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Recent Developments in the Sterling Exchange Market
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Under the changed foreign exchange regulations announced by the British authorities last December, private trading in dollar exchange was resumed in London for the first time since the introduction of exchange control in September 1939. During the first three months after these changes were made, however, spot sterling remained at or near the official support level; this fact led Professor Hawtrey to observe that "The step recently taken towards a free foreign exchange market has meant....merely a further devaluation of the pound by a fraction of 1 per cent." 1/ But within two days after London money rates were raised on March 11, spot sterling had risen by two cents; this gain was actually improved upon during the week following and has since been maintained.

The mid-March strength of spot sterling was probably due to short covering and, in particular, to a speeding up of payments by merchants who had been speculating against sterling by means of leads and lags in payments for commercial transactions. Although the initial impulse to the rise in the spot rate was largely the result of technical factors in the foreign exchange market, its continued strength has been due to the fact that sterling speculation has become expensive. As a consequence of higher money rates after March 11, American merchants, who had been speculating against the pound by borrowing sterling at the lower London rates, suddenly found that London accomodation cost more and was more difficult to obtain. Sterling speculation was also discouraged by the fact that, once spot sterling had risen above the support level, uncertainty as to the pound led prudent traders to reconsider their sterling position. There is reason to attribute this covering by merchants to the additional uncertainty introduced by market rumors that the pound would be allowed to float freely.

London private trading in dollars resumed

With the reopening of the London foreign exchange market last December 17, private dealers were allowed once again to trade in spot dollar exchange within the 4-cent range represented by the Bank of England's widened official-buying and official-selling rates; they were also able to resume trading in forward exchange for approved transactions at rates set in a market without formal official intervention. These alterations did not imply any relaxation in Britain's exchange control machinery, but the changes did mean that a private foreign exchange market could be reconstituted for the first time since the introduction of exchange control in September 1939.

The wartime exchange control administration had virtually destroyed private trading in dollar exchange in London. Under the wartime arrangement, the Bank of England operated in United States dollars at an

1/ Letter, London Times, February 28, 1952, p. 5.

official spot selling rate of $4.02-1/2 and at a spot buying rate of $4.03-1/2 to the pound. Commercial banks, in turn, dealt in dollars with their customers at the Bank's official rates and received for their services a handling commission which varied with the amount of the transaction. In forward exchange, there were neither private dealings nor a market for trading. Rather, the Bank of England stood ready to supply unlimited amounts of forward dollars; however, this service was restricted to cover genuine commercial transactions. The Bank completed future contracts at unvarying prices; a nominal commission of 1/4 cent per month, or about 1 per cent per annum, was charged for this facility.

This arrangement for trading in dollar exchange was not modified significantly during the post-war period until last December; in fact, London dealings in dollars continued at fixed and officially-determined rates and no attempt was made to reconstruct the pre-1939 private exchange market. In the New York market, the sterling spot rate was maintained within the Bank of England's official rates; the New York Federal Reserve Bank stood ready, as the Bank of England's agent, to trade at the two extremes of the official British spread. However, futures trading in New York was in a market without official intervention and rates were determined by local market forces. American merchants were able to obtain forward exchange in London but only to cover commercial transactions acceptable under Bank of England regulations.

Under post-war conditions, the Bank of England's open-end commitment to provide forward dollar cover at a fixed price and for a nominal fee proved to be an open invitation for commercial interests to place upon the Bank responsibility for carrying large unbalanced positions in forward exchange. The Bank soon found that most of its forward trading, particularly during critical periods, was in one direction. When sterling was under pressure, British importers would be more anxious to cover future dollar needs than British exporters would be eager to sell forward dollar earnings. Where sterling appreciation was anticipated, the Bank found its position unbalanced in the opposite direction: British exporters would be more concerned to dispose of prospective dollar accruals than importers would be to buy dollars in advance.

Contributing to the Bank's one-sided experience in dollar futures was the existence in New York of a free futures market with flucutating rates, since American traders (with commercial transactions acceptable to the British authorities) would make use of the Bank's forward facilities when the fixed London rates were more advantageous than those in New York. London banks would purchase 90-day sterling at $2.78-5/8 and would sell it at $2.81-3/8. 1/ Since the 1949 devaluation, 90-day sterling has risen above $2.81-3/8 only during September and October, 1950, when rumors of sterling appreciation led to a general movement into sterling. 2/ On the

1/ These rates are based on the Bank of England's charge of 1/4 cent per month for future cover.
2/ Selected spot and forward quotations during this period are to be found in Table I appended.

other side, the 90-day rate in New York declined below $2.78-5/8 only briefly during October/November and again in December, 1951. Thus, the Bank of England found itself buying forward dollars from New York merchants when sterling appreciation was expected and purchasing sterling futures from that source when sterling devaluation was under discussion.

Of course, the structure of charges contributed to these difficulties. The small charge for forward cover encouraged merchants to make liberal use of the facility whenever they sensed the slightest exchange rate uncertainty. The unchanging rates at which the Bank operated stimulated one-sided trading; appropriate changes in the Bank's rates, which would bring the cost of forward cover to the trading community more in line with the risk involved, might have discouraged, or perhaps checked, these unbalanced movements.

To end these difficulties, the Bank decided to get out of the forward exchange business and to pass over to the London foreign exchange market responsibility for providing forward cover. Effective last December 17, the Bank ceased quoting official buying and selling rates for forward delivery; instead, for the first time since 1939, London commercial banks were authorized to deal in forward contracts as principals at rates set by market conditions. If an effective private market was to be created in London, however, the commercial banks had to be allowed some freedom in exchange operations. Accordingly, the British regulations were changed to allow the commercial banks to maintain, within certain limitations, open positions in forward exchange. They were no longer "required to cover open positions with the Bank of England although they retain the right to do so, by means of spot transactions, if they wish." 1/ A British bank with a futures dollar contract is now left free to maintain an open position 2/ or to cover the transaction in either of these ways:

(a) by means of a spot or forward transaction with another commercial bank in the sterling area;

(b) by means of a spot or forward transaction with a North American bank against sterling to be paid to or from an American Account; or

(c) by means of a spot transaction with the Bank of England.

Spot trading arrangements were also modified, and the scope of private trading in spot dollars substantially widened. Previously, the Bank of England's official selling rate had been $2.79-7/8 and its buying

1/ Notice of Foreign Exchange Committee (London), "Dealing in Certain Foreign Currencies", Ref. No. 441, December 15, 1951, page 1.
2/ These open positions, which are subject to agreement with the Bank of England, are for the banks' own account and risk.

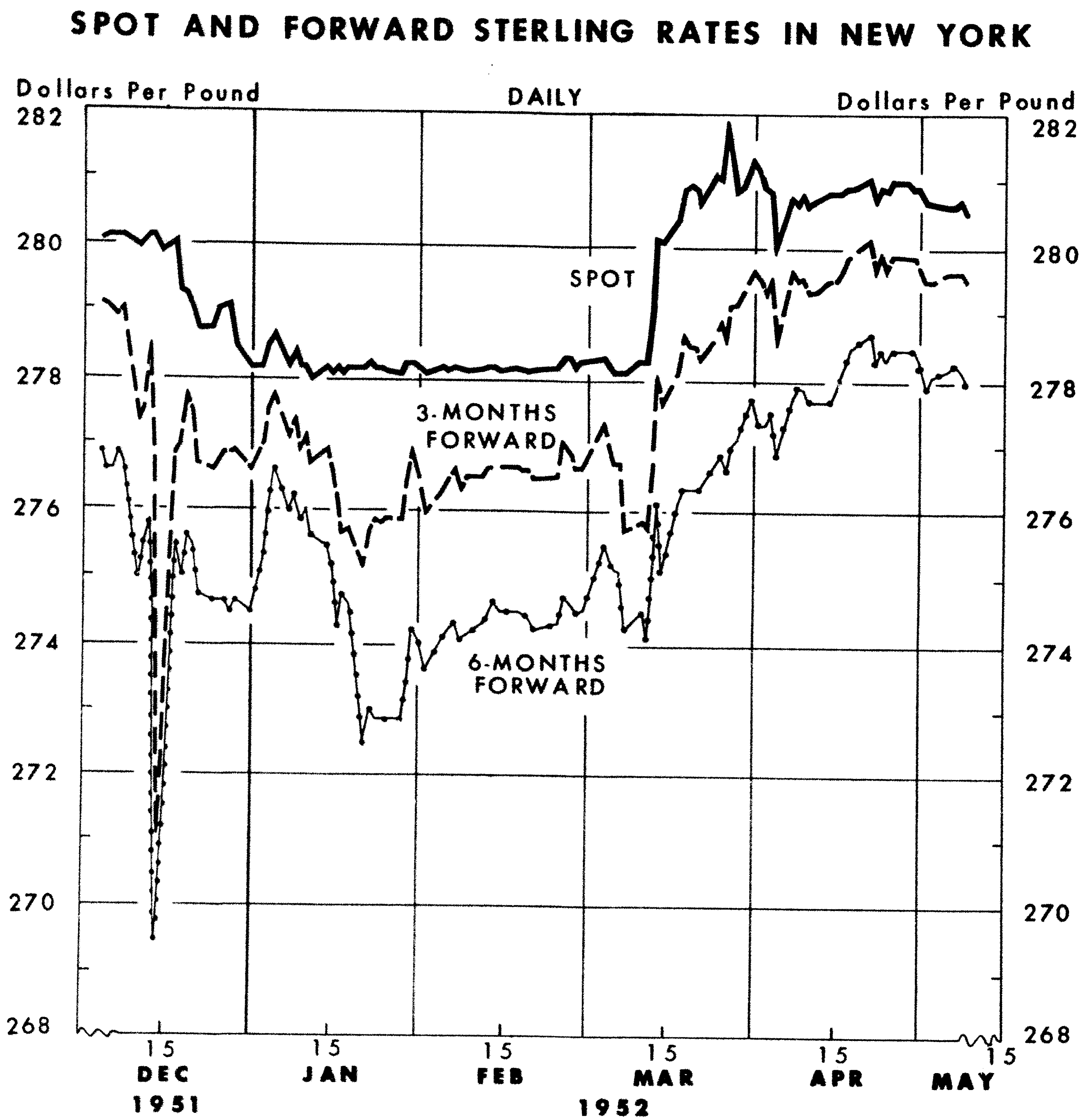
rate $2.80-1/8 to the pound. Commercial banks provided dollar exchange to their customers, charging a commission above the Bank's rates which varied with the amount of the transaction; in addition, the banks had been allowed, under a 1947 modification in practice, to marry purchases and sales within the same day and, thereby, earn for themselves the spread between the official limits. On December 17, the Bank widened its spot rates to $2.78 on the selling and $2.82 on the buying side; this spread, which allowed a fair margin for private trading and private risk-taking, represented 70 per cent of the one-per cent (of parity) authorised under the terms of the Fund agreement. 1/ Within the new range, commercial banks are allowed to deal in spot dollars where they are satisfied that the trading is for a bona fide commercial transaction consistent with Britain's exchange and import control regulations. The banks can deal in United States dollars with their customers, with other sterling area banks and, subject to limitations established by the authorities, with banks in the American Account Area.

Sterling before and just after the December changes

Although the pound had been under persistent pressure throughout the second and third quarters of 1951 as a result of the sterling area's growing balance-of-payments difficulties, forward sterling quotations in the New York market had recovered by the end of November from the severe declines registered during September and October when 90-day futures hit a post-devaluation low of $2.71-1/4. 2/ But weakness reappeared during the second week in December, as may be seen in the attached chart; market rumors and disturbing reports of devaluation account for the dip which occurred on December 10. 3/

On the heels of this disturbance came the report from London that certain exchange control measures of a technical nature would be announced over the week-end of December 15. Despite official statements that the dollar-pound relationship would not be disturbed by these changes, devaluation fears produced "the wildest and weakest market for the currency here (in London) since the pound was devalued in 1949." 4/ Under this pressure, 90-day sterling fell in the New York market to

1/ Section 3 (i), Article IV, Articles of Agreement of the International Monetary Fund.
2/ On October 17, 1951, selected spot and 90-day quotations for sterling in the New York market from January, 1949, through November, 1951, which are shown in Table I appended should be consulted for a summary of New York market quotations during this period.
3/ According to the New York Herald Tribune, one Washington newsletter had forecast a surprise devaluation over a week-end in the near future and a second privately circulated publication had predicted a devaluation of the pound in the first quarter (1952) to $2.24, the Australian pound parity. Dec. 11, 1951 issue, page 36. See also the news report of the Journal of Commerce, page 2.
4/ New York Times, London date line, December 15, 1951, page 20.



SPOT AND FORWARD STERLING RATES IN NEW YORK
Dollars Per Pound
DAILY
Dollars Per Pound
282
280
278
276
274
272
270
268
SPOT
3-MONTHS FORWARD
6-MONTHS FORWARD
15
DEC
1951
15
JAN
15
FEB
1952
15
MAR
15
APR
15
MAY

$2.71-3/8. Sterling quickly recovered from this panic situation, however, and as soon as the technical nature of the December 17 changes were made known, forward rates returned to previous levels. But the situation both in London and in New York remained unsettled during the latter part of December as the markets settled down to private trading in London under the new arrangements.

By the end of December, spot sterling had reached a floor, at or near the official support level, where it remained, with only minor fluctuation, until mid-March. Forward rates narrowed at the beginning of 1952, but futures fell rapidly to a low on January 21; thereafter, a slight strengthening occurred, and 90-day futures fluctuated between $2.76 and $2.77 until mid-March. Six-month sterling moved with the 90-day rate.

Sterling's sharp rise in mid-March

During the second week in March, the market position of both spot and forward sterling underwent a sudden improvement. Within the two-day period between March 11 (the day of the new British budget) and March 13, spot sterling rose by two cents and forward rates by slightly more. These gains were actually improved upon in the following week and have since been maintained, despite occasional fluctuation as may be seen in the chart.

The general weakness of sterling during the preceding period, with spot sterling at the support price and with a substantial forward discount, made the mid-March rises dramatic. Furthermore, during the Friday of the week preceding, there occurred in New York a "sharp break in British sterling which carried the spot pound off to $2.78, the official support price, and widened the discounts on forwards more than a full cent at the bottom of the decline... All of the action piled up Friday afternoon after London had closed." 1/

The initial impulse to the March 12 movement in the spot rate was largely technical in nature. Many speculators who had participated in the heavy December 14 selling were caught in a squeeze, since under market practice, they had to deliver on 90-day contracts no later than Monday, March 17. When the new monetary policy was announced on March 11, speculators had only a few days left in which to cover short positions. These operators had to come into the spot market at a time when spot sterling offerings from London were affected by the uncertainty introduced into the London money market by the unexpected and substantial rise in Bank rate. The result of this situation was a rise in the spot rate from $2.78-1/4 on Tuesday to $2.79-1/8 on Wednesday and to $2.80-1/4 on Thursday. The rate rose further, to a shade under $2.81, during the week of March 17.

1/ New York Times, March 10, 1952, page 30.

But these technical factors can explain little more than the initial upward push during the middle of March. Thereafter, the continued strength in the sterling rate reflected the impact of the budget and the new monetary policy upon the market. Short sterling positions were widely held and there was general covering. This general covering can be partially explained by the size of, and the protracted delay in, the leads and lags pressure against sterling which had commenced during the second quarter of 1951 but which had not been reversed over the winter months. 1/

But is it reasonable to attribute to changed market expectations about sterling prospects the exclusive responsibility for setting off the return capital flow? Was the improvement in the sterling area's prospects brought about by the March 11 measures sufficient to account for the instantaneous reversal in payments which occurred? Certainly merchants had no reason to fear an appreciation. On the contrary, the pound could be expected to be under pressure from the sterling area's balance-of-payments deficit for a few months longer; with external unbalance to continue until the second half of 1952, in fact, speculators might easily have taken the low level of reserves announced at the end of February to be an argument for continued speculation against sterling, not a reason for bringing it to a halt. For example, the decline recorded for April 4 can be attributed to market disappointment at the level of reserves at the end of March which Chancellor Butler had announced that day; yet, despite this sensitivity to the low level of reserves, the rate jumped back almost a full cent on the next business day. The confidence factor can hardly be held by itself to explain the sustained strength which sterling has shown since March 11.

In addition to the need for spot exchange for maturing commitments, the reason for the sustained demand for sterling must be found in the fact that sterling speculation suddenly became expensive. As a result of the rise in Bank Rate from 2-1/2 to 4 per cent on March 11, which was the signal for a general rise in short-term rates in the London money market, American merchants who had been speculating against the pound by borrowing sterling at the lower London interest rates suddenly found that London accomodation cost more and was more difficult to obtain. 2/ American traders had previously been opening new sterling credits to finance their imports as older credits matured, so that there was a continuing lag in dollar payments to Britain behind the physical shipment of sterling area merchandise to this country. The volume of dollar payments to Britain which was being deferred in this way was cut back sharply as the March 11 monetary measures limited the new London financing available to, or used by, American merchants.

1/ See "A Note on Leads and Lags in Sterling Payments," this Review, April 22, 1952.

2/ Both the February 28 restrictions on acceptance financing in London and the tightening of the London money market as a result of the uncertainty created by the abrupt and unexpected shift to dear money on March 11 contributed to this result.

The importance of exchange rate uncertainty

But there was an additional way in which sterling speculation was discouraged: merchants could no longer take the future price of sterling for granted, as they could during the period when spot remained at the support level. Uncertainty as to the spot rate was sufficient to cause prudent traders to abandon uncovered positions which had been based upon devaluation hopes.

Yet the arithmetic itself hardly explains why merchants covered their sterling needs. If the appreciation of the pound to a new parity can be ruled out, 1/ then it is difficult to see why - under existing arrangements - merchants chose to cover at or around \$2.81 spot until they were forced to by the need to make actual payment. 2/ At this price, the pound could presumably rise only one-cent more, though it could decline by three cents. Why were merchants, who had previously foregone windfall profits on forward discounts of 2 per cent per annum or more in order to speculate against sterling, now unwilling to run the risk of a one-cent rise in the spot rate? Might the market not at least have waited to see how stable the \$2.81 spot rate might prove to be, especially with Britain's reserve so low?

What the arithmetic does not really seem to explain can be understood by another factor: the uncertainty introduced into the sterling situation by rumors that the British authorities might free the pound. The possibility of an upward drift of spot sterling beyond the current spot rate is not deemed to be so much smaller than the possibility of a downward movement that prudent traders could afford to disregard it completely and to orient their transactions exclusively on the basis of a

1/ Surely, the critical level of Britain's reserves could only mean that the authorities would have to postpone moving the pound to a new parity until they were able to increase their holdings of gold and dollars substantially.

2/ Forward rates have been moving with the spot quotations, as may be seen in the chart. This argument does not apply to the operations of the commercial banks but the extent to which the banks are willing to take positions in foreign exchange is limited. Such positions as are taken are, in general, based upon what the banks think the commercial houses can be expected to do.

fall. 1/ After all, there are limits to the exchange rate risks which import-export houses can assume; a small exchange loss is serious to a house which has relatively limited capital resources compared to the volume of borrowed funds used to finance the movement of goods in foreign trade.

Merchant speculation, in the form of leads and lags in payments for approved transactions, has tended to grow rapidly under the conditions of limited risk of exchange fluctuation which have prevailed in the post-1945 world. Unvarying daily market rates, supported by exchange and import controls, made this sort of speculation virtually riskless to the individual trader, since at any particular time the exchange rate could be expected to move only in one direction and only in a single step from one fixed parity to another. This regime has been characterised by large and disequilibrating movements of short-term capital in the form of leads and lags in merchant payments, at least so far as sterling is concerned; these movements have taken place within the framework of elaborate exchange and import controls. 2/

However, this type of merchant speculation is vulnerable to exchange rate uncertainty. Traders simply are not in a position to risk large exchange losses. To bring this speculation under control, it is sometimes argued that it is necessary to abandon the fixed par-value system of Bretton Woods; but this extreme position neglects the fact that such speculation can be controlled within a system of fixed par values provided it is made too expensive for the individual merchant. Short-term money rates can contribute to this end, but it is also necessary that uncertainty be introduced into the foreign exchange market. With

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1/ This is not to suggest that, if sterling were freed today, the possibility of an upward drift would be greater than that of a downward trend. On the contrary, the sterling area's current account is not expected to be brought into balance until the second half of the year; during the period of current imbalance, sterling will be under continuing selling pressure. What is relevant here, however, is not the likely price of sterling but merely the commercial appraisal of the risk involved in gambling on the pound's future price. Moreover, the higher short-term money rates in London, compared to New York, make it somewhat more profitable for banks to invest in sterling rather than in dollars and, therefore, tend to offset a small preponderance of expectation of a slight downward drift. It should be remembered that, throughout April, 90-day futures were being bought at $2.79-1/2 to $2.80 and six-month forwards at around $2.78; this fact can only mean that, despite the common knowledge about the sterling area's prospects for the next few months, some merchants preferred to cover at these high prices rather than to assume the risk of obtaining their sterling at a future date.

2/ They would surely be expected to continue under the less extensive controls over capital movements envisaged under Article VI, Section 3 of the Fund's Articles of Agreement.

sufficient (potential) daily fluctuation in spot rates, the merchant can no longer take for granted the cost of his foreign exchange needs at some future date; the prudent trader will, therefore, tend to remain "close to shore". Whether the one-per cent spread in spot rates, possible under the Fund's articles, will be sufficient to bring under control the post-war leads and lags in sterling payments is one of the more interesting questions growing out of the exchange innovations introduced last December.

TABLE I
Selected spot and three-month forward sterling rates in the New York market

	Spot	Three-month forward		Spot	Three-month forward
1949:			1950:		
Jan. 18	4.03-1/4	4.02-1/2	June 21	2.80-3/16	2.80
Feb. 11	4.03-1/4	3/8	28	2.80-3/16	2.79-13/16
Mar. 25	4.03-1/8	4.01-3/4	July 19	2.80-3/16	2.80-3/16
Apr. 15	4.02-7/8	3.95-7/8	Aug. 30	2.80-3/16	2.80-3/16
22	4.03-1/4	3.97	Sept. 13	2.80-3/16	2.81-1/4
May 20	4.02-7/8	3.93-1/8	27	2.80-3/16	2.81-5/16
June 17	4.03	3.96-7/16	Oct. 4	2.80-3/16	2.83
July 1	4.02-7/8	3.89-3/8	25	2.80-3/16	2.81-1/4
29	4.03-1/4	3.92	Nov. 15	2.80-3/16	2.80-7/8
Aug. 12	4.03-1/8	3.90	Dec. 13	2.80	2.80-3/16
19	4.02-13/16	3.83-1/2	1951:		
26	4.02-13/16	3.77-13/16	Jan. 17	2.80-1/16	2.80-1/2
Sept. 2	4.02-13/16	3.77-3/4	Feb. 14	2.80-1/8	2.80-11/16
9	4.02-13/16	3.81	Mar. 21	2.80-3/16	2.80-7/8
16	4.02-13/16	3.81	May 23	2.80-1/8	2.80-7/8
30	2.80-1/4	2.81-1/8	June 20	2.80-1/8	2.81
Oct. 13	2.80-3/16	2.81-1/8	27	2.80-1/8	2.81
Nov. 3	2.80-3/16	2.80-11/16	Aug. 29	2.79-15/16	2.80-11/16
17	2.80-3/16	2.80	Sept. 26	2.79-15/16	2.78-7/8
Dec. 16	2.80-3/16	2.80	Oct. 10	2.79-15/16	2.75-1/2
1950:			17	2.79-15/16	2.71-1/4
Jan. 18	2.80-3/16	2.80	24	2.79-15/16	2.73-1/2
Feb. 15	2.80-3/16	2.79-5/8	31	2.80-1/8	2.76-1/2
Mar. 22	2.80-3/16	2.79-3/4	Nov. 7	2.80	2.76-1/4
Apr. 26	2.80-3/16	2.79-3/4	28	2.80-1/8	2.79-3/8
May 24	2.80-3/16	2.79-3/4			