DIVISION OF INTERNATIONAL FINANCE

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

H. 13
No. 200

June 16, 1965.

CAPITAL MARKET DEVELOPMENTS ABROAD

I. United Kingdom
II. Nine Charts on Financial Markets Abroad
III. Latest Figures Plotted in H. 13 Chart Series

I. United Kingdom: Money and Capital Markets, April-June 1965

The weak tone of British financial markets was not significantly altered by the announcements on June 3 of a reduction in Bank Rate from 7 to 6 per cent and an increase of 5 percentage points in the minimum hire purchase downpayment requirements. In May, market conditions had deteriorated noticeably: spot sterling eased continually; equity prices and government bond yields moved irregularly as trading volume diminished; and in the last week of May the discount on three-month forward sterling widened out by 62 basis points. (See Table 1.) After the new policy measures were announced, spot sterling showed but minor improvement; equity prices and government bond yields changed little. The discount on forward sterling narrowed appreciably, but mainly in response to lower money market rates. (See Table 1.)

Table 1. United Kingdom: Selected Financial Market Indicators April-June, 1965

	Actual April 16	Change from previous date to: May 14	May 21	May 28	June 4	June 11	Actual June 11
Interest rates							
Treasury bill a/	6.45	-0.13	-0.02	+0.07		-0.06	5.62
Government bonds b/							
5% 1967	6.65	0.00	0.00	-0.03	-0.20	-0.02	6.40
5% 1971	6.82	-0.13	-0.12	+0.12	+0.02	-0.05	6.66
3-1/2% 1979-81	6.67	+0.08	-0.08	-0.15	+0.13	-0.05	6.60
5-1/2% 2008-12	6.60	+0.12	-0.05	+0.03	+0.07	-0.02	6.75
3-1/2% War Loan	6.65	+0.04	-0.07	+0.10	+0.07	-0.07	6.72
Stocks b/ c/							
Price index	104.67	+4.46	-0.13	-3.85	-0.79	+0.20	105.56
Share yield	5.66	-0.41	+0.18	+0.15	+0.04	-0.01	5.61
Exchange rates							
Spot (U.S. cents)	279.72	+0.08	-0.14	-0.36	+0.12	-0.06	279.36
Forward (per cent per annum)	-2.55	+0.59	+0.14	-0.62	+0.62	+0.14	-1.68

a/ Maximum tender.
b/ Previous Thursday.
c/ *Financial Times* 500 industrials.

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The deterioration of market conditions in May followed a brief period of modest strength. Between mid-April and early May, spot sterling gained considerable ground and on one occasion touched $280.01 (U.S. cents); the forward discount narrowed considerably; government bond yields drifted lower and equity prices rose.

This firmer tone in mid-April was apparently related to measures taken by the British authorities primarily designed to strengthen the market for sterling. On April 14, the Prime Minister in his speech to the Economics Club of New York, once again expressed the determination of his government to maintain the par value of the pound. On April 29, the Bank of England made a call for special deposits of 1 per cent for the London clearing banks and one-half per cent for the Scottish Banks, to restrain the growth of domestic credit. (The percentages apply to the commercial banks' own gross deposits and are in addition to their regular reserve requirements.) It was estimated the banks' lending capacity would be reduced by £95 million. Then, in early May, the Bank of England requested the commercial banks and other financial institutions to limit the expansion of loans to domestic users (except nationalized industries and local authorities) to 5 per cent between March 1965 and March 1966. These new guidelines are more stringent than those given last December and encompass loans to finance spending for plant and equipment. Credit extension for this purpose was encouraged by the directive of last December.

Financial markets maintained their improved posture through early May; however in the second week of that month, spot sterling began to ease, perhaps in response to the disappointing export figures for April released at that time. Slowly, this softer tone began to affect other financial markets. The gilt-edged market had become quite sensitive by the end of May, and Chancellor Callaghan's announcement that a select group of government bonds would be exempt from the capital gains tax led to a re-alignment of market yields. By mid-June, long-term yields were above the April 16 level even though short-term rates had eased appreciably.

Money market rates down after change in Bank Rate. Most money market rates fell by about one percentage point after the decrease in Bank Rate on June 3. (See Table 2 and Charts 1 and 5.) However, the selective credit control measures together with the apparent absence of money flows to London kept credit conditions tight.

The residential mortgage market is one area which might experience some easing of conditions as a result of the decrease in Bank Rate. The building societies, unlike many institutional borrowers, did not raise their deposit rates when Bank Rate was raised last November. As a result, the flow of new funds to the societies diminished greatly in 1965. Even though the societies raised their mortgage rates to 6-3/4 per cent in January, they had to sell-off short-term assets to satisfy their loan commitments made earlier and cut down on future commitments. With the decrease in Bank Rate, most deposit rates fell; however, the societies raised their deposit rate from 3-3/4 to 4 per cent in an attempt to increase the flow of funds to home building over the next few months.

Table 2. United Kingdom: Selected Money Market Rates
April-June, 1965
(per cent per annum)

	April		May			June	
	9	23	7	21	28	3	11
Call money a/	6.44	6.50	6.50	6.38	6.38	5.38	5.38
Deposit rates:							
Less than 3-days:							
Local authority	8.31	7.25	7.25	6.94	7.12	6.06	5.94
Euro-$	4.12	4.12	4.25	4.31	4.38	4.38	4.38
90-day							
Local authority:	7.75	7.31	7.06	6.82	6.88	6.37	6.44
Euro-$	4.75	4.75	4.88	4.93	5.25	5.12	5.00
Treasury bill	6.41	6.35	6.24	6.19	6.28	5.56	5.49

Prior to the change in Bank Rate, a number of special factors contributed to a mixed pattern of short-term rate movements: call money rates generally remained high; the Treasury bill yield and local authority deposit rates eased during most of May then moved up sharply at the end of the month; and Euro-dollar rates began to rise. (See Table 2 and Charts 1 and 5.)

In the Treasury bill market, expectations of a cut in Bank Rate, coupled with the unusually low amount of Treasury bills offered at the weekly tender, led the discount houses to repeatedly raise their bidding price. As a result, on May 21, the Treasury bill yield reached its lowest level since the increase in Bank rate last November 23. To push up the bill rate, the Bank of England forced the houses to borrow at the penalty rate on a number of occasions as it had done during similar past periods. Finally, on May 30, the houses lowered their bidding price and the bill rate rose to 6.28 per cent.

In the local authority deposit market rates declined steadily through much of May after moving along a rising trend since late in 1964. This turnaround apparently reflected two factors: (1) the sizeable narrowing in the discount on forward sterling; and (2) an increase in borrowing at the Public Works Loan Board (a Treasury agency). During the first six weeks of the current fiscal year, the local authorities reportedly borrowed about £136 million--nearly one-third of their allotment for the entire 1965-66 fiscal year. At the end of May, rates increased noticeably, perhaps in response to the wider discount on forward sterling.

Rates in the Euro-dollar market moved up appreciably in May. (See Table 2.) The 90-day rate reached a peak of 5.25 per cent late in May--12 basis points higher than the previous high recorded on March 10. Rates eased somewhat in early June; but in the third week of the month they began to rise once again, and on June 14 the rate on 90-day deposits was 5.06 per cent.

Capital markets still weak. The decrease in Bank Rate and the new minimum downpayment requirements on hire purchase contracts had very little impact on British capital markets. By June 10, bond yields and stock prices had shown only minor improvement and the volume of trading, which had fallen noticeably in May, remained at a low level. (See Table 1 and Chart 6.)

The weaker tone in capital markets in May apparently reflected the softening of the sterling exchange rate, capital gains tax uncertainties, and perhaps the impact of restrictive monetary policy. Tax considerations particularly contributed to deterioration in the government bond market. According to a statement by Chancellor Callaghan on Wednesday, May 26, some capital gains on gilt-edged transactions would be exempt from the new tax. However, the market had a very difficult time in understanding the criteria for exemption and trading, already at a low level, came to a virtual standstill on Thursday and Friday.

In the stock market, where conditions have been very sensitive to movements in the exchange rate, the steps to strengthen the credit squeeze cast a shadow on the business outlook; the demand for equities eased in the latter part of May and prices dropped off sharply. (See Chart 6.)

In late April and early May, capital markets had exhibited a somewhat firmer tone. (See Table 1.) Government bond yields tended to drift lower at times on expectations of a cut in Bank rate and renewed rumors that "gilts" would be exempt from capital gains tax. In the stock market, prices were pushed up by the government's compensation terms for steel nationalization and Conservative Party victories in the local elections.

Private sector borrowing continues to rise. Despite high interest rates in the United Kingdom, advances by the London clearing banks (seasonally adjusted) and the building societies continued to expand during April, as did installment credit. In May, however, bank advances fell sharply, perhaps reflecting the special deposit and ceiling requirements. (See Table 3.)

The very large April increase in bank advances, more than any other sign, of inflationary pressure, led the Bank of England to make its call for special deposits and place the five-per cent ceiling on the growth of domestic credit. Then on June 3, the Board of Trade increased the downpayment requirements on hire purchase contracts by 5 percentage points--from 20 to 25 per cent on automobiles and from 10 to 15 per cent on other consumer durables.

Table 3. United Kingdom: New Borrowing by the Private Sector, 1965
(£ million)

	Jan.	Feb.	Mar.	Apr.	May	Outstanding May 30, 1965
Bank advances a/	-46	-35	+45	+88	-76	4,574
Installment credit b/	- 2	+10	+16	+18	n.a.	c/ 1,157
Net new issues by U.K. corporations	+21	+26	+40	+ 6	+28	--
Advances by building societies	+83	+67	+84	+79	n.a.	--

a/ London clearing banks: seasonally adjusted.
b/ Finance houses and department stores.
c/ April 30, 1965.

Foreign trade position deteriorates in April and May. Britain's foreign trade position took a turn for the worse in April and May after showing sustained improvement through the first three months of the year. (See Table 4.) Rising imports and stagnant exports led to a trade deficit of £76 million in April and £109 million in May. Market expectations were for a somewhat better performance, at least on the export side. It was thought, however, that imports would be bunched in May owing to the decrease in the import surcharge from 15 to 10 per cent which went into effect on April 27. Also, British authorites noted that the U.S. dock strike could still be inflating the import bill.

Table 4. United Kingdom: Foreign Trade, January-April 1965
(£ million seasonally adjusted)

	January	February	March	April	May
Imports (c.i.f.)	465	440	468	476	501
Exports (f.o.b.)	368	390	387	387	377
Re-exports (f.o.b.)	14	14	13	13	13
Difference	-83	-36	-68	-76	-109
Trade balance a/	-34	+11	-19	-29	- 49

a/ Balance of payments basis.

Foreign reserves rise in April and May. Official holdings of gold and foreign exchange, as reported by the Bank of England, rose $22.4 million in April and $506.8 million in May. (See Table 5.) However, the April figures were obscured by the use of central bank credits, and the ones for May by the Fund drawing.

Table 5. United Kingdom: Official Holdings of Gold and Foreign Exchange, January-April, 1965
($ million)

	January	February	March	April	May	Total holdings May 30, 1965
Gold and foreign exchange	-16.8	+64.4	-33.6	+22.4	+506.8	2858.8

On May 12, the International Monetary Fund agreed to a $1.4 billion equivalent drawing by the United Kingdom. This raised Britain's total drawings to about $2.4 billion and increased the Fund's holdings of sterling to 197.4 per cent of the United Kingdom's quota. Of the $1.4 billion drawn in May, $475 million came from the Fund's own holdings, $525 million from borrowing under the G.A.B. and $400 million from the sale of gold to various countries.

Of the $1.4 billion drawn in May, about $1.1 billion was used to pay-off outstanding central bank credits. The remaining $300 million plus about $40 million more from a long-term Swiss credit were added to reserves. Hence, the true reserve gain for May was about $167 million.

Sterling remains weak in foreign exchange markets. In spite of the new policy measures announced on June 3, sterling remained generally weak in the foreign exchange markets. The spot rate rose a little on June 4, but this improved position was not maintained in the days that followed. The forward discount on three-month contracts did narrow appreciably, partly in response to lower money market yields in London. As a result, the covered differential on Treasury bills remained in favor of New York. (See Table 6 and Charts 8 and 9.)

After a brief respite in April, sterling came under selling pressure in May: between April 30 and May 28, the spot rate fell 64 points. The forward rates weakened only after May 21, but the change was substantial. (See Table 6 and Charts 8 and 9.) Market conditions continued to deteriorate in June: on June 2 the spot rate reached 279.30 U.S. cents and the forward discount was quoted at 2.79 per cent. As a result of the wider forwards, the covered differential on Treasury bills once again favored New York.

The firmer tone of the market in April was apparently related to two separate factors. The spot market received a considerable boost from the Prime Minister's April 14 declaration to defend the par value of sterling, and at one point in late April, the rate touched 280.01 (U.S. cents). Forward sterling benefited from continued expectations of an "early" cut in Bank rate and the discount declined by 22 basis points by April 30.

Table 6. United Kingdom: Exchange Rate and Arbitrage Calculations, April-June, 1965

	April		May			June	
	15	30	7	21	28	4	11
Exchange Rates							
Spot (U.S. cents)	279.72	279.94	279.85	279.66	279.30	279.42	279.36
Forward (per cent per annum)	-2.55	-2.33	-2.05	-1.82	-2.44	-1.82	-1.68
Three month yields and yield spreads							
Treasury bills							
U.K. (covered)	3.74	3.87	4.08	4.68	3.76	3.67	3.74
U.S.	3.91	3.90	3.87	3.88	3.85	3.82	3.79
Difference	-0.17	-0.03	+0.21	+0.40	-0.09	-0.15	-0.05
Deposit rates							
Local authority (covered)	5.12	4.73	5.01	5.00	4.44	4.55	4.76
Euro-$	4.81	4.81	4.88	4.93	5.25	5.12	5.00
Difference	+0.31	-0.08	+0.13	+0.07	-0.81	-0.57	-0.24
Euro-$ a/	4.81	4.81	4.81	4.88	5.00	5.25	5.00
New York C.D.'s a/ b/	4.27	4.29	4.31	4.33	4.33	4.34	4.33
Difference	+0.54	+0.52	+0.50	+0.55	+0.67	+0.91	+0.67

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

The change in market sentiment for spot sterling in May was generally attributed to the poor showing of the April trade figures and the domestic signs of inflationary pressures. In the market for forward sterling, these considerations were apparently outweighed, until May 21, by anticipations of a cut in Bank Rate. When Bank Rate was not changed, selling pressure developed in the forward markets.

The narrowing discount on forward sterling through May 21 had mixed effects on covered yield spreads. The covered differential on Treasury bills moved in favor of London by a substantial amount despite the easing in the U.K. bill rate. On the other hand, the differential between local authority and Euro-dollar deposits tended to fall because uncovered local authority rates declined while Euro-dollar rates rose. The differential between Euro-dollars and New York certificates of deposit did not change substantially because both rates moved upwards. (See Table 6 and Charts 8 and 9.)

With the widening of the forward discount at the end of May, covered U.K. paper became increasingly unattractive--a situation that was not appreciably influenced by the decrease in Bank Rate. The covered differential on Treasury bills turned again in favor of New York, and Euro-dollar deposits were earning about 80 basis points more than covered local authority deposits. By June 11 there was selective improvement in these covered differentials. (See Table 6.)

Price of gold shows easing tendency. The price of gold in the London market eased noticeably during late April; May price movements were irregular but in June prices again moved downward. (See Table 7.) In April, reduced demand coupled with an increased supply from new production led to a fall in the London fixing price; in May erratic fluctuations in demand led to modest price movements, while in June demand in general has been somewhat diminished from earlier levels.

Table 7. United Kingdom: London Fixing Price for Gold
April-May, 1965
(U.S. dollars)

	April		May		June	
	15	30	7	28	4	11
Price per fine ounce	35.1713	35.1062	35.1169	35.1007	35.1013	35.0949

II. Nine Charts on Financial Markets Aborad

Chart 1 - International Money Market Yields for U.S. Dollar Investors
Chart 2 - Interest Arbitrage, United States/Canada
Chart 3 - Interest Arbitrage, New York/London
Chart 4 - Interest Arbitrage for German Commercial Banks
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

Europe and British Commonwealth Section.

Latest Figures Plotted In H.13 Chart Series

Chart 1	Per cent per annum
Upper panel	
(Wednesday, June 9)	——
Euro-$ deposit	5.00
U.S. certif. of deposit	4.33
Lower panels	
(Friday, June 11)	
Treasury bills: U.S.	3.79
U.K.	5.42
Canada	3.88
Finance Co. paper: U.S.	4.25
Canada	5.09
Hire-purchase paper, U.K.	4.63
Chart 2	
(Friday, June 11)	
Treasury bills: Canada	3.88
U.S.	3.79
Spread favor Canada	+0.09
Forward Canadian dollar	+0.41
Net incentive (Canada +)	+0.50
Chart 3	
(Friday, June 11)	
Treasury bills: U.K.	5.42
U.S.	3.79
Spread favor U.K.	+1.63
Forward pound	-1.68
Net incentive (U.K. +)	-0.05

Chart 5	Per cent per annum
(Friday, June 11, except as noted)	——
Treasury bills:	
U.S.	3.79
U.K.	5.42
Germany	3.12
Canada	3.88
Swiss 3-month deposits (Date: June 11)	n.a.
Euro-$ deposit (London)	5.13
Japan: composite rate (Date: April)	7.921
Chart 6	
Bonds:	
U.S. govt. (Wed., June 9)	4.18
U.K. war loan (Thurs., June 10)	6.74
German Fed. Railway (Fri., June 11)	6.89
Swiss Confederation (Fri., June 4)	3.91
Canadian govt. (Wed., June 9)	5.14
Netherlands Perpetual Government Bond (Fri., June 4)	5.28

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

Chart 1

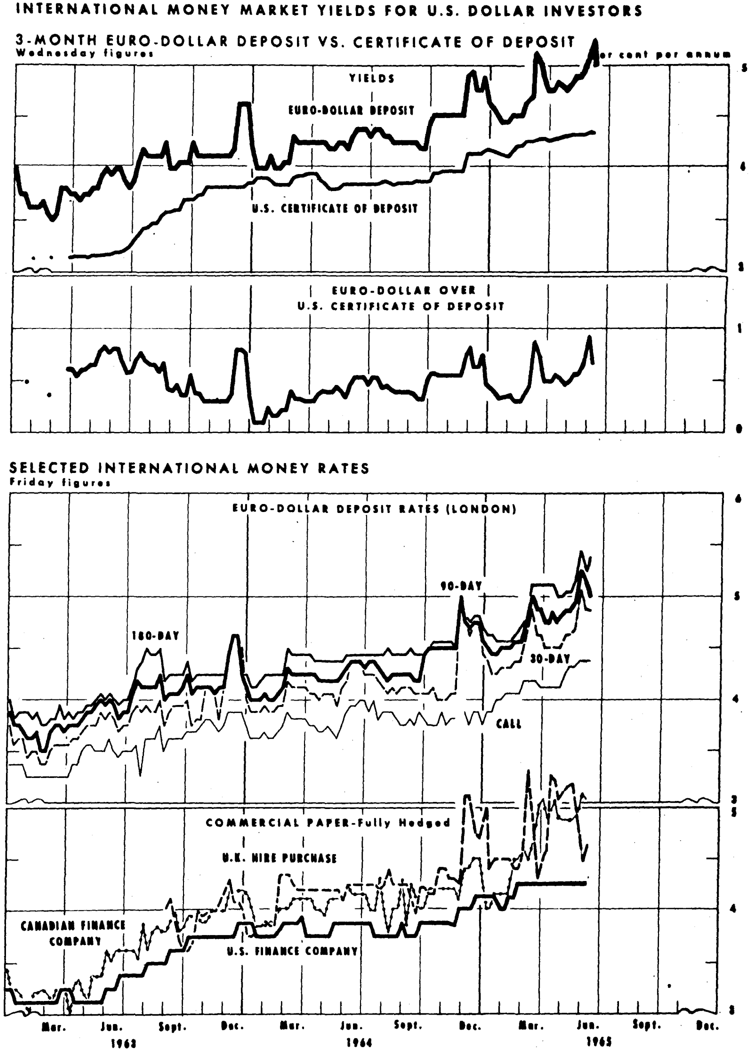
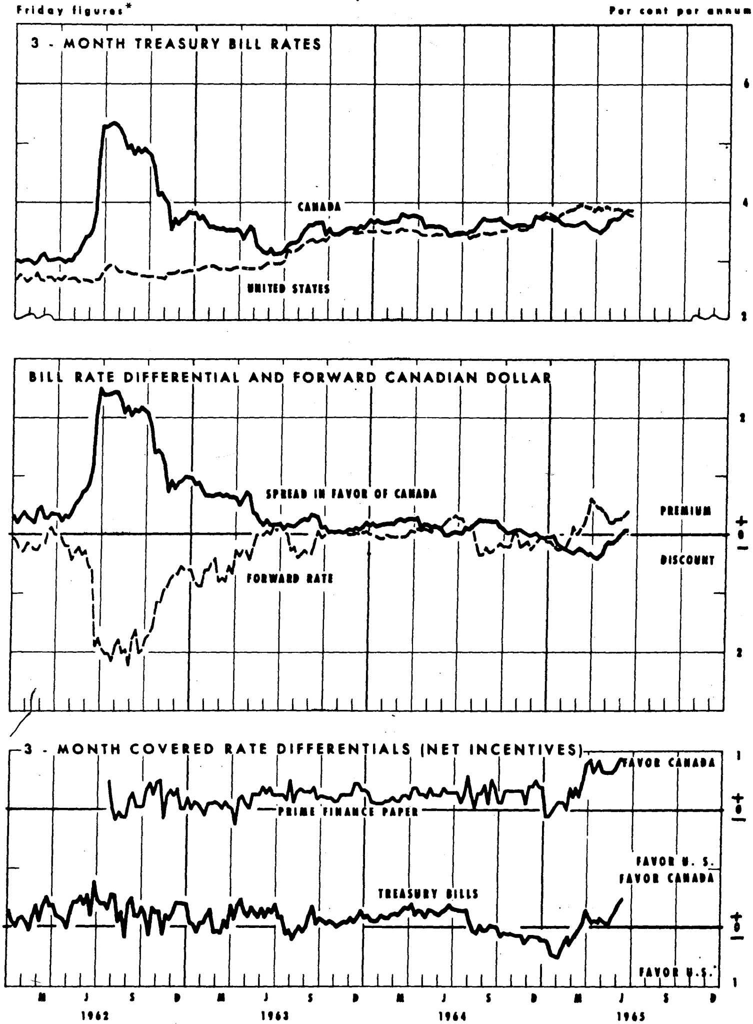

INTERNATIONAL MONEY MARKET YIELDS FOR U.S. DOLLAR INVESTORS
3-MONTH EURO-DOLLAR DEPOSIT VS. CERTIFICATE OF DEPOSIT
Wednesday figures
Per cent per annum
YIELDS
EURO-DOLLAR DEPOSIT
U.S. CERTIFICATE OF DEPOSIT
EURO-DOLLAR OVER U.S. CERTIFICATE OF DEPOSIT
SELECTED INTERNATIONAL MONEY RATES
Friday figures
EURO-DOLLAR DEPOSIT RATES (LONDON)
90-DAY
180-DAY
30-DAY
CALL
COMMERCIAL PAPER-Fully Hedged
U.K. HIRE PURCHASE
CANADIAN FINANCE COMPANY
U.S. FINANCE COMPANY
Mar.
Jun.
Sept.
Dec.
1963
1964
1965

Chart 2

INTEREST ARBITRAGE, UNITED STATES/CANADA

Friday figures*



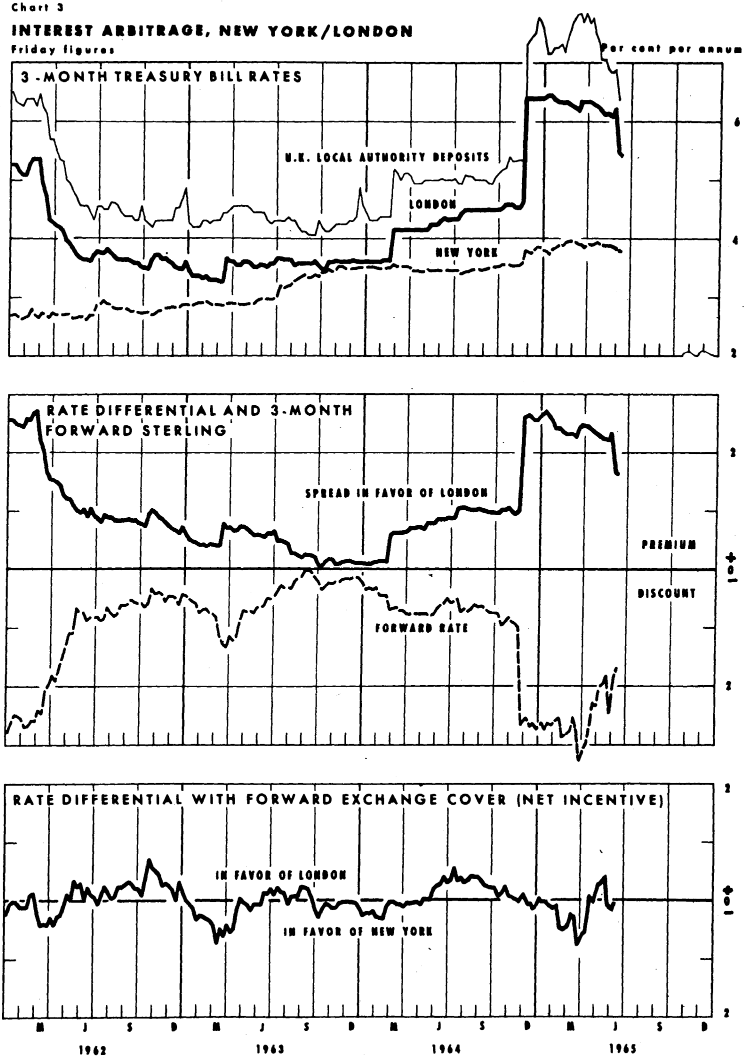
Thursday figures 1962, Friday thereafter.

12

Chart 3

INTEREST ARBITRAGE, NEW YORK/LONDON

Friday figures



13

Chart 4

INTEREST ARBITRAGE FOR GERMAN COMMERCIAL BANKS

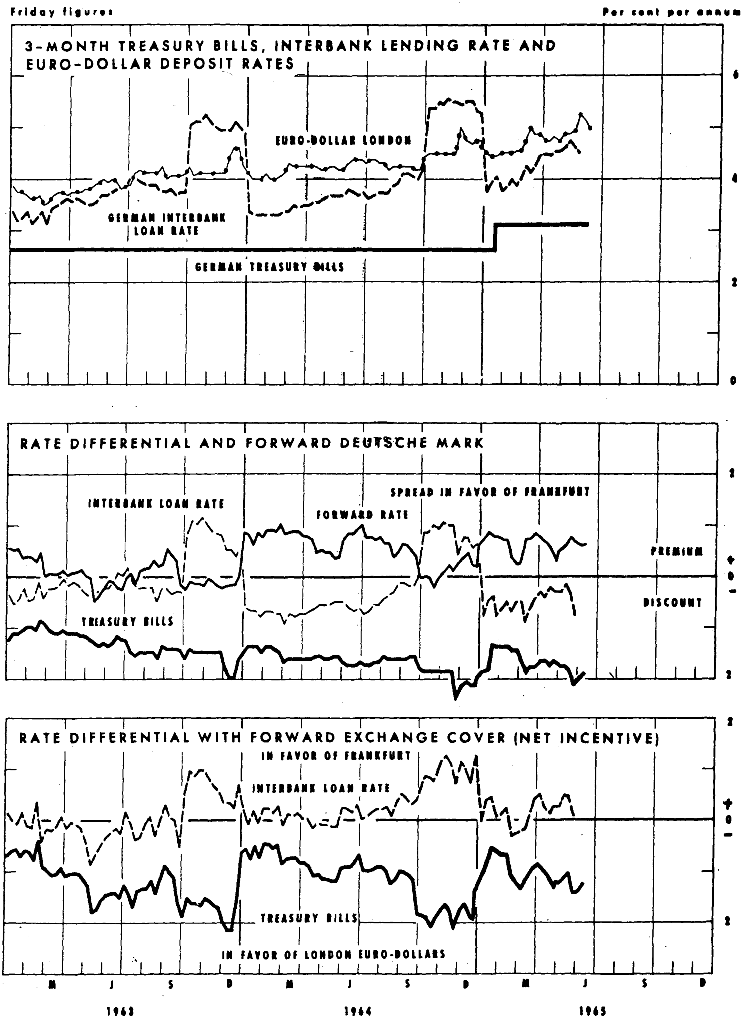
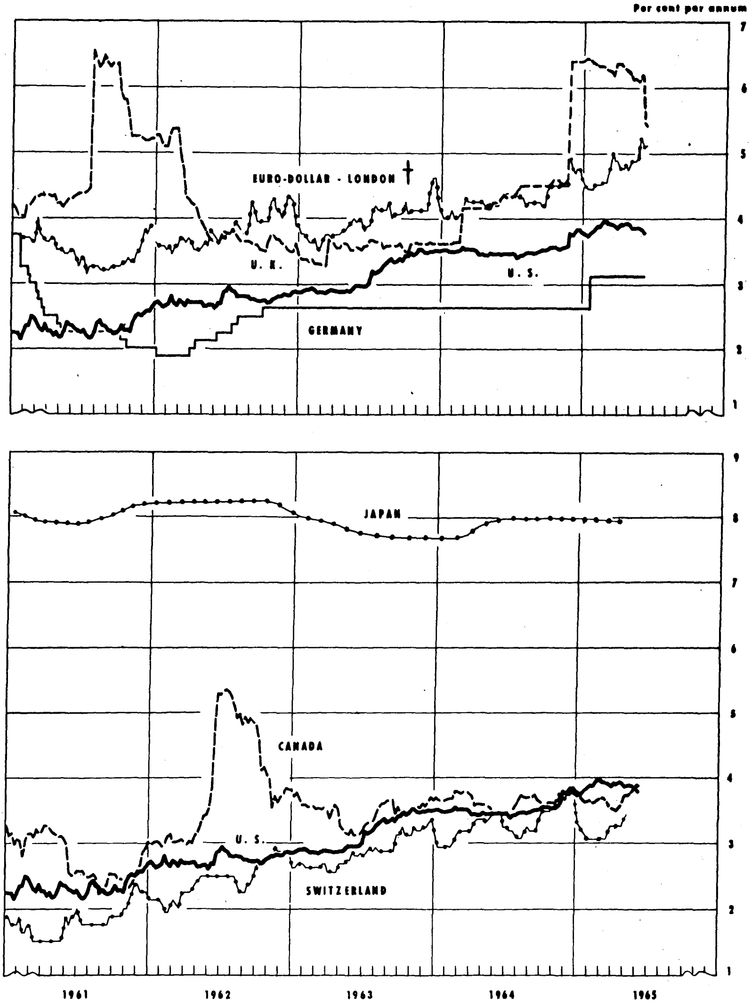


Chart 5
SHORT-TERM INTEREST RATES*

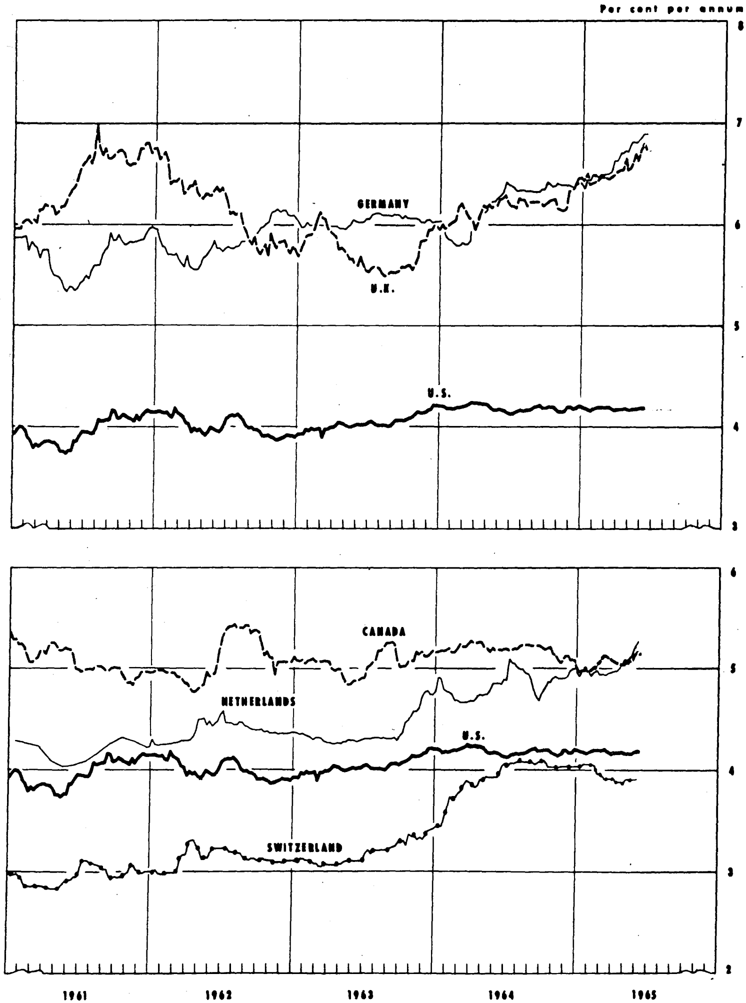


* 3-month treasury bill rates for all countries except Japan (Average rate on bank loans and discounts) and Switzerland (3-month deposit rate)

† 3-month rate for U.S. dollar deposits in London

Chart 6

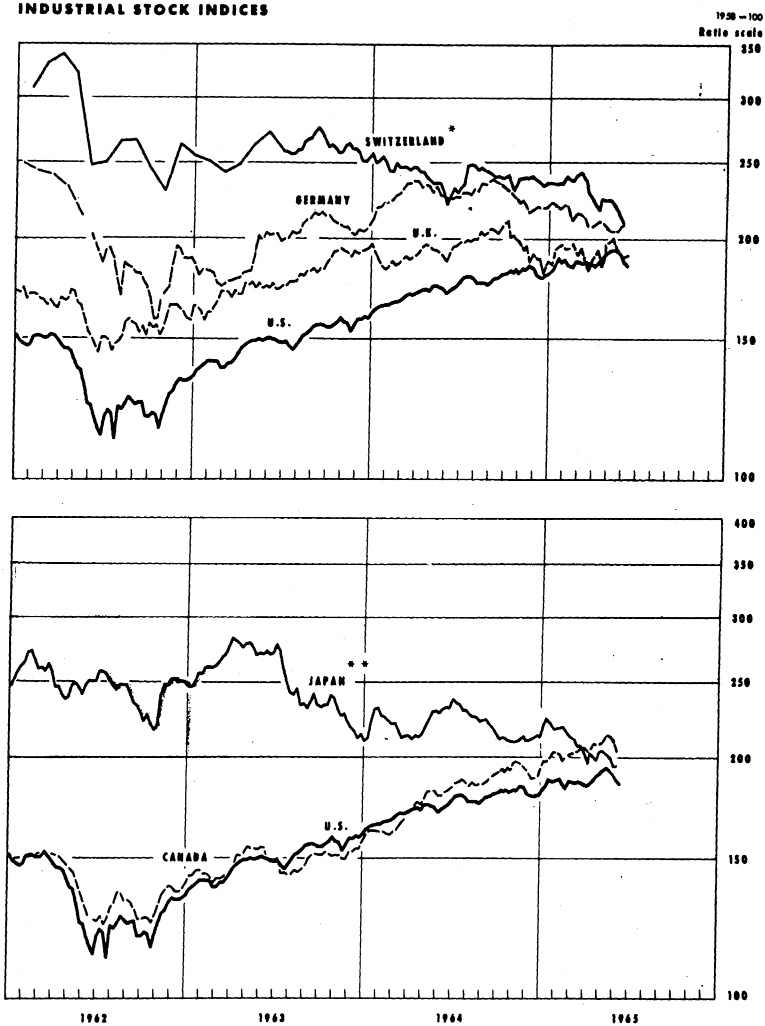
LONG-TERM BOND YIELDS



16

Chart 7

INDUSTRIAL STOCK INDICES



* Swiss Bank Corporation industrial stock.

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

Chart 8

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

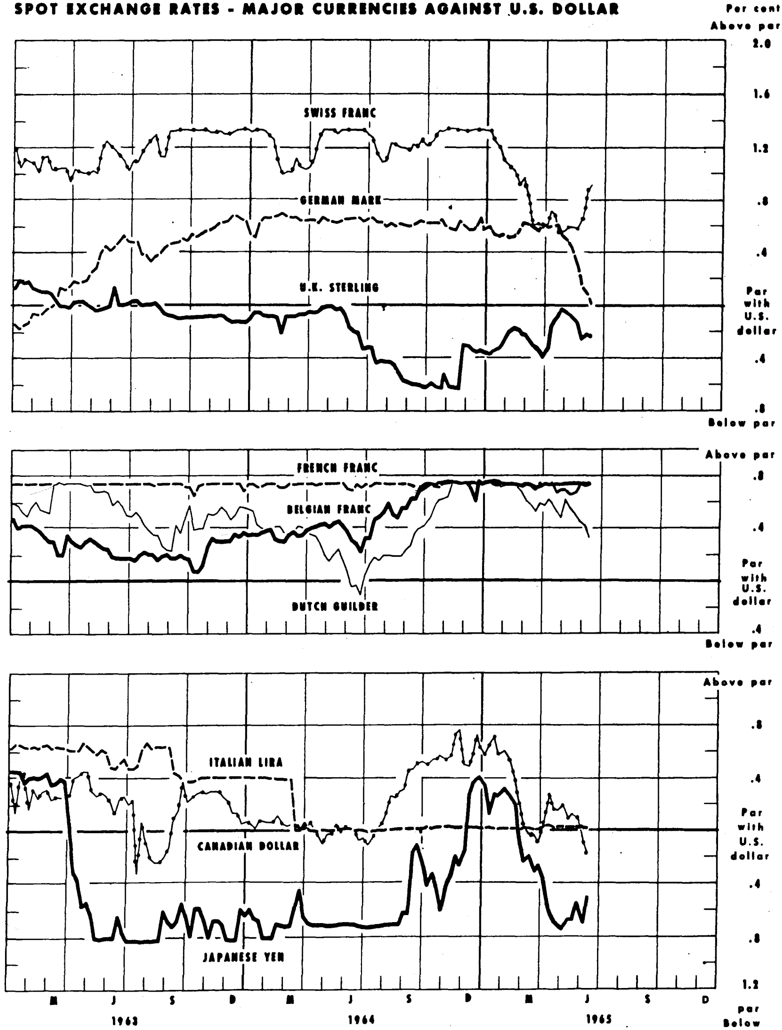


Chart 9

3-MONTH FORWARD EXCHANGE RATES

Friday figures