ESSAYS IN INTERNATIONAL FINANCE

No. 26, August 1956

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

SAMUEL I. KATZ

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DEPARTMENT OF ECONOMICS AND SOCIOLOGY

PRINCETON UNIVERSITY

Princeton, New Jersey

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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 personal opinions and do not reflect the views of the Federal Reserve Board.

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GARDNER PATTERSON, *Director*
International Finance Section

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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 reestablished 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 1/4 of 1 U.S. cent (\$2.79 7/8 to \$2.80 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 1. Furthermore, since 1952, the midpoint 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 ¼ 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 ¼ 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 ¼ cent.

The fluctuations in excess of ¼ 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 ¼ 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)

Quarterly	Current account	Long-term capital[a]	Total	Trade in outstanding securities	Foreign-held dollar balances	Other capital movements[b]	Total short-term capital movements
	CURRENT-ACCOUNT AND INVESTMENT			SHORT-TERM CAPITAL MOVEMENTS, BY TYPE			
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.