DIVISION OF INTERNATIONAL FINANCE

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

H. 13
No. 226

December 15, 1965.

1.

CAPITAL MARKET DEVELOPMENTS ABROAD

I. United Kingdom: Money and Capital Markets, September-December 1965

During September and early October, British financial markets maintained a firm tone, but some deterioration became evident in November, at the time of the Rhodesian crisis, and conditions weakened further after the December 6 increase in U.S. discount rates. Long-term bond yields rose steadily from late October to early December. (See Table 1.) By December 10 long-term yields were above, but short-term yields were still fractionally below their mid-September levels. Both the sterling exchange rate and industrial stock prices continued to register gains until late November, when they too weakened.

Table 1. United Kingdom: Selected Financial Market Indicators
September-December 1965
(per cent per annum) a/

	Actual Sept. 17	Change from: Sept. 17-Oct. 22	Oct. 22-Nov. 26	Nov. 26-Dec. 3	Dec. 3-Dec. 10	Actual Dec. 10
Interest rates						
Treasury bill (maximum tender)	5.52	-0.06	-0.06	-0.02	+0.10	5.48
Government bonds b/						
3% - 1959-69	6.45	-0.20	+0.02	-0.00	+0.08	6.35
5% - 1971	6.55	-0.08	+0.01	-0.06	+0.17	6.59
3-1/2% - 1979-81	6.25	-0.03	+0.10	+0.05	+0.08	6.45
5-1/2% - 2008-12	6.30	0.00	+0.10	+0.05	+0.07	6.52
3-1/2% - War loan	6.35	-0.01	+0.10	+0.05	+0.08	6.57
Euro-dollar rates						
90-days	4.44	+0.48	+0.20	+0.13	+0.31	5.56
180-days	4.88	+0.12	+0.12	+0.13	+0.37	5.62
Industrial stocks b/ c/						
Price index	104.59	+6.68	+2.57	-2.64	+0.14	111.34
Share yield	5.71	-0.32	-0.11	+0.13	-0.19	5.22
Exchange rates						
Spot (U.S. cents)	279.84	+0.44	+0.08	-0.14	+0.04	280.26
Forward	-1.88	+0.65	+0.13	+0.03	+0.10	-0.97

a/ Except stock price index and spot exchange rate.
b/ Entries are for days preceeding ones shown.
c/ *Financial Times* 500 industrials.

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A combination of external and domestic factors contributed to the advances in bond yields. Growing concern about the effectiveness of the government's incomes policy and fading hopes (after the U.S. discount rate action) of a cut in the U.K. Bank rate were the main considerations that produced an easier tone in the gilt-edged market. Market expectations of a lower Bank rate had been evident for some weeks and were responsible for the net fall of 14 basis points in the maximum tender yield on Treasury bills between September 17 and December 3. (See Table 1.) On December 10, lower bid prices by the discount houses raised this yield 10 basis points to 5.48 per cent.

The Federal Reserve action also produced a predictably sharp rise in rates paid on U.S. dollar deposits in London. Between December 3 and 10, the rate on 180-day deposits jumped 37 basis points to 5.62 per cent. (See Tables 1 and 2 and Chart 1.)

In the foreign exchange market, the demand for sterling, bolstered by announcements of large reserve gains and favorable foreign trade performances for September and October, remained strong through late November. (See Chart 8.) However, uncertainties connected with the Rhodesian situation contributed to a decline in the sterling rates between November 26 and December 3.

Industrial stock prices also eased in late November, but this appeared to be primarily related to the November 29 statement by Chancellor Callaghan, that further restrictive measures "on the demand side" might be needed if the strong rise in money incomes this year threatened the restoration of balance in the external accounts by the end of 1966. (See Chart 7.)

The growth of private-sector credit continues to be retarded by the special restraints on bank lending and consumer installment loans. Bank advances (subject to a 5 per cent growth ceiling for the 12 months ending in March 1966) rose at an annual rate of less than 3 per cent between March and November; installment credit (with the stiffer down payment requirements and shorter repayment periods imposed in June and July) levelled out in August-October. By contrast, there were large rises in new corporate flotations and in mortgage loans by the building societies during the period under review.

<u>Money market rates rise in December</u>. British 90-day money market rates rose across the board in early December after the U.S. interest-rate action of December 6. (See Table 2.)

Table 2. United Kingdom: Selected Money Market Rates August-December 1965
(per cent per annum)

	Aug. 27	Sept. 17	Oct. 15	Nov. 26	December 3	December 10
Call money	5.50	5.50	5.53	5.44	5.38	5.38
Deposit rates						
Local authority						
2-days	6.31	5.94	5.81	5.88	6.06	6.06
90-days	6.63	6.31	6.12	6.25	6.38	6.44
Euro-dollars						
Call	4.00	4.00	4.25	4.25	4.50	4.50
90-days	4.44	4.44	5.06	5.12	5.25	5.56
Treasury bill (market rates)	5.47	5.44	5.37	5.31	5.31	5.41

Prior to this step, short-term rates had had a mixed but downward tendency, largely on the expectation of a Bank rate cut. However, there was no substantial relaxation of the tight conditions that have prevailed for the last 12 months. (See Table 2 and Charts 1 and 2.)

In the call money market, conditions remained tight through mid-November and the Bank of England assisted the market, at times by buying Treasury bills; the Bank also on occasion forced the discount houses to borrow at Bank rate. Conditions eased in the later part of November and the rate on day-to-day money fell slightly.

At times during the period under review, borrowing by the discount houses from the Bank led them to raise the bill yield at the next tender. Between September 17 and December 3, however, there was a net decline of 13 basis points in the market rate. (See Table 2.) On December 10, the market yield rose but was still 6 basis points below the level on August 27. (See Table 2.)

Local authority deposit rates, which had dropped off quite sharply between end-August and end-September, were stable throughout much of October and November and then began to rise. (See Table 2 and Chart 3.) The earlier downturn in rates seemed to be related to the return of foreign funds to London.

In the Euro-dollar market, rates rose in response to the December 6 U.S. discount rate action. Earlier, rates in the London market for foreign currency deposits had risen by small margins between mid-September and early October, partly in response to year-end window-dressing operations; and after six weeks of relative stability, rates rose again between November 26 and December 3. (See Table 2 and Chart 5.)

Capital markets weaken after strong recovery. Conditions in British capital markets were unsettled in November and early December after nearly two months of steady improvement. Between October 22 and December 10, long-term bond yields rose as much as 23 basis points while stock prices held firm at levels substantially above the July-August levels. (See Charts 6 and 7.)

Prior to the recent softer tone, conditions in British capital markets had been much improved over conditions in the second quarter. Between mid-September and late October yields on short bonds dropped sharply and long-term yields firmed at levels much below the July-August "crisis" peaks. (See Chart 6.) The strength of the market was evidenced by depletion of the short-dated tap stock--6-1/2 per cent Exchequer stock, 1967--on October 21 and the depletion of the medium dated tap stock--6-1/2 per cent Treasury stock, 1976--on October 28.

In the market for industrial stocks, the Financial Times 500 stock index rose 9 points between September 17 and October 22. (See Table 1.) Improved market confidence, acted to push up prices.

New capital issues have been unusually heavy in recent months. In addition, borrowers have shown a greater preference for fixed interest securities over equity shares, in part because interest payments have been accorded more favorable treatment--compared to dividends--in the new corporate tax legislation.

Growth of private-sector credit shows mixed tendencies. During the period under review, new credit extended to the private sector proceeded irregularly. The growth of installment credit slowed noticeably in the third quarter and the amount of this debt outstanding actually declined in August and September. Bank advances--seasonally adjusted--rose modestly in recent months, with the annual rate of growth for the March-November period at less than 3 per cent, well within the 5 per cent ceiling set by the Bank of England for the 12 months ending in March 1966. However, new issues by U.K. corporations were much heavier in the third quarter, and again in October-November. Finally, mortgage lending by the building societies held steady at the second quarter rate during the third quarter, but then picked up sharply in October. Such lending had declined steadily from late in 1964 to mid-1965. (See Table 3.)

Table 3. United Kingdom: New Borrowing by the Private Sector 1964-1965
(£ m: monthly or monthly average)

	1964		1965				
	III	IV	I	II	III	Oct.	Nov.
Bank advances a/							
Actual	45	35	58	-4	-10	-30	-25
Seasonally adjusted	70	70	-12	4	18	10	20
Installment credit b/	14	10	8	18	10	- 4	n.a.
Net issues of U.K. corporation c/	42	27	29	31	45	34	73
Advances by building societies	95	91	78	73	73	93	n.a.

a/ London clearing banks.
b/ Finance houses and department stores.
c/ Net of redemptions.

The faster growth of new corporate bond issues was partly seasonal, but may also reflect the squeeze on bank advances. The pick-up in mortgage lending reflects the very large-scale flow of funds to the building societies which has been underway since last June. (On June 3, when Bank rate was lowered from 7 to 6 per cent, the societies raised their deposit rates in order to attract more funds.) Finally, the slow-down in the growth of consumer installment credit in the third quarter, and the actual September-October declines in the outstanding total undoubtedly reflects the stiffer downpayment requirements and shorter repayment periods introduced by the Board of Trade in June and July.

Foreign trade position improves. Britain's foreign trade position--after adjustment for seasonal factors--has improved noticeably in recent months. (See Table 4.) In the third quarter, exports increased substantially and imports rose but little from second quarter levels. As a result, the trade dificit (on a balance-of-payments-basis) dropped from £40 million a month in the second quarter to £26 million in the third. The trade deficit declined further in October-November. (See Table 4.)

Table 4. United Kingdom: Foreign Trade 1964-1965
(£ m: Seasonally adjusted monthly or monthly average)

	1964	1965 I	1965 II	1965 III	1965 Oct.	1965 Nov.	Jan.-Nov.
Imports (c.i.f.)	475	458	483	487	484	496	478
Exports (f.o.b.) a/	381	396	393	414	409	426	404
Difference	-84	-62	-90	-73	-75	-70	-74
Trade balance b/	-46	-13	-40	-26	-22	-17	-25

a/ Includes re-exports.
b/ Adjusted to balance of payments basis.

The improvement in Britain's export performance over the last five months arrested the deterioration in the trade position that took place in the second quarter. For the first 11 months of 1965, the average monthly trade deficit (on a balance-of-payments basis) was about £25 million; this compares with £13 million per month in the first quarter and £26 million in the first 6 months.

Return of confidence boosts foreign exchang holdings. The recent improvement in Britain's foreign trade position was undoubtedly one of the several factors contributing to the maintenance of confidence in sterling, which became evident in early September. As a result, Britain's official holdings of gold and foreign exchange were reported to have risen by over $400 million in the three months, September through November. (See Table 5.) The total inflow of foreign exchange was somewhat greater because the Bank of England repaid an unspecified amount of central bank credits during this period.

Table 5. United Kingdom: Official Holdings of Gold and Foreign Exchange 1965
(millions of U.S. dollars)

	I	II	III	Sept.	Oct.	Nov.	Total holdings Nov. 30, 1965
Gold and foreign exchange	+14	a/+462	-36	+171	+118	+115	2,988

a/ Of which $343 m represents residuals of IMF and Swiss credits after repayment of "Basle" type aid.

Sterling strengthens after recent set-backs. The spot pound, which had been weakening since late November, dropped further just after the rise in U.S. discount rates. By December 7 it reached 280.15 U.S. cents; however, market conditions then became more settled, and a growing demand pushed the rate up to 280.26 on December 10. (See Table 6 and Chart 8.)

Table 6. United Kingdom: Exchange Rates and Arbitrage Calculations, September-December 1965

	September		October		November		December	
	3	24	8	22	12	26	3	10
Exchange rates								
Spot (U.S. cents)	279.18	279.95	280.30	280.28	280.34	280.36	280.22	280.26
Fwd. (p.c. p.a.)	-2.59	-1.73	-1.35	-1.23	-1.32	-1.10	-1.07	-0.97
Three month yields and yield spreads								
Treasury bills								
U.K. (covered)	2.93	3.63	3.89	4.07	4.01	4.14	4.17	4.36
U.S.	3.84	3.94	3.98	4.01	4.05	4.09	4.10	4.31
Difference	-0.91	-0.31	-0.09	+0.06	-0.04	+0.05	+0.07	+0.05
Deposit rates								
Local authority (covered)	3.97	4.71	4.84	4.96	4.80	5.15	5.31	5.57
Euro-dollar	4.38	4.50	5.00	4.92	4.94	5.12	5.25	5.56
Difference	-0.41	+0.21	-0.16	+0.04	-0.14	+0.03	+0.06	+0.01
Euro-dollar	4.44	4.50	4.88	4.94	4.94	5.00	5.25	5.62
N.Y. C.D.'s	4.31	4.33	4.45	4.47	4.47	4.94	4.49	4.64
Difference	+0.13	+0.17	+0.43	+0.47	+0.47	+0.51	+0.76	+0.98

From September to late November, the demand for sterling strengthened considerably bringing about a significant rise in the spot rate and a pronounced narrowing of the forward discount.

The strengthening of forward sterling during the period under review had a marked impact on covered interest differentials. The covered differential on Treasury bills swung from 91 basis points in favor of New York on September 3 to about 6 basis points in favor of London on October 22. (See Table 6.) Since late October the covered spread between the two rates has fluctuated narrowly on either side of interest parity.

The covered differential between local authority and Euro-dollar deposit rates moved erratically during the period under review. (See Table 6.) The rise in Euro-dollar rates, the narrowing discount on forward sterling and swings in uncovered local authority rates all contributed to these movements.

The rise in Euro-dollar rates widened the spread between these deposits and New York C.D.'s. (See Table 6.) From early October to early December, the rate on C.D.'s. had been pushing very close to the maximum permitted at that time by the Federal Reserve's Regulation Q. However, on December 6, the maximum rate payable on time deposits by member banks was raised from 4.50 to 5.50 per cent and market rates in New York advanced slightly.

London gold price eases. The price of gold at the fixing in London has dropped off in recent months after rising to $35.1668 in early October. (See Table 7.) The increase in price through the first part of October seems to have been related to political uncertainties surrounding the India-Pakistan conflict. The demand for gold eased when some of these uncertainties were removed by U.N. action and the price slipped to $35.0992 on October 22. Since then there have been modest fluctuations in the price and on December 10 it was set at $35.1147.

Table 7. United Kingdom: London Fixing Price for Gold

	September	October		November	December
	17	1	22	19	10
Dollars per fine ounce	35.1324	35.1668	35.0992	35.1222	35.1147

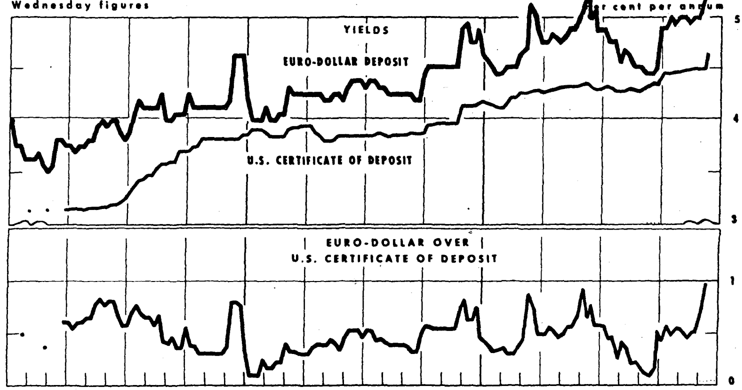
Europe and British Commonwealth Section.

Chart 1

INTERNATIONAL MONEY MARKET YIELDS FOR U.S. DOLLAR INVESTORS

3-MONTH EURO-DOLLAR DEPOSIT VS. CERTIFICATE OF DEPOSIT

Wednesday figures



SELECTED INTERNATIONAL MONEY RATES

Friday figures

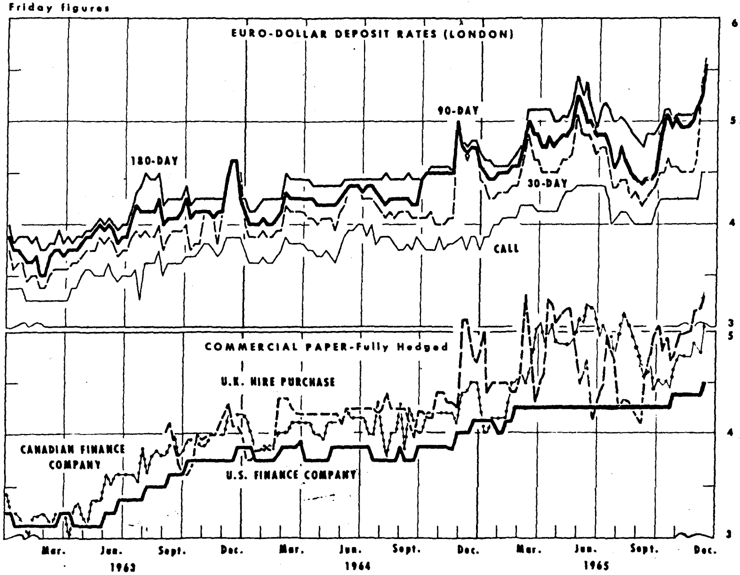
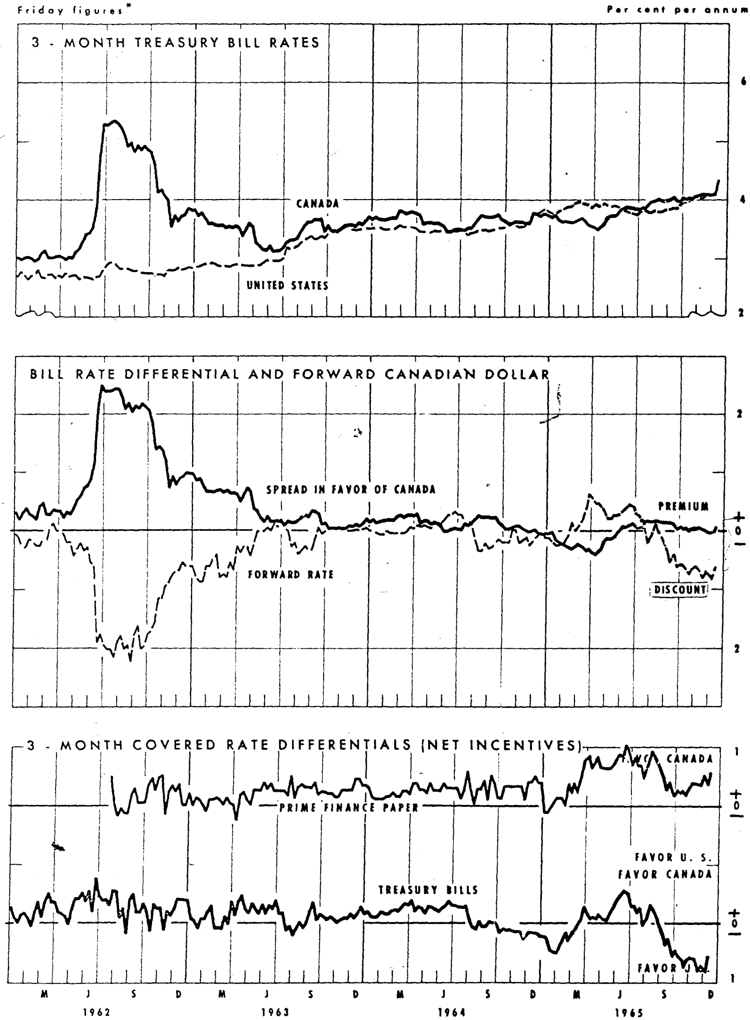


Chart 2

INTEREST ARBITRAGE, UNITED STATES / CANADA



* Thursday figures 1962, Friday thereafter.

Chart 3

INTEREST ARBITRAGE, NEW YORK/LONDON

Friday figures

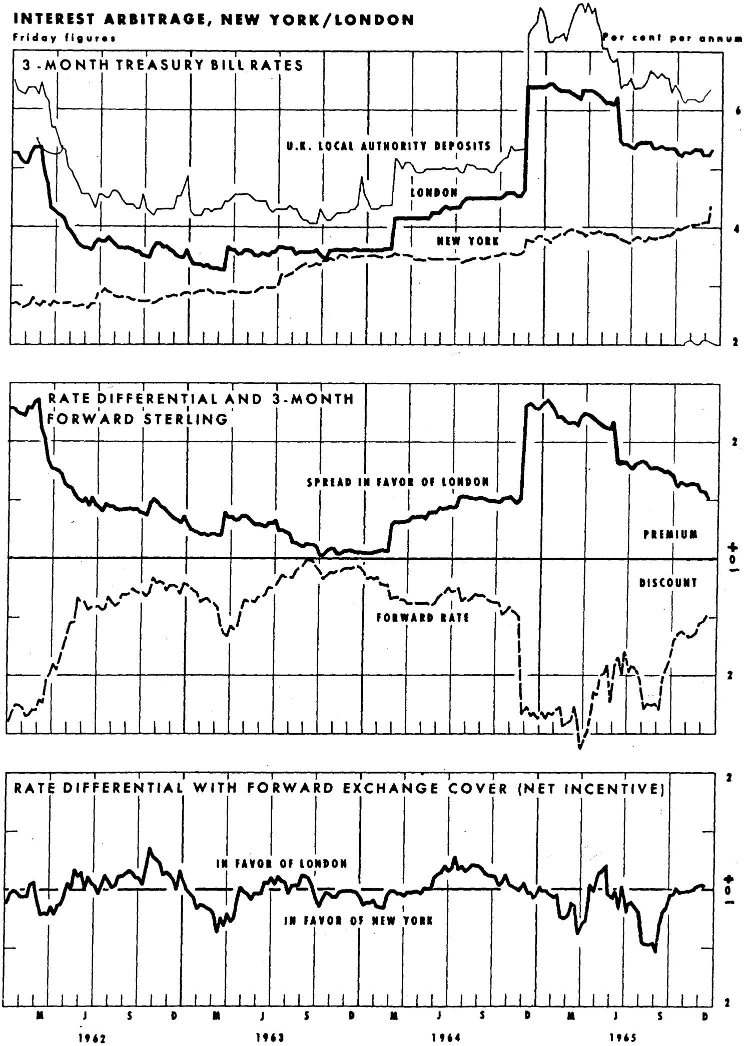
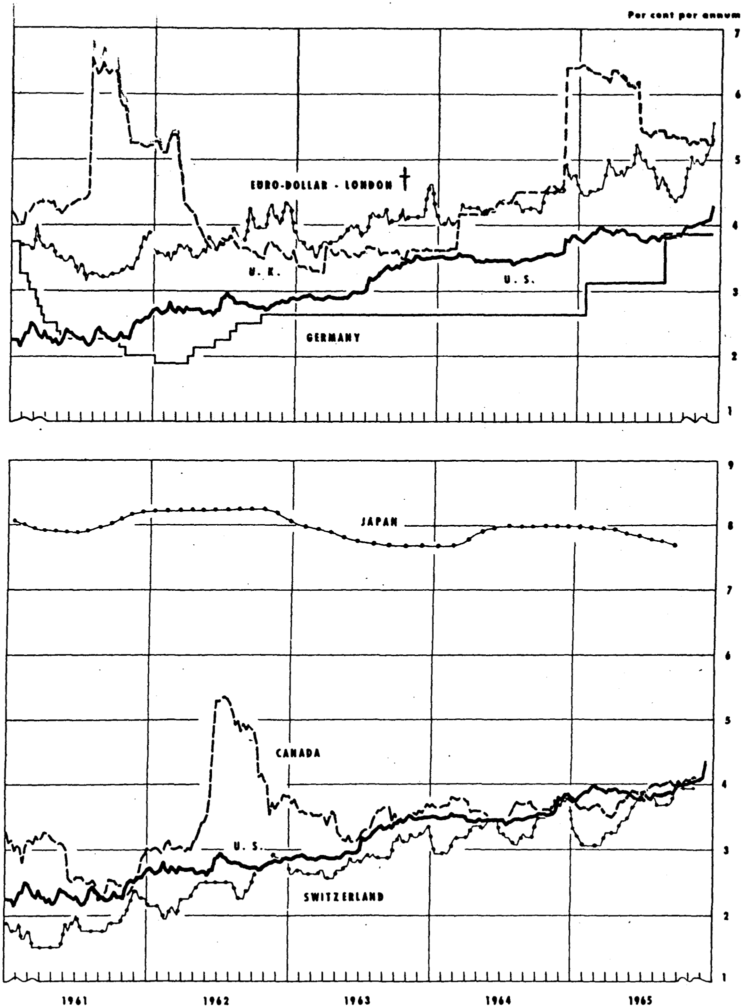


CHART 4 was not published in this issue.

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

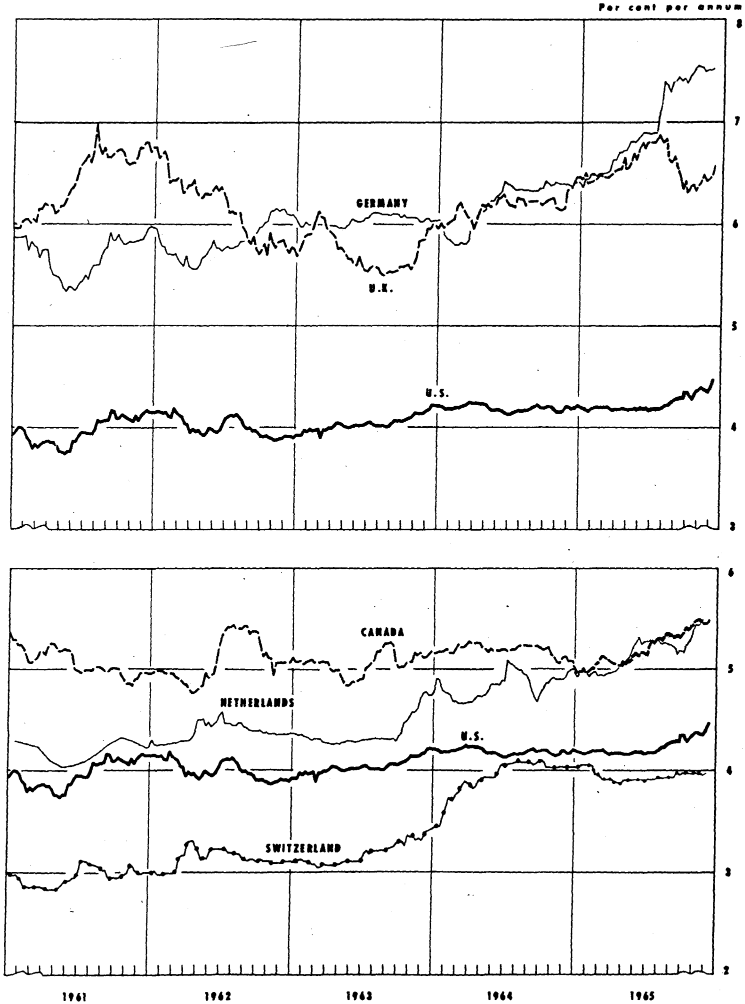
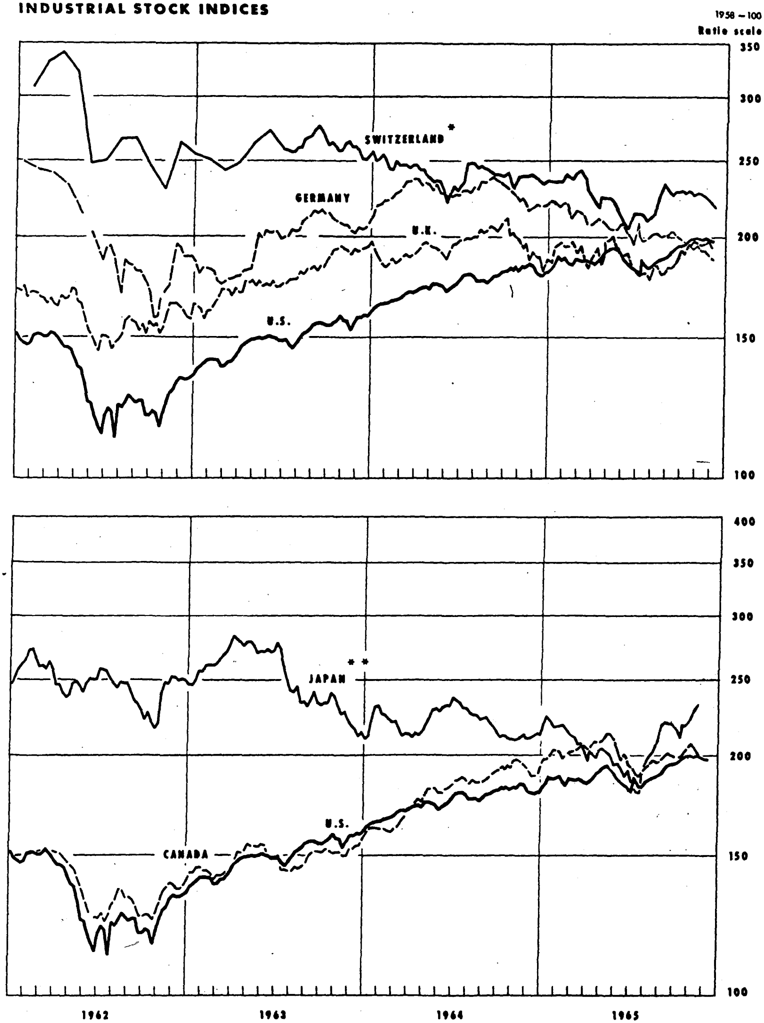


Chart 7

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

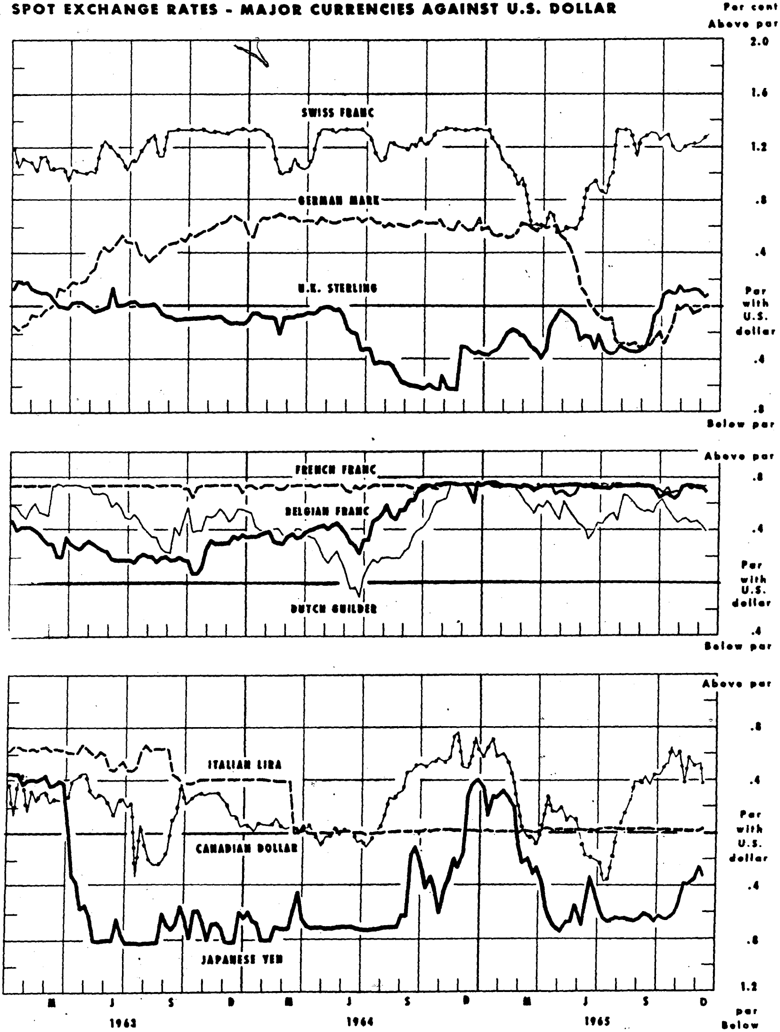
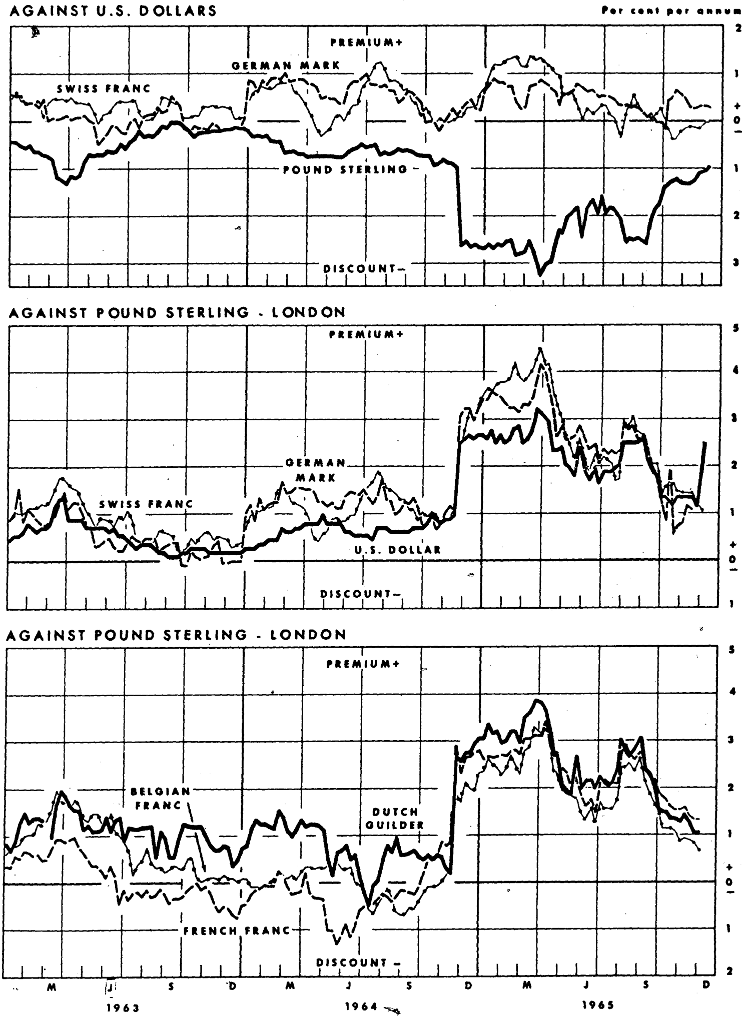


Chart 9

3-MONTH FORWARD EXCHANGE RATES

Friday figures



III. Latest Figures Plotted In H.13 Chart Series, 1965

Chart 1	Per cent per annum
Upper panel	
(Wednesday, December 8)	
Euro-$ deposit	5.62
U.S. certif. of deposit	4.64
Lower panels	
(Friday, December 10)	
Euro-dollar deposits: Call	4.50
7-day	4.75
30-day	5.62
90-day	5.56
180-day	5.62
Finance Co. paper: U.S.	4.50
Canada	5.07
Hire-purchase paper, U.K.	5.34

Chart 2	
(Friday, December 10)	
Treasury bills: Canada	4.38
U.S.	4.31
Spread favor Canada	+0.07
Forward Canadian dollar	-0.61
Net incentive (Canada +)	-0.54

Chart 3	
(Friday, December 10)	
Treasury bills: U.K.	5.33
U.S.	4.31
Spread favor U.K.	+1.02
Forward pound	-0.97
Net incentive (U.K. +)	+0.05

Chart 5	Per cent per annum
(Friday, December 10, except as noted)	
Treasury bills:	
U.S.	4.31
U.K.	5.33
Germany	3.88
Canada	4.38
Swiss 3-month deposits (Date: November 15)	3.94
Euro-$ deposit (London)	5.56
Japan: composite rate (Date: September 24)	7.680

Chart 6	
Bonds:	
U.S. govt. (Wed., December 8)	4.47
U.K. war loan (Thurs., December 9)	6.57
German Fed. Railway (Fri., December 3)	7.51
Swiss Confederation (Fri., December 3)	3.97
Canadian govt. (Wed., December 8)	5.49
Netherlands government perpetual (Fri., November 26)	5.50

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