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Board of Governors of the Federal Reserve System

Division of International Finance

# REVIEW OF FOREIGN DEVELOPMENTS

May 11, 1954



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In the spring of 1953, the discussion of sterling convertibility was seriously revived for the first time in many years. The United Kingdom had overcome the slight recession following the Korean boom without endangering its internal financial stability, and had achieved approximate equilibrium in its global balance of current international payments as well as in the sterling area's dollar balance.

At that time, however, many observers doubted the permanence of these improvements. They pointed to the unprecedented prosperity in the United States, and argued that a slight readjustment in the U. S. economy would result in another sterling crisis, as it had in 1949. They pointed to the low volume of imports and argued that a return to a more normal level of imports would eliminate the current account surplus. Finally, they pointed to the tight import and exchange restrictions imposed by the United Kingdom and most members of the outer sterling area, and argued that relaxation of these restrictions would undermine the international position of sterling.

Developments in 1953 and in the first quarter of 1954 did not conform to these gloomy forecasts but vindicated the judgment of the optimists who believed that the United Kingdom would continue to improve its international financial position and would not be seriously hurt by a moderate readjustment in the U. S. economy 1/.

## U. K. balance of current payments

In 1953, the U. K. global balance of current international payments showed a surplus of £ 120 million (excluding U. S. aid), virtually the same amount as in 1952. The trade deficit (with imports computed f.o.b.) and the surplus on service account were both about £ 80 million larger than in 1952. The current account surplus was achieved in the face of a 10 per cent increase in the physical volume of imports, which brought this volume to a postwar peak. Virtually the entire surplus was accumulated in the second half of the year (see Table 1). 2/

This favorable result was facilitated by a drop in import prices by 12 per cent, which overshadowed the drop in export prices by 3 per cent, thus significantly improving the country's terms of trade. Moreover, the country's earnings included £ 73 million of U. S. troop expenditure and offshore procurement receipts, an increase of £ 27 million over 1952. Nevertheless, the achievement of a surplus was particularly significant in view of the substantial relaxation in the U. K. trade restrictions: during the year, the authorities gradually restored the liberalization of 75 per cent of all intra-European imports and loosened controls on dollar imports, especially in the field of staple foodstuffs and raw materials. The fact that these relaxations did not bring about a disruptive flood of imports appears to justify the expectation that further liberalization would similarly fail to endanger the country's trade balance.

1/ See this Review, July 7, 1953 and October 20, 1953.

2/ All tables at end of article.

The regional distribution of current receipts and expenditures showed an improvement in the balances with relatively "hard" currency areas, and a corresponding drop in the surplus with relatively "soft" currency areas. These changes were particularly important from the point of view of progress toward convertibility since they tended to lessen the danger of "regional disequilibrium" -- a surplus in inconvertible currencies that could not be used to cover a deficit in convertible currencies.

The current account deficit of the United Kingdom with the dollar area (excluding U. S. aid) dropped to £ 109 million, about one-third of the 1952 figure; in the second half of the year, the deficit was larger than in the first half, primarily because of the year-end service of the country's Government debts to the United States and Canada (see Table 2). The 1952 deficit with the EPU area was replaced by a current surplus of £ 104 million (see Table 3). On the other hand, the surplus with the outer sterling area was reduced to £ 179 million, about one-half of the 1952 figure; the reduction took place almost entirely during the first half of the year (see Table 4). The surplus with "other" non-sterling countries gave way to a deficit.

It is natural for the United Kingdom to finance a dollar deficit by means of a surplus with the outer sterling area. In 1953, the small size of its dollar deficit made it possible for the country to draw only to a moderate extent on its surplus with the outer sterling area for this purpose; in fact, the regular U. K. purchases of gold from the outer sterling area (£ 79 million) covered almost three-fourths of the U. K. dollar deficit. Moreover, the United Kingdom did not need to rely for its dollar resources on a surplus with the non-sterling non-dollar world; this fact might quiet the f fears of those Europeans who believe that the United Kingdom would use the convertibility of European currencies to earn dollars by means of artifically increasing its surplus with the European nations. At the same time, the actual surplus of the United Kingdom with the European nations should quiet the fears of those Britishers who believe that the European nations would use the convertibility of sterling to earn dollars by means of a surplus with the sterling area.

## U. K. balance of capital payments

In 1953, the net capital outflow from the United Kingdom amounted to £ 207 million, almost 2-1/2 times as much as in 1952. A small outflow to the dollar area, and a larger one to the OEEC area, probably represented mainly the repayment of (public) indebtedness; however, an outflow of £ 158 million to the outer sterling area -- more than 1-1/2 times as much as in 1952 -- presumably represented primarily an increase in foreign investment. In conformity with the movement of the current account surplus, most of the capital outflow occurred in the second half of the year. The underdeveloped regions of the outer sterling area still have to rely primarily on the London market for their capital requirements, and the resumption of relatively large investments in the outer sterling area is part of the return to a more normal pattern of payments within the British Commonwealth.

In the sector of short-term assets, an increase in gold and dollar holdings by £ 240 million ($672 million) was almost exactly offset by a rise in sterling liabilities (net of U. K. holdings of non-dollar currencies) of £ 222 million; in the second half of the year, the changes were much smaller than in the first. The movements represented a reversal of the changes that occurred in 1952, when gold and dollar holdings fell by £ 175 million ($490 million; see Table 5) and sterling liabilities dropped by £ 346 million (see Table 6). These movements reflected primarily the return of the outer sterling area to a surplus position in its dollar accounts. Under the principle of the sterling area "dollar pool", a dollar surplus of the outer sterling area results in an identical rise in the dollar (or gold) holdings of the United Kingdom andin the sterling holdings of the outer sterling area since the dollars earned by the outer sterling area are generally sold for sterling to the Bank of England.

While sterling balances of the outer sterling area rose, the balances of countries outside of the sterling area continued to drop moderately; however, American and Canadian account sterling balances rose by £ 28 million. Sterling in these accounts is freely convertible into dollars; the fact that residents of the dollar area are increasingly willing to hold liquid funds in convertible sterling rather than in dollars presumably reflects the conviction that the pound-dollar rate — which currently is near the upper "gold point" of $2.82 — will continue to remain high, i.e., that the U. K. balance of dollar payments will continue to be favorable. The slight difference in interest rates between London and New York may have encouraged this movement, and the reopening of the British international commodity markets -- most recently, of the gold market — has no doubt added to the flow of liquid funds from the dollar area into convertible sterling accounts.

This development seems to permit the conclusion that a further extension of convertibility privileges -- if it does not threaten the stability of the sterling rate — would encourage foreign holders again to keep a large part of their liquid funds in London, as they used to do before 1931.

In the first four months of 1954, the U. K. gold and dollar holdings continued to grow at almost the same rapid rate as in the first half of 1953, and official reserves at the end of April reached £ 1,007 million ($2,820 million). However, in contrast to last year, a large part of this increase presumably represents the inflow of capital rather than the balance of current dollar transactions of the sterling area.

The present reserves are equal to 27 per cent of the country's annual payments on goods and services, or an estimated 26 per cent of the entire sterling area's annual merchandise imports from non-sterling sources; they therefore have exceeded the ratio which some observers believe to be the minimum permitting further decisive steps toward elimination of exchange controls.

In this connection, it may be important to note that the U. K. gold and dollar holdings would have risen in 1953 even if there had been no U. S. aid (£ 105 million) nor any U. S. troop and offshore procurement expenditures (£ 73 million). The equilibrium in the U. K. dollar balance thus did not depend on U. S. assistance or military payments.

## Outer sterling area balance of payments

As usual, the British figures give only fragmentary data on the balance of payments of the outer sterling area with the non-sterling world. They are sufficient to indicate, however, that the area's global surplus with the non-sterling world rose from £ 162 million in 1952 to £ 274 million in 1953, and that this change was due primarily to the area's trade with the dollar countries showing a surplus of £ 86 million instead of last year's slight deficit (see Table 7). The area's trade surplus with the OEEC countries increased slightly. However, the area's current balance with the non-sterling world, and especially with the dollar area, showed a much smaller surplus in the second than in the first half of the year.

The sterling holdings of the independent members of the outer sterling area rose by £ 168 million to £ 1,774 million. The U. K. Colonies increased their balances by £ 85 million to £ 1,161 million — the smallest rise since 1949. The sterling liabilities to dependent territories present less of a problem to the U. K. authorities than those to independent nations, and a moderate increase in these balances is also in the interest of the Colonies themselves since it permits an increase in the Colonial currency circulation commensurate to the economic development of the regions. On the other hand, the decline in the rate of accumulation of colonial balances was probably convenient since the recent rapid growth of these balances had been considered abnormal and, moreover, given rise to accusations of Colonial exploitation.

## Effects of U. S. economic adjustment

The recent adjustment in the U. S. economy failed not only to affect adversely the balance of payments of the sterling area in 1953, but also to influence the U. K. trade balance in the first quarter of 1954. In that quarter, U. K. exports (including re-exports) to all areas amounted to £ 701 million, or £ 46 million more than in the first quarter of 1953, despite the lower level of export prices. The value of imports (c.i.f.) remained virtually unchanged — implying a significant rise in volume, in view of the fall in import prices —, and the trade deficit declined by about one-fourth. The trade balances with the sterling and the non-sterling world improved by virtually the same amounts (see Table 8).

Exports to the United States reflected moderately the adjustment in the U. S. economy: in the six-month period ending March 31, 1954, U. K. exports (including re-exports) to the United States amounted to £ 79 million, as against £ 90 million in the preceding six months and £ 87 million in the corresponding period of 1952/53 (see Table 9). However, there was less than the usual seasonal downward movement between the last quarter of 1953 and the first quarter of 1954; unless the readjustment in the United States gets worse, its direct effect on the United Kingdom may well be no greater in the future than during the past six months. Moreover, during that period imports from the United States dropped more than exports and the U. K. trade balance with the United States (as well as the trade balance with the dollar area as a whole) tended to improve rather than to deteriorate. The direct effect of the U. S. adjustment thus seems to be negligible in terms of the over-all international financial position of the United Kingdom.

Indirectly, there may well be additional and more important effects, especially through a decline in dollar revenues of the outer sterling area. In January 1954, U. S. imports from the outer sterling area were 24 per cent lower than in January 1953; if this figure were applied to the entire year, imports would indeed be down by almost £ 100 million ($276 million) annually. However, the difference in the value of imports in January 1954 and January 1953 was largely the consequence of the drop in the world-market price of several raw materials, such as rubber, which took place mainly during the first half of 1953. This price drop appears to have stopped, and for this reason the difference between the 1953 and the 1954 value of imports is expected to be much smaller in the later months of 1954 than in January. The loss of dollar receipts will therefore probably reach only a fraction of the sum just mentioned.

## Conclusion

The U. K. balance of payments in 1953 was thus satisfactory both globally and in relation to the dollar area, and the first quarter of 1954 seems to have brought further improvement. These facts do not mean, however, that all danger of disequilibrium has passed. The country's international financial situation still suffers from the following weaknesses:

(1) The rise in U. K. gold and dollar reserves has been paralleled by a corresponding rise in sterling liabilities; the net reserve position of the United Kingdom -- even excluding sterling liabilities to the rest of the sterling area -- is still a negative figure.

(2) Three-fourths of the rise in gold and dollar reserves may be attributed to U. S. aid and military expenditures. Aid is rapidly decreasing and military expenditures are not a very satisfactory basis for permanent equilibrium although they may be expected to remain an important item in our balance of payments for a considerable time.

(3) The U. K. balances of trade and of payments are still protected by direct controls.

(4) The current account surplus (excluding U. S. aid) is still too small to provide a source of capital exports sufficient to satisfy the needs of the underdeveloped regions of the outer sterling area.

(5) The deficit in the current dollar balance of the United Kingdom (excluding U. S. aid) has to be covered primarily through a surplus in the current dollar balance of the outer sterling area; this surplus apparently has been declining since the middle of 1953.

These weaknesses may well endanger the country's international financial equilibrium in the case of unstabilizing developments in the world economy. Such developments may result from a number of contingencies, including the following:

(1) The adjustment in the U. S. economy may belie optimistic forecasts, or it may have delayed repercussions on other countries, which might lead to a drop in sterling area exports to these countries.

(2) A rapid recovery in the United States may increase prices of raw materials and foodstuffs and thus bring about a deterioration in the terms of trade of the United Kingdom; moreover, it may induce a reflux of capital from the United Kingdom to the United States.

(3) Some independent members of the outer sterling area may turn to policies that would involve a strain on their balance of payments and thus might constitute a drain on the gold and dollar reserves of the sterling area, administered by the United Kingdom.

(4) The increased "hardening" of sterling may induce other nations with inconvertible currencies to discriminate against sterling goods (outside of OEEC where such discrimination is outlawed).

At present, there is no indication that any of these contingencies might be imminent. However, their potential influence seems to justify a continuation of the present U. K. policy favoring a rather cautious approach to the elimination of trade and exchange restrictions, even though the balance of payments figures in themselves might warrant a somewhat more rapid rate of progress.

Table I

United Kingdom Balance of Payments, 1952-53

(In millions of pounds sterling)

| | 1952 | 1953 Total | 1953 1st half | 1953 2nd half |
|---|---|---|---|---|
| Imports (f.o.b.) | 2,943 | 2,872 | 1,465 | 1,407 |
| Exports & re-exports | 2,826 | 2,675 | 1,318 | 1,357 |
| Trade balance | - 117 | - 197 | - 147 | - 50 |
| Shipping (net) | + 106 | + 122 | + 66 | + 56 |
| Interest (net) | + 77 | + 49 | + 40 | + 9 |
| Government (net) | - 190 | - 157 | - 78 | - 79 |
| Other services (net) | + 241 | + 303 | + 129 | + 174 |
| Service balance | + 234 | + 317 | + 157 | + 160 |
| Total current balance | + 117 | + 120 | + 10 | + 110 |
| U. S. Government aid | + 138 | + 105 | + 58 | + 47 |
| Foreign investment (-) | - 84 | - 207 | - 48 | - 159 |
| Rise in (net) sterling liabilities (+) | - 346 | + 222 | + 166 | + 56 |
| Rise in gold and dollar holdings (+) | - 175 | + 240 | + 186 | + 54 |

Source: United Kingdom Treasury, United Kingdom Balance of Payments 1946 to 1953, Cmd. 9119.

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Table 2

United Kingdom and Outer Sterling Area Balance of Payments with Dollar Area

1952 - 53

(In millions of pounds sterling)

| | 1952 | 1953 Total | 1953 1st half | 1953 2nd half |
|---|---|---|---|---|
| U. K. imports (f.o.b.) | 605 | 516 | 254 | 262 |
| U. K. exports & re-exports | 411 | 446 | 216 | 230 |
| U. K. trade balance | -194 | -70 | -38 | -32 |
| U. K. service balance | -116 | -39 | +10 | -49 |
| Total U. K. current balance | -310 | -109 | -28 | -81 |
| Defense aid | +138 | +105 | +58 | +47 |
| U. K. capital balance 1/ | + 32 | + 24 | +23 | + 1 |
| Total U. K. balance | -140 | + 20 | +53 | -33 |
| OSA trade balance | - 14 | + 86 | +63 | +23 |
| OSA service & capital balance | + 52 | - 9 | -14 | + 5 |
| OSA gold sales | + 72 | + 79 | +31 | +48 |
| Total OSA balance | +110 | +156 | +80 | +76 |
| EPU area transfers (net) | -172 | + 18 | +34 | -16 |
| Other transfers (net) | + 27 | + 46 | +19 | +27 |
| Total transfers (net) | -145 | + 64 | +53 | +11 |
| Rise in gold & dollar holdings | -175 | +240 | +186 | +54 |

1/ Including change in sterling balances.

Source: United Kingdom Treasury, United Kingdom Balance of Payments, 1946 to 1953, Cmd. 9119.

Table 3

United Kingdom and Outer Sterling Area Balance of Payments with EPU Area, 1952-53

(In millions of pounds sterling)

| | 1952 | 1953 Total | 1953 1st half | 1953 2nd half |
|---|---|---|---|---|
| U. K. imports (f.o.b.) | 738 | 677 | 334 | 343 |
| U. K. exports & re-exports | 732 | 759 | 375 | 384 |
| U. K. trade balance | - 6 | + 82 | + 41 | + 41 |
| U. K. service balance | - 20 | + 22 | + 13 | + 9 |
| Total U. K. current balance | - 26 | +104 | + 54 | + 50 |
| U. K. capital balance 1/ | - 44 | - 60 | - 25 | - 35 |
| Total U. K. balance | - 70 | + 44 | + 29 | + 15 |
| OSA trade balance | + 63 | + 85 | + 59 | + 26 |
| OSA service & capital balance | - 43 | - 59 | - 27 | - 32 |
| Total OSA balance | + 20 | + 26 | + 32 | - 6 |
| Transfers (net) | - 19 | - 40 | - 10 | - 30 |
| Change in EPU position 2/ | - 69 | + 30 | + 51 | - 21 |

1/ Including change in sterling balances.

2/ Settled partly in gold or dollars and partly by change in EPU debit balance (Table 6).

Source: United Kingdom Treasury, United Kingdom Balance of Payments, 1946 to 1953, Cmd. 9119.

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Table 4

United Kingdom Balance of Payments with Outer Sterling Area, 1952-53

(In millions of pounds sterling)

| | 1952 | 1953 Total | 1953 1st half | 1953 2nd half |
|---|---|---|---|---|
| Imports (f.o.b.) | 1,242 | 1,314 | 695 | 619 |
| Exports & re-exports | 1,323 | 1,210 | 599 | 611 |
| Trade balance | + 81 | - 104 | - 96 | - 8 |
| Service balance | + 286 | + 283 | + 118 | + 165 |
| Total current balance | + 367 | + 179 | + 22 | + 157 |
| Capital balance | - 94 | - 158 | - 59 | - 99 |
| Transfers 1/ | - 162 | - 274 | - 173 | - 101 |
| Fall in £ liabilities | + 111 | - 253 | - 210 | - 43 |

1/ Including gold purchases.

Source: United Kingdom Treasury, United Kingdom Balance of Payments, 1946 to 1953, Cmd. 9119.

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Table 5

Official Gold and Dollar Holdings, 1951-54

| | | Millions of pounds sterling | Millions of dollars |
|---|---|---|---|
| 1951: | December 31 | 834 | 2,335 |
| 1952: | March 31 | 607 | 1,700 |
| | June 30 | 602 | 1,685 |
| | September 30 | 602 | 1,685 |
| | December 31 | 659 | 1,846 |
| 1953: | March 31 | 774 | 2,166 |
| | June 30 | 845 | 2,367 |
| | September 30 | 888 | 2,486 |
| | December 31 | 899 | 2,518 |
| 1954: | March 31 | 959 | 2,685 |
| | April 30 | 1,007 | 2,820 |

Source: United Kingdom Treasury, United Kingdom Balance of Payments, 1946 to 1953, Cmd. 9119.
International Monetary Fund, International Financial Statistics.

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## Table 6

### United Kingdom Sterling Liabilities, 1951-53

(In millions of pounds sterling)

| | Dec. 31 1951 | Dec. 31 1952 | June 30 1953 | Dec. 31 1953 |
|---|---|---|---|---|
| Liabilities to: | | | | |
| Dollar Area | 38 | 34 | 42 | 62 |
| Other non-sterling countries | 980 | 721 | 675 | 711 |
| Total non-sterling countries | 1,018 | 755 | 717 | 773 |
| U. K. Colonies | 968 | 1,076 | 1,134 | 1,161 |
| Other sterling area | 1,825 | 1,606 | 1,758 | 1,774 |
| Total sterling area | 2,793 | 2,682 | 2,892 | 2,935 |
| Non-territorial organizations | 566 | 567 | 566 | 509 |
| Total | 4,377 | 4,004 | 4,175 | 4,217 |
| Official holdings of non-dollar currency (-) | - 14 | - 40 | - 16 | - 10 |
| EPU debt (+) | 166 | 219 | 190 | 198 |
| Grand Total | 4,529 | 4,183 | 4,349 | 4,405 |

Source: United Kingdom Treasury, United Kingdom Balance of Payments, 1946 to 1953, Cmd. 9119.

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## Table 7

### Outer Sterling Area Balance with Non-Sterling Area, 1952-53

(In millions of pounds sterling)

| | 1952 | 1953 Total | 1953 1st half | 1953 2nd half |
|---|---|---|---|---|
| Trade balance with dollar area | - 14 | + 86 | + 63 | + 23 |
| Service and capital balance with dollar area 1/ | +124 | + 70 | + 17 | + 53 |
| Trade balance with EPU area | + 63 | + 85 | + 59 | + 26 |
| Service and capital balance with EPU area | - 43 | - 59 | - 27 | - 32 |
| Balance with rest of world | + 32 | + 92 | + 61 | + 31 |
| Net balance | +162 | + 274 | + 173 | + 101 |

1/ Including gold sales to United Kingdom.

Source: United Kingdom Treasury, United Kingdom Balance of Payments, 1946 to 1953, Cmd. 9119.
United Kingdom Treasury, Economic Survey 1954, Cmd. 9108.

Table 8

United Kingdom Foreign Trade, 1952-54

(In millions of pounds sterling)

| | | Exports (Including re-exports) | | | Imports (c.i.f.) | | | Balance | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | Total | Sterling Area | Non-Sterling Area | Total | Sterling Area | Non-Sterling Area | Total | Sterling Area | Non-Sterling Area |
| 1952: | 1st Quarter | 782 | 399 | 383 | 986 | 359 | 627 | - 204 | + 40 | - 244 |
| | 2nd Quarter | 665 | 308 | 357 | 918 | 360 | 558 | - 253 | - 52 | - 201 |
| | 3rd Quarter | 612 | 272 | 340 | 788 | 344 | 444 | - 176 | - 72 | - 104 |
| | 4th Quarter | 667 | 305 | 362 | 791 | 375 | 416 | - 124 | - 70 | - 54 |
| 1953: | 1st Quarter | 655 | 306 | 349 | 817 | 387 | 430 | - 162 | - 81 | - 81 |
| | 2nd Quarter | 654 | 302 | 352 | 875 | 407 | 468 | - 221 | - 105 | - 116 |
| | 3rd Quarter | 660 | 310 | 350 | 825 | 344 | 481 | - 165 | - 34 | - 131 |
| | 4th Quarter | 717 | 350 | 367 | 828 | 366 | 462 | - 111 | - 16 | - 95 |
| 1954: | 1st Quarter | 701 | 340 | 361 | 822 | 401 | 421 | - 121 | - 61 | - 60 |

NOTE: Figures differ from those presented in Tables 1-4 because they are based on trade rather than payments transactions and imports are computed c.i.f. rather than f.o.b.

Source: United Kingdom Board of Trade, Report on Overseas Trade, June 1953, March 1954. The Economist, May 1, 1954.

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Table 9

United Kingdom Trade with Dollar Area, 1952-54

(In millions of pounds sterling)

| | | Exports (Including re-exports) | | | Imports (c.i.f.) | | | Balance | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | Total 1/ | United States | Canada | Total 1/ | United States | Canada | Total 1/ | United States | Canada |
| 1952: | 1st Quarter | 91 | 50 | 26 | 211 | 117 | 72 | - 120 | - 67 | - 46 |
| | 2nd Quarter | 94 | 45 | 31 | 212 | 82 | 96 | - 118 | - 37 | - 51 |
| | 3rd Quarter | 89 | 40 | 36 | 158 | 53 | 87 | - 69 | - 13 | - 17 |
| | 4th Quarter | 102 | 45 | 39 | 141 | 64 | 65 | - 39 | - 19 | - 26 |
| 1953: | 1st Quarter | 93 | 42 | 35 | 132 | 71 | 51 | - 39 | - 29 | - 16 |
| | 2nd Quarter | 108 | 45 | 48 | 164 | 67 | 73 | - 56 | - 22 | - 25 |
| | 3rd Quarter | 102 | 45 | 39 | 181 | 52 | 104 | - 79 | - 7 | - 65 |
| | 4th Quarter | 101 | 40 | 39 | 156 | 63 | 76 | - 55 | - 23 | - 37 |
| 1954: | 1st Quarter | 90 | 39 | 32 | 129 | 62 | 51 | - 39 | - 23 | - 19 |

1/ Including rest of dollar area

NOTE: Figures differ from those presented in Table 2 because they are based on trade rather than payments transactions and imports are computed c.i.f. rather than f.o.b.

Source: United Kingdom Board of Trade, Report on Overseas Trade, June 1953, March 1954. The Economist, May 1, 1954.

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Samuel I. Katz

Comments on the Wider Transferability of Sterling


## Summary

On March 22, 1954, the United Kingdom removed all restrictions on transfers of sterling among transferable accounts (and the former bilateral accounts) 1/ and on transfers from those accounts to accounts of sterling area residents. 2/ Sterling payments are permitted for capital as well as current transactions. Transfers from accounts of sterling area residents to transferable accounts and transfers from transferable accounts to accounts of residents of the dollar area remain subject to special license.

One effect of this action was to end British restrictions on the sale in markets outside the United Kingdom of transferable sterling for dollars (or any other currency) to transferable account residents. As a result, holders of transferable sterling may now use such foreign exchange markets to convert sterling into dollars at only a minor discount below the spot rate, provided the transaction is permitted by the exchange regulations of the countries involved.

However, direct convertibility of the pound, in the sense in which the term is usually understood, is not facilitated by the changes. That is, the Bank of England will not convert transferable sterling into dollars for foreign monetary authorities nor will it permit transferable sterling to be accepted in payment for Britain's exports to the dollar area. Transferable accounts can still be held only in the names of residents of transferable countries. In addition, discriminatory import controls against imports from the dollar area continue in effect in all the sterling countries (except South Africa).

Despite these limitations, the United Kingdom, by widening the transferability of sterling, has assumed substantial risks since the framework of exchange controls for the policing of transferable sterling has been dismantled. If a wide discount on transferable sterling were permitted to reappear, this would make it profitable once again for United States importers


1/ A detailed summary of the various categories of sterling is to be found in an Appendix to this note.

2/ Hungary, Persia, and Turkey are temporarily excluded from the transferable account area; however, it is expected that this discrimination will be lifted when existing financial negotiations between these countries and the United Kingdom are successfully conducted.

to use it to pay for sterling area raw materials, as was done in 1948 and 1949, through circuitous ("cheap sterling") operations, and the United Kingdom would find it more difficult than in earlier years to check the resultant losses in its dollar receipts.

Since the British authorities are aware of the danger of cheap sterling trading, they would not have relaxed these controls unless they were confident that the present comfortable position of the sterling area's balance of payments could be maintained. Indeed this is one of the most significant implications of the move. Should its external position become less favorable, the United Kingdom might be forced to take steps to prevent a weakening in the transferable rate, either through direct support operations by the Bank of England (which might amount to a sort of "convertibility") or through increased restrictions against outpayments of sterling to transferable countries (such as tighter import controls), or through a reimposition of foreign exchange restrictions limiting the area of transferability of the pound.

## Britain removes restrictions on use of transferable sterling

Under the March 22 amendments to its exchange regulations, residents of transferable account countries -- that is, a group which now includes 48 countries outside the dollar and sterling areas -- may use their current sterling receipts for payments to other residents of a transferable country or of a sterling country without reference to the Bank of England. However, the Bank of England does not assume any responsibility for providing facilities for converting such sterling into dollars.

Outside the United Kingdom, foreigners do not run counter to British regulations when they sell transferable sterling to other residents of a transferable account country for dollars at the official par or at free market prices. In fact, such transactions have been facilitated by three specific relaxations in Britain's regulations: (a) payments of transferable sterling may now be freely made on capital as well as current account; (b) foreign central banks are no longer requested to police the use of transferable sterling and (c) the number of transferable accounts at British banks is no longer limited.

Wider sterling transferability does not involve any direct dollar liability nor any direct risk of gold or dollar losses by the Bank of England since transferable sterling may not be credited to any convertible sterling account. However, it does increase the risk of indirect dollar losses to the extent that it widens the possibility and removes some of the stigma attached to "cheap" sterling transactions. Indirect conversion into dollars may be made as hitherto in the United Kingdom through the purchase of dollar area raw materials through the commodity markets. 1/

In addition, with the reopening of the London bullion market, which also took place on March 22, transferable account residents are able for the first time since the war to hold convertible ("registered") sterling which may be used to buy gold or to be converted into dollars and can of course be invested in the London market.

The limited volume of the sterling in foreign hands made it possible for Britain to allow a wider transferability. This shortage of foreign-held sterling grew out of the large 1953 balance of payments surplus of the sterling area resulting partly from the competitiveness of Britain's exports at the current exchange rate. However, sterling area restrictions have contributed to this shortage, because residents in the sterling countries can make payments to a transferable account only for transactions approved by their local authorities.

The United Kingdom prohibits the receipt of transferable sterling in payment for its exports to the dollar area; the other sterling countries and virtually all foreign countries have similar prohibitions on receipts of sterling for exports to the dollar area. Despite these prohibitions, however, residents in the dollar area may evade some of these restrictions and use transferable sterling for non-trade payments to sterling or transferable account countries, through subsidiaries or agents domiciled in a transferable country. The United Kingdom apparently has no objection to the use of transferable sterling for any type of payment (whether for trade or capital account) which does not involve crediting it to one of the accounts of the dollar area.

## Transferable sterling can be converted in the market into dollars at a small discount

Since transferable sterling was quoted at around \$2.79-1/4-1/2 for the week ending April 23 compared with a spot rate of \$2.81-13/16-7/8, it might be argued that the British have in fact virtually achieved convertibility. In this view, the narrow discount on transferable sterling is taken to indicate that the risks of full convertibility are much less than commonly supposed.

However, transferable sterling still has a restricted market. The demand is limited by the fact that all sterling countries and most other countries forbid their exporters to accept such sterling in payment for shipments to the dollar area. Market supply is limited by the fact that foreign

1/ An expansion in the range of such transactions is expected. For example, it is expected that British merchants will soon be allowed to buy dollar goods in a transferable account country for resale to another transferable country but not where eventual resale to the sterling area is suspected (since sale to a sterling country would mean an accrual of sterling to the credit of a transferable account without an import license).

countries in general require sterling earnings to be sold to the central bank and that the central banks do not leave more than working balances in sterling in private hands nor do they themselves sell sterling in the free market.

It is true that foreign monetary authorities could nevertheless get rid of transferable sterling and acquire dollars -- if they wanted to do so -- without themselves selling transferable sterling in the free market at a discount. They could, for instance, permit exporters to dispose of their receipts of transferable sterling for dollars while the central banks would use their own holdings to pay for the country's sterling imports. There is no evidence that such actions are being taken or considered anywhere in the world. However, the possibility of such actions suggests the conclusion that the British authorities do not primarily depend on the expectation that foreign monetary authorities would immobilize their excess holdings of sterling.

In any case, the free market cannot be ignored as a measure of the foreigners' valuation of the pound. If the supply offered for dollars at current rates exceeded the restricted demand, the market quotation would decline. Thus, the stability of the transferable sterling quotation at around $2.79-3/8 indicates that holders are in general unwilling to take a discount of about 1 per cent in order to obtain dollars. It is possible that foreigners hold some transferable sterling as a speculation, seeking a profit from the expected elimination of this discount, and that with official convertibility the supply of sterling might be substantially increased. However, it seems more likely that under existing conditions the paucity of offerings at a 1 per cent discount suggest that there might not be a great rise in supply in the event of official convertibility.

## How convertible is sterling?

If convertibility is defined in terms of holder's being able to convert transferable sterling into dollars at a price within the IMF margin of the par value, transferable sterling is now convertible on a market basis. 1/

Even so, the wider transferability of sterling, which has facilitated this *de facto* convertibility as defined above, has not involved the United Kingdom in two major types of risks inherent in a more broadly defined convertibility operation. In the first place, the Bank of England has no obligation to make possible such convertibility at the current or at any other price nor

1/ This is, however, a dual price convertibility. The price at which residents outside the dollar area can convert sterling into dollars in the free market is, of necessity, somewhat less favorable than the rate assured to dollar area residents by the Bank of England.

does it assume any dollar liability for transferable sterling. Secondly, British banks may not accept transferable sterling (in place of dollars) in payment for exports to the dollar countries. (For discussion of convertible pound with a floating rate, see final paragraphs of this paper).

The new regulations did not affect the restrictions on blocked ("security" or "switch") sterling held by foreign residents. This sterling can be used only to buy sterling area securities, but it has been saleable to other non-Britishers for dollars at a discount since the end of the war. Sales of security sterling do not at present involve a dollar drain on the United Kingdom, since the purchasing foreigner must be willing to hold a sterling security in an approved (British) depository under British control. It would be possible for the United Kingdom to maintain controls over these accounts or any other form of withdrawal of capital from the sterling area even after convertibility of current sterling earnings was established.

Emphasis on the risks which were not assumed by the Bank of England as a result of the widened transferability should not obscure the importance of the added risks which have been assumed. If the discount on transferable sterling should widen, foreigners could more easily than hitherto deprive the sterling area of dollar receipts through cheap sterling transactions.

During 1948 and 1949, discounts of between 5 and 10 per cent, depending upon the commodity, where sufficient to cover the additional transshipment and documentation and to compensate for the special risks involved in such circuitous transactions. The new regulations create widened possibilities for such commodity shunting, provided only that transferable sterling goes to a sufficient discount. In particular, the recent shift in the attitude of the Bank of England no longer opposing trading in discount sterling by United States banks would provide better banking facilities for such operations and remove the "black market" stigma of such transactions.

The combined effect of these potential dangers is sufficient to warrant the conclusion that the wider transferability of sterling is more than a technical change in Britain's exchange regulations. Having decided to widen the transferability of sterling despite these dangers, the British authorities must be confident that the present strength of the sterling area's balance of payments will be maintained. Should these expectations be disappointed, the United Kingdom might have to take steps to prevent a weakening in the transferable rate, either through direct support operations by the Bank of England (which would then provide convertibility at British expense), or through increased restrictions against sterling area merchandise imports from the transferable countries, or through a reimposition of exchange restrictions limiting the area of transferability of the pound.

The main differences between the present de facto (market) convertibility of transferable sterling and de jure (by Bank of England) convertibility of all foreign-held sterling may be summarized as follows:

1) As long as the Bank of England maintains a fixed par value for the pound, with the obligation to keep the dollar rate of convertible sterling within 1 per cent of par, convertibility would impose on the Bank the duty of preventing sterling from falling below par, while at present the Bank has no commitment to maintain any price for transferable sterling.

2) Should the Bank of England decide to abandon the par value of sterling when it became convertible, it would theoretically be at liberty to let the market determine the dollar price of sterling, exactly as the dollar price of transferable sterling is determined at present. However, in two basic points the situation would still be different from the present situation:

First, the present limitations on the pound-dollar market would be abolished: the Bank of England would presumably accept sterling payments for exports to the dollar area as well as to the present transferable sterling area and all foreign central banks would permit the use of sterling in transactions with the dollar area. This widened use of (transferable) sterling might be a source of strength, but under unfavorable circumstances it could become a source of weakness for the pound-dollar rate.

Second, a drop in the pound-dollar rate would have far more important effects on the British economy. At present, a drop in the dollar price for transferable sterling by, say, 10 per cent would probably mean that "cheap" sterling transactions would again become profitable. The resultant dollar loss would probably be rather limited since Britain's imports from the dollar and other areas would continue to be paid at the official rate for convertible sterling. With a floating pound, however, an identical drop in the dollar rate of (convertible) sterling would increase the sterling costs of all foreign goods imported into the British and other sterling economies.

The Bank of England would be sensitive to a widening of the spread between the official and transferable rate which would revive "cheap sterling" transactions and endanger confidence in sterling; however, it would be under greater compulsion to intervene in the market in order to avoid changes in the costs of imports than it would in the case of a corresponding decline in the dollar price of transferable sterling.

For these reasons, the risk of economic disturbances to the sterling countries would be greater in the case of de jure convertibility (by the Bank of England), even with a floating rate, than under the present system of a de facto (market) convertibility of transferable sterling.

## APPENDIX

### Summary of United Kingdom Exchange Control Regulations Prior to March 22, 1954

1. Resident (sterling area) Accounts.

   Held by resident of any sterling area country.

   Such sterling could not (and cannot now) be transferred to other types of accounts or converted into dollars except for transactions approved by the local authorities of the sterling country.

2. Dollar area (American and Canadian) Accounts.

   Held by residents of United States, Canada, 14 Latin American countries, Philippine Islands and Liberia.

   Such sterling could (and can now) be converted into dollars or transferred to other sterling accounts at holder's option.

3. Transferable Accounts.

   Held by residents of 18 non-dollar countries, including 8 countries within the European Payments Union, 3 Communist countries, and 7 other countries.

   Such sterling could be transferred at holder's option for "direct current transactions" (as determined by the local monetary authorities) to any other transferable account or to any sterling area account. Payments to any other type of sterling account required specific approval of the Bank of England for each individual transaction.

4. Bilateral Accounts.

   Held by residents of some 30 non-dollar countries, including a group of countries with strong currencies (such as Switzerland, Belgium and Portugal), a large number of countries with soft currencies (such as Brazil, Turkey, and Argentina), and a miscellaneous group of countries where special considerations led the United Kingdom to desire to segregate financial transactions (such as China, Yugoslavia, Iran, and Hungary).

Such sterling could be transferred at holder's option only to sterling area accounts. Payments to any other country (whether dollar or transferable or even any other bilateral account country) required specific approval by the Bank of England. In actual practice, the British authorities have been allowing a wide measure of "administrative transferability" for bilateral sterling.

5. Unclassified Accounts.

Held by resident of 7 countries (Afghanistan, Albania, Andorra, Nepal, Saudi Arabia, and Yemen).

Such sterling could be transferred to sterling area or other "unclassified" accounts.