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Exchange Flexibility and the Stability
of Sterling

Samuel I. Katz

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Exchange Flexibility and the Stability of Sterling

Samuel I. Katz

The recent discussion of whether a freeing of exchange rates would be conducive to a material freeing of international trade and payments increases interest in Britain's recent limited changes in foreign exchange arrangements. Late in 1951, the British authorities introduced a widened spread between the buying and selling rates at which the Bank of England traded in foreign exchange. This British experiment was the first case where the introduction of greater exchange flexibility took place within the restrictive provisions of the Fund agreement and did not involve the "freeing" of the rate by withdrawing official trading limits or abandoning an effective official par value. Not only has a functioning private exchange market been revived in London but sterling has shown considerable market resilience, despite external difficulties experienced by the sterling countries around the time the new arrangements were introduced. Following a review of the structural changes made in the London market and the pound's recent course, this study seeks to explore certain implications of a policy of exchange flexibility.

Narrow "gold points" for sterling

Despite the fact that wider "gold points" are permitted under Article IV of the Fund agreement, the British authorities maintained only narrow spreads between the official rates ("gold points") at which the Bank of England was prepared to buy and sell foreign exchange until a major change in direction took place late in 1951. ^{1/} Until the end of 1946, for example, the Bank's official selling rate for the United States dollar was \$4.02-1/2 and its buying rate \$4.03-1/2 to the pound; early in 1947, the spread was narrowed to \$4.02-3/4 and \$4.03-1/4. After September 1949, there was a further reduction, the post-devaluation rates being \$2.79-7/8 and \$2.80-1/8. ^{2/}

The narrow gold points limited the extent to which uncertainty could be introduced into trading in spot exchange. Consequently, whenever the outlook for sterling became less favorable, speculation against the pound tended to emerge, encouraged by the fact that a short sterling position was virtually riskless; furthermore, the liberal availability of funds in the London market as a result of the easy money policy facilitated foreign

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- ^{1/} Article IV, Section 3 (i) authorizes fluctuations in spot transactions within one per cent on either side of the currency's declared par value. In this study, the phrase "gold points" will be used for convenience to describe the official trading rates in effect for the Bank of England, despite the great difference in meaning and in function between these trading rates and the gold points under the classical gold standard mechanism.
- ^{2/} With a \$4.03 par value, the outer limits for spot trading under Article IV would have been \$3.99 and \$4.07. With a \$2.80 par value, the outer limits became \$2.772 and \$2.828.

borrowing and the lower short-term rates in effect actually meant that such financing would be at a lower cost. 1/ As a result of these incentives, substantial flows of short-term funds, generally of a disequilibrating character, occurred throughout the post-war period, despite the existence of exchange controls which blocked short-term capital movements of the pre-1939 character.

This speculation took the form of leads and lags in sterling payments by merchants in connection with their normal trading operations. 2/ The merchant could speculate against the pound merely by maintaining an uncovered sterling position: he could assume a future sterling commitment without obtaining the sterling in the spot or futures market at the prevailing rate of exchange. 3/ When the sterling area's balance of payments was in difficulty, the merchant could be certain that the pound would not be appreciated to a higher par value; the par value might remain unchanged or be lowered. In the circumstances, the narrow gold points further limited the risk involved in a short sterling position; the cost of spot sterling at some future date would not exceed the current cost because the Bank of England was committed to trade at the fixed selling price. On the other side, the merchant could shift into a long position in sterling whenever the improved position of the sterling area raised the possibility that the par value of the pound might be raised. Thus, whenever there was a prospect that the sterling rate might be altered, the narrow gold points in effect for spot exchange encouraged merchants to carry out short-term speculation of a disequilibrating character.

Furthermore, the exchange arrangements forced the monetary authorities to assume administrative burdens and, particularly in the case of forward exchange, substantial economic risks. Elimination of private trading in dollar exchange in London, the result of the introduction of wartime controls, placed upon the Bank of England special responsibilities to provide dollar

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- 1/ It should be noted that, where there is a distinct prospect of a currency adjustment, speculation is likely to occur regardless of the technical arrangements in effect in the exchange market. The distinctive weakness of the system with narrow gold points is the fact that it made postponement of sterling payments virtually riskless and, hence, encouraged short-sterling positions on the slightest provocation.
- 2/ This type of sterling speculation is analyzed in my article, "Leads and Lags in Sterling Payments", Review of Economics and Statistics, February 1953, page 53.
- 3/ The foreign (non-British) merchant could effect a short-term capital movement by speeding up or delaying sterling currency payments; by altering the credit terms on commodity transactions; and by shifting into sterling to finance the physical movement of merchandise. The British merchant could speculate by shifting (within the limits allowed under Britain's export and import regulations) the timing of his foreign currency or foreign merchandise transactions.

exchange to the market. Under the war time exchange arrangements, the Bank was committed to operate in U. S. dollars at an 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 dollar exchange with customers at the official rates and received a handling commission which varied with the amount of the transaction. In forward exchange, no private dealings were possible nor was there a market for trading; instead, the Bank of England stood ready to supply unlimited amounts of forward dollars for approved commercial transactions. 1/ Futures contracts were at unvarying prices regardless of the external prospects of the sterling countries, the Bank charging a nominal commission of 1/4 cent per month per pound for this facility. This structure of charges contributed to the Bank's difficulties, in that the slight charge for forward cover encouraged merchants to make liberal use of the service whenever they sensed the slightest exchange rate uncertainty.

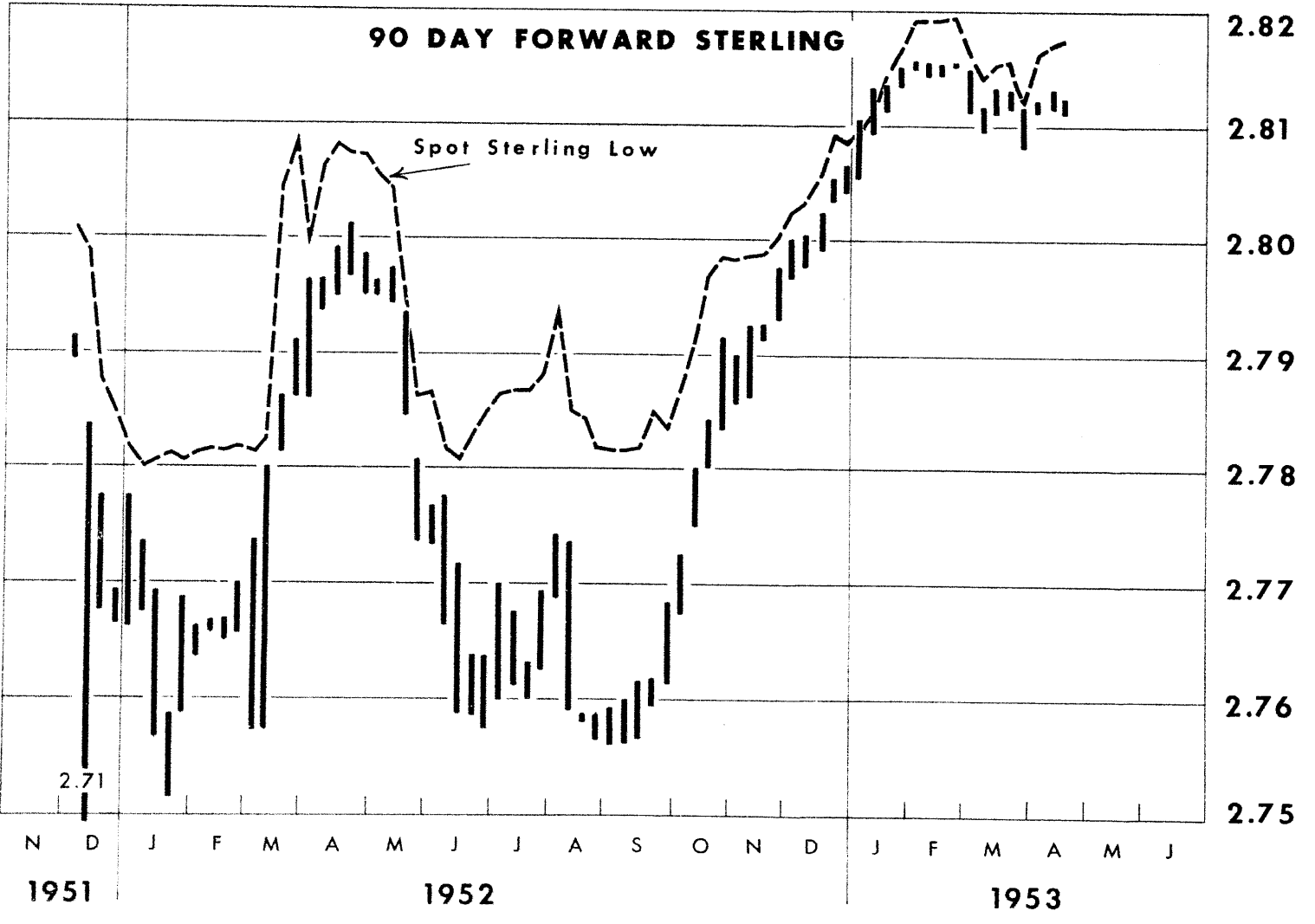
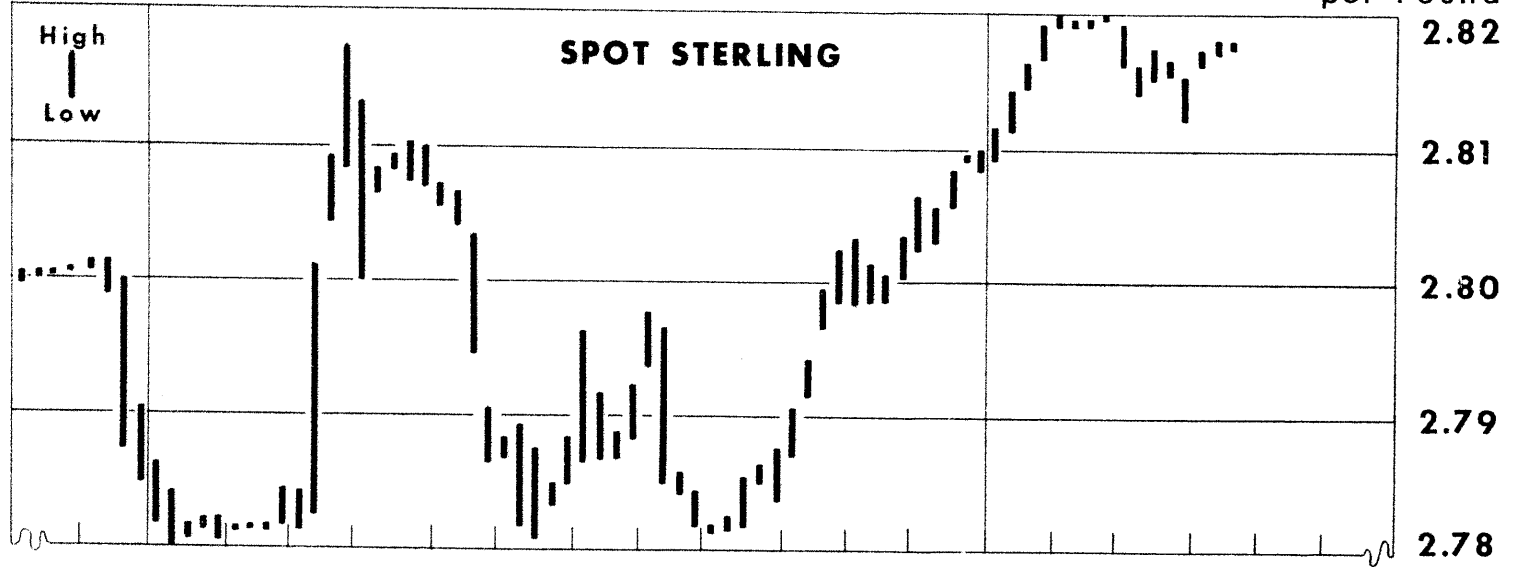
Under the post-war revival of foreign trade, the Bank of England's open-end commitment to provide forward dollar cover at a fixed price for a nominal fee proved to be an open invitation for commercial interests to place upon the Bank responsibility for carrying large unbalanced positions in forward exchange. The Bank soon found that most of its forward trading, particularly during critical periods, was in one direction. 2/ When sterling was under pressure, for example, the British importer would be more anxious to cover forward dollar needs than the British exporter would be eager to sell forward dollar earnings. When sterling appreciation was anticipated, the Bank found its position unbalanced in the opposite direction. 3/

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- 1/ In the New York market, the spot rate was maintained within the Bank of England's official rates. But a "free" forward market existed in New York, with rates determined by local market conditions; and the co-existence of a "free" New York market with a pegged "market" in London contributed to the difficulties of the Bank.
- 2/ See, for example, "The New Foreign Exchange Market," The Banker, January 1952, pages 20-21.
- 3/ Contributing to the Bank's one-sided experience in dollar futures was the existence in New York of a free futures market with fluctuating rates, since American traders (with commercial transactions approvable under British regulations) would make use of the Bank's forward facilities when the fixed London rates were more advantageous than those in New York. Based upon the Bank of England's charge of 1/4 cent per month, London banks would purchase 90-day sterling at \$2.78-5/8 and would sell at \$2.81-3/8. Since the 1949 devaluation, 90-day sterling rose above \$2.81-3/8 only during September and October 1950 when rumors of sterling appreciation led to a general movement into sterling. On the 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 when sterling devaluation was a possibility.

STERLING RATES IN THE NEW YORK MARKET

HIGH AND LOW FOR THE WEEK

Dollars
per Pound



Introduction of wider gold points

In a major change in policy effective December 17, 1951, the foreign exchange operations of the Bank of England were curtailed, the Bank withdrawing all forward facilities and widening the spread at which it dealt in spot exchange, and private trading in dollar exchange was resumed in the London market. Once again private dealers were allowed to trade in spot dollars within the Bank's selling rate of \$2.78 and buying rate of \$2.82 to the pound for bona fide commercial transactions eligible under Britain's regulations. The Bank withdrew completely from forward exchange dealings, and London banks were authorized to deal in forward exchange as principals at rates set by the market with no formal official intervention. To develop a functioning market, the banks were granted greater freedom in spot dealings and were allowed to maintain, within certain limits, open positions in forward exchange.

Widening the spot spread had no immediate impact upon the volume of short-term speculation against the pound. On the contrary, U. S. interests increased their borrowings of sterling from British institutions during January and February 1952 in order to postpone dollar payments, according to United States statistics shown in the table in Appendix A.1/ The continued short-sterling positions maintained by U. S. interests and Britain's large deficit on current dollar payments underlie the weakness of sterling in the early months in 1952 which may be seen in the chart on the following page showing the spread (high and low quotation) on a weekly basis for spot and, in the lower section, for 90-day sterling. The fact that spot sterling remained at the official support level around \$2.78 led Professor Hawtrey to observe at the end of February that "the step recently taken towards a free foreign exchange market has meant . . . merely a further devaluation of the pound by a fraction of one per cent." 2/

However, a rise in the sterling rate occurred during the second week of March (see chart) following the March 11 rise in the Bank of England's discount rate from 2-1/2 per cent to 4 per cent. The initial impulse to the mid-March jump in the pound was largely technical in nature. Speculators who had participated in the heavy selling on December 14, 1951 when 90-day sterling fell to \$2.71 (see chart) were caught in a squeeze since, under market practice, they had to deliver on their contracts no later than Monday, March 17. On March 11, however, "the budget news forced a feverish scramble to

1/ As shown in appended table A, short-term sterling liabilities of U. S. banks to foreigners increased on a net basis by \$41 million during January and \$13 million during February.

2/ Letter, London Times, February 28, 1952, page 5.

enlarge sterling balances by banks and commercials. More particularly it provoked a 'squeeze' against those who had gone short of the pound and hurried to cover those commitments." 1/ With operators seeking sterling to cover maturing commitments under those conditions, spot sterling was quoted at \$2.78-1/4 on March 11, \$2.79-1/8 on the following day and \$2.80-1/8 on March 13.

But these technical factors can explain little more than the initial upward push. Thereafter, the continued strength in the sterling rate during April and the first half of May 1952 reflected the impact of the budget and the new monetary policy upon the market. Short sterling positions which had been widely held had to be covered and sterling had to be obtained for current requirements.

The need to obtain exchange to meet maturing commitments and the fact that sterling speculation had suddenly become expensive contributed to the improved position of sterling. The rise in Bank rate on March 11 was the signal for a general rise in short-term rates in the London money market; hence, speculation against the pound, which had taken the form of borrowing sterling at the lower London interest rates, was made less attractive in that London accommodation cost more and, perhaps more important, had become more difficult to obtain. 2/

But sterling speculation became more costly in another way: merchants could not longer take the future price of spot exchange for granted as they had been able to do during the preceding period when the pound remained around the support level. Since spot sterling could rise to — and in fact in the last week of March (see chart) did approach — the \$2.82 limit, the wider gold points introduced an added risk factor into the foreign exchange market. As a consequence, prudent traders tended to reduce uncovered commitments which had been based upon devaluation hopes or expectations. Adding to the uncertainty at the time there were market rumors that the British authorities were intending to "set the pound free."

1/ New York Times, March 17, 1952, page 29. The report adds: "The movement coincided almost to a day with the three-month interval from December 14, last, when relaxation of sterling controls and the turning of forwards trading to banks precipitated heavy selling."

2/ In late February, the Bank of England had also cut back the usance of drafts under letters of credit subject to exchange control from 120 to 90 days and restricted refinance facilities available to foreigners in the London market.

What wider gold points really mean

In the current discussion about exchange rate policy, there is confusion about the significance of "freeing" the currency or letting it "float" or "widening" the spot rate. It is evident that there are at least three distinct concepts of what widening the official spread can mean.

Perhaps the least generally discussed concept looks upon "freeing" the exchange rate (that is, abandoning the par value and withdrawing fixed official trading rates) as a temporary transitional device prior to the establishment of a new fixed par value. At a time when the established rate is clearly out of line or where a major relaxation of import or currency restrictions would be introduced, the exchange rate might be freed so that market sentiment could help to guide the authorities to the new par value. If this conception is clearly understood to cover only a transitional program, with the rate fluctuation limited in time, it can be quite consistent in the long run with the objectives of exchange stability of the fixed par-value system of Bretton Woods.

More widely held is the view, which runs counter to the ideas underlying the Bretton Woods arrangements, that fluctuating rates (abandoning a par value and withdrawing fixed official trading quotations) can be used as an automatic means of effecting balance in a country's external payments, either with or in the absence of controls. This often-stated case, which can be made attractively consistent in theory if perhaps less convincing as a practical program, holds that the adoption of a freely fluctuating pound would make possible an automatic balance in Britain's external accounts: the reasoning is based upon the proposition that there is a price at which any pair of demand and supply schedules for sterling can be brought together and the exchange market cleared. ^{1/} Although some of the implications of this position will be considered at a later stage, an evaluation of this hypothesis would lead us away from the main theme of this study.

Under the third concept, the change in exchange arrangements is looked upon merely as a technical operation with limited objectives. This line of policy would make use of greater exchange flexibility in an attempt to moderate the difficulties which have actually been experienced during the post-war period where the par-value system has been maintained within narrow gold points. In recent years, these difficulties have been of

^{1/} See, for example, Milton Friedman, letter, The Economist, January 3, 1953, page 16.

three main types: (a) the arrangements provided incentives for merchant speculation because there was little risk in a short-sterling position; (b) there was unrelenting pressure upon foreign exchange reserves because the authorities were forced to defend rates within narrow limits; and (c) the monetary authorities were forced to assume administrative burdens and risks because there was no functioning private market to take care of commercial requirements.

Within the framework of this third concept, two alternate exchange policies could be adopted to cope with these difficulties. Greater exchange flexibility could be achieved by abandoning prevailing official buying and selling rates and either: (a) introducing widened gold points for official operations; or (b) announcing to the market that official buying and selling rates will no longer be in effect. With either arrangement, an additional risk will be introduced into the exchange market; the authorities will have somewhat more freedom to let the rate slide rather than to surrender reserves; and, finally, a freely functioning private exchange market could be set in motion, with commercial banks and brokers able to trade with each other at market rates for approved transactions. Consequently, it will be well to compare these alternative policies.

Are gold points significant?

On one significant technical point an exchange system with fixed official buying and selling rates, with or without a declared par value, is similar to the classical gold standard: there are announced limits to the fluctuation of the spot exchange rate. Until the par value is altered or new gold points established, the financial and trading community and foreign monetary authorities are assured that, under normal trading conditions, exchange rate movements will be confined within the pre-determined and announced limits.

The fact that exchange fluctuations will ordinarily be so confined, however, does not mean that the spot rate will necessarily be more stable under a regime with gold points than under a system without a declared spread. Where the monetary authorities are prepared to defend a market rate and where trade and exchange restrictions are used as defensive measures, as has been true in the recent history of the Italian lira for example, a high degree of stability can be attained without any official spread. Where defensive restrictions in the fields of trade and payments are avoided, then the ability of the authorities to maintain a stable rate will depend -- in either of the alternatives we are considering -- primarily upon the degree of external balance attained and, secondarily, upon the volume of reserves available to support the currency.

The difference between these two types of exchange arrangements -- and hence the significance of the gold points -- appears to lie in another direction: that is, in the operational freedom in the exchange market afforded to the local monetary authority. With gold points in effect, their freedom is limited by the commitment to a fixed range of price fluctuation, a commitment wholly absent where no declared gold points exist. 1/

This limitation has both an international and a market significance. In the international field, the system with a declared spread provides a bulwark against the development of a chain of competitive depreciation; at least, it preserves virtually all the safeguards in this direction which are to be found in the Bretton Woods arrangements. 2/ This protection against competitive depreciation is less evident where the authorities are committed to no official spread. Hence, the significance of this safeguard becomes a matter of individual assessment of the usefulness of the Bretton Woods obligations in preventing the recurrence of a wave of international competitive depreciation.

If the danger of competitive depreciation is somewhat less, the problem of exchange stability in different markets may be as great under a system with fixed spreads as under one with no official rates. The wider the official spread, the more difficult this "cross rate" problem becomes and the greater the danger that currencies will have different values in different markets. Nonetheless, these difficulties have existed under the narrow gold points previously in effect: throughout the post-war period, the market values for trading currencies have differed from exchange values based upon the official parities. To some extent, it has been possible to maintain values at legal parities by means of controls in an isolated legal exchange market, but exchange discounts have tended to emerge in illegal markets. The difficulties with broken cross-rates seem to be not a matter of exchange mechanism but a problem of imperfect market conditions; these differentials tend to develop as a result of the obstacles to the movements of goods and funds which prevent arbitrage operations from evening out excessive price differences.

1/ The monetary authorities are committed only to operate at the official trading limits; but, unless they are able -- through intervention in the market or through other measures -- to keep the currency from remaining at the lower support level, a difficult market situation is likely to develop.

2/ See Article IV, Section 4 of the Fund's Articles of Agreement. Since members undertake in sub-section (b) to permit exchange transactions only within prescribed limits (for spot exchange, within one per cent of parity), there is somewhat greater danger that currencies may have different values in different markets where wider gold points are in effect than would be the case with narrow official trading limits.

Within the exchange market, the commitment to a declared spread provides the merchant with a standard for purposes of pricing and for making economic decisions which is firmer and more reliable than is found in the case where no official rates exist. 1/ To this extent, it can be argued that, under normal conditions, foreign trade is thereby facilitated. To be sure, in the absence of such a spread, the trader can make use of the forward market to cover much of the added exchange risk. Nonetheless, a range of business transactions and of investment decisions exists which would be discouraged or interfered with by the greater risks and pricing difficulties associated with an undeclared spot range. In reality, our suggestion that merchandise trade would be discouraged where no official rates are in effect does no more than re-state an accepted weakness of a flexible exchange mechanism.

Furthermore, the existence of an official spread should, at least in theory, provide the merchant with attractive incentives to conduct his exchange operations in an equilibrating manner under certain circumstances. Where no limits are in existence, the prudent trader is encouraged to maintain a covered position at all times; hence, such equilibrating flows of funds would not seem to be practical. With an official spread in effect, however, he might be induced upon occasion to alter the timing of his exchange operations to take advantage of a bargain rate or, on the other side, to act in an opposite way when the rate is near the other limit of the official range. This may be no more than a theoretical possibility under prevailing economic conditions. In any case, such equilibrating capital movements can hardly be expected to develop except where the market accepts the declared price range as a realistic value for the currency and has confidence that the par value can be maintained.

Concluding observations

Britain's experience with widened gold points since late 1951 provides ground for suggesting that greater exchange flexibility, if conceived as a technical operation with limited objectives, can be useful as a stabilizing factor in the exchange market. 2/ By providing a more satisfactory base for the market position of sterling, the recent exchange innovations, including the opening of a functioning private

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- 1/ The wider the spread, the less positive this advantage of a fixed parity system becomes. The advantage would seem to remain where the spread is no wider than the gold points introduced by Britain in December 1951. How much they could be widened without negating this advantage is largely a matter of judgment.
- 2/ This favorable British experience was in large measure a reflection of the technical success of the new monetary policy in the United Kingdom. An appropriate policy in the monetary field is indispensable as a support for a program of exchange flexibility.

market capable of taking care of the exchange requirements of commercial interests, has been a positive step toward greater stability for the pound. Furthermore, despite the external payments difficulties experienced by the sterling area countries during the first three quarters of 1952, the spot rate has moved widely within the official spread, as may be seen in the chart, and has not remained at the lower support price as had been feared at the time the wider gold points were initiated.

The checkered movement of sterling since December 1951 reflects the impact of adverse as well as favorable external factors upon the market position of the pound. If the strength shown from March to May may be attributed to a general covering of short sterling positions following the introduction of the new monetary policy, the weakness recorded from the latter part of May to October reflects the sterling area's continuing external difficulties, particularly with the European Payments Union countries. The subsequent strength of the currency in the latter part of 1952 and early 1953 reflects the demonstrated effectiveness of the restoration of monetary policy in Britain as well as the improved external position of the British countries as affected by the severe import restrictions in effect.

Britain's experience with wider gold points commenced at a time of severe external imbalance and extended through unfavorable as well as favorable periods of time; despite the adverse circumstances, however, sterling has demonstrated considerable market resilience. The period where a widening of the rates meant only a further devaluation proved to be short-lived. Nonetheless, Britain's experience in early 1952 stands as a warning that wider gold points can lead to disappointing results; if the currency does not rise above the support level, the same difficulties will be encountered with wider gold points as can be expected where a narrow official spread is in effect.

If a policy of greater exchange flexibility is to be pursued, the major decision to be made is whether the gold points are to be maintained or whether all official quotations are to be withdrawn. Although the authorities have greater freedom of action where no announced market range exists, two advantages seem to be associated with the system of gold points: greater protection is provided against competitive depreciation and foreign trade ought to be facilitated somewhat by the official commitment to an official spread. Yet it is significant that the gold-point arrangement is essentially a compromise position which attempts to avoid the worst disadvantages of either a system of narrow trading limits or of fluctuating exchange rates.

The main disadvantages of the gold-point system seem to arise around the difficult question which must be decided: how wide should the declared spread actually be? With too narrow a spread, the disadvantages

of the earlier post-war exchange arrangements might reappear; with too wide a range, the market may be able to find little meaning in any official price commitment. If the spread is wide enough to avoid the rigidities of narrow gold points, new difficulties are likely to emerge, particularly in maintaining orderly exchange conditions and cross rates in a world with exchange and import restrictions. Hence, a step toward wider gold points makes desirable parallel steps in the direction of a freer movement of goods and short-term funds to increase arbitrage possibilities. Trade is also likely to be disturbed, the greater the degree of exchange fluctuation.

Since the selection of any exchange arrangement is a choice of distinct advantages inseparable from particular disadvantages, new difficulties of maintaining exchange stability are likely to be encountered under a system of wider gold points. Consequently, the demonstrated weakness of the former system of narrow trading limits should not lead to the conclusion that a wide degree of exchange flexibility is necessarily desirable at this time. The clear disadvantages of a high degree of flexibility should be borne in mind, particularly if a period of intensely competitive selling is in prospect. Is there not some danger that the post-war experience with the rigid par-value system during a period of easy selling may lead to the widespread acceptance of too much exchange flexibility -- at a time when only buyers' markets are to be found?

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UNITED STATES: Changes in short-term Claims on,
and Liabilities to, Foreigners in Sterling

(In millions of U. S. dollars)

	U. S. short-term claims payable in sterling on: a/		U. S. short-term liabilities payable in sterling to: b/		Monthly change in net sterling position c/
	United Kingdom	Australia	United Kingdom	Australia	
1950:					
September	56.5	38.2	38.1	.4	+ 46.6
October	109.9	48.8	29.8	.9	+ 71.8
November	98.6	42.6	22.5	.6	- 9.9
December	83.5	32.8	25.8	.8	- 28.4
1951:					
January	66.1	20.6	25.3	.5	- 38.8
February	75.9	21.3	28.3	.4	+ 7.6
March	71.7	34.1	32.0	.4	+ 4.9
April	79.2	28.0	41.0	.7	- 7.9
May	76.2	26.6	41.9	.6	- 5.2
June	90.5	20.4	42.7	.4	+ 7.1
July	87.4	18.2	40.8	.5	- 3.5
August	68.7	15.9	41.1	.6	- 21.4
September	38.7	12.6	34.1	1.1	- 26.8
October	19.6	10.0	36.0	.8	- 24.3
November	19.0	5.6	46.6	.6	- 15.4
December	19.4	3.6	59.4	.6	- 14.4
1952:					
January	13.5	3.1	95.1	.5	- 42.2
February	18.8	1.7	112.2	.7	- 13.4
March	20.8	1.2	109.3	1.6	+ 3.5
April	21.1	1.0	101.3	.5	+ 9.2
May	23.3	1.1	82.0	.5	+ 21.6
June	20.6	.8	59.8	.6	+ 19.1
July	21.2	.7	51.9	.7	+ 8.3
August	20.5	.6	40.7	.7	+ 10.4
September	14.8	.6	40.1	.5	- 4.9
October	17.5	.4	35.7	.4	+ 7.0
November	20.9	.5	33.2	.3	+ 6.1
December	19.2	1.0	30.2	1.0	+ 1.1
1953:					
January	23.5	.6	30.9	.5	+ 3.7
February			31.8	.9	

Source: -- Treasury Bulletin (monthly), U. S. Treasury Department.

a/ Covers sterling deposits of U. S. reporting banks and domestic customers due from foreigners.

b/ Covers sterling liabilities reported by U.S. banks due to foreign banks and official institutions.

c/ A plus (+) occurs when the sterling position of U.S. interests is enlarged either because of a rise in U.S. sterling claims or a decline in U.S. sterling liabilities during the month. A minus (-) occurs when the U.S. sterling position is reduced either because U.S. sterling claims decline or U.S. sterling liabilities rise.