisaged changes in the corporation and capital gains taxes, but the government provided few details.

Financial markets did not respond favorably to the autumn budget message. Although the stock market staged a brief rally, bond prices held steady and the pound remained weak in foreign exchange markets. Trade figures for October published on November 18 showed a seasonally adjusted deficit of £92 million--virtually unchanged from previous months. Bond prices then began to ease, stock prices fell sharply, and the pound came under even heavier selling pressure. On November 23, Bank rate was raised to the crisis level of 7 per cent. The stock market rallied once again, but bond prices, as expected, eased further. The pressure on sterling abated temporarily, then resumed on November 24 and 25. On November 25, a $3 billion support package for sterling was offered by eleven central banks, the Bank for International Settlements, and the U.S. Export-Import Bank. Although selling pressure on the pound subsided temporarily, the spot rate began to weaken again in early December and the forward discount remained quite wide.

On December 8, the Bank of England called for a selective credit squeeze, requesting the clearing banks to curtail loans for property development and consumer purchases. On the same day, Chancellor Callaghan presented additional information about tax revisions first proposed in the autumn budget. No tax rates were mentioned. However, the Chancellor announced that a single corporate income tax would replace the income and profits taxes now in effect. With no change contemplated in the tax on dividends, the new corporation income tax would favor the retention of income. On capital gains, the Chancellor's announcement indicated that coverage would be extended from short-term gains (six-months or less) now taxed under a law passed by the Conservative government last year to long-term gains.

Financial markets did not respond favorably to these explanations. Stock and bond prices continued to fall and in the foreign exchange market the spot pound eased further and the forward discount widened. These trends continued after the announcement on December 16 of a slightly larger trade deficit--£103 million--for November. On Thursday, November 17, the Bank of England ordered the government broker to offer buying prices for the whole range of government securities. This move effectively reversed, at least temporarily, the trends of prices in the gilt-edged market.

On December 18, the government announced that it was deferring its year-end payments of about $175 million on loans made by the United States and Canada at the end of World War II. The amounts will be added to the outstanding balance, postponing final payments until 2003.

The rise in bond yields is indicative of the general increase in the cost of funds borrowed from all sources that has taken place since the new Bank rate became effective. In addition to the two percentage points increase in the rates on bank loans, call money, and the Treasury bill tender, hire purchase companies have raised their rates on automobiles and industrial loans by about one percentage point. Moreover, press reports suggest that house mortgage rates, which are currently 6.0C per cent, may be pushed up to 6-3/4 per cent next month.

Money market tightens before Bank rate increase. An excess demand for short-term funds developed in the four weeks prior to the November 23 Bank rate increase and money rates generally rose above their end-October levels. In the four business days after the increase, conditions in the money market were quite unsettled. In December, conditions were more stable, but the discount houses and local authorities experienced difficulty in securing short-term funds, and rates were pushed up further. (See Table 2 and Chart 5.)

Table 2. United Kingdom: Selected Money Market Rates
October-December, 1964
(per cent per annum)

	October	November				December	
	30	6	13	20	27	4	11
Call money a/	4.44	4.50	4.50	4.50	6.25	6.18	6.38
Local authority deposits (90 days) a/	5.31	5.31	5.37	5.37	7.31	7.44	7.50
Euro-dollar deposits (90 days)	4.50	4.50	4.50	4.50	5.00	4.75	4.68
Treasury bill (market rate) b/	4.59	4.53	4.53	4.62	6.41	6.41	6.41

a/ Estimated from a range of rates quoted in the Financial Times.
b/ Adjusted to U.S. basis.

Call money was in particularly short supply throughout November, and the Bank of England had to provide a sizable amount of assistance on nearly every business day; but there was no borrowing by the discount houses at Bank rate. Prior to the increase in Bank rate, call loans from the clearing banks usually carried a rate of 4.50 per cent, although some commanded over 4.60 per cent. Just after the increase a rate of 6.25 per cent prevailed. In early December, conditions eased somewhat and the rate fell; however, by the middle of the month call money was again in short supply, pushing the rate to about 6.38 per cent.

A number of factors appear to have contributed to the generally tight conditions that prevailed during November: tax transfers outpacing government disbursements; conversion of sterling balances into other currencies; and the desire of the clearing banks to satisfy the demand for advances partly at the expense of the discount houses. Within the context of the speculative attack upon sterling it is not unreasonable to believe that pressure was brought to bear upon the discount houses directly by a withdrawal of foreign money deposited with them.

Local authorities also found it more difficult to attract funds as the uneasiness about the pound and uncertainty about policies of the new government became more widespread. Rates in 90-day deposits were raised to a median of 5.37 per cent. It was reported that during the run on sterling local authorities lost a good deal of their foreign deposits.

Although 90-day deposit rates jumped to 7.31 per cent after the rise in Bank rate funds were still scarce and rates continued to rise during December.

Evidently the Treasury bill market did not experience the same pre-Bank rate pressures observed in the other two markets. In fact, the Treasury bill market rate was somewhat easier in the first two weeks of November than in the last two weeks of October. However, in the third week of November the rate rose by about 10 basis points, reportedly in anticipation of a higher Bank rate. After the increase in Bank rate on November 23 the market rate jumped about 2 percentage points to 6.41 (adjusted to a U.S. basis) and has remained there, with Bank of England support, to date.

In the Euro-dollar market, 90-day deposit rates held steady at 4.50 per cent until the week of November 23. Then, in response to the increase in maximum rates payable on U.S. Time Certificates of Deposit from 4 per cent to 4-1/2 per cent for maturities of 90 days or more, the rate jumped to 5.00 per cent. More recently, however, it has eased back to around 4.68 per cent. This may reflect a switching of funds from the discount and local authority markets to the Euro-dollar market.

Capital markets unsettled by a number of factors

After the announcement of the import surcharge and export rebate schemes at the end of October capital markets generally displayed a firm tone. However, capital markets were unsettled by a succession of events: presentation of the autumn (November 11) budget, announcement of the £92 million trade deficit for October, the increase in Bank rate, the Bank of England's letter and Chancellor Callaghan's December 8 statement on taxes. (See Tables 1 and 3 and Chart 6.)

Prior to presentation on November 11 of the autumn budget, there appeared to be some switching from stocks to government bonds and, as a result, bond prices rose while stock prices fell. This might well have been due to anticipation of a more comprehensive capital gains tax, possibly exempting gilt-edged bonds, and to new corporate taxes. When it became known on November 11 that these new taxes were not to be implemented immediately, the stock market rallied, pushing the Financial Times 30 industrial stock index up about 10 points. However, bond prices remained unchanged.

During the following week, the trade returns for October were announced indicating no basic change from the pattern of earlier months--a trade deficit over [illegible] million. Selling pressure then developed in both the gilt-edged and stock markets and prices fell.

Table 3. United Kingdom: Selected Capital Markets Yields, October-December, 1964

	October	November				December	
	29	5	12	19	26	3	10
Government bonds							
5% 1967	5.40	5.35	5.32	5.42	6.02	6.05	6.22
3% 1965-75	5.90	5.91	5.92	5.95	6.18	6.20	6.30
5% 1986-89	6.05	6.05	6.06	6.08	6.24	6.25	6.31
2-1/2% Consols	6.03	6.02	5.99	6.03	6.21	6.18	6.24
Stocks							
Share yield a/	4.80	4.94	4.88	5.14	5.05	5.18	5.25
Yield gap b/	1.13	1.08	1.11	0.89	1.16	1.00	0.99
Stock index c/	356.5	344.9	355.7	340.3	348.1	338.2	335.0

a/ Share yield on Financial Times 500 stock index.
b/ Difference between rate on 2-1/2 per cent consols and share yield.
c/ Financial Times 30 industrial stock index.

Following the Bank rate increase on November 23, the stock market recovered and, as expected, bond prices eased. However, at the long end of the yield curve, market rates rose by only 18 basis points or less, as compared to the 20 to 30 basis points increase registered after an identical increase in Bank rate in 1961.

In early December, bond prices held steady but stock prices fell to the lowest point since last June. After the Chancellor's December 8 explanatory statement on the proposed tax revisions, bond and stock prices eased further. On December 17, the Bank of England stepped into the gilt-edged market to halt the downward slide of prices, offering buying prices for the entire range of listed government bonds. This move proved to be effective and prices firmed, at least temporarily.

New issues (net of redemptions) totalled about £37 million in October, and £35 million in November--down considerably from the third quarter average. Although the largest absolute declines were recorded by the "quoted public companies" segment, the largest percentage decline was recorded by local authorities. Foreign sterling borrowing increased modestly. (See Table 4.)

Table 4. United Kingdom: Capital Issues (Net of Redemptions), 1964
(millions of pounds; month or monthly averages)

	First Quarter	Second Quarter	Third Quarter	October	November
U.K. quoted public companies	59.1	46.7	42.3	25.8	29.9
U.K. local authorities	5.4	7.7	13.2	4.2	-1.3
Overseas borrowers	9.3	7.7	2.9	6.7	6.0
Total	73.8	62.1	58.4	36.7	34.6
Gross issues	83.4	67.7	63.6	39.8	36.8
Gross redemptions	9.6	5.5	5.2	3.1	2.2

Source: Bank of England.

Net borrowing by public companies has been falling since the first of the year, but local authority borrowing had risen steadily in 1964 until October, when it too began to decline. While it is not certain whether these movements reflect normal seasonal patterns or more immediate market forces, last year these same patterns were not recorded.

In November it was reported that some business firms postponed issues until the impact of the increase in Bank rate became more clear.

During November, two dollar denominated loans totalling $45 million were floated in the London market.

Central bank urges selective credit rationing

In the third quarter of 1964, the pattern of new credit extended by finance houses and department stores, on the one hand, and the clearing banks, on the other, showed a noticeable change. 1/ Installment credit extensions have slowed noticeably while new bank advances have reached and maintained a very high level. (See Table 5.) Although there is no easily discernible cause for the more moderate pace of installment credit extension, the surge of bank advances may well be related to the high import bill of the last few months.

However, it is clear that the heavy pace of bank lending has kept a downward pressure upon liquidity ratios, which have been in the neighborhood of 29 per cent to 30 per cent throughout the year. The minimum ratio agreed upon between the clearing banks and the Bank of England is 28 per cent. The

1/ Although the installment data are not seasonally adjusted monthly changes this year differ significantly from those of last year. In 1963 new credit extensions grew strongly in the second half of the year. In 1964 strong growth was limited to the first half of the year. Hence the slowdown in the rate of growth of installment credit this year is not a purely seasonal phenomenon.

Table 5. United Kingdom: Credit Extensions, 1964
(millions of pounds)

	1st Qtr. a/	2nd Qtr. a/	3rd Qtr. a/	Sept.	Oct.	Nov.	Total Outstanding end-Oct. c/
Instalment credit by:							
Finance houses	14	29	13	12	n.a.	n.a.	339
Department stores	0	0	1	1	n.a.	n.a.	744
Total	14	29	14	13	n.a.	n.a.	1083
Bank advances (London clearing banks) b/	32	31	65	70	p/ 90	p/ 60	p/ 4525

a/ Monthly average.
b/ Seasonally adjusted; excludes advances to nationalized industries.
c/ End-September for instalment credit.
p/ Preliminary.

Sources: Instalment credit, Board of Trade; bank advances, Bank of England.

British financial press has reported that the clearing banks have been rationing credit in recent months in order to meet prescribed liquidity ratios.

In his discussion of the November 23 increase in Bank rate Chancellor of the Exchequer Callaghan stated: ". . . as regards the home economy, the rise in Bank rate is a reinforcement of our earlier measures to check the pressures of demand and to release resources for exports and for import substitution." He went on to say that ". . . the monetary situation (would be watched) very closely and if further action seems to be necessary I shall take it."

A further step was taken on December 8, when the Bank of England in a letter to the banks requested that loans to exporters and those purchasing plant and equipment be continued, but that loans for property development and consumer purchases be curtailed.

Trade deficit unchanged in October and November. The October and November trade returns showed no basic change from earlier months. Values of both imports and exports registered small variations, but the average trade deficit for these two months was close to £100 million. (See Table 6.)

Table 6. United Kingdom: Foreign Trade, September-November, 1964
(millions of pounds; seasonally adjusted)

	September	October p/	November p/
Imports (c.i.f.)	472	455	474
Exports (f.o.b.)	346	351	357
Re-exports (f.o.b.)	14	12	14
Balance	-112	- 92	-103
Trade balance	e/ - 62	e/ - 55	e/ - 54

p/ Preliminary.
e/ Estimated.

Source: Board of Trade.

Last October, labor government officials estimated a current account deficit for 1964 (on a balance of payments basis) in the neighborhood of £700-800 million (about $2 billion), no account being taken of the impact of the import surcharges and the export rebates. Imports of manufactured and semi-manufactures goods--the major categories affected by the surcharge--had been running at an annual rate of $3.78 billion, and the government expected these imports to be reduced by about $560 million. However, there was no official estimate of the impact of these measures on the total trade accounts.

Spot sterling stronger, but arbitrage incentives now favor New York. Since the announcement on November 25 of the $3 billion support package, spot sterling has remained above 279.00 (U.S. cents) but the forward discount has remained quite wide, suggesting that external confidence in sterling has not been fully restored. In fact, the covered differentials on U.K.-U.S. Treasury bills favored New York by 3 basis points on November 27 and 7 basis points on December 11. However, covered local authority deposits are now slightly more attractive than Euro-dollar deposits for the first time since September. (See Table 7 and Charts 1 and 3.)

The run on sterling began a few days after the end-October announcement of surcharge on imports and the rebates for exports. Pressure became particularly heavy over week-end periods through mid-November. Spot sterling remained quite weak and the forward discount quite wide after presentation of the autumn budget--an indication of the extent to which confidence had deteriorated.

Table 7. United Kingdom: U.K./U.S. Exchange Rates and Arbitrage Calculations, October-December, 1964

	October 30	November 6	November 13	November 20	November 27	December 4	December 11
Exchange rates							
Spot (U.S. cents)		278.53	278.27	278.27	279.13	279.15	279.04
Forward (per cent per annum)	-0.82	-0.91	-0.92	-1.01	-2.652	-2.535	-2.678
3-month yields and yield differentials							
Treasury bills							
U.K. (covered)	3.77	3.62	3.61	3.61	3.76	3.87	3.71
U.S.	3.53	3.54	3.56	3.59	3.79	3.76	3.78
Differential	0.24	0.08	0.05	0.02	-0.03	0.11	-0.07
Local authority - Euro-$							
Local authority (covered)	4.49	4.40	4.45	4.37	4.28	4.90	4.89
Euro-$	4.50	4.50	4.50	4.50	5.00	4.75	4.68
Differential	-0.01	-0.10	-0.05	-0.13	-0.72	0.15	0.21
Euro-$ - New York certificate of deposit							
Euro-$ a/	4.50	4.50	4.50	4.50	4.80	4.94	4.75
New York certificate of deposit a/b/	3.95	3.95	3.95	3.95	4.13	4.13	4.13
Differential	0.05	0.05	0.05	0.05	0.67	0.81	0.62

a/ Previous Wednesday.
b/ Secondary offering rates for negotiable certificates of time deposit.

When Bank rate was not raised on Thursday, November 19, the run on sterling began in earnest and selling pressure was very heavy on Friday, November 20. In an unexpected move on Monday (November 23), the Bank of England raised Bank rate from 5 to 7 per cent. Selling pressure abated temporarily, then resumed on Tuesday and carried over into Wednesday. To save the pound, eleven central banks, the U.S. Export-Import Bank and the Bank for International Settlements made available to the Bank of England a total of $3 billion. This was in addition to the longer term $1 billion loan from the International Monetary Fund. The announcement of so large a fund to support the pound brought the selling of spot sterling to a halt. However, sizable sales of forward contracts continued to keep the forward discount in excess of -2.65 per cent.

Then, in December, spot sterling began to weaken once again and the forward rate remained under considerable pressure. The government then made its clarification of the planned revision of corporation and capital gains taxes and the Bank of England sent its letter to the banking community. However, spot and forward sterling remained quite weak.

November reserves lowest since December 1957. Officially reserve losses amounted to $87 million in October and $109 million in November, reducing total holdings to [illegible] million--the lowest level since December of 1957. (See Table 8.)

Table 8. United Kingdom: Reserve Position, September-November, 1964
(millions of dollars)

	September	October	November	Outstanding November 30, 1964
Changes in gold and convertible currencies	-45	-87	-109	2343
Drawing rights on I.M.F.	-2	--	--	a/ 2439

a/ September 30, 1964.

Source: Bank of England.

Publication of the November reserve figures was accompanied by the announcement that the government had made the expected $1 billion borrowing from the I.M.F. The loan carries interest at 3 per cent and is to be repaid over the next three to five years.

The Fund had some difficulty in meeting the precise currency needs of the United Kingdom out of its existing holdings. Accordingly, it activated the General Arrangements to Borrow (GAB) and sold some of its gold. The entire $1 billion was met by drawing $345 million from current holdings, $405 million under the GAB ~~,~~ and $250 million from the sale of gold.

Gold price edges upward in December. During November the fixing price of gold in the London market was unaffected by the selling pressure on sterling, with prices moving moderately in the neighborhood of $35.100 per fine ounce. However, in December the price climbed steadily, and on December 17 reached $35.126, the highest level since the Cuban crisis of October 1962. (See Table 9.)

Table 9. United Kingdom: London Fixing Price for Gold, October-December, 1964

	October	November		December	
	30	13	27	4	11
Price per fine ounce (U.S. dollars)	35.118	35.102	35.101	35.114	35.122

Europe and British Commonwealth Section.

Chart 1

INTERNATIONAL MONEY MARKET YIELDS FOR U.S. DOLLAR INVESTORS

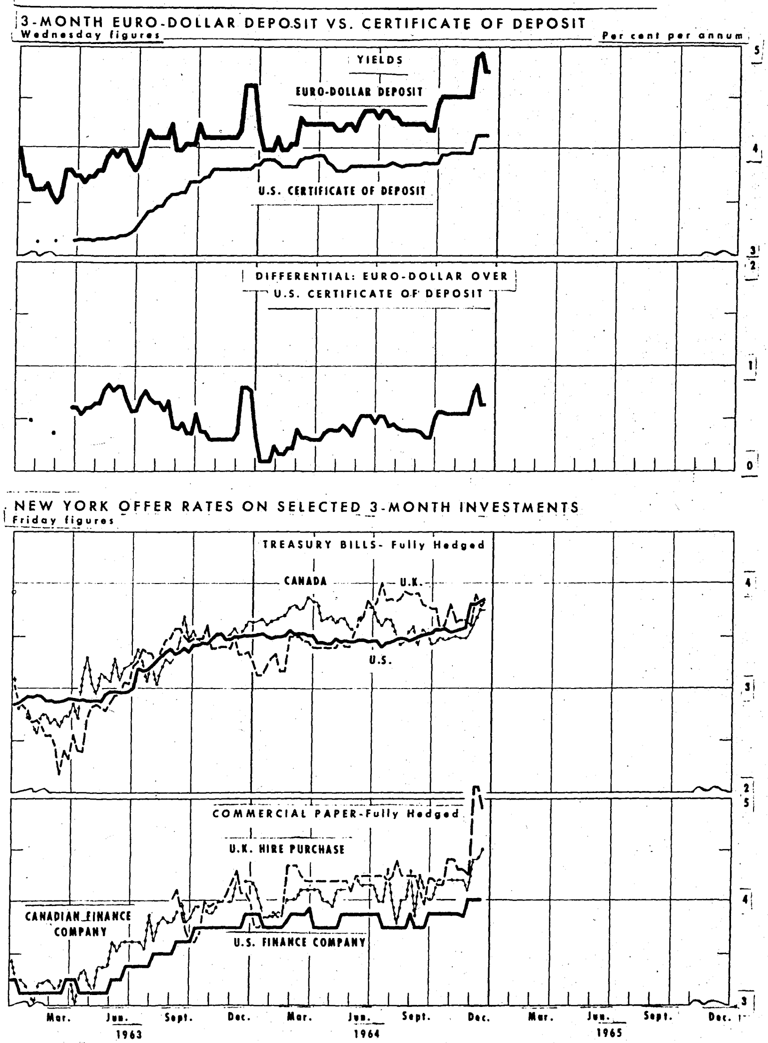
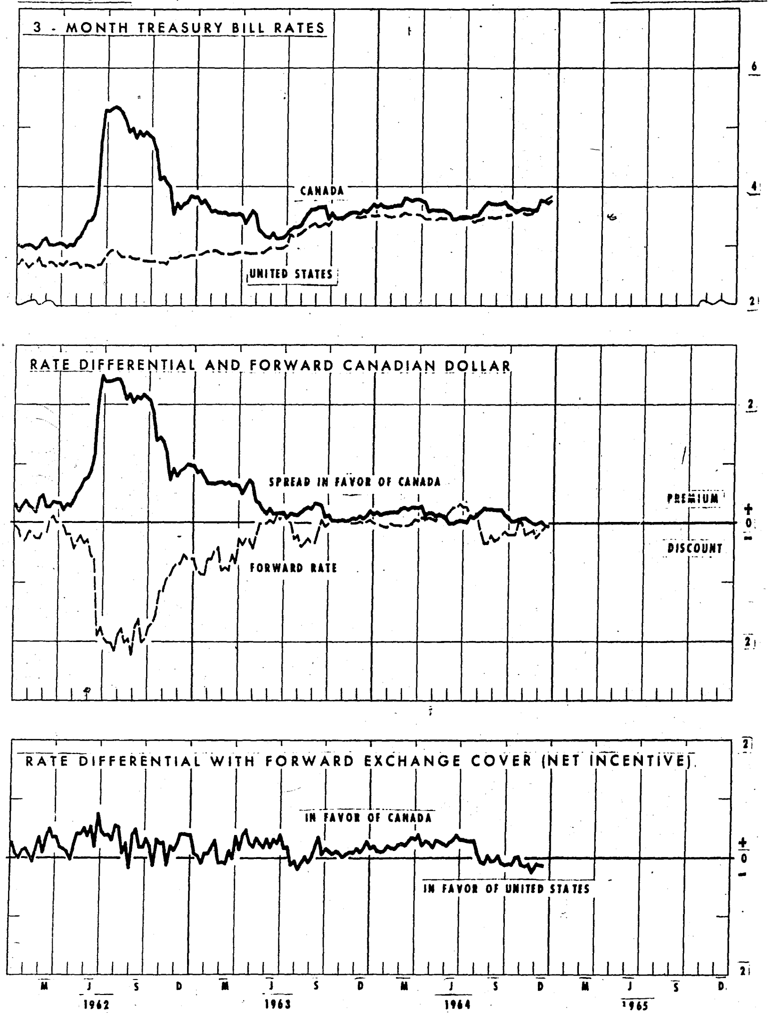


Chart 2

INTEREST ARBITRAGE, UNITED STATES / CANADA

Friday figures*

Per cent per annum



*Thursday figures 1962, Friday thereafter.

Chart 3

INTEREST ARBITRAGE, NEW YORK/LONDON

Friday figures

Per cent per annum

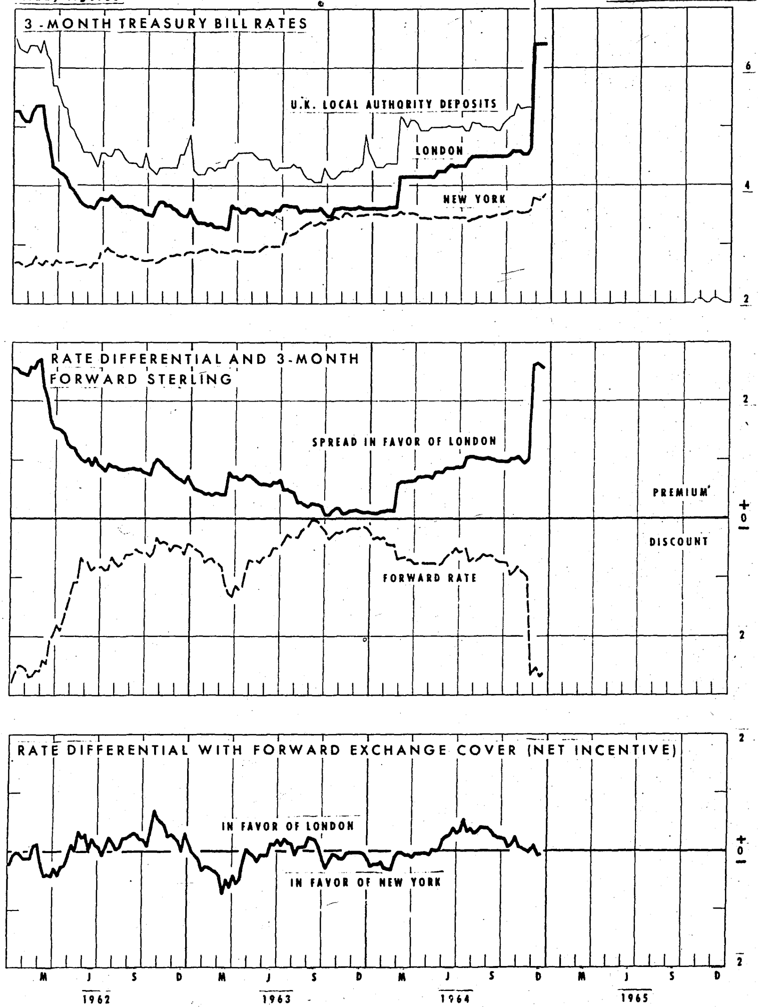


Chart 4

INTEREST ARBITRAGE FOR GERMAN COMMERCIAL BANKS

Friday figures

Per cent per annum

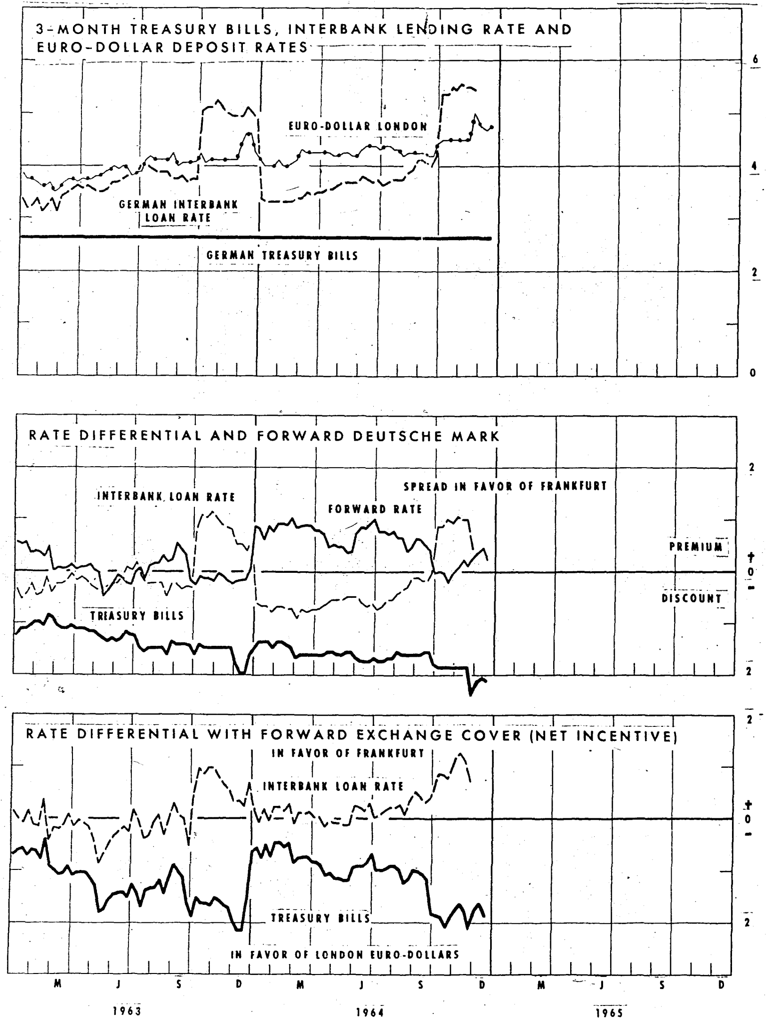


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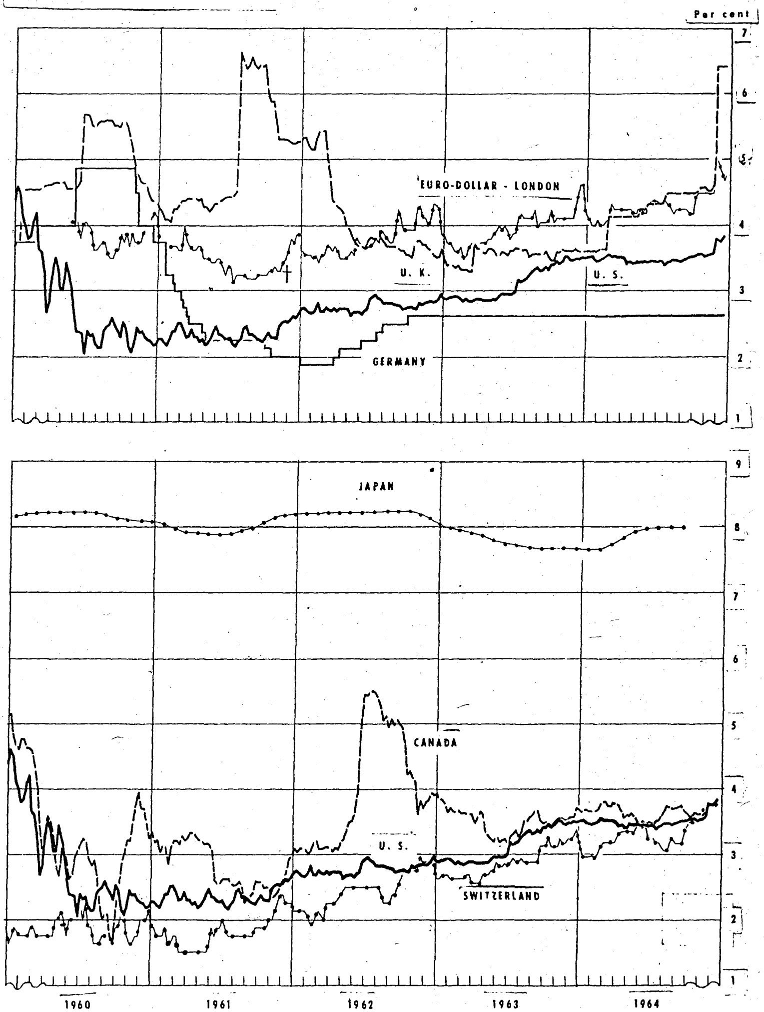
Chart 5

SHORT-TERM INTEREST RATES *



* 3-month treasury bill rates for all countries except Japan (Average rate on bank loans and discounts) 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

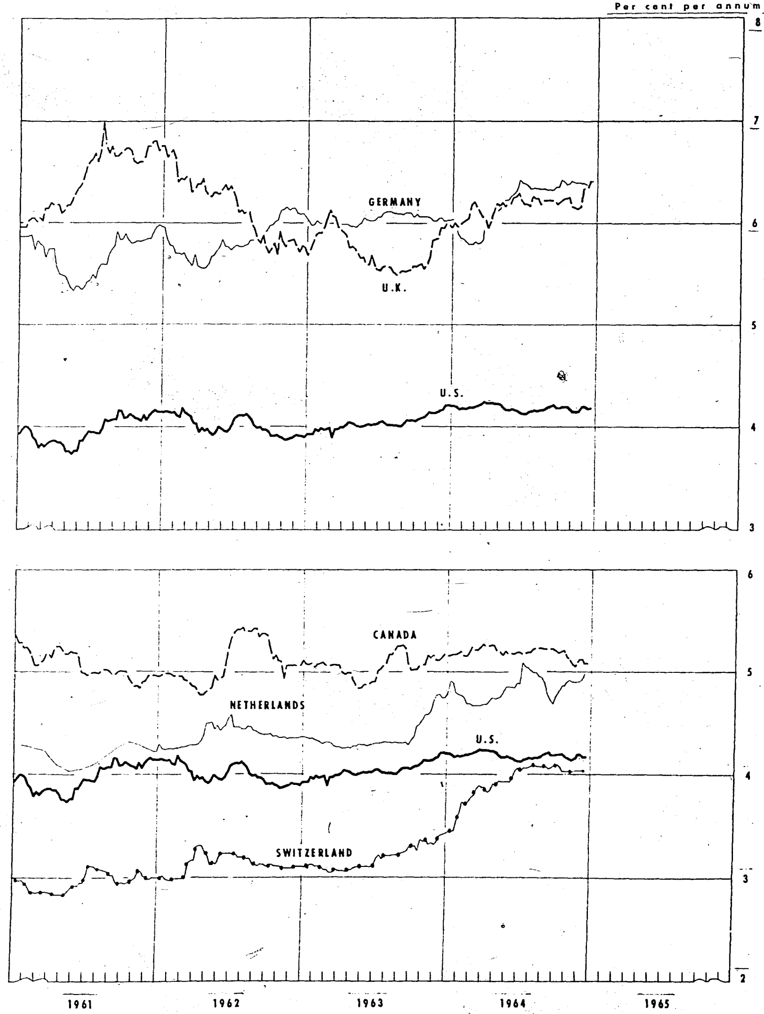
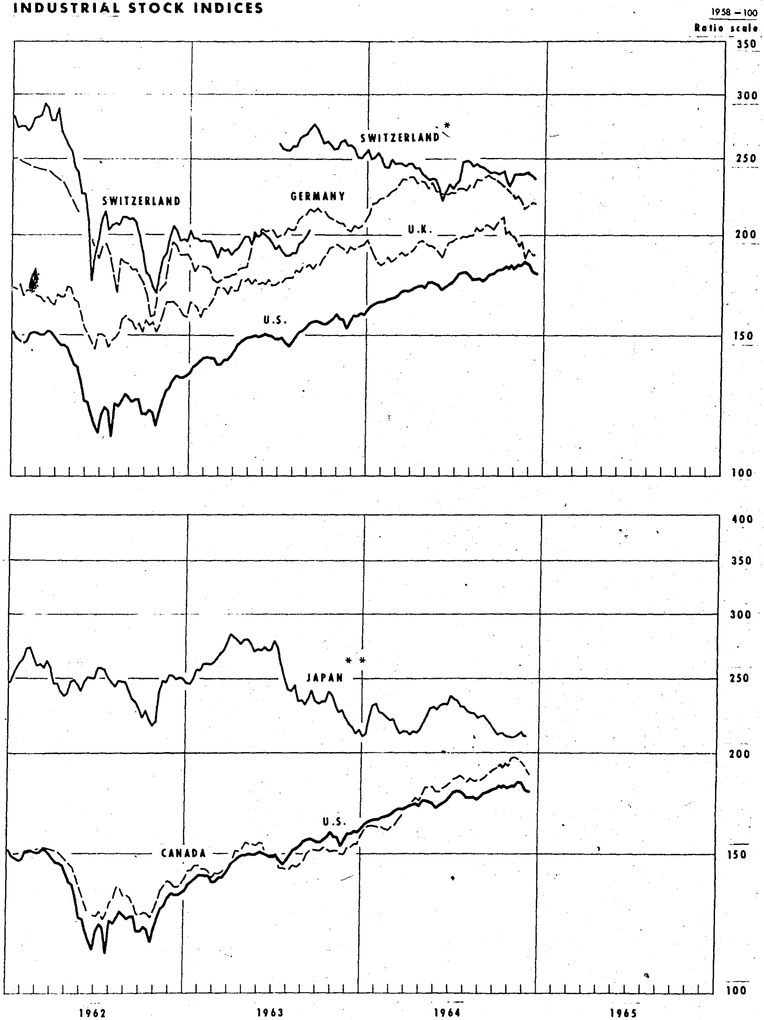


Chart 7

INDUSTRIAL STOCK INDICES



* New series Swiss Bank Corporation industrial stock index.

* * Japan, index of 225 industrial and other stocks traded on the Tokyo exchange

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Chart 8

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

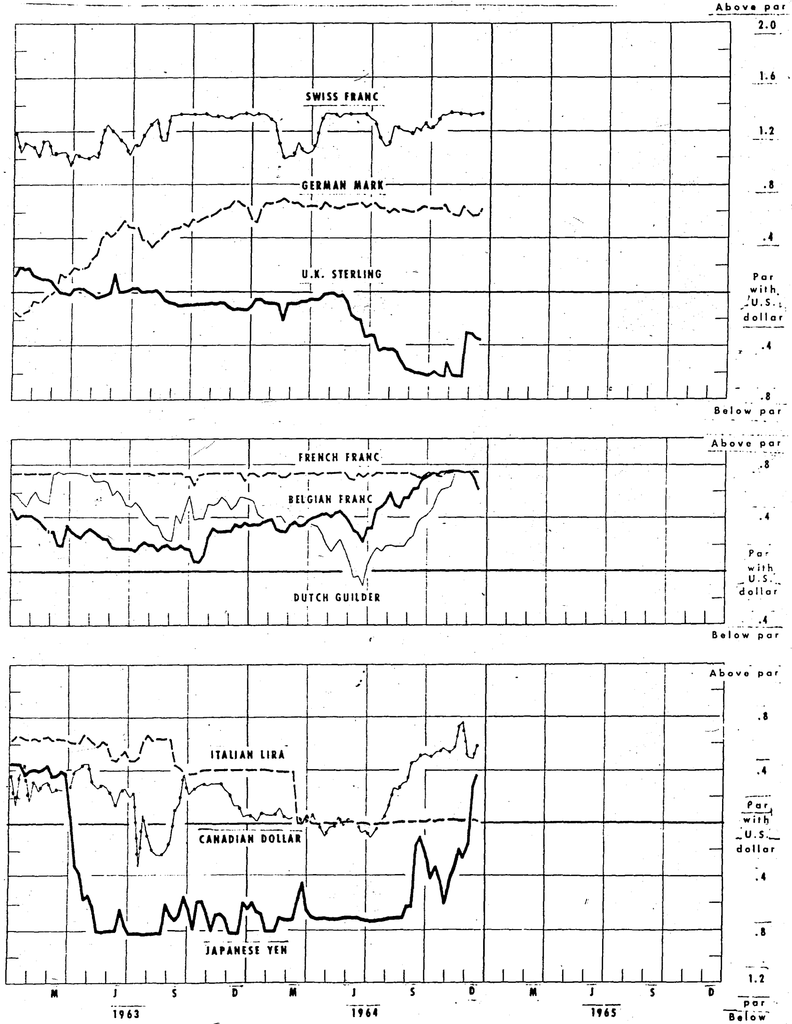


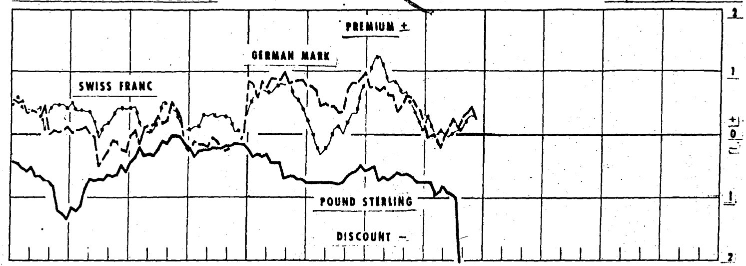
Chart 9

3-MONTH FORWARD EXCHANGE RATES

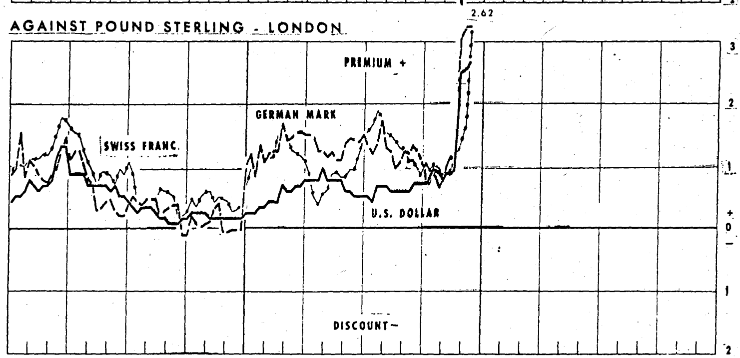
Friday figures

AGAINST U.S. DOLLARS

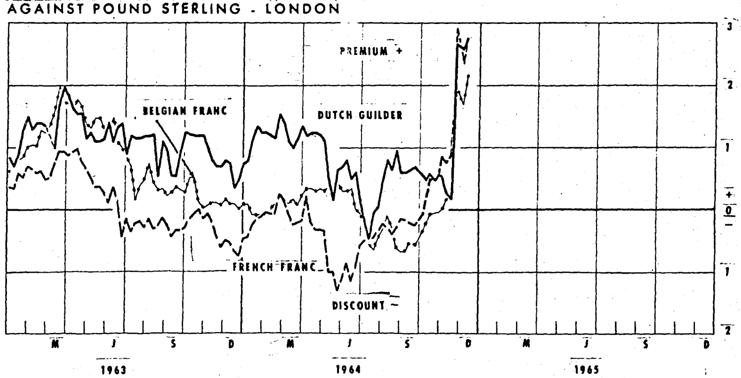
Per cent per annum



AGAINST POUND STERLING - LONDON



AGAINST POUND STERLING - LONDON



December 23, 1964

III. Latest Figures Plotted In H.13 Chart Series, 1964

Chart 1	Per cent per annum
Upper panel	
(Wednesday, Dec. 16)	
Euro-$ deposit	4.75
U.S. certif. of deposit	4.12
Lower panels	
(Friday, Dec. 18)	
Treasury bills: U.S.	3.84
U.K.	3.83
Canada	3.74
Finance Co. paper: U.S.	4.00
Canada	4.50
Hire-purchase paper, U.K.	4.90

Chart 2	
(Friday, Dec. 18)	
Treasury bills: Canada	3.77
U.S.	3.84
Spread favor Canada	-0.07
Forward Canadian dollar	-0.07
Net incentive (Canada +)	-0.14

Chart 3	
(Friday, Dec. 18)	
Treasury bills: U.K.	6.41
U.S.	3.84
Spread favor U.K.	+2.57
Forward pound	-2.62
Net incentive (U.K. +)	-0.05

Chart 5	Per cent per annum
(Friday, Dec. 18, except as noted)	
Treasury bills:	
U.S.	3.84
U.K.	6.41
Germany	2.63
Canada	3.77
Swiss 3-month deposits (Date: Nov. 15)	3.68
Euro-$ deposit (London)	4.75
Japan: composite rate (Date: Sept. 25)	7.986

Chart 6	
Bonds:	
U.S. govt. (Wed., Dec. 16)	4.18
U.K. war loan (Thurs., Dec. 17)	6.46
German Fed. Railway (Fri., Dec. 11)	6.38
Dec. 18	6.40
Swiss Confederation (Fri., Dec. 11)	4.04
Canadian govt. (Wed., Dec. 16)	5.08
Netherlands Government perpetual (Fri., Dec. 11)	4.98

For description and sources of data see special annex to H. 13 Number 164, September 23, 1964.