

L.5.2.
RESTRICTED

RFD. 140

Board of Governors of the Federal Reserve System
Division of Research and Statistics
International Sections

REVIEW OF FOREIGN DEVELOPMENTS

June 6, 1950

- Recent Monetary Developments in the United Kingdom
By Samuel I. Katz 14 pages
- A Note on Post-Devaluation Dollar Prices of Sterling
Area Exports
By Samuel I. Katz 4 pages

This review is intended primarily for internal circulation and should in no case be cited or quoted. It consists of personal and informal contributions by the authors, which in many cases represent tentative analyses of the subject considered.

RECENT MONETARY DEVELOPMENTS IN THE UNITED KINGDOM

Samuel I. Katz

Considerable progress toward monetary stabilization was achieved in the United Kingdom during the 1949-50 fiscal year which ended in March. The ten-year expansion in deposits, which had already slowed down during the previous fiscal year, has for the moment come to an end. Major changes toward a more traditional internal monetary organization occurred during the year, primarily as a result of a shift in Treasury financing from the clearing banks to the money market. This shift was aided by the Treasury surplus, the continued foreign assistance, as well as the reduction in the pressure on the Treasury's cash position because of a change in the movement of sterling balances. Despite the emphasis placed upon fiscal policy under the disinflation program, greater use has also been made of conventional monetary instruments, and especially of a higher long-term rate of interest, to maintain internal stability. Although short-term rates continue to be frozen, the monetary authorities have been able effectively to retain the initiative in controlling the cash base of the clearing banks and have continued in effect a restrictive credit policy, largely by means of open-market operations and moral suasion.

Short-term Treasury financing and the London money market

Since the mid-1920's, the Treasury bill, issued by tender, has been the floating debt instrument which the government has used to obtain loanable funds from the financial community to meet the Treasury's current cash requirements. Introduced upon Walter Bagehot's advice in 1877, the tender bill became standardized as a three-months' instrument marketable in the discount market, and hence a flexible form of near-cash for the clearing banks. Originally, the banks, participating along with the discount houses, purchased bills both by direct tender and through the discount market. However, when a severe contraction in commercial bills accompanied the slump in world trade in the mid-thirties, the clearing banks came to the aid of the discount houses by voluntarily agreeing not to purchase bills by direct tender but only from the discount market. In addition to borrowing from the financial community, the Treasury has drawn upon the internal resources of government agencies as a temporary source of cash through the use of the tap Treasury bill, Ways and Means Advances, which are in the nature of overdrafts or short-term advances, are also used for temporary borrowings from government departments and, to a much more limited extent, from the Bank of England.

Although the discount market began to handle Treasury bills in place of the traditional commercial bill in the mid-thirties, its peculiar function as the intermediary between the clearing banks and the central bank was still preserved. So long as the discount market could continue to call upon the resources of the central bank in case of need, the traditional structure of the London money market was not changed, however much the type of security handled by the discount houses altered. The distinctive organization of the London money market has developed out of the tradition that the clearing banks did no rediscounting directly with the central bank and no short-term loan business with each other.

Traditionally, the discount market mobilized supplies of short-term funds, both internal and foreign, to satisfy the needs of business and government. It enabled the clearing banks to achieve flexibility in handling their short-term assets; because the discount houses provided an outlet for call money from the

clearing banks, 1/ enabled the banks to select bills of desired maturities and established a ready market for such sales as they might choose to make. By having direct access to the central bank, the discount houses became the mechanism through which central bank assistance flowed into the monetary system. In times of stringency, the banks would withdraw their call funds from the discount market and force the bill-houses into the Bank of England for funds. As a result, the rediscount rate of the Bank was immediately reflected in the price at which short-term funds could be obtained by the financial and business community. It was through this process that the penalty bank rate became the major instrument of central bank policy, especially in the period before 1914.

The emergence of the tender bill as the staple commodity of the discount market, however, had the result of increasing the impact of Treasury financing upon the internal monetary situation. No longer was the market established primarily by commercial bills, with Treasury offerings accounting for only a relatively minor sector of its operations.

A profound change in this traditional structure was brought about by the introduction, as a wartime emergency measure, of a new instrument of floating debt, known as the Treasury Deposit Receipt, which opened up a regular direct channel between the clearing banks and the Bank of England. The Treasury borrowed surplus funds directly from the clearing banks; the Deposit Receipt was, in fact, not so much a new debt instrument as a book entry, non-negotiable and not even transferable. 2/

1/ In New York, the tradition of daily settlement in the Stock Exchange provides a market for call funds; in London, only a minor portion of call funds finds its way into the Stock Exchange. Before the war, settlement on a two to three weeks basis was general for all markets except the unspeculative gilt-edged market where settlement was daily. During the war daily settlement was made general

2/ The Treasury Deposit Receipt, conventionally known as T.D.R.'s, is described by the Treasury as "Treasury deposits by banks" and by the banks as "Treasury deposit receipts". Initially, the T.D.R. was a six-months instrument but, in mid-1948, five and seven-months receipts were introduced. The T.D.R. initially could be turned into cash in an emergency by rediscount directly by the Bank of England, but this term became a dead letter since it was intended to mean a general emergency which did not arise. (See W.T.C. King, "The London Discount Market" in Current Financial Problems and the City of London, pp. 17 ff.)

A technical adjustment in the term of tender bills to 91 days and in Deposit Receipts to 154, 182 and 210 days was announced on April 20, 1950. This step will provide the clearing banks and the money market with a more even flow of maturities.

The Deposit Receipt system was not only untraditional but inflexible. This was not due so much to the longer term of the loan as it was to the fact that the discount market was by-passed and the Treasury dealt directly, through the Bank of England, with the clearing banks. 1/ After it was decided how total borrowings were to be divided between tenders and Deposit Receipts, the Treasury announced each Friday a total sum to be called from the banks against Deposit Receipts, and left to the clearing and Scottish banks responsibility for establishing quotas for individual banks. The banks had to meet their weekly quotas; the only discretion left to them was to choose the days during the following week on which the funds were to be passed over to the Treasury. 2/

Throughout the war period, the Treasury relied heavily upon the Deposit Receipt for short-term borrowing. In the first two years of the new system, Deposit Receipts increased by £655 million while tender bills increased by only £190 million. However, as sales of war supplies to Britain led to the accumulation in London of sterling balances, these balances competed for the limited supply of Treasury bills offered at tender. As a result, in mid-1941 the British Government arranged with certain Commonwealth central banks not to place their sterling holdings in Treasury bills by tender but in tap bills, which had previously been restricted primarily to government departments. By the end of the war, foreign holdings of Treasury bills at tap may have accounted for the major portion of the tap bills outstanding.

Monetary aspects of the disinflation program

In the course of its program of disinflation, the British Government has used the budget surplus and the sterling proceeds of E.R.P. aid to retire floating debt.3/ Accumulation of a budget surplus in itself is deflationary since the credit base of the banking system is reduced as deposits and reserves are drained into the treasury account. But treasury disbursements, even to retire government debt, return reserves to the banking system and thus tend to neutralize the deflationary contraction of the surplus. To determine the ultimate monetary effect of a debt-retirement program, therefore, it is necessary to analyze the monetary effect of the actual repayments effected.

Speaking broadly, the economic effect of retiring bank-held debt is to reduce the money supply, at least temporarily. The use of a cash surplus accumulated by the Treasury to retire short-term debt held by the commercial banks returns reserves to the banking system. Hence, the volume of bank reserves and, therefore,

1/ One advantage of the new system was the more direct routing of funds. During the war period, the Treasury desired that disbursed cash be returned as quickly as possible to the Exchequer. There was also some doubt as to whether it was practicable or wise to use the mechanism of the discount market to accumulate the vast sums which were obviously required, even on short-term borrowing. If circumstances had arisen in which the Treasury would have had to operate outside London, a greatly simplified system would have had to be devised; King suggests that this might have been the decisive factor which led to the introduction of the Deposit Receipt system. King, op. cit. p. 20.

2/ Economist, Sept. 10, 1949, p. 573. See, also, King, op. cit., p. 19 "T.D.R.'s, therefore, though nominally short-dated securities, have come to be regarded as the least liquid of the bank's earning assets."

3/ For a discussion of the theory underlying the disinflation program, see this Review, March 29, 1949, esp. pp. 5-6.

the credit base is restored but the volume of bank deposits is reduced: the more favorable reserve position would presumably induce banks to restore deposits to the previous level and the deflationary effect of the surplus would disappear. Retirement of debt held by the Central bank, however, sustains the full monetary contraction. In this process, the reduction in the assets of the Central bank leads to a permanent extinction of commercial bank deposits and of bank reserves and thus to a permanent contraction of the credit base.

It is clear, however, that the deflationary impact of the surplus cannot be maintained when a bond-support program is in effect. Where prices of both long and short-term governments are supported, commercial banks are at liberty to replenish their depleted reserve balances by sales of bonds from their portfolios.

The post-war monetary difficulties in the United Kingdom differed from those in the United States, although a similar legacy of war finance in the form of large bank holdings of short and long-term debt is found in both countries. 1/ Virtually unlimited access of commercial banks to reserve funds created serious difficulties of credit control in the United States, while the monetary control difficulties in Britain were related to Dalton's cheap money drive, which was initiated in the fall of 1945. Instead of using official resources to preserve the existing level and structure of interest rates, the British Treasury launched a drive to push down the entire level of rates on governments. In mid-October 1945, the rate on Deposit Receipts was arbitrarily reduced from 1-1/8 per cent to 5/8 per cent; this was immediately followed by a reduction in the bill rate from 1 to 1/2 per cent. Dalton also wanted "to condition public opinion to the idea of 2-1/2 per cent as the maximum rate of interest on long-term loans to the British Government." 2/ The substantial increase in the money supply which accompanied the drive on interest rates, the largest expansion in British monetary history in so short a period of time, caused the Government to abandon its aggressive program and to allow the rates to find their own levels with only limited and intermittent stabilizing operations. 3/

Part of the explanation of the resultant large creation of credit lies of course in the substantial budget deficit at that time. 4/ Cripps' budget introduced in April 1948 called for a large surplus and, in fact, the Treasury was able to realize an over-all surplus of £352 million compared to a slight over-all deficit of £18 million in fiscal 1947-48. At the same time, the monetary authorities assumed a policy of virtual non-intervention in the face of rising long-term rates; however, they relied primarily upon qualitative financial controls and direct physical controls, rather than upon the higher rate of interest, to stabilize the internal economy.

1/ British commercial banks, however, held only about 15 per cent of the government debt in March 1946 as compared to 32 per cent in the United States.

2/ House of Commons Debate, April 15, 1947.

3/ A summary of the monetary effects of the Treasury drive on the long-term rates, as reflected in changes in deposits and the assets of the clearing banks, is found in the Appendix.

4/ In the United States there was a Treasury surplus.

Although short-term rates were stabilized at the low October 1945 levels, monetization of the debt through commercial bank sales of marketable debt to replenish reserve funds did not occur in the United Kingdom as it did in the United States. The bulk of the clearing banks' holdings of floating debt was held in Deposit Receipts, which are non-marketable; in economic effect, this is similar to the secondary reserve recommended by the Federal Reserve authorities in 1947. 1/ The fact that long-term rates were not actively supported introduced a risk factor which would deter the sort of switching from short to long maturities which took place in the United States. Thus, the British monetary authorities were able to retain the initiative in controlling the credit base of the clearing banks through the twin central-banking weapons of open-market operations and moral suasion. 2/

Since the clearing banks did not threaten to vitiate the effective control by the monetary authorities of the credit base, the debt retirement program had no important objective in terms of strengthening the credit control machinery. 3/ The lending activities of the clearing banks were brought into line with Treasury policy through the issuance of policy directives to the Bank of England. As a result of the restrained credit policies of the clearing banks, the postwar monetary expansion was associated with Treasury needs and not with the demands of the private sector.

With the budget surplus, Treasury requirements on the banking system were, of course, reduced. But the clearing banks were providing a large portion of the Treasury's cash needs by the untraditional Deposit Receipt. Return to a more traditional arrangement involved the reduction in calls through the T.D.R., thus enabling the clearing banks to increase their assistance of the money market. With additional financing, the market could then handle a greater volume of Treasury bills by tender. A substantial switch from the Deposit Receipt to the tender bill actually occurred during 1949-50, and without upward pressure on short term interest rates.

The disinflation program was accompanied, during fiscal 1949-50, by significant changes in Britain's internal monetary structure. 4/ The direction of these changes was toward a more traditional organization of the money market and the prevalence of a higher long-term rate of interest; in addition, the ten-year expansion in deposits has for the moment come to an end.

Changes toward more traditional arrangements in the money market followed the Treasury switch in floating debt financing, from Deposit Receipts to tender bills, apparently reflecting a change in official policy. As a result of reduced

1/ See Federal Reserve Bulletin, December, 1947, p. 1461.

2/ The traditional prestige of the Bank of England, the concentration of resources in the British banking system, the great cohesion and agreement within the banking community and the desire on all sides to avoid more stringent control measures help to explain the peculiar effectiveness of moral suasion as a central banking technique in Britain.

3/ Had the surplus been used to retire long-term debt, it would have held back the rise in long term rates which occurred.

4/ The details of these changes are summarized in the attached Appendix.

T.D.R. calls, the clearing banks were able to expand their discounts (including Treasury bills) and call loans to the money market, thereby improving the flexibility and liquidity of their portfolios. With additional funds available, the discount market was able to handle a larger volume of tender bills without disturbance to short-term money rates. Deposits were stabilized since reduced Treasury demands upon the clearing banks exceeded the increase in their advances to the private sector. In addition, the Treasury has accepted a 3 1/2 per cent long-term rate on a gilt-edge issue for the first time since the early 1930's.

The size of the budget surplus during the year, however, does not appear to account for these important changes: the overall surplus for 1949-50 of £62 million was sharply below the £352 million surplus achieved during 1948-49. There appears to have been an easing of the Treasury's cash position during 1949-50 out of proportion to the reduced and limited Treasury surplus.

Although the favorable internal impact of external developments appears to have contributed to the easing of the Treasury's cash position last year, it is most difficult to isolate and measure the influence. ^{1/} Despite the arbitrary nature of the period selected and the lack of detailed figures, however, external developments in the last half of 1948 will be compared with developments in the last half of 1949 to determine whether there is any evidence that external changes between the two periods was in the direction of easing the Treasury's cash position. ^{2/} The limited significance of conclusions based upon these time periods should be borne in mind in evaluating the conclusions which can be drawn from the analysis. At best, the study yields an indication of direction of change.

Monetary repercussions of external developments

The major external developments, other than changes in the net current account position, which have a direct internal monetary impact, are found in changes in sterling balances (including sterling capital export) and in gold and dollar reserves. The direction of changes induced by these factors can, in theory be indicated rather simply. It is well-known that a large, though indeterminate, volume of sterling balances are retained in the form of tap bills. ^{3/} For analytical purposes, and in the absence of information which would indicate the contrary, it will be assumed that when balances are reduced, tap bills are allowed to run out and, when foreign-held balances rise, new tap bills are taken up.

^{1/} The inability of obtaining external data on a time period comparable with fiscal data is one source of difficulty. Estimates of the balance-of-payments and of changes in sterling balances and sterling capital export can only be obtained for six-month periods ending in June and December; the fiscal year runs from April to March and the period of large Treasury surplus is confined to the January-March quarter.

^{2/} Devaluation occurred in the middle of the second half of 1949 but data cover only the entire six months.

^{3/} King, op. cit., p. 21.

Under this assumption, the drawing down of sterling balances directly affects the Treasury's cash position; when the realized sterling is used to pay for British exports, it offsets the contractive effect of the budget surplus. 1/ The payments for British exports neutralize the budget surplus in that they return reserves to the clearing banks and restore the level of deposits.

It is generally thought that sterling capital export from Britain is identical in its monetary effect with a running down of sterling balances, but it is not clear that, in the short-run, this proposition is entirely accurate. In fact it is strictly accurate only in the case where the capital export leads to an equivalent increase in Britain's exports with a particular country. Where any part of the capital outflow takes the form of an increase in the receiving country's sterling holdings, the effect of capital outflow is not identical with an equivalent release from blocked sterling balances but serves as a monetary offset to such releases to the extent that sterling balances rise.

This proposition is illustrated in the example of a capital export to Australia where no additional British exports are made. 2/ In making the capital export, Englishmen surrender deposits at their clearing banks, and in turn the banks surrender reserves to the Bank of England. When the Bank of England purchases tap bills on behalf of the Australian Commonwealth Bank, sterling is transferred from the Australian account at the Bank of England to the Treasury account. If, at the same time, an equivalent sterling balance release to India has been authorized, funds flow from the Treasury to the Indian account at the Bank of England. When India makes payments to British exporters, clearing bank reserves and deposits are then restored. Thus, the deflationary effect of capital exports on the United Kingdom takes place only in the case when, and to the extent that, the capital export leads to a rise in Australia's sterling holdings and not to a corresponding expansion in Britain's exports to Australia. In addition, it is in effect limited to the short-run, since the sterling liability represents an eventual claim upon British resources. But it is precisely this short-run effect which is relevant to our present analysis.

Since changes in gold and dollar reserves are effected through the Exchange Equalization Account, and since its sterling assets are held mainly in tap bills, changes in reserves also have a direct monetary impact. It is generally thought that when the Account buys gold its normal procedure is to allow some of its bill to mature, thus obliging the Treasury to raise additional cash; when the Account sells gold, it normally invests the proceeds in tap bills, thus supplying the Treasury with funds and reducing the demands of the Treasury on other sources. 3/

1/ In this analysis, it is assumed that Treasury expenditures are unaffected by changes in the foreign-held balances. Where tap bills are allowed to run out, additional cash must be raised by the Treasury: where marketable bills are disposed of in the market, presumably the raising of Treasury cash for committed operations becomes more difficult. Consequently, the economic effect is identical whether the sterling is realized by allowing tap bills to run out or by selling marketable instruments.

2/ Speculative movements awaiting appreciation of the Australian pound, emigre capital or even normal investments with a high Australian-pound content exemplify this type of export. Where the effect of the capital outflow is deflationary in the United Kingdom, it is inflationary in Australia.

3/ F.E. Paish, "The Floating Debt, 1914-39 And Its Effect On The British Banking System", in Studies in Financial Organization, by T. Balogh, p. 194.

It will be remembered that the specific purpose for setting-up the Account was to neutralize the internal monetary impact of gold inflows and outflows. Under the gold standard, an inflow of gold expanded the credit base of the banking system. This expansion is prevented by the operations of the Account: in order to purchase an inflow of gold, the Account drains reserves from the banking system by selling bills to the market before restoring the credit base with a sterling payment for the gold. The effect of a gold outflow is similarly neutralized, since the Account purchases tap bills as gold and dollars are released. When the Account purchases tap bills, the Treasury's cash needs from other sources are reduced; when tap bills are sold, the Treasury requires additional cash. Hence, reductions in sterling balances and purchases of gold and dollars lead to a tightening of the Treasury's cash position; increases in sterling balances and sales of gold and dollars tend to ease the Treasury's immediate position.

The shift from a £45 million current account surplus in the last six months of 1948 to a £55 million deficit in the corresponding period in 1949 is of course in the direction of reduced inflationary pressure in the United Kingdom in 1949. When we distinguish between the current account position and the Treasury's immediate cash position, the material in Table A below suggests that, on balance, a substantial easing of the cash position occurred between the latter half of 1948 and the latter half of 1949. In place of a £193 million reduction in sterling balances in the latter half of 1948, there was a rise of £110 million in the same period in 1949. ^{1/} Adding together the changes in sterling balances (eliminating the £61 million post-devaluation write-ups) and in reserves, there was a drain of Treasury cash and a return of reserves to the banking system amounting to £178 million in the last half of 1948 compared to virtual balance in the last half of last year. Evidence of an easing of the Treasury's cash position in 1949 is also revealed in an analysis of Britain's external accounts with the Rest of the Sterling Area. Between the two half-years, Britain's sterling capital exports increased from £47 million to £122 million; but the British current account surplus to the sterling countries actually declined from £160 million to £95 million. Since the sterling area balances shifted from a reduction of £107 million to a rise of £37 million, the heavier capital export during the latter part of last year took the form of increases in sterling balances and not the form of a heavier British export surplus on current account. This development, as we have already seen, resulted in an easing of the Treasury's immediate cash needs. The relevant facts on changes in Britain's external position between these two periods are summarized in Table A (on next page).

There appears to be something more than coincidence between the easing of the Treasury's cash position in the latter half of 1949 and the acceleration in the rate of Treasury substitution of tender bills for Deposit Receipts, particularly marked after July 1949. In fact, it is possible that the rise in sterling balances did not occur until after devaluation; published figures show only the net change in the last six months of 1949. Nonetheless, the mere fact that sterling balances did not fall and therefore did not impose a cash drain on the Treasury in the latter part of 1949, as they did in the last half of 1948, was in itself a significant change in the internal monetary situation.

^{1/} The latter figure should be adjusted to allow for the £61 million post-devaluation payments made to foreign creditors under revaluation guarantees. Part of the writing-up involved increases in the long-term debt; the remainder, reflecting a rise in floating debt, did not involve a drain of Treasury cash.

Table A

United Kingdom - Changes in selected external items.
(In millions of pounds)

	1948 (July - Dec.)	1949 (July - Dec.)
1. Current account surplus (+) or deficit (-)	+ 45	- 55
2. a. U. K. surplus with rest of the sterling area	+ 160	+ 95
b. Capital export	+ 47	+ 122
3. Changes in sterling balances:		
a. Sterling area	- 107	+ 37
b. Non-sterling countries	- 86	+ 73
c. Total	- 193	+ 110
4. Changes in gold and dollar reserves	- 15	+ 48

Short-run prospects for monetary policy

To the extent that the Treasury's cash position in 1949 was eased by the failure of sterling balances to decline, this factor contributed to the technical improvement in Britain's financial structure. Consequently, the statistics may exaggerate the permanence of the apparent progress toward internal stabilization. Renewed liquidation of externally-held balances at any time would tend to feed inflationary forces within the economy.

In his April 18 budget speech, the Chancellor indicated that inflationary forces continue to threaten the British economy. Thus far, however, the impact of devaluation on Britain's costs and prices has been successfully held to a minimum. Although the danger period has by no means ended, prospects that Britain will be able to keep inflationary pressures from this source relatively well restrained are good. In fact, there is clear evidence that disinflationary forces are gaining momentum in the United Kingdom. In the early postwar period, expanding British output flowed into increasing fixed capital formation and exports. When the export drive was arrested in the spring of 1949, however, supplies in the home market improved substantially; part of these goods was absorbed in heavier consumption but a large portion went into the rebuilding of stocks, which in itself suggests a weakening of internal inflationary pressures.

Inflationary pressures from the creation of new deposits during the past two years have not only been reduced substantially, but the rise in deposits has actually fallen far short of increased current domestic output.

Nonetheless, it is important to recognize Britain's longer-term difficulties resulting from a limited volume of personal savings relative to the volume of investment. Thus far, investment has been controlled through the Capital Issues Committee and through qualitative controls applied by the clearing banks; but these financial devices have been less of a restraint on investment than the direct physical controls of building and shortages of essentials such as steel and raw materials. Greater availabilities of these essentials will not remove the need for restraining investment; in fact, the disappearance of these scarcities may well mean that the financial restraints will be under greater pressure. With the government's budget no longer absorbing purchasing power, an inadequacy of personal savings will be reflected more directly in additional internal inflationary pressures.

With the first gilt-edged issue at 3-1/2 per cent in nearly 20 years, the Treasury has adjusted its thinking to the existing higher long-term rates. ^{1/} This acquiescence and the recent shift toward a more traditional monetary structure, however, does not mean that government policy is likely to rely primarily upon orthodox monetary techniques. There is a wide body of British opinion which considers interest rate as too blunt a restraint upon investment. Further, Paish has pointed out that long-term rates would have to be very high indeed in view of the profitability of a large part of current investment. ^{2/} Nonetheless, the significance of the Treasury acceptance of higher long-term rates should be recognized: this is an important step in the direction of more traditional reliance upon the rate of interest.

An increase in short-term rates, however, is thought to be unlikely because of the additional burden on the Exchequer which would result from such a rise and because of the large volume of foreign-held balances in short-term obligations. Paish suggested that short-term rates on "the seasonally fluctuating margin of Treasury bills and on all commercial bills" might be allowed to rise and to vary under an agreement between the Treasury and the holders of floating debt whereby the great bulk of existing Treasury bills would continue to be held at the present low rates of interest. ^{3/} In the absence of some such special arrangement, continued rigidity in the money market is to be expected. A general unfreezing of short-term rates would require a substantial reduction in the floating debt. Some progress has been made along these lines through the use of ERP aid and the Treasury surplus. But both these factors have already diminished in importance and in order to obtain a rapid and large reduction, funding in the traditional sense would probably be necessary; but the spread between money market and gilt edged rates makes this unlikely. A further source of difficulty lies in the large volume of floating debt held by foreigners. As we have seen, a rapid reduction of such balances has an inflationary impact on the monetary situation. Therefore, it is difficult to foresee a sufficiently rapid reduction in the floating debt to permit substantial changes in short-term rates in the near future. Unfavorable as this conclusion may be, it would be infinitely more serious were it not for the fact that the monetary authorities have been able, despite the frozen short rates, to retain the initiative and to control effectively the cash base of the clearing banks.

^{1/} This was a £150 million 3-1/2 per cent guaranteed bond, dated 1976-79 offered in May by the British Electricity Authority. In 1948, the Authority borrowed £100 million at 3 per cent.

^{2/} F. W. Paish, "Prospects For Interest Rates," London and Cambridge Economic Bulletin, February 1950, p. 14.

^{3/} Op. cit., p. 15

The switch in Treasury financing from Deposit Receipts to tender bills is reflected in substantial shifts in the assets of the clearing banks, as shown in Table II. Deposit Receipts represented over one-third of the deposits of the clearing banks in March 1945, but only about 8 per cent by March 1950. As a result, the clearing banks were able to extend their assistance to the discount market: their money market assets (money at call and bills discounted) amounted to 28 per cent of clearing bank deposits in March 1950 compared to only 7 per cent in March 1945. The slight decline in the proportion of cash holdings after 1946 was nominal since the clearing banks abandoned their former practices of window dressing on December 31, 1946, when the banks agreed that "the daily ratio of cash balances to deposit liabilities will be maintained on the basis of 8 per cent." ^{1/}

Table II

United Kingdom - Clearing bank statistics
for month of March
(In millions of pounds)

	1939	1945	1946	1947	1948	1949	1950
Gross deposits	2,152	4,459	4,749	5,556	5,794	5,815	5,783
Net deposits	2,092	4,318	4,585	5,370	5,601	5,612	5,579
Cash	232	464	493	466	472	474	485
Money market assets:							
Call money	141	180	254	444	468	482	534
Discounts	190	149	379	750	804	870	1,106
Total	331	329	633	1,194	1,272	1,352	1,640
Treasury Deposit Receipts	--	1,681	1,443	1,317	1,153	956	444
Investments	611	1,153	1,246	1,455	1,486	1,496	1,503
Advances	992	780	863	1,034	1,308	1,429	1,602
Cash	10.8	10.4	10.4	8.4	8.1	8.2	8.4
		(as percent of gross deposits)					
Money market assets:	15.4	7.3	13.3	20.5	22.0	23.3	28.3
Treasury Deposit Receipts	--	37.7	30.4	23.7	19.9	16.4	7.7
Investments	28.4	25.9	26.2	26.2	25.6	25.7	26.0
Advances	46.1	17.5	18.2	18.6	22.6	24.6	27.7

Despite the large expansion in bank investments, mainly governments, the proportion of investments to deposits has remained relatively stable. The large post-war expansion in their investment holdings occurred between March 1945 and 1947, the period of the cheap money drive in its most extreme form. Although investments continued to rise thereafter, the actual annual increases were slight. Advances have continued to expand throughout the post-war period and by March 1950 amounted to 28 per cent of deposits compared to 17.5 per cent in 1945; however,

^{1/} Economist, Dec. 14, 1946, p. 962.

they remained well below the 46 per cent in 1939.

The large post-war expansion in net deposits, which occurred between March 1946 and March 1947, was associated with the major Treasury drive for a $2\frac{1}{2}$ per cent long-term rate. In the following year, the rate of increase slackened appreciably, and since March 1948, the period of the Crippsian disinflation program, deposits have been remarkably stable. In fact, the figure for March 1950 was slightly below that for the same month in the two previous years. ^{1/} Nonetheless, there is evidence that for the moment the 10-year expansion in deposits has come to an end. The seasonally-adjusted index of net deposits prepared by Lloyd's Bank, shown in Table III, amount to 256.5 for March 1950 (1938=100), a level slightly below the index for the same month in 1948 and 1949.

Table III

United Kingdom - Percentage increase in net deposits and index of net deposits

Period	Percent increase in net deposits					Index of net deposits ^{a/}		
	1946	1947	1948	1949	1950	1948	1949	1950
<u>12 months ending:</u>								
January	+6.0	+18.6	+2.7	+4.9	+ .6	248	260	262
February	+6.4	+17.8	+2.1	+3.0	+ .4	249	257	257.5
March	+6.2	+17.1	+4.2	+ .2	- .6 ^{b/}	257	258	256.5
April	+7.2	+15.0	+4.9	- .2	- .1	260	259	
May	+5.9	+13.4	+4.7	+ .9	- .6	258	260	
June	+6.1	+12.0	+5.3	+ .9		259	262	
July	+5.8	+10.0	+5.3	+1.1		258	261	
August	+6.6	+ 8.2	+4.8	+1.1		258	259	
September	+8.1	+ 6.0	+5.8	+ .3		259	259	
October	+10.8	+ 5.2	+6.3	+ .2		261	262	
November	+14.2	+ 5.0	+4.8	+ .2		261	262	
December	+16.7	+ 4.5	+4.0	+1.0		261	263	

^{a/} Lloyd's Bank index, seasonally adjusted. 1938=100.

^{b/} The March drop is explained in part by the switchover by the International Monetary Fund from cash to interest-free Treasury notes for part of its sterling resources. (See Economist, April 8, 1950, p. 788.)

^{1/} Part of the March 1950 absolute decline has been attributed to a technical change in the sterling holdings of the I.M.F. with the Bank of England, the composition of which changed from deposits to interest-free Treasury notes. (Economist, April 8, 1950, p. 788.)

A supplementary, and perhaps more revealing, measure of the rate of change in deposits during the post-war period, also shown in Table III, is based on the monthly percentage increase in net deposits compared to the level for the same month in the previous year. This compilation shows a rapid rate of increase ranging between 10 and 17 per cent from October 1945 to July 1946. Thereafter, the rate of increase slackened perceptibly but remained at a relatively high level of around 5 per cent throughout 1948. During the fiscal year, 1949-50, however, the increase virtually disappeared: the average monthly per cent increase was below 1 per cent.

Table IV shows the yield on $2\frac{1}{2}$ per cent consols by months after January 1945 and measures the post-war changes in the long-term rate of interest. The Daltonian cheap money drive which was initiated in the fall of 1945 resulted in a persistent decline in long-term rates to a monthly low of about 2.54 per cent which was maintained between October 1946 and January 1947.

Table IV

United Kingdom: Yield on $2\frac{1}{2}$ percent consols,
by months, 1945 to date
(in percent)

Month	1945	1946	1947	1948	1949	1950
January	3.04	2.71	2.54	3.08	3.12	3.59
February	3.03	2.70	2.58	3.15	3.09	3.56
March	3.01	2.67	2.64	3.22	3.11	3.62
April	3.00	2.60	2.63	3.28	3.10	
May	3.01	2.58	2.62	3.25	3.08	
June	3.00	2.57	2.68	3.27	3.21	
July	3.00	2.58	2.78	3.28	3.36	
August	2.89	2.59	2.99	3.26	3.48	
September	2.82	2.56	2.99	3.22	3.45	
October	2.80	2.54	2.90	3.18	3.56	
November	2.75	2.53	2.87	3.16	3.62	
December	2.75	2.54	3.01	3.14	3.51	

Thereafter, the government, in an apparent change in policy, abandoned the aggressive drive against higher long-term rates, because a rapid expansion in credit had accompanied the drive; this expansion intensified internal inflationary pressures and aggravated the balance of payments position, a particularly serious development at the time when the July, 1947 deadline for sterling convertibility was approaching. By the end of 1947, consols had returned to a 3 per cent yield.

For the next 18 months, the yield remained relatively stable. But the decline in consol prices was resumed as the critical mid-1949 gold and dollar drain commenced late in the spring. Following devaluation, the prices reached a low point on November 10, 1949 when $2\frac{1}{2}$ per cent consols yielded about 3.80 per cent. On November 11, the authorities intervened, but only to the limited extent necessary to stabilize the market.

June 6, 1950

A NOTE ON POST-DEVALUATION DOLLAR PRICES OF STERLING AREA EXPORTS

Samuel I. Katz

When sterling was devalued by 30.5 per cent last September, it was felt in many quarters that a resultant sharp decline in dollar prices of major primary products exported to this country would cause a drop in dollar earnings of the sterling area as a whole. The actual post-devaluation decline in United States prices of sterling area primary products was, in fact, quite limited. From the point of view of maximizing dollar proceeds from sterling area exports, the actual post-devaluation price developments were particularly favorable. Since American demand for sterling area raw materials is inelastic with respect to price and since British manufactured goods have a higher price-elasticity, it was clearly desirable that dollar raw material prices be maintained relative to those of British manufactures. Available statistics indicate that the post-devaluation course of dollar prices was along these lines.

Immediate effects on dollar prices of raw materials

After devaluation eight major raw materials, which make up the bulk of the dollar earnings of the sterling area had declined to a low of 9 per cent in early November 1949, but recovered quite rapidly thereafter and by January 1950 had returned to pre-devaluation levels. An index of the dollar prices of these eight commodities, constructed by the Business Conditions Section of the Board's Division of Research and Statistics, shows a drop of about 5 per cent for the month of November compared with August as shown in Table I. This is an index of the dollar prices of eight raw materials with the 1948 value of United States imports as weights. A somewhat similar index prepared by E.C.A./London to include 19 commodities exported to this country by the sterling area, shows comparable movements in the dollar prices.

While the eight-commodity index had recovered by January 1950 to the pre-devaluation level, the series shows no uniform movement for individual prices. In January, for example, tin and wool were sharply below the August 1949 level and slight declines are shown for goatskins and tea while substantial increases were recorded for burlap, cocoa and rubber and jute prices had risen slightly.

The limited immediate decline in dollar prices of sterling area primary products is particularly significant in that many critics of devaluation, in Britain and in Southeast Asia, had expressed fears about a reduction in dollar earnings as a result of price decline not compensated for by a more than proportionate expansion in American imports. There was an increase in the quantity of U. S. imports after devaluation. As will be seen in Table II, the quantity of U. S. imports between October and April has tended to be heavier than during the rest of the year. ^{1/} Nonetheless, an index of physical quantity of imports (with 1948=100) averaged 82.2 for the last quarter of 1949 compared with 85.3 in

^{1/} The post-devaluation increase was clearly not alone seasonal. Heavier U. S. purchases grew out of the recovery in U. S. industrial production which began in mid-1949 and the resumption of American purchases following devaluation.

the same period in 1948. In the first quarter of 1950, however, the index was 112.6 as compared with a quarterly average of 105.8 for the previous year.

Table I

Dollar Prices of Eight Major Primary Products
Exported by the Sterling Area
(1948=100)

Commodity	Post-war high (August 1948)	Pre-devalua- tion low (June 1949)	August (1949)	November (1949)	January (1950)	March (1950)
Burlap	96.2	79.1	91.3	98.8	102.6	94.0
Cocoa	111.2	47.6	56.7	62.2	69.1	57.9
Goatskins	91.0	103.5	108.2	98.9	104.7	107.3
Jute	105.4	94.6	81.1	72.4	85.4	85.4
Rubber	108.7	74.8	76.1	76.4	83.8	90.2
Tea	93.8	97.8	99.9	92.8	96.9	87.2
Tin	103.8	103.8	103.8	89.7	76.9	76.2
Wool	114.2	105.4	105.4	85.9	91.8	98.9
Composite index of eight-commodi- ties	105.8	83.7	87.4	83.2	87.7	87.3

Source: Business Conditions Section, Division of Research and Statistics, Board of Governors of the Federal Reserve System.

Table II

Quantity Index of United States Imports of Eight Major Primary Products
from the Sterling Area
(1948=100, data are three-month moving averages centered)

	1947	1948	1949	1950
Jan.	-	129.8	99.2	107.7
Feb.	137.5	128.6	105.8	112.6
March	120.8	118.0	107.2	
April	124.3	110.9	99.0	
May	121.5	96.7	79.3	
June	109.1	96.6	66.2	
July	89.7	95.3	68.2	
August	84.1	89.5	65.6	
September	75.3	80.3	68.5	
Oct.	81.8	69.2	72.5	
Nov.	95.9	85.3	82.2	
Dec.	116.8	89.0	97.1	

Source: Business Conditions Section, Division of Research and Statistics, Board of Governors of the Federal Reserve System

Sharp second-quarter rise in raw material prices

Since the end of March 1950, the index of sterling area primary product prices has risen quite sharply. The eight-commodity index, which stood at 86.9 on March 25 had reached 107.2 for the week of June 3, an increase of around 23 per cent. Although the boom in rubber prices accounts for a major portion of the increase, higher prices of cocoa beans, wool and jute contributed to the index's rise. As a result of this rapid ten-week increase in raw material prices, the index on June 3 was about 17 points, or 19 per cent, above the eve-of-devaluation level recorded for September 17, 1949. In fact, the June 3 weekly index was at the highest point recorded in the post-war period, the previous post-war peak being 105.8 for the month of August 1948.

Table III

Index of Dollar Prices of Eight Major Sterling Area Primary Product Exports: Selected Comparisons (1948=100)

Commodity	March 25 1950	June 3, 1950	Actual Change	Sept. 17, 1949	June 3, 1950	Actual Change
Burlap	91.9	86.5	- 5.4	94.0	86.5	- 7.5
Cocoa	57.1	76.7	+ 19.6	50.9	76.7	+ 25.8
Jute	78.9	83.8	+ 4.9	93.0	83.8	- 9.2
Rubber	90.4	149.9	+ 59.5	83.5	149.9	+ 66.4
Tin	77.9	78.6	+ .7	103.8	78.6	- 25.2
Tea	90.9	83.9	- 7.0	105.0	83.9	- 21.1
Wool	98.9	111.9	+ 13.0	105.4	111.9	+ 6.5
Goatskins	105.0	101.1	- 4.0	103.5	101.1	- 7.4
Eight Commodity index	86.9	107.2	+ 20.3	89.8	107.2	+ 17.4

Source: Business Conditions Section, Division of Research and Statistics, Board of Governors of the Federal Reserve System

-The relatively high level of dollar prices of raw materials has lead to a boom in the sterling incomes of sterling area primary producers. With the sterling proceeds of an equivalent dollar price 44 per cent greater following devaluation, the incomes of sterling area primary producers have not only been maintained in terms of sterling but have been substantially increased. The Journal of Commerce, for example, has calculated, that a planter selling 100 pounds of cocoa realized just over £5 sterling at prices prevailing before devaluation compared with a return of £10/9/0 at current prices.¹ The unfavorable side of this picture is found in the sharp rise in sterling prices to British

industry, on the one hand, and to the substantial income inflation among producers on the other. There is a danger that the higher sterling incomes may lead to a renewal expansion of foreign purchases, especially from dollar sources, by primary producing countries out of their augmented incomes.

Prices of Britain's exports drop sharply

By contrast, dollar prices of most of Britain's own exports to this country appear to have dropped sharply, although the statistical data on price movements for these commodities are less representative than are the price indexes on raw materials. On the basis of an index constructed by using price averages reported by E.C.A. and weighted by the 1948 value of United States imports from the United Kingdom, a decline from pre-devaluation levels of nearly 15 per cent had taken place by November 22, 1949 for commodities comprising about 48 per cent of U. S. imports from Britain in 1948 (see Table IV). Whiskey and creosote prices, included in the index, were unchanged but the average decline for the remaining 28 per cent of the trade was nearly 25 per cent by November. The index turned up after November and by March 21 the total index had risen by nearly 4 per cent and the index excluding whiskey and creosote by nearly 7 per cent. No information is available on prices for goods not included in the index, and there is no basis for determining how representative this index may be as a measure of price changes for other goods.

Table IV

Percent Decline in Reported Dollar Prices of
Selected Exports by OEEC Countries
to the United States
(Sept. 13, 1949=100)

Country	Percent of devaluation	Percent trade covered in index in 1948	November 22, 1949 price index	March 21, 1950 price index
United Kingdom:				
Total index	30.5	47.7	85.4	88.5
Index excluding whiskey and creosote	30.5	28.4	75.5	80.6
France	22.3	38.6	91.4	92.3
Italy	9.1	34.7	89.3	87.3
Belgium	12.3	14.4	89.9	93.4
Germany	21.6	12.6	87.5	85.8
Netherlands	30.2	8.4	97.3	87.1
Switzerland	0	66.7	100.0	96.4
Portugal	13.1	78.3	99.4	102.3

Source: Price data from E.C.A. Report, "Devaluation and Prices". U. S. imports in 1949 used as weights.

It is of interest to note that, for that portion of trade accounted for by the commodities included in the indexes shown in Table IV, the fall in dollar prices of exports from other E.R.P. countries was much more limited than for the United Kingdom. This was, however, probably due to the fact that the currency devaluation in most of the European countries shown in the table was substantially less than the British depreciation.