

ESSAYS IN INTERNATIONAL FINANCE

No. 26, August 1956

TWO APPROACHES TO
THE EXCHANGE-RATE PROBLEM:
THE UNITED KINGDOM AND CANADA

SAMUEL I. KATZ



INTERNATIONAL FINANCE SECTION

DEPARTMENT OF ECONOMICS AND SOCIOLOGY

PRINCETON UNIVERSITY

Princeton, New Jersey

*This is the twenty-sixth number in the series ES-
SAYS IN INTERNATIONAL FINANCE published from
time to time by the International Finance Section of
the Department of Economics and Sociology in
Princeton University.*

*The author, Samuel I. Katz, is an economist in
the Division of International Finance of the Board
of Governors of the Federal Reserve System. The
conclusions in this essay, however, represent his per-
sonal opinions and do not reflect the views of the
Federal Reserve Board.*

*The Section sponsors the essays in this series but
takes no further responsibility for the opinions ex-
pressed in them. The writers are free to develop their
topics as they will. Their ideas may or may not be
shared by the editorial committee of the Section or
the members of the Department.*

*The submission of manuscripts for this series is
welcomed.*

GARDNER PATTERSON, *Director*
International Finance Section

ESSAYS IN INTERNATIONAL FINANCE

No. 26, August 1956

TWO APPROACHES TO
THE EXCHANGE-RATE PROBLEM:
THE UNITED KINGDOM AND CANADA

SAMUEL I. KATZ

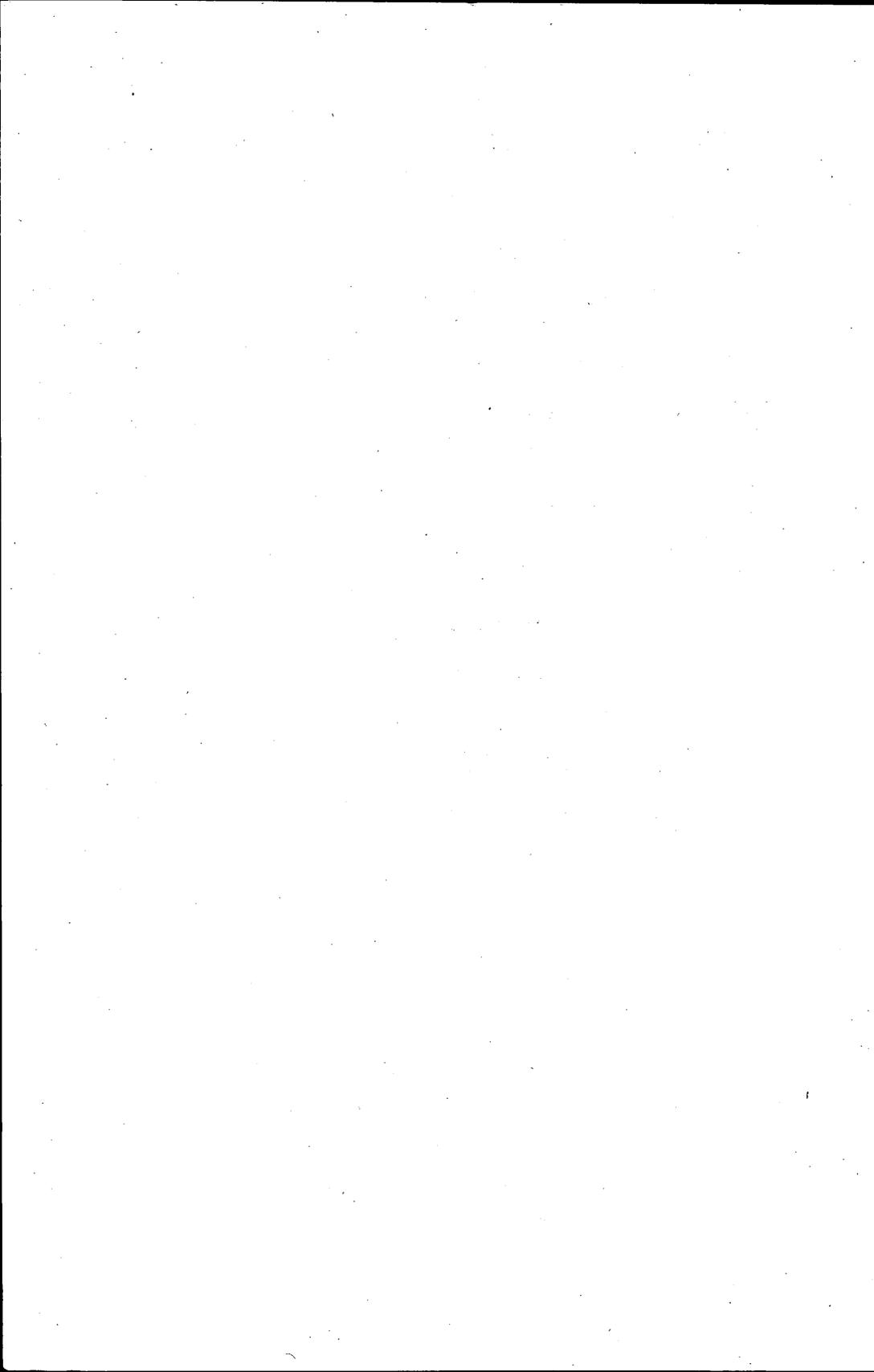


INTERNATIONAL FINANCE SECTION

DEPARTMENT OF ECONOMICS AND SOCIOLOGY

PRINCETON UNIVERSITY

Princeton, New Jersey



TWO APPROACHES TO THE EXCHANGE-RATE PROBLEM: THE UNITED KINGDOM AND CANADA*

INTRODUCTION

THE Bretton Woods Agreement of 1944 envisioned for the post-war world a system of stable exchange rates. Under the Articles of the International Monetary Fund, member countries are obligated to declare a par value for their currencies and to establish maximum and minimum rates for spot exchange transactions within one percent on either side of the par value. The member is expected to propose to the Fund changes in the par value only to correct a fundamental disequilibrium in the balance of payments.

The adoption of exchange stability as a major goal of the International Monetary Fund was designed to avoid disorderly exchange markets and competitive exchange depreciation. The exchange arrangements set up at Bretton Woods, with declared par values and with announced limits within which rates may fluctuate, resemble in expected outcome the former gold standard, under which currency values were defined in terms of gold and market rates fluctuated narrowly within gold points determined by the actual cost of shipping gold between financial centers.

The advantages of this type of fixed exchange system are like those of the traditional gold standard. Limited uncertainty about rates is thought to facilitate merchandise trade and to permit commodity flows to be determined, within existing tariffs and trade controls, primarily by relative market prices. The fixed par values simplify long-term capital investment decisions and, since only limited fluctuation in rates is possible, short-term funds may move in response to very slight interest rate differentials.

Just as the major controversy during the pre-1939 period in the field of exchange rate policy concentrated on the relative merits of the traditional gold standard and of flexible exchange rates, so the primary

* The writer is indebted to Mr. J. Herbert Furth for discussions of the problems in this essay over an extended period and to Mr. Wendell E. Thorne for suggestions on the organization of the material. He is indebted to Professor Edward Campion Acheson of the George Washington University who introduced him to problems of foreign exchange.

controversy in this field after 1945 centered on the relative effectiveness of fixed and fluctuating exchange rate policies. Economists opposed to the rigidities of the gold standard and other types of fixed exchange arrangements were critical of the Bretton Woods system because they were not satisfied that the economic arguments favored a policy of fixed rates. The proponents of exchange flexibility held that forward exchange contracts could eliminate most of the uncertainty of rates for the merchant, and that rate fluctuations would be less disturbing than commodity price movements. They also suggested that impediments to trade were produced by economic distortions growing out of attempts to maintain fixed rates in an unbalanced world economy where the various nations were not prepared to adjust conflicting domestic policies.

The fixed rate system was associated in the years after 1945 with stringent controls since most Fund members emerged from the war with comprehensive controls over foreign trade and payments. During the war and early postwar years, foreign exchange transactions were closely regulated in the United Kingdom and Canada, as in nearly all other belligerent countries. In both countries, the central banking authorities were committed to operate in foreign currencies at fixed buying and selling prices, with only nominal spreads between the two quotations. In turn, commercial banks dealt with customers in foreign currencies at the official rates and received a handling commission which varied with the amount of the transaction. Only in financial centers outside these countries were there free markets for the pound and the Canadian dollar, and both currencies tended to be quoted in these markets at a discount against the United States dollar.

In 1950, in a major departure from wartime arrangements, Canada suspended the par value of its currency and adopted a flexible exchange policy. Since then, the Canadian dollar has remained a fluctuating currency while the British pound has continued to have a par value and a fixed spread for spot transactions. The recent experience of Britain and Canada, particularly since this divergence in exchange practice began, throws light on the question of fixed and fluctuating exchange rate policies under the economic conditions prevailing in the past few years.

MOVES TOWARD EXCHANGE-RATE FLEXIBILITY IN CANADA AND THE UNITED KINGDOM

Faced with an inflow of speculative funds from the United States, which had been attracted by the expectation that the Canadian currency would be appreciated, the Canadian authorities decided to allow their dollar to become a fluctuating currency on September 30, 1950. In place

of a fixed par value and official buying and selling rates, the exchange rate for foreign currencies was to be determined by market forces. Since the prewar market disappeared when wartime exchange control was introduced in 1939, this action required the restoration, under emergency conditions, of a private foreign-exchange market in Canada. At the request of the Canadian authorities, the banking community was able to restore private trading in foreign exchange over a single weekend. This step was very important in setting into motion the recent trend toward greater exchange flexibility.

Thereafter, the Canadian authorities proceeded step-by-step to dismantle administrative controls over foreign transactions. By early 1951, the import restrictions which had been instituted for balance-of-payments considerations had been removed. Finally, on December 14, 1951, the authorities were able to announce the abolition of all exchange controls.

Three days later, on December 17, 1951, the United Kingdom re-established private exchange trading in London. Private traders were allowed to deal with each other in spot exchange within a widened official range and in future deliveries at market prices without any official supports. The Bank of England widened the spread in its buying and selling rates for spot United States dollars from $\frac{1}{4}$ of 1 U.S. cent ($\$2.79\frac{7}{8}$ to $\$2.80\frac{1}{8}$) to 4 U.S. cents ($\2.78 to $\$2.82$), and authorized private trading for bona fide commercial transactions within that range.

However, this increased flexibility applied only to the limited volume of technically convertible American or Canadian account sterling. It was not until March 1954 that the much more substantial volume of non-convertible sterling was affected: some 48 different kinds of currently-earned non-convertible sterling accounts were merged into a unified transferable account. Residents in any of these transferable-account countries—that is, all countries outside the dollar and sterling areas—were permitted to use current earnings of sterling to make payment to any resident of the transferable or sterling areas without reference to the Bank of England.

Three countries (Hungary, Iran, and Turkey) which were left on a bilateral basis in March 1954 because of special difficulties were later included in the transferable area.

In addition, the London bullion market was reopened and a new type of convertible pound (called "Registered Account") was created for the settlement of transactions in gold by residents of transferable-account countries. Simultaneously, the United Kingdom dismantled much of the administrative machinery which had been established to

prevent the sale of non-convertible pounds for dollars. In particular, such transactions were made less difficult by three specific relaxations in Britain's regulations: (a) payments of transferable sterling could be freely made on capital as well as on current transactions; (b) foreign central banks were no longer requested to police the use of transferable sterling; and (c) limitations on the number of transferable accounts which foreign countries could maintain at British banks were removed.

With these changes, the United Kingdom was able to reach a half-way mark toward full convertibility. Foreign holders of non-convertible pounds found that they could shift between (spot) pounds and dollars and gold. In fact, *The Economist* for July 17, 1954 noted that "any non-resident acquiring current sterling—or even capital sterling—has been able to exchange it for any currency he wanted, and in recent months he has been able to do so almost without loss."

This *de facto* convertibility imposed no direct dollar liability on the Bank of England; transferable pounds could not be credited to a convertible sterling account, and they could not be swapped for dollars in London. A further step in the direction of convertibility, involuntary in character, and one which imposed an additional liability on the central gold and dollar reserves, was taken in February 1955 when Chancellor Butler authorized the Exchange Equalization Account to operate in foreign markets in support of the transferable pound. This step became necessary because the discount on transferable sterling widened to nearly 3 percent in the early part of 1955 and foreign residents once again found it profitable—as they had in 1949—to use discount sterling for commodity-shunting. That is to say, merchants could buy goods in soft-currency countries for sale in dollar markets at discount prices or could sell dollar goods in soft-currency markets at a substantial premium. Such commodity-shunting constituted a drain on the official reserves and took business away from British traders who could not participate in this type of operation.

This decision made the Exchange Equalization Account for the first time responsible for the transferable sterling rate. In its support operations, the Account has bought transferable pounds against dollars in markets outside the United Kingdom. Its policy has been to intervene on a sufficient scale to keep the transferable rate about 1 percent below the rate for spot sterling. As a result, the transferable pound since early 1955 has fluctuated with convertible sterling and the United Kingdom has achieved for currently-earned, non-convertible sterling "a high degree of effective convertibility of sterling . . . into dollars at discounts . . . approximately 1 percent below the official rates."*

*International Monetary Fund *Annual Report, 1955* (Washington: 1955), p. 7.

Regulations governing the use of blocked sterling capital funds or security sterling have also been relaxed. Security sterling or "switch sterling" is sterling of a capital nature held by non-residents of the sterling area; in general, it is derived from the proceeds of the sale of sterling securities which could be invested in sterling securities redeemable in not less than ten years. Since the war, American residents could sell their holdings for dollars to other Americans. These sales involved no dollar losses to Britain because the buyer could only buy sterling securities and keep them with authorized British institutions. However, during the past few years, capital repatriation has been permitted administratively on a case-by-case basis. In 1954, for example, a London office building was purchased from American owners for £2.5 million in security sterling. In September 1955, despite Britain's difficulties, the regulations were relaxed to allow European holders of sterling securities to sell them for dollars to residents of the dollar area. In addition, these blocked funds could be invested in securities maturing in five years (instead of ten years as formerly). Finally, sterling bearer securities could be exported to the owner or his agent abroad and no longer had to be held at an authorized British financial institution.

EXTENT OF EXCHANGE-RATE FLUCTUATION IN THE TWO CURRENCIES, 1950-55

Even though the Canadian authorities have followed a flexible and the British authorities a fixed exchange policy, the two currencies have recently shown increasingly similar market behavior. Since 1950, the range of the fluctuating Canadian dollar has diminished and that of the fixed-parity pound has widened. Measurement of day-to-day market fluctuations also indicates a marked similarity in operating practices. The average annual fluctuation of the Canadian dollar has declined from 6.1 U.S. cents between 1950-1952 to 2.9 cents between 1953-1955, as may be seen in Table I. Furthermore, since 1952, the mid-point of the high and low daily quotation for the year has varied less than a single cent (between 101.7 and 102.6 cents). Since 1953, the Canadian dollar has fluctuated less than 1 percent beyond the range (2 percent) provided under Article IV, Section 3(i) of the Fund Agreement.

The range for fluctuation of the pound increased in December 1951 with the widening of the official spread from one-quarter to 4 U.S. cents and again in February 1955 when the British authorities began to support the transferable rate at about 1 percent below the convertible

pound. In 1954 and again in 1955, the fluctuations for the pound exceeded the range for the Canadian dollar in terms of U.S. cents, although not in percent of par value or mid-point. By adding the 1 percent discount on the transferable pound to the 1.4 percent range for the convertible pound, the effective range for currently-earned sterling under existing arrangements could be as much as 2.4 percent of the par value. This fluctuation is almost comparable in percentage terms to the actual flexibility of the Canadian dollar about its mid-point since 1953.

TABLE 1
 UNITED KINGDOM AND CANADA: SELECTED EXCHANGE RATES
 IN NEW YORK^a
 (In U.S. cents per unit of currency)

	POUND				CANADIAN DOLLAR				
	High	Low	Spread	Percent Fluctuation ^b	High	Low	Spread	Mid-point	Percent Fluctuation ^c
1950	280.1	279.9	0.2	0.07	96.7	88.4	8.3	92.6	9.0
1951	280.1	278.3	1.8	0.6	98.1	93.2	4.9	95.7	5.1
1952	281.2	278.1	3.1	1.1	104.3	99.0	5.3	101.7	5.2
1953	281.9	279.6	2.3	0.8	103.1	100.4	2.7	101.8	2.7
1954	281.9	278.5	3.4	1.2	103.8	101.3	2.5	102.6	2.4
1955	280.5	278.2	2.3	0.8	103.6	100.0	3.6	101.8	3.5
	(275.7) ^d		(4.8)	(1.7)					

Source: Federal Reserve Bank of New York.

^a From the daily noon-buying rate in New York, the highest and lowest quotation during the calendar year has been selected.

^b Spread as percent of \$2.80 par value.

^c Spread as percent of mid-point of high and low quotation.

^d Low quotation for transferable sterling after March 1955.

Comparison of the actual market movement during the trading day indicates a marked similarity in the operating techniques of the two currencies. The spread between the high and low quotation for each trading day during the twelve months of 1955, as reported by *The New York Times*, averaged (in terms of 1/32's of a U.S. cent) about 3.25 for the pound and 2.24 for the Canadian dollar or substantially less than 1/4 of a U.S. cent. This fact is confirmed by an actual count of the daily movement during the calendar year 1955; there was a daily fluctuation of 1/4 U.S. cent or less in 209 days for the pound and 223 days for the Canadian dollar. There were recorded only 35 days for the pound and 26 days for the Canadian dollar where the daily movement was greater than 1/4 cent.

The fluctuations in excess of $\frac{1}{4}$ cent were not evenly spread throughout the year but were concentrated in months when the two currencies were falling sharply. For example, the price of the Canadian dollar fell sharply in February when the Bank of Canada's discount rate was reduced; over one-third of the days of large movement (exceeding $\frac{1}{4}$ cent) were concentrated in February. Similarly, nearly half the large daily fluctuations for the pound were concentrated in the three months, May to July, when the pound declined in price and was under continuous market pressure.

When compared with par value or mid-point, the Canadian dollar has fluctuated substantially more than the pound, as may be seen in Table 1. However, there has been a recent tendency for the two rates to converge. From 1950 to 1955, for example, the percent fluctuation of the Canadian dollar narrowed from 9.0 to 3.5 percent, while that of the pound increased from 0.07 to 0.8 percent or, if the transferable quotation is included, to 1.7 percent.

FACTORS IN THE TREND TOWARD STABILITY OF THE CANADIAN DOLLAR

The stability of the Canadian dollar since 1953, achieved in spite of marked fluctuations in the country's trade and payments position, is due mainly to the emergence of short-term capital flows which have moderated movements in the rate.* These flows, thus far of an equilibrating character, have in the main been associated with shifts in the timing of payments in foreign trade.

Because a country importing substantial capital from outside would be expected to run a current-account deficit, the degree of instability in Canada's payments position can be measured only by adding the long-term capital inflow to the current-account balance. By this criterion, the Canadian position has been subjected to marked quarterly fluctuations, even in the last three years when the currency fluctuations moderated perceptibly. For example, the net quarterly figures found in Table 2 which combine the current and long-term capital accounts fluctuate: in 1953, between a deficit of \$136 million and a surplus of \$148 million; in 1954, between a deficit of \$101 million and a surplus of \$56 million; and in 1955, between deficits of \$9 million and \$220 million.

The impact of quarterly payments fluctuations of these magnitudes

* A more detailed discussion of Canada's experience with a fluctuating currency and the nature of the various capital movements is available in my articles, "Le dollar canadien et le cours de change fluctuant," *Bulletin d'Information et de Documentation* (Banque Nationale de Belgique), May 1955, and "The Canadian Dollar: A Fluctuating Currency," *Review of Economics and Statistics*, XXXV, August 1953, pp. 236-43.

on the market price of the Canadian dollar has been moderated by short-term capital flows of an equilibrating character. In general, a rising value for the Canadian dollar has been accompanied by a short-term capital outflow. For example, the Canadian dollar rose from 93.5 cents in June 1951 to a peak of 104.2 cents in September 1952; the short-term capital outflow for these five quarters amounted to \$831 million, as may be seen in Table 2. Similarly, the dollar rose from 100.6 cents in June 1953 to 103.4 cents in February 1954; the short-term capital outflow during these three quarters totalled \$278 million. On the other hand, a falling value for the Canadian dollar has been accompanied by either a reduced capital outflow or an actual capital inflow. For example, the currency fell from 104.2 cents in September 1952 to 100.6 cents in June 1953; the capital movement shifted from an outflow in mid-1952 to an actual inflow in the second quarter of 1953. Similarly, the dollar fell from 103.4 cents in February to 101.9 cents in June 1954; the heavy capital inflow during the second quarter of 1954 may be seen in Table 2. During 1955, the Canadian dollar declined from 103.5 cents in January to 100.1 cents in December; during this period, there were heavy capital inflows recorded in both the second and fourth quarters.

These short-term capital flows have been mainly of three types: purchases and sales of outstanding securities, changes in Canadian-dollar balances, and a miscellaneous capital category. Foreigners acquired Government of Canada securities and Canadian-dollar balances in expectation of exchange appreciation during 1950; there were substantial movements in these categories in 1951 but thereafter only in isolated quarters (see Table 2).

Since 1951, in fact, these short-term capital flows seem mainly to reflect shifts in the timing of payments for exports and imports. The "other capital movements" category, which has dominated the short-term capital flow in recent years, includes a miscellaneous collection of private payments and an "errors and omissions" residual; but the Bureau of Statistics has concluded that "study of this residual over a number of years suggests that it represents principally changes in receivables and payables not directly recorded."*

The equilibrating character of these short-term capital flows seems to be the outgrowth of two factors: (a) the strength of the Canadian position; and (b) the passive exchange policy in effect. The strength of the Canadian dollar has reflected stable domestic economic and political conditions, a high demand for Canadian exports in world mar-

* Dominion Bureau of Statistics, "Quarterly Estimates of the Canadian Balance of International Payments," Third Quarter, 1954, p. 5.

TABLE 2

CANADA: SELECTED BALANCE-OF-PAYMENTS STATISTICS

(In millions of Canadian dollars)

CURRENT-ACCOUNT AND INVESTMENT SHORT-TERM CAPITAL MOVEMENTS,
BY TYPE

Quarterly	Current account	Long-term capital ^a	Total	Trade in outstanding securities	Foreign- held dollar balances	Other capital move- ments ^b	Total short-term capital movements
1950:							
I	- 45	+ 10	- 35	+ 8	+ 67	+ 29	+102
II	-105	+ 74	- 31	+ 11	+ 66	+ 19	+ 96
III	- 10	+ 73	+ 63	+295	+131	+153	+579
IV	-174	+ 27	-147	+ 15	- 31	- 9	- 25
1951:							
I	-236	+ 44	-192	+ 63	- 20	+ 32	+ 75
II	-352	+189	-163	+ 1	- 13	+195	+183
III	- 65	+ 58	- 7	+ 11	- 77	- 4	- 70
IV	+136	+225	+361	- 37	- 82	- 95	-214
1952:							
I	+ 28	+138	+166	0	- 4	-175	-179
II	+ 44	+165	+209	- 19	+ 4	-189	-204
III	+ 75	+103	+178	- 51	+ 2	-115	-164
IV	+ 17	+ 80	+ 97	- 24	- 68	- 32	-124
1953:							
I	-186	+199	+ 13	+ 10	+ 45	- 94	- 39
II	-194	+ 58	-136	- 35	+ 20	+ 41	+ 26
III	- 15	+100	+ 85	- 5	- 71	- 14	- 90
IV	- 48	+196	+148	- 1	- 11	-122	-134
1954:							
I	-176	+223	+ 47	+ 16	- 18	- 52	- 54
II	-189	+ 88	-101	+ 21	+ 13	+102	+136
III	+ 20	+ 36	+ 56	+ 1	+ 10	- 25	- 14
IV	- 86	+ 89	+ 3	+ 17	+ 17	- 21	+ 13
1955:							
I	-155	+ 94	- 61	- 31	+ 30	- 31	- 32
II	-166	+ 25	-141	+ 7	+ 40	+156	+203
III	- 85	+ 76	- 9	- 22	+ 6	+ 9	- 7
IV	-259	+ 39	-220	+ 27	+ 15	+120	+162

Source: Dominion Bureau of Statistics, "Quarterly Estimates of the Canadian Balance of International Payments."

^a Direct investment in Canada plus new Canadian issues abroad less retirements.

^b Includes mainly short-term capital movements in the form of (a) changes in international open account commercial indebtedness, (b) private and chartered bank holdings of foreign exchange, (c) loans between private unrelated parties, and (d) a balancing item representing unrecorded capital movements and errors and omissions.

kets, and the continuing inflow of long-term capital for investment in resource development projects (which has not been responsive to exchange-rate fluctuations). This investment inflow, which has provided an undertone of strength for the currency in the market, has offset the principal structural weakness in Canada's external payments position—Canada's need to acquire dollars in addition to those obtained from direct sales to the United States in order to settle the current-account deficit with the United States.

But in addition to these favorable factors, the exchange policy in effect probably encouraged the equilibrating capital flows. In a Parliamentary statement, the Finance Minister stated that the exchange policy aimed merely "to ensure orderly conditions in the foreign exchange market. No attempt is made to reverse persistent trends but only to smooth out excessive short-run fluctuations." Within this limited objective, the Governor of the Bank of Canada stated that the Exchange Fund Account has operated in the market "to exercise a cushioning influence on a moderate scale." The Account tends to operate against any movement in the rate, but only on a limited scale. It sells Canadian dollars when the Canadian dollar begins to move upward and U.S. dollars when the U.S. dollar rises. Where the rate movement continues in the face of moderate official offerings, the movement would seem to be more than a momentary fluctuation. Mr. Turk, of the Bank of Canada, has elaborated on how a short-run movement is distinguished from a trend: when an insistent demand is exerting strong pressures on the rate in one direction, the Canadian practice seems to be to ensure that the market is not entirely devoid of supply and, on the other hand, when the weight of supply is pressing heavily in the other direction, to ensure that demand is not completely lacking.*

In place of a "cushioning" policy, the Canadian authorities might have adopted a "rate-determining" policy in which the Account would attempt to exert a determining influence on market price. However, they were not prepared to assume "rate-determining" responsibilities after the currency was freed. The 1950 speculative inflow had demonstrated that foreign private funds available could not be comfortably managed with available official resources in the foreign-exchange and domestic-security markets. With such an active trading program, they feared that private traders might become preoccupied with official intentions and that a disorderly element might be introduced into the newly-freed market as a result of attempts to outguess or embarrass the Canadian authorities.

* Sidney Turk, "Foreign Exchange Market in Canada," *The Canadian Chartered Accountant*, August 1953, page 66.

With exchange rate uncertainty increased by the official trading policy, private traders were encouraged to take positions on their own responsibility. These movements have taken on an equilibrating character tending to moderate fluctuations in the rate. In this way, the official exchange policy has tended to encourage the growth of short-term capital movements which have acted, in turn, to reduce the need for official stabilization operations.

Limited official trading objectives do not necessarily mean limited market operations. The difference between a "cushioning" and a "rate-determining" policy is not found chiefly in the scale or frequency of official trading. On the contrary, the authorities may maintain a continuous interest in the market throughout the day in carrying out a "cushioning" policy. So long as purchases by the Exchange Fund are fully offset by sales, operations by the Fund do not affect the trend of market prices. In this sense, the gross volume of official operations is less significant than the net changes in official reserves—that is to say, the extent to which the authorities decide to increase or reduce official reserves rather than to allow a change in market price. Changes in official reserves, in the words of Turk, ultimately reflect the net operations of the Fund.

DISEQUILIBRATING CAPITAL FLOWS IN STERLING

The short-term sterling capital movements have differed from the Canadian experience; they have been consistently disequilibrating in character. In general, temporary funds have moved out of sterling when a fall in the pound was in prospect. These perverse movements occurred when there was only a nominal ($\frac{1}{4}$ U.S. cent) spread between the official buying and selling limits for foreign exchange and they continued after the official spread was widened to 4 U.S. cents.

The speculative capital flows experienced by the United Kingdom before 1951 took the form of shifts in the timing of sterling payments by merchants in their normal trading activities; capital flows not directly related to trade were checked by Britain's exchange controls which blocked short-term money flows of the pre-1939 character to countries outside of the sterling area. Because he expected the exchange parity to be altered, the merchant was encouraged to take a speculative position by the belief that the pound could move, if at all, only in a predictable direction. He tended to anticipate his future sterling needs when he thought the rate might rise, and to delay buying pounds for his normal commitments when sterling payments difficulties arose. With only a nominal spread, the future cost of the exchange he needed would

be no greater, and might be much less, than the current cost in terms of his local currency.

The use of sterling as a major trading currency and the availability of credit in London to finance foreign trade has meant that these speculative pressures came from merchants all over the world. When the pound was under pressure, British importers could speed up purchases and exporters delay collections on foreign sales. Foreign merchants would react along parallel lines, with foreign sellers tending to accelerate, and foreign buyers to postpone, sterling settlements. Foreign merchants could postpone payment by lengthening the credit and by refinancing in the London market; where the transaction was being financed outside the sterling area, the merchant could shift his borrowing to London and could assume a sterling obligation without forward covering.* The relatively low level of London money rates and the easy-money policy in effect facilitated this type of speculation against the pound.

Even after the pound's official spread was widened at the end of 1951, the short-term capital flows continued to be disequilibrating. For example, *The Financial Times* noted on May 2, 1955, that the "big loss of gold during (February) was a change in the timing of ordinary commercial payments" and that the "development of such 'leads and lags' on commercial account is a normal concomitant of a bear movement on sterling."

Fluctuations in the sterling position of United States residents confirm the disequilibrating character of the short-term capital flows both before and after 1951, as recorded in United States statistics.† United States residents acquired sterling assets during the fall of 1950 and again throughout 1954 when the international position of sterling improved. These sterling positions were quickly liquidated during the second half of 1951 and again in early 1955 when balance-of-payments difficulties emerged once again. On the sterling liabilities side, it appears that United States residents took short positions by borrowing

* Merchant speculation in the form of shifts in the timing of sterling payments is described in my article, "Leads and Lags in Sterling Payments," *Review of Economics and Statistics*, XXXV, February 1953, p. 53.

† These figures, which are found in the *Bulletin* of the U.S. Treasury, are based on reports of United States banks covering transactions of United States residents with British and Australian residents payable in sterling. Forward exchange contracts are not included. Furthermore, dollar transfers from accounts in United States banks held by non-residents are excluded. For example, when an Italian or Canadian resident moves dollars from New York to London, the transfer is recorded as a decline in United States liabilities to Italy or Canada and not as an increase in United States claims on the sterling countries. Of course, direct transfers between Canada and Britain and between European financial centers and Britain are not covered.

heavily in London during the winter of 1951-52; these liabilities were quite sharply reduced during the second quarter of 1952, partly as a result of special restrictions on foreign-trade credits introduced in February 1952. (For foreign residents, credits were limited to 90 days and refinance facilities were restricted in February 1952.) Since the revival of monetary restraint in Britain in March 1952, there has been no resumption of sterling borrowing on the 1951-52 scale. This fact suggests that the magnitude of the bear pressures against the pound may be less since 1952 than they were earlier; it may at least partially explain how the United Kingdom was able to meet a major bear movement during the summer of 1955 with less reserve losses than in the 1949 and 1951-52 difficulties.

Part of the explanation of these continued disequilibrating capital flows may be found in the tendency of the pound to remain uncomfortably near the upper and lower support points, even after the official range was widened to 4 U.S. cents. On a monthly average basis, for example, the pound has remained between \$2.79 and \$2.81 in only 17 out of 48 months between the beginning of 1952 and end of 1955. It has been within 1 U.S. cent of the upper limit in 18 months and within 1 cent of the lower limit in 13 months. The rates have averaged within $\frac{1}{2}$ cent of the official buying and selling prices for a total of 15 months. Even with the widened spread, therefore, the pound has been pushed against the buying and selling support limits during periods of either distinctly favorable or unfavorable developments.

Nonetheless, Britain's experience during 1955 suggests that these difficulties cannot be eliminated merely by introducing greater rate flexibility. On the contrary, two episodes occurred which underscored the vulnerability of a flexible rate policy when external and internal disequilibrium prevails.

In the first place, the discount on transferable sterling widened late in 1954 to nearly 3 percent, at which point commodity-shunting became profitable. Even though the economic imbalance persisted, however, the British authorities were able to stabilize the discount on transferable sterling at about 1 percent following the announcement in February 1955 that the Exchange Equalization Account was assuming responsibility for that rate.

A second episode commenced in June 1955 when Continental banks and commercial houses ran down their balances to minimum levels. One reason for these withdrawals was a series of strikes in Britain on the railways, docks, and Atlantic liners which came at a time of seasonal strain in the balance of payments. According to *The Economist* of July 2, 1955, a more important cause was the reaction of Continentals to

discussions in Paris on the renewal of the European Payments Union and the allied topic of convertibility. At these discussions, it developed that the British authorities visualized convertibility in association with a more flexible exchange rate. Flexibility for the pound under the circumstances "has all too readily been translated into the prospect of depreciation." Because of this fear, bear pressure on the pound persisted throughout the summer, despite vigorous official defense of the prevailing rate; it came to an end only in mid-September when Chancellor Butler made the public commitment at the annual International Monetary Fund meetings that there would be no early change in exchange rate policy or practice in these words:

There is no doubt about the policy of the Government in relation to the exchange value of the pound sterling, and I can give this policy in one sentence. It has been, and will continue to be, the maintenance of exchange parity of \$2.80 to the pound, either in existing circumstances or when sterling is convertible. In the long run this must depend upon our efforts. Nothing else can replace this.

I have made it clear that we do not contemplate any early move on any—and I repeat any—aspects of the exchange front.*

After this public commitment that the \$2.80 par value would be defended and that no early move on *any* aspect of exchange policy was contemplated, the bear pressure against the pound abated. This episode is particularly revealing because, just a year earlier at the end of April 1954, a period when the sterling position was strong, the rumor that the range on spot sterling would be widened caused market pressure actually to push the spot sterling rate above the official trading limit. In the issue of May 1, 1954, a financial reporter of *The New York Times* noted sales at \$2.82-1/32 in the New York market on April 30 and added:

Predictions continued to be made freely among foreign exchange men that an upward revision of the upper trading limit was likely. . . . Suggested new trading spreads range from \$2.77¹/₄—\$2.82³/₄ to \$2.75—\$2.85.

Britain's experience, therefore, suggests that a fluctuating exchange rate policy is vulnerable when internal inflation and external imbalance are apparent. During periods of strength, a flexible rate policy makes it possible for the authorities to allow the rate to rise without a formal appreciation as an alternative to maintaining the existing upper limit or raising the par value. On the other hand, instead of being a means by

* International Monetary Fund, *Summary Proceedings, Annual Meeting, 1955* (Washington: 1955), p. 39.

which weak internal policies can be offset, a flexible rate policy would seem to require more effective—rather than less effective—efforts to maintain internal stability. During periods of weakness, foreign traders may continue to acquire a currency, even though it is near the support level, where they are satisfied that the authorities can defend the spot rate but might be reluctant to do so if there were a flexible rate in effect. The contrast between Britain's experience in 1954 and in 1955 when greater flexibility in the pound rate was generally expected by the market—particularly when compared with Canada's favorable experience with a fluctuating currency during six years of continuous economic strength—would seem to underscore the enduring relevance of Professor Robbins' observation:

But in general I am yet to be convinced that the dilemma is escapable that, when the general financial position is strong, free rates are usually unnecessary and that, when it is weak, they are apt to be a source of appalling danger.*

FLEXIBLE VERSUS FIXED EXCHANGE RATES: CONCLUSIONS FROM THE CANADIAN AND BRITISH EXPERIENCES

On the basis of postwar Canadian and British exchange experiences, there seem to be two demonstrated weaknesses of a fixed exchange policy (with fluctuations within the limited ranges thus far in effect for the pound). In the first place, there has been a tendency for the rate to move near the lower support level in periods of disturbed conditions and to approach the upper support point in periods of favorable developments. In either situation, the authorities lose maneuverability in market operations. On the lower side, they have no choice but to use reserves to support the rate. Furthermore, the market no longer can provide reliable guidance as to the strength of the pressures on the rate.

In the second place, the fixed rate system has distinct disadvantages when it becomes necessary to change the par value of the currency. In both the United Kingdom and Canadian devaluations in 1949 there was no role for market experiment in the movement of the exchange rate from one par value to another as an essential part of the process of determining the appropriate exchange value. The difficulty in determining a realistic par value was one reason why the Canadian authorities decided to allow the currency to fluctuate in 1950. Further-

* Lionel Robbins, "The International Economic Problem," *Lloyds Bank Review*, January 1953, page 16.

more, under a fixed par value system, it is more dangerous to devalue too little rather than too much; as a consequence, there is a tendency to select a rate so low that a second devaluation will clearly not be required.

At the same time, there seem to be two problems associated with a flexible exchange policy. In the first place, a currency which is to fluctuate should be strong. At least, Canada's favorable experience contrasts with Britain's difficulties in the summer of 1955 when reports that the pound's spread would be widened produced substantial bear pressures on the sterling rate. Even though Britain's external disequilibrium continued, the restiveness of foreign traders abated as soon as the Chancellor convinced the market that he intended to take the internal measures necessary to maintain the \$2.80 par value and that he would not disturb the existing support level.

Secondly, a flexible exchange policy means that the authorities have full operational freedom in the exchange market; they have no commitment to restrict the movement of the rate, as they do when official buying and selling rates are in effect.* A sharp clash on this point dominated the European Payments Union discussions in the summer of 1955. According to *The Banker* for July 1955, the official British view maintained that one of the conditions of convertibility must be a far greater flexibility of exchange rates than existed at the time. The case for greater rate flexibility was reportedly based in part on technical market considerations: such flexibility was needed to provide the authorities with an effective and economical means of resisting and smoothing out temporary fluctuations in the balance of payments and short-run speculative pressures against the pound. On the other hand, European opinion tended to emphasize the need for a fixed parity and only a modest range of permissible fluctuations. The Europeans wished to reduce speculative and competitive dangers that were associated in their minds with rate flexibility; they suspected that the clearing of European payments through sterling would be subject to greater speculative dangers in the future with a more flexible rate policy than was the case when only a limited range of fluctuation about the par value was in effect.

The resolution of this controversy, which is found in the exchange-rate provisions of the European Monetary Agreement signed in Paris on August 5, 1955 by all members of the European Payments Union, provides a convenient summary of postwar experience with reference to fixed and fluctuating exchange rates. Under the Agreement, each

* This point is developed in some detail in my article, "Exchange Flexibility and the Stability of Sterling," *American Economic Review*, March 1954, pp. 101-103.

member is committed "to inform its partners of the margins—valid until further notice—beyond which it will not allow the value of its currency, in terms of a given standard, to fluctuate."* Thus, the principle of unilaterally-determined margins to which the authorities are committed is linked with freedom to change the margins when notice is given to other members. A greater degree of exchange flexibility is combined with a currently valid commitment by the monetary authorities to other member nations and to the foreign exchange market to keep the fluctuations within specific limits until further notice.

CONCLUDING OBSERVATIONS

Although Canadian and British foreign exchange policies diverged in 1950 when Canada adopted a flexible exchange policy, the two currencies have recently tended to converge. The Canadian dollar has fluctuated less, particularly since 1953, while the pound's range of fluctuation has been widened, initially in 1951, and again in 1954 through official support of transferable sterling. Because, according to economic theory, a fixed exchange system is the direct opposite in major respects of a flexible exchange policy, it is unexpected that a fixed pound and a fluctuating Canadian dollar should show common tendencies.

The decision to restore a private exchange market in Canada in 1950, and shortly thereafter in Britain, helps to explain this converging tendency. After the markets were reactivated, a marked similarity in daily operating techniques developed, if one may judge from the actual movements in rates during the trading day in the twelve months of 1955.

* O.E.E.C. Press Release, Paris, 29th July 1955 (Press/A [55] 39) under title of "The O.E.E.C. Council Prolongs the European Payments Union until 30th June 1956, and approves the text of a European Monetary Agreement to come into force upon the return to convertibility," page 3. The relevant sections of the *European Monetary Agreement* published by the O.E.E.C. in Paris on 5th August 1955 include: Fifth paragraph of Preamble (page 6) and Articles 9 and 13 of Part II, The Multilateral System of Settlements (pages 13 and 18). This agreement is not now operative; it is to come into effect only if and when the European Payments Union is terminated. The similarities between the European Monetary Agreement and the exchange arrangements under The Tripartite Agreements of September 25 and October 13, 1936 between the United States, United Kingdom, and France should be noted. Under the Tripartite Agreement, balances of currency held by the other two Exchange Equalization Accounts were convertible into gold at the current market price of gold and the arrangement was subject to termination on 24 hours' notice. This agreement "enabled the three monetary authorities to prevent an appreciation of their currencies or, what is the same thing, a depreciation of the other two currencies, without having to run any exchange risk." (Paul Einzig, *World Finance, 1935-37* (London: 1937), p. 255). The restrictive provisions of the European Monetary Agreement seem designed to achieve two objectives of the Tripartite Agreement: to avoid the risk of exchange losses in foreign currencies and, more far-reaching, to prevent the emergence of competitive depreciation as a threat to the European trade and payments system.

To be sure, the two countries commenced with different rate policies. But the Canadian authorities found that a policy of limited official trading objectives contributed to rate stability in the exchange market by increasing uncertainty and by encouraging private traders to take positions on their own accounts; there emerged private short-term capital flows which have thus far been of an equilibrating character and have served to moderate fluctuations in the rate for the Canadian dollar. On the other side, the British authorities found it convenient in December 1951 to abandon the policy of nominal spreads, which had characterized their exchange arrangements in earlier postwar years, in order to widen the maneuver area of the Exchange Equalization Account.

The similar operating experiences of the two currencies suggest that a fixed and a fluctuating exchange system may not lead to such different day-to-day exchange variations and different operating techniques in the exchange market as economic theory would suggest. Each type of exchange arrangement has disadvantages inseparable from advantages. The tendency of the British and Canadian currencies to show a similar market behavior, on the one hand, and the compromise among European nations embodied in the terms of the European Monetary Agreement, on the other, seem to be outgrowths of attempts by monetary authorities to minimize the particular disadvantages of both a fixed and a fluctuating exchange arrangement.

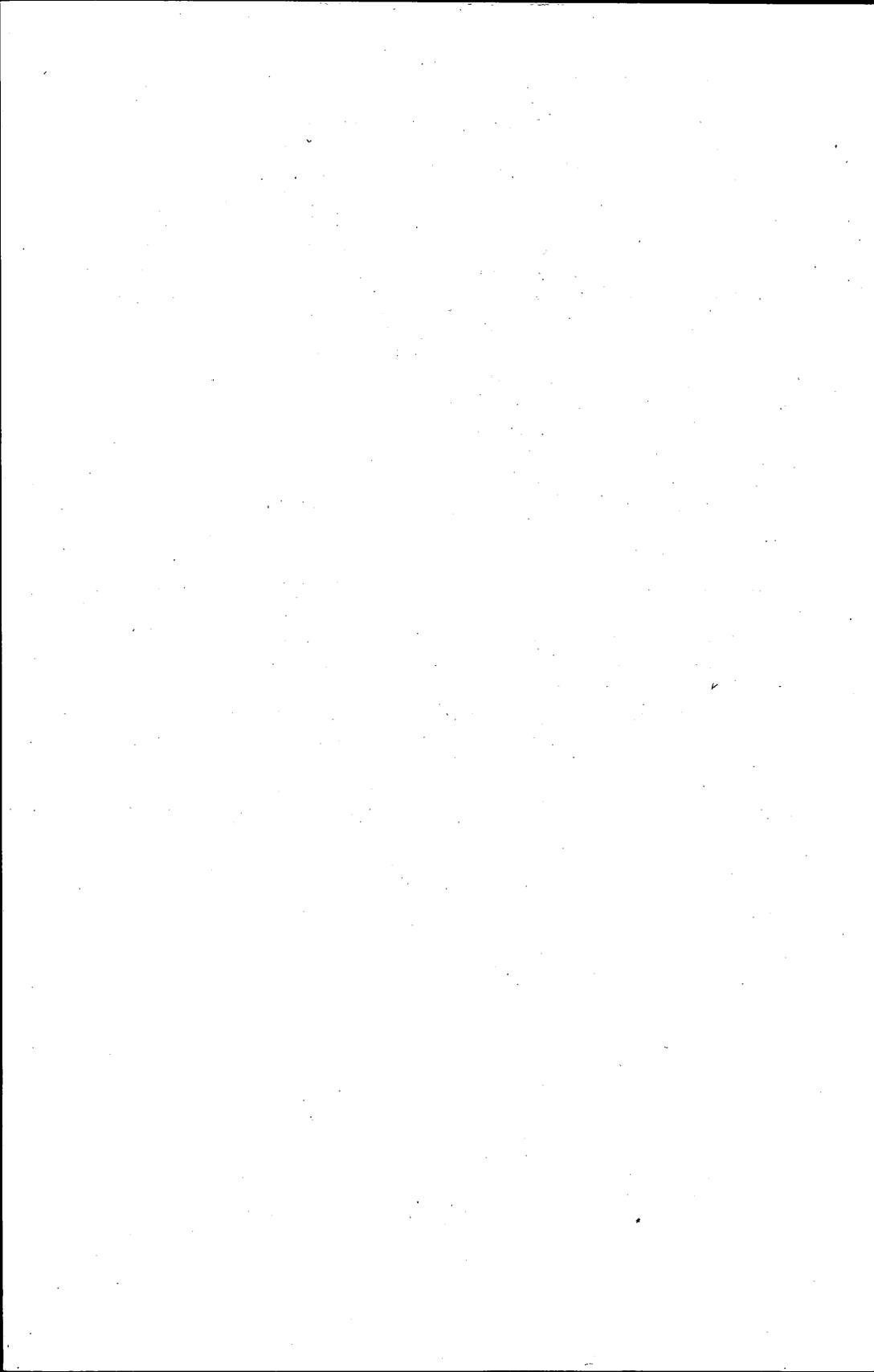
The converging tendency of the two currencies has been accompanied by marked progress toward convertibility. For practical purposes, a currency may be defined as convertible if current earnings of foreigners can be converted by them into gold or United States dollars in domestic and foreign markets at either a fixed or a fluctuating rate. For monetary convertibility to be substantive and effective in an economic sense, particularly for the local resident, there must also be an absence of restrictions on trade and payments, especially of a discriminatory character. Being without exchange or import restrictions, the Canadian dollar is convertible for capital as well as for current transactions.

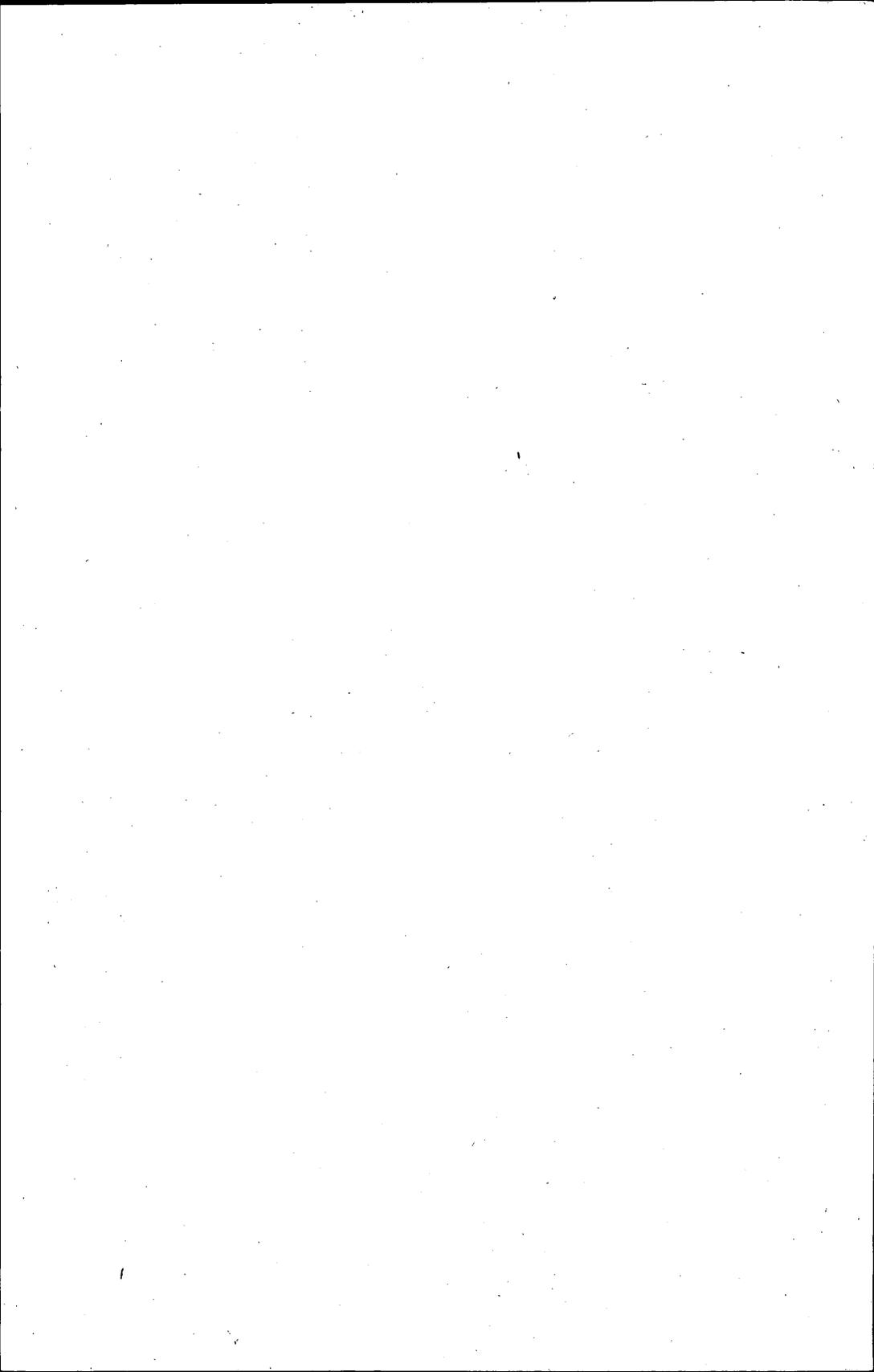
While the United Kingdom has made marked progress in the direction of this type of convertibility, the extent of its achievement is controversial. One view emphasizes the distance yet to be covered by concentrating on the existence of exchange control over current transactions, on the discriminatory nature of Britain's controls over imports and invisibles, and on Britain's reluctance to unify the convertible and transferable rates.

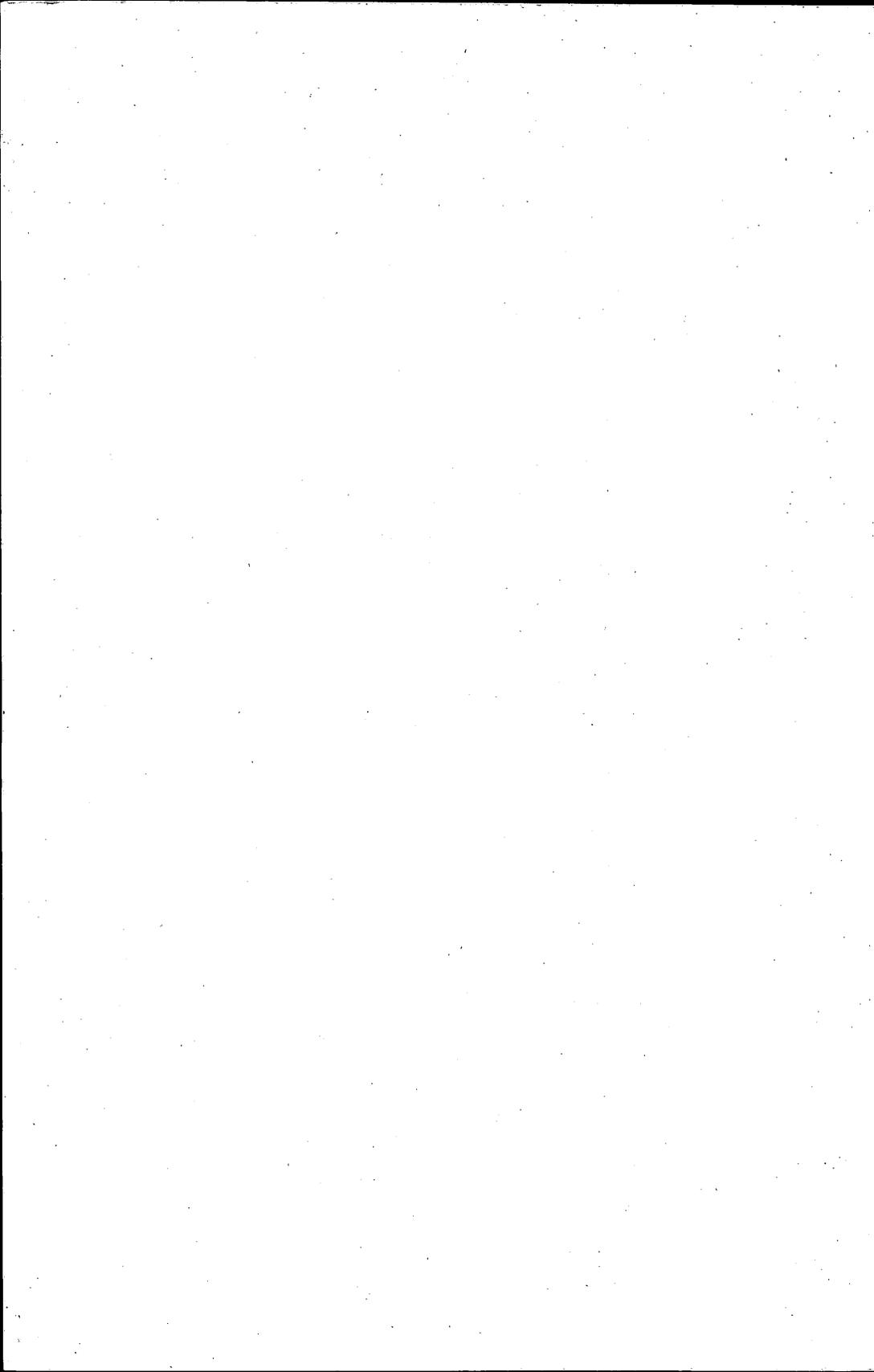
The more optimistic view starts with the proposition that non-residents can freely convert currently-earned sterling into dollars outside

the United Kingdom at the holder's option, at a discount which has been stable at about 1 percent since March 1955. The difference between this type of market convertibility and the convertibility defined above is the difference between a common law and a legal marriage arrangement. Just as there is much legal significance in Britain's unwillingness to take formal convertibility commitments, so there is substantial economic significance in the present arrangement of market convertibility. Because a deficit with a transferable-account country can now involve as direct a drain on Britain's reserves as a comparable deficit with a convertible currency, it is no longer reasonable to justify discrimination on balance-of-payments grounds. Even though discriminatory controls which are protective in origin may be as difficult to modify as restrictions based on payments grounds, the elimination of an economic justification for discrimination represents a major step towards a more liberal world trade and payments system.

However, it would be a mistake to exaggerate the role of exchange rate policy in this achievement. The reconstruction of war destruction, the reduction of internal inflationary pressures, and the adoption of more realistic exchange rates in 1949 were fundamental to the better balanced position of European economies after 1951. Furthermore, the revival of monetary policy as a major instrument of economic stabilization contributed to the establishment of a greater degree of internal financial stability and of external payments balance in most European countries. It must be recognized that, without such stability, neither a fixed nor a fluctuating exchange rate policy can guarantee to maintain the external value of the currency. With such stability, it is not clear that there is material difference between a fixed or fluctuating-rate policy; a strong flexible currency may indeed prove to be about as stable as a fixed-rate currency.







RECENT PUBLICATIONS OF
INTERNATIONAL FINANCE SECTION

Survey of United States International Finance.
By International Finance Section Staff.

- | | |
|-------------------------|--------|
| 1. Volume covering 1949 | \$1.75 |
| 2. Volume covering 1950 | \$2.25 |
| 3. Volume covering 1951 | \$2.25 |
| 4. Volume covering 1952 | \$2.75 |
| 5. Volume covering 1953 | \$2.75 |

Order from any bookseller or from PRINCETON UNIVERSITY PRESS.

The International Finance Section also publishes from time to time papers in three series, which should be ordered directly from the Section. STUDIES are distributed without charge to persons abroad, but there is a fee of \$0.25 in coin or stamps to cover postage and handling costs for United States residents. ESSAYS and SPECIAL PAPERS are distributed without charge by the Section to all interested persons and standing requests to receive new numbers as they are published will be honored. Numbers in these three series still in print are as follows.

PRINCETON STUDIES IN INTERNATIONAL FINANCE

4. Postwar Bilateral Payments Agreements. By Merlyn N. Trued and Raymond F. Mikesell. (April 1955)
5. The First Three Years of the Schuman Plan. By Derek Curtis Bok. (December 1955)

ESSAYS IN INTERNATIONAL FINANCE

20. "The Colonial Sterling Balances." By Ida Greaves. (September 1954)
22. The Bank for International Settlements, 1930-1955. By Roger Auboin. (May 1955)
24. International Cost-Sharing Arrangements. By Thomas C. Schelling. (September 1955)
25. The Belgium-Luxembourg Economic Union, 1921-1939: Lessons from an Early Experiment. By James E. Meade. (March 1956)

SPECIAL PAPERS IN INTERNATIONAL ECONOMICS

1. A Survey of International Trade Theory. By Gottfried Haberler. (September 1955)
2. The Validity of International Gold Movement Statistics. By Oskar Morgenstern. (November 1955)

