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Recent Developments in the Sterling Exchange Market
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Recent Developments in the Sterling Exchange Market

The downward drift in the foreign exchange value of the pound, which commenced in August 1954, was largely the outgrowth of the usual seasonal pressure upon sterling during the third quarter, the heavy capital inflow into London of last spring, and some disappointment at Britain's decision not to undertake full convertibility immediately. However, market confidence in the sterling outlook was reflected in the premium recorded for forward pounds over spot pounds during the period when spot sterling was declining.

The pound's recent declines have come after a prolonged period of strength which commenced in the fall of 1952, about six months after the severe loss of reserves during the 1951-52 crisis had been halted. After reaching a low of around $2.7827 in September 1952, the pound rose to $2.8059 by December and averaged $2.8127 for the twelve months of 1953. During this period, the British authorities reiterated their intention to restore the full convertibility of sterling and, to this end, introduced a series of relaxations of exchange and trade controls; the liberalizations affected both the use of sterling by residents of the Sterling Area and by foreign residents in non-dollar countries.

The recent exchange control relaxations introduced by Britain on March 22, 1/ which contributed to the second-quarter capital inflow, have resulted in widened use of sterling for payments by foreigners, including financing between Europe and North America. The present halfway house toward convertibility provides the United Kingdom with certain advantages combined with only minimal risks; in particular, the United Kingdom is able to maintain simultaneously a fixed dollar rate for merchandise imports and exports, and a fluctuating rate for transactions by foreigners on capital or current service account. Foreigners also find the present flexibility attractive: they can now freely move from sterling (whether transferable, security or American-Account) into gold or dollars at only minor discounts. Nevertheless, the United Kingdom has continued to take further steps to reduce controls over foreign payments and to relax discriminatory trade restrictions. Thus, the movement toward a freer trade and payments system remains a major goal of the United Kingdom's international economic policy.

Weakness of sterling in the third quarter of 1954

After remaining relatively stable with the monthly average for spot sterling fluctuating only between $2.811 and $2.818 from January to July, the pound drifted downward during the third quarter of 1954. With only a minor interruption, the spot pound fell from $2.181 in early August

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1/ See my paper on "Comments on the Wider Transferability of Sterling", May 11, 1954.

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to a low of $2.792 at the end of September, as may be seen in the chart. Thereafter, a recovery occurred during early October but was interrupted by a further period of weakness around the middle of the month and again in early November.

The strength of forward sterling has been in marked contrast with the weakness of spot sterling throughout the quarter, as may be seen in the lower section of the chart where the quotation on 90-day forward sterling is compared with the movement of the spot quotation. As spot sterling commenced to weaken in the summer, the discount of 3-month forwards narrowed perceptibly and by the latter part of August had been replaced by virtual parity; a small premium of forward over spot was maintained during September and became slightly larger during October but by November had virtually disappeared.

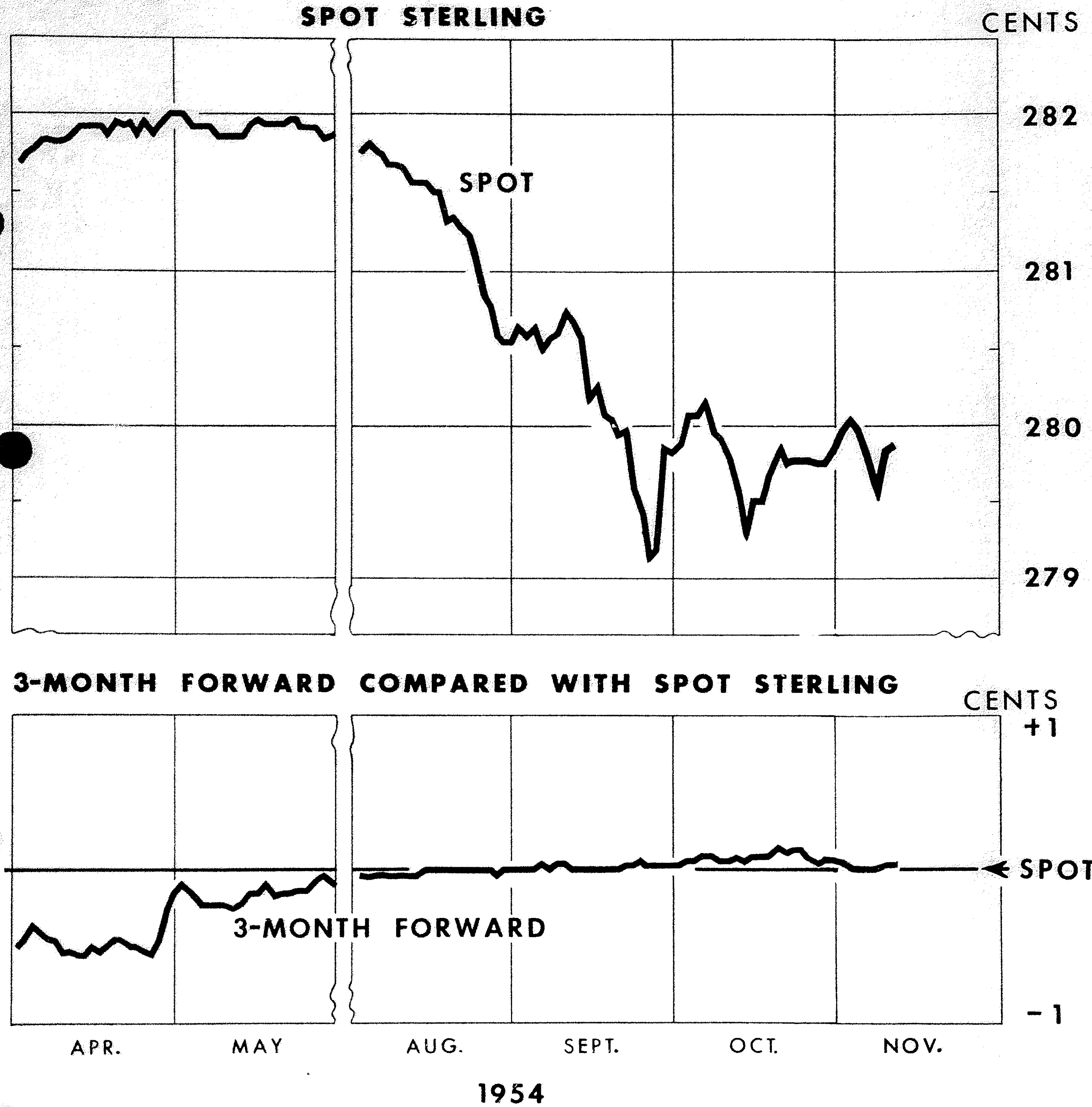
This weakness of the pound rate was partly seasonal in character. The United Kingdom's outpayments, particularly for imports of primary products from the dollar area are normally heavy during the late summer months. Furthermore, the sterling area's dollar earnings from exports to North America are at a seasonal low point for the year. However, the recent declines also appear to be influenced by the aftereffects of the heavy short-term capital movement into sterling which occurred last spring.

Short-term capital movement in the spring of 1954

A series of liberalizations of exchange regulations by the U. K. was responsible for the heavy movement into sterling which is reflected in the marked growth in the current gold and dollar surplus shown in Table I. The rise in Britain's current balance first occurred in March in connection with: (a) the reopening of the private London gold market; and (b) the consolidation of the various types of sterling into a single category of foreign-held sterling for residents outside the dollar and sterling areas. The movement of funds to London for operations in the gold market helps to account for the sudden rise in Britain's current dollar surplus from $9 million in February to $88 million in March.

Thereafter, the movement into sterling was even more spectacular. Rumors in the foreign exchange market that the spread for spot sterling might be widened from the existing range of $2.78 - 2.82 to a range of $2.75 - 2.85 produced an inflow of funds into sterling which contributed to surpluses of $126 million in April and $159 million in May. This movement was largely the result of United States commercial interests anticipating their foreseeable sterling needs through futures contracts with their commercial banks. In addition to merchant purchases of sterling,

STERLING RATES IN NEW YORK MARKET



there was "a fairly steady influx of foreign funds (into London), apparently stemming from the fact that interest rates in (the United Kingdom) now compare favorably — from the viewpoint of the lender — with those obtaining in many overseas centers." 1/

This inflow was particularly heavy during the final days of April. The pound broke "through the upper control level of $2.82" on April 30, and "at $2.82-1/32 the pound was at its highest point reached since devaluation in September of 1949." 2/ The effects of the late April movement are also found in the substantial reduction in the discount for 3-month forward contracts shown in the bottom section of the chart. This discount narrowed progressively from April 28 until on May 3 it became only 3-32 below the spot rate.

The market pressure on sterling eased during May, partly as a result of an official British statement on May 3 that the rumors about the United Kingdom being about to ask the International Monetary Fund to allow a wider spread on the sterling-dollar rate were "quite unfounded." 3/ In consequence "spot sterling was in much less demand in the first week of May than in the final week of April." 4/ Finally, on May 14, the Bank of England reduced its discount rate in a move to bring the general level of London money market rates more in line with those prevailing in New York and continental financial centers.

It is difficult to obtain from available statistics an exact measure of the volume of the movement into sterling. Official United States statistics on short-term capital movements show a movement into the United Kingdom of some $30 million during April and a return flow of around $10 million during May. But these figures appear to be inconsistent with the marked improvement in Britain's current balance during April and May, as shown in Table I.

The fact that the May increase in reserves was substantially larger than the rise in April may in large measure have been the result of a technical accident. When United States importers covered their future sterling needs during the last two days in April, commercial banks

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1/ Financial Times (London), May 1, 1954 page 4.

2/ The New York Times, May 3, 1954, page 35.

3/ Financial Times (London), May 4, 1954, page 1.

4/ The New York Times, May 10, 1954, page 30.

that had entered into futures contracts to accommodate their customers had to buy spot sterling to cover these commitments; the relative scarcity of forward sterling sales offered at the time was reflected in the narrowing of the discount on 3-month forward. These spot purchases by the banks, which took place on April 29 and 30, were delivered, according to market practice, on May 3 and 4; hence, these transactions were not incorporated in the official figures of the United Kingdom or of the United States which reflected the position at the close of business on April 30.

The American banks invested their spot sterling funds in London at the more attractive London yields, mainly in 21-day (interest-bearing) deposits and in Treasury bills. But the limited availability of American banking funds for investment in London probably provided a powerful incentive for these banks to attempt to work off their unbalanced sterling position; by taking advantage of future sterling offerings as they appeared, they were able to reduce the proportion of contracts covered by spot sterling held as London deposits.

Aftereffects of the capital movement

From August on, there has been a sustained decline in the spot rate and a relative firming of forwards quotations in relation to the spot rate, as may be seen in the chart. This downward drift of spot sterling seems to reflect the over-bought position of American importers as well as heavy seasonal payments by Britain for dollar merchandise. Supplies of spot sterling during the past three months were augmented by some American commercial interests which found that they had no immediate need for the sterling maturing under futures contracts entered into last April. Furthermore, the statements at the Fund and Bank meetings in Washington in late September that convertibility of sterling was not an early possibility contributed to the pound's weakness. For example, London reported "selling of sterling by Middle and Far Eastern interests, which had rushed in when the pound was displaying strength in the late spring, in the belief that convertibility was then near at hand." 1/

The relative strength in the forward quotations suggest that many of these importers are renewing their forward position, either in anticipation of needs over the coming six months of heavy sterling area exports to the United States or as a means of having a firm price for distributing raw materials and other sterling merchandise; their alternative to renewal would be to liquidate their losses on the former contracts. Since American interests have not chosen to maintain an uncovered sterling position, the strong forward position reflects market optimism about the prospects of the pound. Sterling purchased now would normally be spent during the usual seasonal expansion in the months to come, but a marked falling off of American demand or a curtailment in British deliveries growing out of the recent dock strike could protract the weakness of spot sterling.

1/ Financial Times (London), September 29, 1954, page 4.

Declines in transferable and security sterling have accompanied the decline in spot sterling. Transferable sterling was quoted at about \$2.77-1/16 at the end of July, \$2.76-1/2 at the end of August, \$2.73-1/8 at the end of September and at \$2.72-1/2 on November 9. The comparative quotations for security sterling were \$2.73-1/2 at the end of September and \$2.72-1/4 on November 9.

The weakness of transferable sterling has been particularly pronounced since September and has been attributed to the relaxation of European restrictions on exchange transactions and on dollar purchases. Transferable sterling has "felt the effect of commercial demand for dollars, a demand accentuated this year by the operations of Continental importers of dollar goods and commodities." 1/ In addition, Germany's recent unfreezing of blocked mark balances held by foreigners may have resulted in capital withdrawal into transferable sterling and then into dollars. The weakness in security sterling seems to reflect the declines in transferable sterling since there is a general tendency for the security and transferable sterling markets to move together.

Two rates for sterling

At present, Britain maintains both a fixed and a "floating" dollar rate for the pound sterling. The "floating" pound rate, reflected in the discount quotations for transferable and security sterling, is being used for current and capital transactions between Europe and North America. The ease with which foreigners can use sterling for any type of transaction not requiring direct British authorization means that the present halfway house to full convertibility is functioning smoothly. For example, funds can be switched between security, transferable and spot sterling and dollars and gold; it is also possible to obtain forward quotations on discount sterling as well as on convertible sterling.

Such flexibility in the use of sterling has attractions for foreigners and, in view of the minimal risks, also for the United Kingdom. For example, the United Kingdom is able to maintain a fixed rate for merchandise imports and exports and a fluctuating rate for capital and service transactions by foreigners. In addition, Britain has undertaken no irreversible commitment, as would be involved in establishing convertibility; its liability to purchase sterling for gold or dollars under present arrangements is rather limited.

1/ Financial Times (London), October 18, 1954, page 4.

The freedom granted foreigners to use transferable sterling could create difficulties for the United Kingdom only if the discount on transferable sterling were to decline sufficiently to make commodity shunting on a substantial scale attractive. This would require a discount of at least 5 to 10 per cent, depending upon the commodity and the countries involved, if Britain's 1949 experience with discount sterling is taken as a valid precedent. Thus far, the largest discount has been about 2 1/2 per cent.

Should the discount widen sufficiently to make commodity shunting attractive once again, the United Kingdom would be confronted with a serious threat to the existing exchange structure. The relaxations in exchange regulations instituted in March 1954 effectively preclude the possibility of supporting a weakening transferable sterling through extensive administrative regulations by the United Kingdom and, upon British request, by foreign monetary authorities. Consequently, the United Kingdom might well be forced to decide whether to intervene actively to support a falling transferable pound by substantial market purchases against dollars. The only possible alternative would seem to be the abandonment of the recent exchange relaxations and a return to the pre-1954 system of restrictions -- a major reversal of basic economic policy with serious effects on the entire domestic and international economic and political situation.

However, if the monetary authorities attempted to support the transferable pound by market purchases, the United Kingdom would have in effect convertibility for foreign-held sterling into dollars or into gold at dual (and partly fluctuating) rates of exchange in a market where the United Kingdom itself would be a significant supplier of dollar exchange. Such purchases would not only involve a direct drain on Britain's foreign exchange reserves but might also raise the question of whether they would not violate the restrictions against multiple currency practices in the Articles of Agreement of the International Monetary Fund. 1/

In the meanwhile, the United Kingdom has continued to reduce controls over payments and trade. In October the basic allowance for personal travel in non-dollar countries authoritzed under the exchange regulations was doubled and legacies to non-residents largely freed from the restrictions on capital transfers. These measures indicate that the British authorities are taking advantage of the current stability of sterling to make further progress in freeing the pound as an international currency and, hence, in preparing the way for the ultimate full convertibility of sterling.

1/ Article VIII, Section 3 prohibits a member country from engaging in "multiple currency practices" except as authorized by the Fund.