ESSAYS IN INTERNATIONAL FINANCE

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STERLING SPECULATION AND EUROPEAN CONVERTIBILITY: 1955-1958

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Princeton, New Jersey

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STERLING SPECULATION AND EUROPEAN CONVERTIBILITY: 1955-1958

IN a major breakthrough towards a freer system of world payments the United Kingdom and 13 other Western European countries agreed at the end of 1958 to establish nonresident convertibility for their currencies. Yet in September 1957, just 15 months before this historic advance, the United Kingdom had experienced severe foreign-exchange difficulties and, between 1955 and 1957, had struggled with a series of four separate exchange crises.

These crises were characterized by substantial speculative capital flows in the form of shifts in foreign-trade financing (known as leads and lags in foreign-trade payments). The speculative shifts in trade financing were carried out by individual merchants in an attempt to reduce the exchange risks inherent in international commodity trading. These speculative disturbances had the short-run effect of keeping European exchange markets unsettled during much of this three-year period; but they had the long-run consequences of forcing European countries to make adjustments in national policies in the direction of greater financial stability within each country and a better balance in external payments among the European countries. Thus, this speculation was at the same time a source of market disturbance and a key factor in the international adjustment mechanism between 1955 and 1957 which made possible the introduction of European currency convertibility.

EXCHANGE SPECULATION AND THE SHIFTING OF TRADING RISKS

Short-term capital flows against the pound between 1955 and 1957, and earlier in the postwar period, differed in three major respects from typical pre-1939 international short-term money flows. Exchange-rate speculation since 1945 (a) has been carried out by merchants in the course of normal trading activity; (b) has been for the speculator risk-reducing and not risk-assuming in character; and (c) has involved little or no out-of-pocket cost to the speculator.

Exchange-rate speculation and merchant trade

Exchange-rate speculation between 1919 and 1939 was purely a financial transaction in which the speculator sought to profit from fluctuations in the foreign-exchange market. In these transactions the speculator did not buy a currency to pay for foreign merchandise or to increase his financial assets, but in order to realize a profit from rate fluctuations. In addition to short-term speculation of this character and to the response of funds to interest-rate differentials, political disturbances induced the international movement of "hot money," especially in the 1930's. In contrast, exchange-rate speculation in the post-1945 period has been directly related to the ordinary flow of commodity trade. Merchants engaging in speculation have done so by altering the timing or by shifting the locale of their trade financing.* Speculation of this character no doubt developed because short-term capital flows not related to commodity trade were blocked by exchange regulations in most countries.

Speculation to reduce exchange-rate risk

After 1945, the foreign trader found that the risk of a change in the exchange rate was an inseparable part of his international dealings in commodities. Therefore he looked for ways to reduce these risks. By contrast, the speculator before 1939 moved into a foreign currency hoping for a profit but recognizing that he was assuming the risk of a loss from the operation.

From the merchant's point of view, the decision to maintain a given par value for a currency was often made by government officials in the face of widespread doubt in the foreign-exchange market about the viability of that par value. The government officials were unwilling either to alter the par value or to take the corrective steps which, in the opinion of the foreign-exchange market, were necessary to maintain the par value. Time after time the merchant watched the pound weaken in the market because of adverse economic developments in Britain's domestic or external situation. Yet he could never be certain whether the British authorities would act decisively to defend the currency or whether they would be forced to devalue. They were forced to devalue in 1949 but in 1951, 1955, 1956, and 1957 they introduced major changes in economic policy to bolster the currency.

Though the British merchant could not anticipate the course of British policy decisions, he had a substantial personal stake in the

* This speculation is reviewed in an article by the author, "Leads and Lags in Sterling Payments," *Review of Economics and Statistics*, February 1, 1953, pages 75-80.

decisions taken. He had little freedom to protect his private interests. Under governmental regulations he was required to surrender foreign-currency earnings within a set period, he could make advance purchases of foreign goods only with an import permit, and he could not transfer funds out of the country without individual authorization. The merchant soon found, however, that he had one area of freedom, the timing of his foreign payments and receipts. He rapidly learned to use this freedom to shift as much as possible of the financial burden of devaluation to central official reserves. The merchant reduced his own risk by changing the timing of his foreign payments or the locale of his foreign financing. To protect himself when the pound began to weaken, the British exporter could delay repatriation of his foreign earnings (within the limit of the regulations) and the British importer could accelerate his payments and, perhaps, buy foreign goods in advance. These shifts in timing reduced the flow of foreign-exchange accruals to the official reserves and accelerated drawings for import payments.

The foreign (non-British) merchant had much more flexibility in these operations than the British resident. His general objective was to reduce his pound holdings and to increase his pound liabilities as much as his credit permitted. The importer of sterling goods sought to delay payments in pounds. He could ask for more generous credit terms; if he could open or renew a sterling credit in London, he could pay the sterling-area exporter and still retain a pound liability.* The non-British seller of goods to a sterling country sought to denominate his sale in another currency or to speed up collection of pounds.

The purposes and consequences of these shifts in trade financing were to reduce the merchant's risks if sterling should be devalued. Because these activities reduced Britain's official gold and dollar reserves, they had the effect of shifting from the merchant to the British Treasury much of the exchange-rate risk associated with a weak sterling position.

Limited out-of-pocket cost of speculation

When the merchant moved out of a weakening pound his "speculation" usually involved little or no out-of-pocket cost to him. Even when he took a short position in sterling his only risk was that the pound would cost slightly more tomorrow than it did today. He knew that, under the Fund's par-value system, the spot rate could not exceed 2 per cent of the par value and that it was limited in the case of the pound to 1.4 per cent by U.K. Treasury decision. Since the currency was weak he could feel certain that the par value would not be raised.

* The use of sterling credits in the bear attack on the pound in 1957 is described in "London's Overseas Credits," *The Banker* (London), February 1958, pages 79-84.

In practice, a short pound position was often actually profitable to the foreign merchant since London borrowing rates were often lower than those at home. In the early postwar period commercial money rates in London were substantially below those in other countries. By 1955 they had risen above the level in New York; but not until the Bank Rate was raised to 7 per cent, in September 1959, did London money rates come close to those in several continental countries and in Japan. As a consequence, it was common for Britain to tighten restrictions on borrowing by foreigners in London during a severe run on the pound.

MEASUREMENT OF STERLING LEADS AND LAGS

Between July 1955 and September 1957, the pound was under almost continuous selling pressure in the foreign-exchange market. During these periods of pressure Britain's reserves (adjusted for special government transactions) were reduced by nearly $2.0 billion. Four separate episodes can be identified on the Chart by (a) the sharp falls in the spot rate, (b) the wider discounts on the forward pound, and (c) the drops in the free-market quotation for the transferable pound. The extent of the declines in sterling rates during these four periods is summarized in Table 1.

TABLE 1

UNITED KINGDOM: SELECTED EXCHANGE RATES

(in U.S. cents per pound sterling)

Period	Spot	3 months forward	Transferable
I. 1955, July to September:			
Recent peak, April 27	280.000	278.813	277.40
Crisis bottom, July 22	278.344	276.063	276.75
II. 1956, May to July:			
Recent peak, May 7	281.063	279.500	278.55
Crisis bottom, August 2	278.250	276.688	275.60
III. 1956, August to November:			
Recent peak, May 7	281.063	279.500	278.55
Crisis bottom, November 30	278.281	275.031	274.45
IV. 1957, July to September:			
Recent peak, May 2	279.469	278.565	277.65
Crisis bottom, September 19	278.281	274.281	275.60

Note: Peaks and crises are measured by the spot pound exchange rate. When the low spot rate was maintained for more than one day, the low point for the forward rate is used.

Three pieces of evidence confirm the importance of leads and lags in merchant payments during these four periods of weakness. In the first place, the *Radcliffe Committee Report* has estimated that "leads and lags of all kinds, apart from the running down of sterling balances, may have caused a loss of some £90 million to £100 million in the third quarter of 1957."* The *Report* added that this figure was "in fact nearly half the reduction in reserves that led to the increase in Bank Rate to 7 per cent in September 1957." The most important elements in this total were "delays in payments to residents of the sterling area ('lags') rather than the hastening of payments by residents ('leads')."

Secondly, statistics prepared by the Organization for European Economic Cooperation in Paris covering the sterling area's monthly trade with Western Europe and parallel figures on Britain's monthly payments balance as reported by the European Payments Union show a pattern of monthly fluctuation between 1955 and 1957 which seem to reflect a short-term capital factor. These monthly statistics on payments and trade show up the speculative flows that tend to have sharp monthly peaks and indicate month-to-month reversals; and therefore are particularly useful because British balance-of-payments estimates are not available on a monthly basis.

Based on these trade and payments figures, a series called the "E.P.U. Non-Trade Residual" has been constructed, which represents the difference between the monthly trade and the monthly payments statistics.** The fluctuations in this residual are shown in the lower part of Chart I and in Table 2.

Movements in the residual series are taken to reflect the influence of speculative outflows. The residual figure is negative (that is, suggesting a capital outflow) when Britain's payments deficit for any month is greater than the trade balance. Thus, a negative residual is taken to reflect a capital outflow where the payments deficit cannot be explained by the trade deficit for that month.

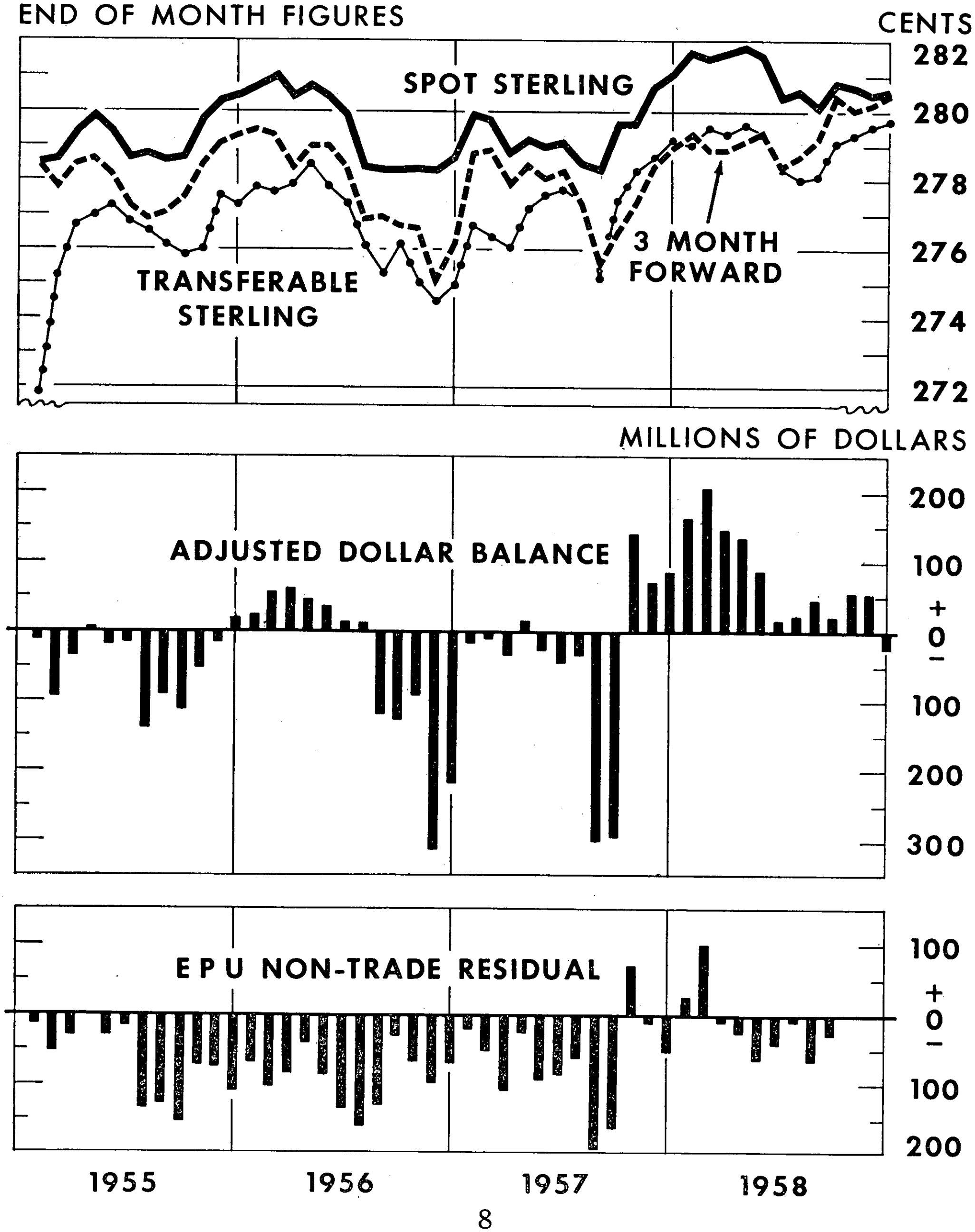
Because the figures are merely a rough residual, they cannot be held to measure the volume of leads and lags. The residual must include a wide range of transfers on invisibles and capital accounts as well as short-term capital flows. Further, the residual series relate only to the sterling area's trade and payments with the E.P.U. countries and do not relate to transactions with other countries. Thus, the seasonal payments

* Cmd. 827, page 236.

** The concept of the Non-Trade Residual and the fluctuation of this series between January 1949 and the middle of 1951 are discussed in "Leads and Lags in Sterling Payments." *op.cit.*, pages 77-79.

UNITED KINGDOM EXCHANGE RATES AND CHANGES IN RESERVES

END OF MONTH FIGURES



by Britain to continental countries in the third quarter (tourism and seasonal imports) regularly contribute to the third-quarter worsening in the residual series.

Despite the rough character of the statistics, the behavior of the series between 1955 and 1957 seems clearly to indicate the influence of short-term sterling speculation. Inspection of the chart reveals that the peaks in the residual estimates coincide with the market pressures on sterling rates. With the exception of the Suez crisis in late 1956, the low points of the market rates for sterling are identical with the monthly peaks in the E.P.U. Non-Trade Residual. The distinctive monthly pattern of the residual series indicates that the impact of speculation blanketed the more lethargic influence of nonspeculative capital and invisibles factors on the series.

Thirdly, the monthly peaks of the speculative outflow from Britain can be compared in timing with a series constructed by the Bundesbank to measure speculative inflows into Germany in 1957. For this purpose, the Bundesbank* combined two monthly series: (1) a net error-and-omissions item in the German balance of payments which is held to be mainly "improvement in terms of payment" (leads and lags in foreign-trade payments in favor of Germany), and (2) net changes in the exchange position of credit institutions. Monthly figures for the German series and for the British E.P.U. Non-Trade Residual for the three years, 1955 to 1957, are found in Table 2.

This table does not show a close relationship in timing between speculative outflows from Britain and speculative inflows into Germany during 1955 and 1956; but the correlation during the peak of the sterling crisis in the summer of 1957 is close. Since the movement of funds from London into Germany in substantial volume did not occur until mid-1957, when there was general talk of a German revaluation in the European financial press, a close correlation between the two series for 1955 and 1956 would have required explanation. For 1957 the correspondence in the critical months of August and September is unexpectedly close.

MAJOR SHIFTS IN FINANCIAL POLICY, 1955-1957

In retrospect, there were immense shifts in financial policy in both Britain and Germany between 1955 and 1957. These changes achieved a much better balance between these two countries, given the differences in their basic (current and long-term capital accounts) payments posi-

* Bundesbank *Monthly Report*, May 1958, page 34. The *Report* calls these two series "factors temporarily much affected by speculation."

TABLE 2

MONTHLY COMPARISON OF EUROPEAN PAYMENTS UNION NON-TRADE RESIDUAL FOR BRITAIN AND SPECULATIVE INFLOWS INTO GERMANY, 1955-1957

(*In millions of U.S. dollars*)

	1955		*1956*		*1957*	
	United Kingdom	*Germany*	*United Kingdom*	*Germany*	*United Kingdom*	*Germany*
January	− 15	− 8	− 68	+32	− 21	+ 65
February	− 52	−13	−102	−31	− 51	+ 43
March	− 30	−15	− 86	+16	−108	− 34
April	0	− 1	− 41	+ 2	− 25	+ 80
May	− 30	−11	− 87	+30	− 92	+ 32
June	− 17	+31	−137	+58	− 84	+ 54
July	−134	+47	−160	+65	− 61	+130
August	−127	+38	−129	+70	−197	+212
September	−151	+35	− 31	+50	−164	+190
October	− 72	−31	− 69	+21	+ 68	− 90
November	− 75	+ 5	− 98	+53	− 8	−139
December	−110	−23	− 70	−84	− 52	−160

Source: United Kingdom: Differences between monthly trade balance with Europe (as reported by the OEEC) and the monthly payments balance (as reported by the E.P.U.). Germany: Combination of monthly net errors-and-omissions figure in balance of payments and net monthly change in foreign-exchange position of German banks. (See Bundesbank's *Monthly Report* for May 1958, page 34.)

tion at that time. These policy changes, which came about largely in response to speculative capital flows that unsettled exchange markets, helped to prepare the ground for the general European move to non-resident convertibility at the end of 1958.

In 1955, the United Kingdom was maintaining a level of money rates substantially below those in most continental centers, despite its uncertain balance-of-payments outlook. On the other hand, money rates were much higher and credit availabilities much tighter in Germany than in other European centers despite the fact that continuing trade and current-account surpluses made Germany the principal surplus and creditor nation in Europe. By the end of 1957, however, British interest rates had moved upward to postwar peaks and those in Germany downward, in many cases to postwar lows.

This marked readjustment in credit conditions was in the direction of a better balanced intra-European payments structure. It was a necessary condition of European payments equilibrium that Germany should achieve a net outflow on capital account substantial enough to offset the large trade surplus if persistent German reserve accruals were to be avoided. As it turned out, speculative inflows into Germany appeared as soon as the German authorities began to tighten credit availabilities for domestic stabilization purposes in late 1955. As a result, heavy German reserve accruals took place during 1956 and 1957, despite some easing of German rates after the middle of 1956, and exchange markets were unsettled by rumors of D-mark appreciation and by speculative inflows into Germany. On its side, the United Kingdom was vulnerable to the pull of funds into Germany since foreigners could obtain sterling to shift into D-marks from Britain's import payments, from balances held in London, and from credits obtained in London financial markets.

The changes in relative German and British interest rates between 1955 and the end of 1958 had the effect of bringing the two rate structures close together. In 1955 the British Treasury bill rate was about 0.20 per cent below, but at the end of 1957 it was 3 per cent higher than, the corresponding German rate. (See Table 3.) The British commercial bank prime lending rate was 3¾ per cent below the minimum German loan rate in 1955, but was only one-half per cent below the German loan rate three years later. Only in long-term bonds did German yields continue substantially to exceed British yields in early 1958. Even so, German bond yields were only about 1 per cent above British bond yields at the end of 1957, compared with a difference of 3 to 4 per cent in January 1955.

Two qualifications should be made to this summary of intra-European financial developments between 1955 and 1958. In the first place, it would be erroneous to conclude that international considerations had a decisive impact either on domestic monetary conditions or on the structure of interest rates. The level of interest rates in both countries was influenced primarily by domestic demand conditions. It happened that, in Britain, demand conditions in security markets were pushing interest rates in the same direction as were international considerations. The reluctance of British investors to buy Treasury securities at prevailing yields and the heavy private demands for capital in 1956 and 1957 were factors pointing to the need for a higher level of money rates in Britain.

In Germany different considerations were involved. The international balance-of-payments surplus was adding to aggregate demand pressures and to internal liquidity. For German policy makers there was a choice

TABLE 3

COMPARISON OF BRITISH AND GERMAN CENTRAL AND COMMERCIAL BANK LENDING RATES, 1955-1959

Date	*Central Bank discount rate* United Kingdom	Germany	*Commercial bank lending rate* United Kingdom[a]	Germany[b]	*German bank borrowing from central bank*
	(in per cent)		(in per cent)		(in billions of DM)
1954: End of year	3	3	4	7¾	1.9
1955: Jan. 27	3½		4½		1.8
Feb. 24	4½		5½		2.2
Aug. 4		3½		8	1.9
1956: Feb. 16	5½		6½		4.3
Mar. 8		4½		9	4.9
May 19		5½		10	4.1
Sept. 6		5		9½	2.9
1957: Jan. 11		4½		9	2.3
Feb. 7	5		6		2.1
Sept. 19	7	4	8	8½	1.6
1958: Jan. 17		3½		8	1.3
Mar. 20	6		7		1.6
May 22	5½		6½		1.3
June 19	5		6		1.5
June 27		3		7¾	1.5
July 21				7½	1.3
Aug. 14	4½		5½		1.0
Nov. 20	4		5		.8
1959: Jan. 10		2¾		7¼	.8

[a] Assumed to be 1 per cent above Bank Rate.
[b] Minimum bank lending rate.
Source: *Monthly Report* of German Bundesbank and *Quarterly Bulletin* of Bank of England.

of alternative policies to cope with these factors; the decision was made in mid-1956 to ease international pressures on the German economy not by appreciating the currency but by lowering credit costs in the country. To the extent that the German authorities deliberately chose to lower German interest rates as an alternative to revaluation of the D-mark, international considerations can be held to have had a key role in fashioning the general line of domestic policy; but it is significant that the German authorities found themselves in a conflict between the desire to lower German interest rates and the need to contain domestic