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Two Approaches To The Exchange-Rate Problem --  
United Kingdom and Canada 21 pages

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Two Approaches To The Exchange-Rate Problem --

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United Kingdom and Canada

Although Canadian and British foreign exchange policies diverged in 1950 when Canada adopted a flexible exchange policy, the two currencies have since tended toward common ground. The Canadian dollar has fluctuated less, particularly since 1953, and the pound's range of fluctuation was widened in 1951 and again in 1955 through official support of transferable sterling. Because in economic theory a fixed exchange system is thought to be diametrically opposite to a flexible exchange policy in major respects, it is unexpected that a fixed and a fluctuating currency should show common tendencies. This confluence has grown out of attempts to devise an effective compromise between a flexible and a fixed exchange system which would minimize the disadvantages of each arrangement. An attempt to reach such a compromise dominated the E.P.U. discussions during the summer of 1955. The compromise reached among the European members of the E.P.U., which is embodied in the European Monetary Agreement, provides that each member be committed to maintain unilaterally-determined margins and be free to change the margins when notice is given.

Moves toward exchange-rate flexibility

Canada—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 pre-war 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 week-end. <sup>1/</sup> 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.

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<sup>1/</sup> An authoritative account of this dramatic development is found in Sidney Turk, "Foreign Exchange Market in Canada," The Canadian Chartered Accountant, August 1953, pp. 66-67.

United Kingdom -- 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  $1/4$  of 1 U.S. cents (\$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. 1/

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. 2/ Residents in any of these transferable-account countries -- that is, all countries outside the dollar and sterling areas 3/ -- were permitted to use current earnings of sterling to make payment to any resident of the transferable or sterling area without reference to the Bank of England.

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.

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, "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." 4/

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1/ These changes are described in "The Foreign Exchange Market," The Economist (London), December 22, 1951, pp. 1538-39.

2/ The details of these changes may be found in The Banker (London), April 1954, pp. 182-3 and "Freer Gold and Sterling," The Economist (London), March 27, 1954, pp. 965-67.

3/ 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.

4/ "How Convertible Is Sterling?" The Economist (London), July 17, 1954, p. 212.

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, 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 per cent in the early part of 1955 (see Table 1) and foreign residents once again found it profitable -- as they had in 1949 -- to use discount sterling for commodity-shunting 1/ which was, in Butler's words, "to the detriment both of our traders and of our reserves." 2/

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 per cent below the rate for spot sterling. 3/ 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 per cent below the official rates." 4/

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1/ The details of commodity-shunting may be found in "Cheap Sterling and Its Uses," The Financial Times (London), February 25, 1955, p. 6.

2/ Hansard (Parliamentary Debates), 24 February 1955, column 1458.

3/ "Policy on the Free Pound," The Financial Times (London), March 10, 1955, p. 4.

4/ International Monetary Fund Annual Report, 1955 (Washington: 1955), p. 7. While the United Kingdom has made marked progress in the direction of convertibility, the extent of its achievement in this field is controversial. One view emphasizes the distance yet to be covered by concentrating on the existence of exchange control, the discriminatory nature of Britain's controls over imports and invisibles, and Britain's protracted 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 at the holder's option at a discount which has been stable at about 1 per cent since March 1955. The difference between this type of market convertibility and full convertibility is the difference between living with a woman and marrying her. Just as there is much legal significance

UNITED KINGDOM: Sterling Exchange Rates in New York

Date	Spot	Discount:		Date	Spot	Discount:	
	sterling	Transferable	Security		sterling	Transferable	Security
	<u>US dollars</u>	sterling	sterling		<u>US dollars</u>	sterling	sterling
		<u>US cents</u>				<u>US cents</u>	
<u>1951:</u>				<u>1954:</u>			
March	2.80-3/32	20-3/32	75-3/32	March	2.81-22/32	4-2/32	4-14/32
June	2.80-3/32	22-19/32	a/	May	2.81-28/32	2-24/32	3
Sept.	2.79-28/32	31-28/32	53-28/32	June	2.81-28/32	4-24/32	4-28/32
Dec.	2.78-6/32	34-6/32	44-6/32	Sept.	2.79-26/32	5-26/32	6-18/32
				Dec.	2.78-17/32	6-17/32	5-27/32
<u>1952:</u>				<u>1955:</u>			
March	2.81-6/32	34-6/32	42-6/32	Jan.	2.78-16/32	6-28/32	7
June	2.78-16/32	13-16/32	32-16/32	March	2.79-12/32	2-25/32	2-28/32
Sept.	2.78-18/32	14-18/32	21-18/32	June	2.78-20/32	1-28/32	20/32
Dec.	2.80-30/32	8-14/32	17-30/32	Sept.	2.78-21/32	2-26/32	2-21/32
				Dec.	2.80-12/32	3-2/32	5-24/32
<u>1953:</u>							
March	2.81-18/32	5-18/32	12-18/32				
June	2.81-14/32	11-14/32	16-6/32				
Sept.	2.80-8/32	7-24/32	11				
Dec.	2.81-3/32	4-3/32	7-27/32				

Source: Federal Reserve Bank of New York and The Financial Times (London) as compiled by the International Monetary Fund.

a/ Not available.

Regulations governing the use of blocked sterling capital funds or security sterling 1/ have also been relaxed. 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. For example, in 1954 a London office building was purchased from American owners for £2.5 million in security sterling with official authorization. 2/ 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. 3/

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4/ (continued from page 3) in Britain's unwillingness to take a formal convertibility commitment, 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 forward in the direction of a more liberal world trade and payments system.

1/ Chancellor Butler described these funds as follows: "Security sterling -- or switch sterling -- is not an official description but is a market term used to describe sterling of a capital nature held by non-residents of the sterling area. It is more formally described as blocked sterling. In general, it is derived from the proceeds of the sale of sterling securities, usually for reinvestment which is permissible in any quoted sterling security redeemable in not less than ten years. The amount of it varies from day to day and no figures for the total or for its distribution between nationals are available." Hansard, July 12, 1955.

2/ The Financial Times (London), December 30, 1954, p. 1 and The Times (London), same date, p. 6.

3/ The Financial Times (London), September 6, 1955, p. 7. It was also announced that blocked funds could be invested in securities maturing in five years instead of ten years as formerly and that sterling bearer securities no longer had to be held at an authorized British financial institution but could be exported to the owner or his agent abroad.

Extent of exchange-rate fluctuation

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 2. 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 per cent beyond the range (2 per cent) provided under Article IV, Section 3(i) of the Fund Agreement.

Table 2

UNITED KINGDOM AND CANADA: Selected Exchange Rates in New York a/

(In U.S. cents per unit of currency)

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

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.

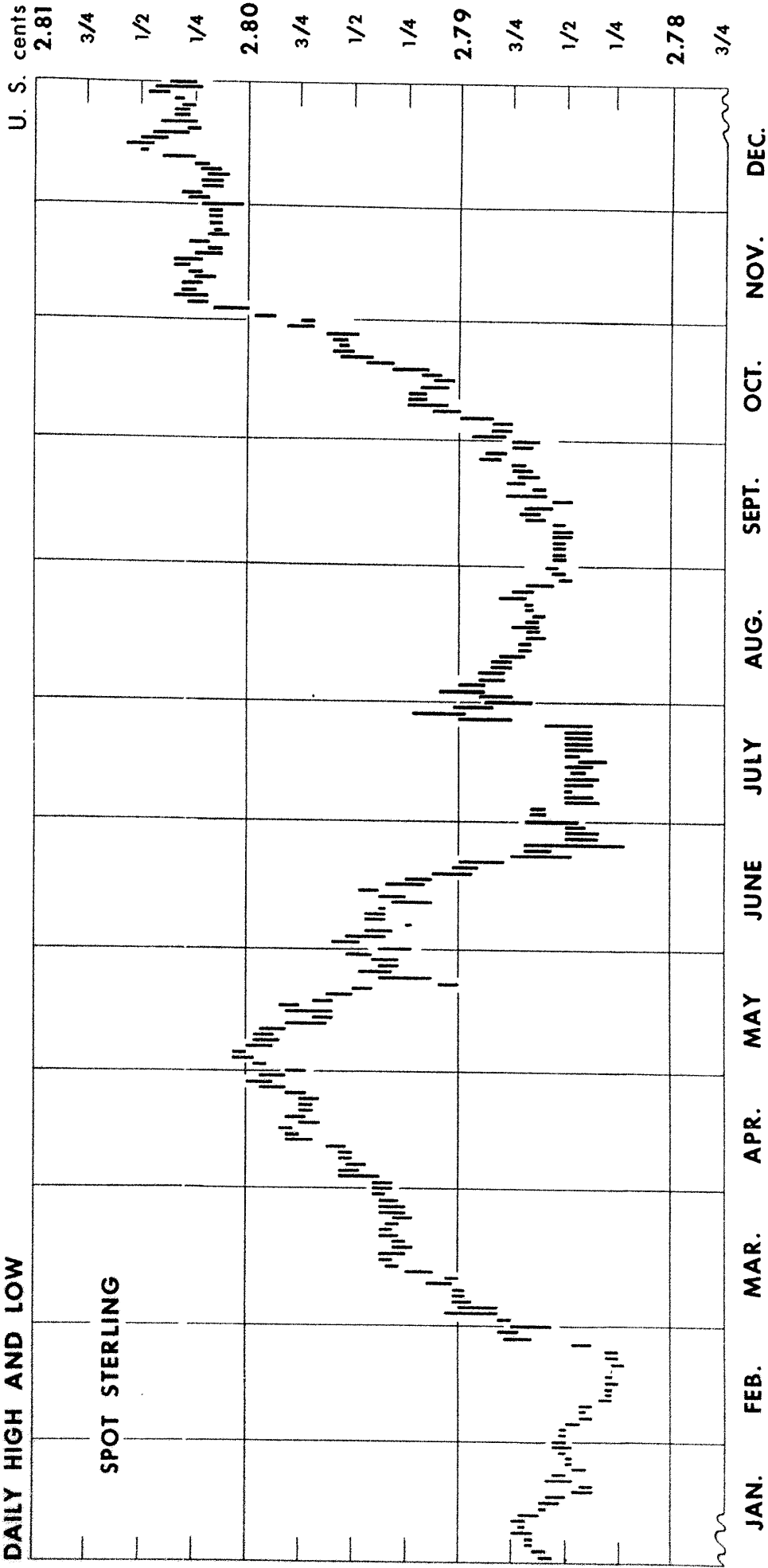
b/ Spread as per cent of mid-point of high and low quotation.

c/ Low quotation for transferable sterling after March 1955.

CHART I

# EXCHANGE RATES IN THE NEW YORK MARKET, 1955

DAILY HIGH AND LOW



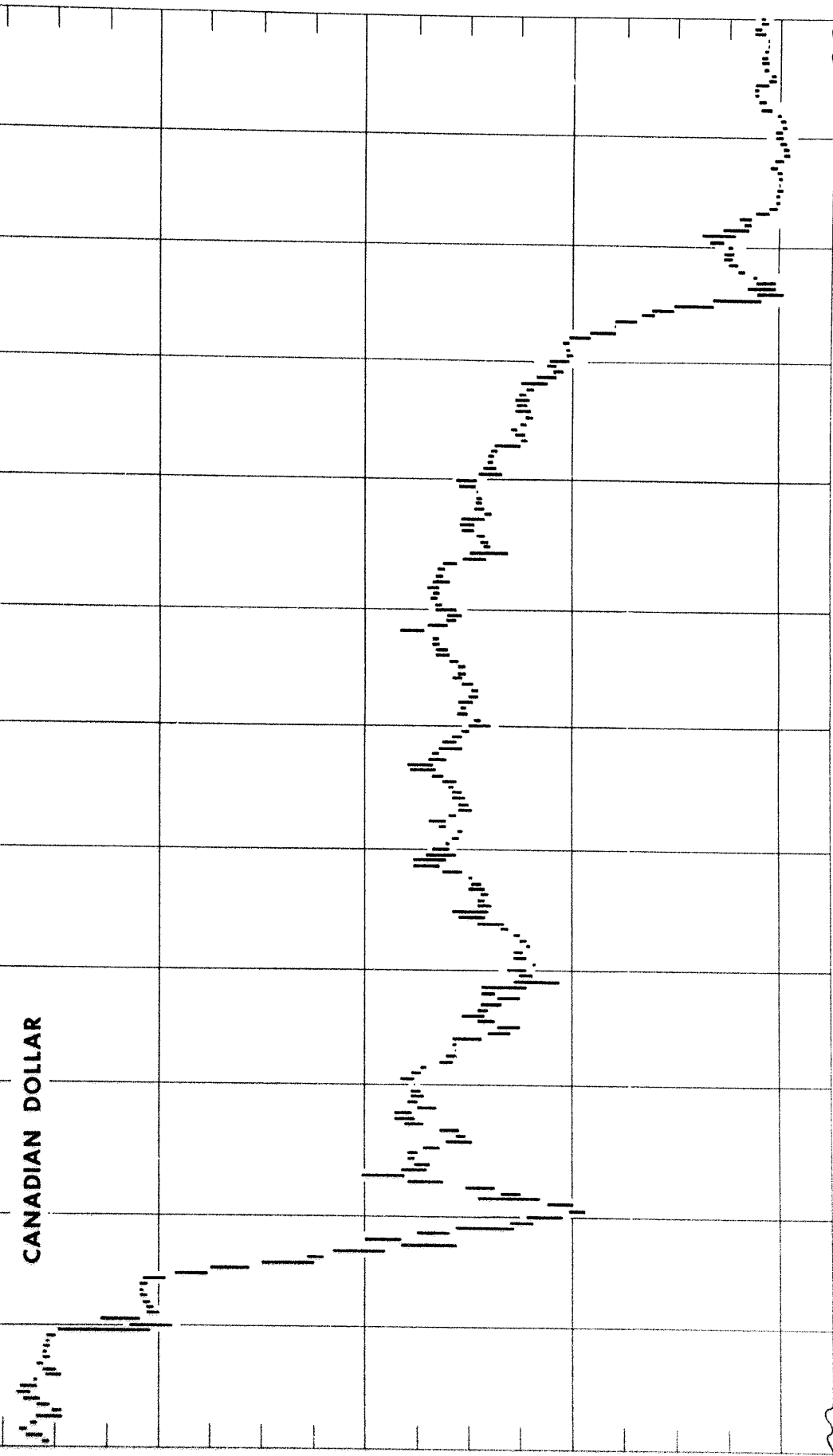


# EXCHANGE RATES IN THE NEW YORK MARKET, 1955

DAILY HIGH AND LOW

U. S. cents  
1.04

CANADIAN DOLLAR



3/4

1/2

1/4

1.03

3/4

1/2

1/4

1.02

3/4

1/2

1/4

1.01

3/4

1/2

1/4

1.00

3/4

1/2

1/4

1.00

3/4

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 per cent 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, though not in per cent of par value or mid-point. By adding the 1 per cent discount on the transferable pound to the 1.4 per cent range for the convertible pound, the effective range for currently-earned sterling under existing arrangements could be as much as 2.4 per cent 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.

Comparison of the actual market movement during the trading day indicates a marked similarity in the operating practices of these two currencies. For example, the pound actually moved more in the average trading day during the 12 months of 1955 than did the Canadian dollar in terms of U.S. cents (though not in per cent of par value or mid-point). The spread between the daily high and low quotation for the year, 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 (as may be seen in Table 3 and in Charts I and II). During 1955, the two currencies commonly moved no more than one-quarter cent within the average trading day: the movement remained within this limit 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 one-quarter cent.

The fluctuations in excess of one-quarter 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 (see Chart II): during February, 10 days of large movement are recorded out of 26 days for the entire year. Similarly, the pound dropped sharply in the second half of June (see Chart I): during that month, 9 days of large movement are recorded out of 40 days for the year. Nearly half the movements in excess of 1/4 cent are concentrated in the three months, May through July, when the pound declined in price and was under continuous market pressure.

There was a marked reduction in the fluctuation of the Canadian dollar after May, even during October when a second sharp drop in price occurred. From June to the end of the year, on only four days did the daily movement exceed one-quarter cent; the actual fluctuation averaged (in terms of 1/32's of a cent) only 1.65 compared with an average of 3.51 for the pound during the same seven months.

Table 3

UNITED KINGDOM AND CANADA: Selected Exchange Rates in New York a/

P O U N D   S T E R L I N G					C A N A D I A N   D O L L A R				
Daily average (in 32's of US cent)	<u>Number of days</u>				Daily average (in 32's of US cent)	<u>Number of days</u>			
	1/4 US cent or less	5/32 to 1/2 US cent	more than 1/2 US cent			1/4 US cent or less	5/32 to 1/2 US cent	more than 1/2 US cent	
<u>1955:</u>									
Jan. 2.05	21	0	0		2.43	19	1	1	
Feb. 2.33	18	1	0		4.64	9	8	2	
Mar. 3.17	20	3	0		3.13	19	3	1	
Apr. 3.05	19	1	0		2.80	17	3	0	
May 3.86	16	5	0		2.31	18	3	0	
June 4.95	13	7	2		1.89	22	0	0	
July 4.05	15	5	0		1.65	20	0	0	
Aug. 2.96	20	2	0		1.65	21	1	0	
Sept. 2.90	20	1	0		1.76	21	0	0	
Oct. 3.65	14	6	0		2.45	18	2	0	
Nov. 2.79	17	2	0		1.37	18	1	0	
Dec. 3.29	16	5	0		0.76	21	0	0	
Total or 3.25 average	209	38	2		2.24	223	22	4	

Source: The New York Times (daily).

a/ The high and low quotation for each day as reported by The New York Times has been compiled and the daily fluctuation computed for each business day of the calendar year 1955.

Recent stability of the Canadian dollar

The recent stability of the Canadian dollar, 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. <sup>1/</sup> 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 position shown in Table 4 ranged between a deficit of \$136 million and a surplus of \$148 million during 1953; between a deficit of \$101 million and a surplus of \$56 million during 1954; and between deficits of \$9 million and \$220 million during 1955.

Short-term capital flows of an equilibrating character have moderated the impact upon the Canadian dollar of the quarterly payments fluctuations. The equilibrating character of the short-term movements since 1950 is shown graphically in Chart III. In general, a rising value for the Canadian dollar has been accompanied by an increasing capital outflow (third quarter 1951 to third quarter 1952; second quarter 1953 to first quarter 1954); a falling value for the currency has been accompanied by a reduced capital outflow or actual capital inflow (third quarter 1952 to second quarter 1953; first and second quarters 1954; second and fourth quarters 1955).

Since 1951, 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 (see Table 4), includes a miscellaneous collection of private payments and an "errors and omissions" residual <sup>2/</sup>; but the Bureau of Statistics has concluded

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1/ 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," Rev. Econ. Stat., August 1953, XXXV, p. 236.

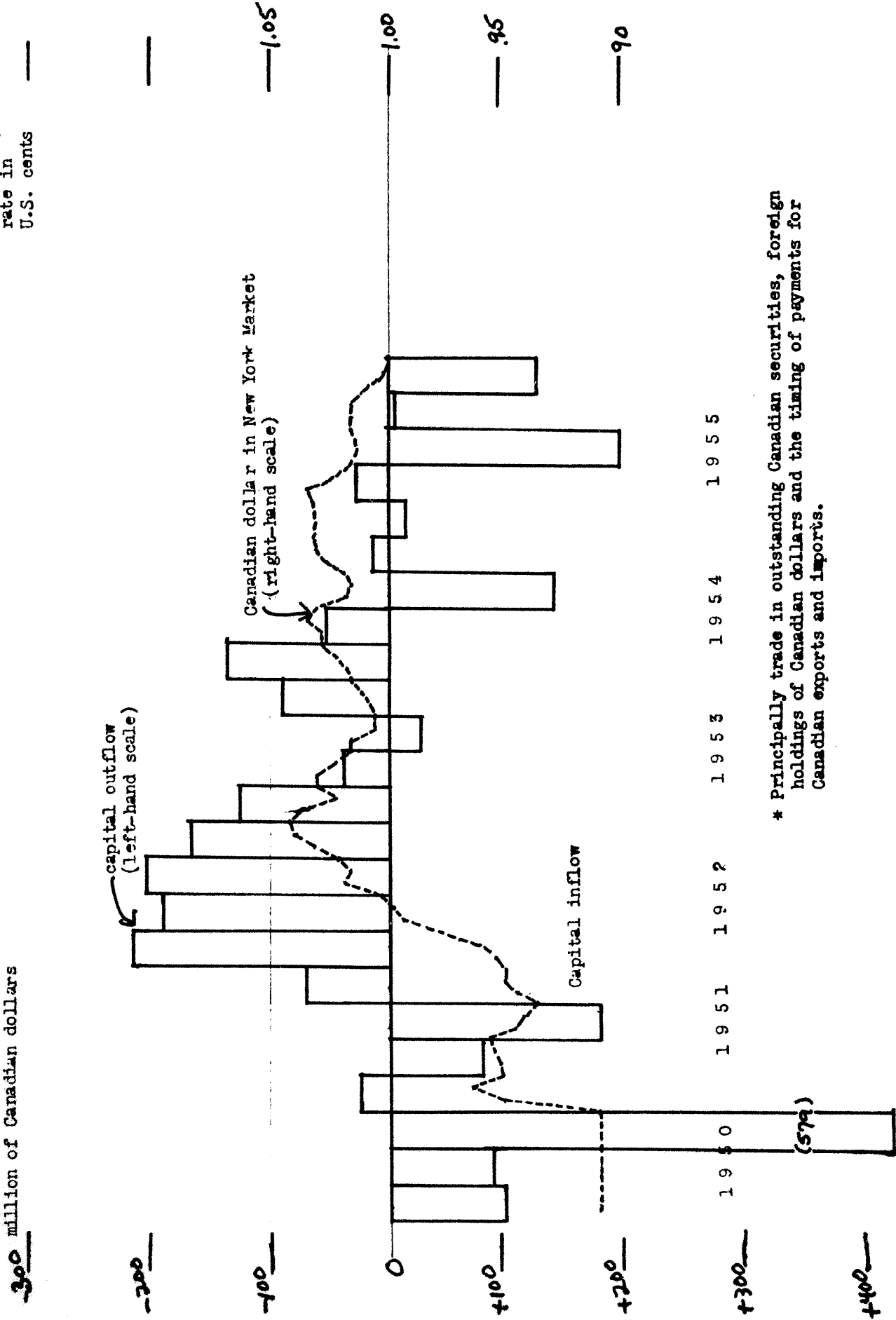
2/ Prior to 1952, foreigners acquired Government of Canada securities and Canadian-dollar balances in the expectation of exchange appreciation. Large movements of funds in securities and bank balances occurred in 1950 and, less frequently, in 1951 but thereafter only in isolated quarters (see Table 4).

Chart III.

CANADA: Short-term capital flows\* and exchange rate

Capital movement in million of Canadian dollars

Exchange rate in U.S. cents



\* Principally trade in outstanding Canadian securities, foreign holdings of Canadian dollars and the timing of payments for Canadian exports and imports.

Table 4

CANADA: Selected Balance-of-Payments Statistics

(In millions of Canadian dollars)

Quarterly	Current-account and investment			Short-term capital movements, by type			
	Current account	Long-term capital a/	Total	Trade in outstanding securities	Foreign-held dollar balances	Other capital movements	Total short-term capital movements b/
<u>1950:</u>							
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
<u>1951:</u>							
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
<u>1952:</u>							
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
<u>1953:</u>							
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
<u>1954:</u>							
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
<u>1955:</u>							
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: "Quarterly Estimates of the Canadian Balance of International Payments," Dominion Bureau of Statistics.

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.

that "study of this residual over a number of years suggests that it represents principally changes in receivables and payables not directly recorded." <sup>1/</sup>

The equilibrating character of these short-term capital flows seems to be the outgrowth of two facts: (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 markets, 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

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<sup>1/</sup> "Quarterly Estimates of the Canadian Balance of International Payments," Third Quarter, 1954, Dominion Bureau of Statistics, p. 5. This conclusion is corroborated by further study of this payments category in The Canadian Balance of International Payments, 1954 (Dominion Bureau of Statistics), pp. 21-22. Annual estimates of the "other capital movements" category are shown as follows in millions of Canadian dollars:

	<u>1950</u>	<u>1951</u>	<u>1952</u>	<u>1953</u>	<u>1954</u>
1. Bank and other balances abroad	- 7	- 14	-168	- 79	- 73
2. Other transactions, including changes in loans and accounts receivable and payable	209	118	-375	-117	70
3. Minor components	<u>- 10</u>	<u>+ 24</u>	<u>+ 32</u>	<u>+ 11</u>	<u>+ 7</u>
Total	192	128	-511	-185	4

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The report states that the growth in bank balances is due to: (a) the restoration of private trading in exchange in 1950; (b) the need for larger working balances as trade increased; (c) the tendency from time to time to defer receipts from abroad; and (d) the need for banks to cover forward exchange commitments to their customers. The trading balances shown in item 2 are part of Canadian open-account assets and liabilities which aggregate "many hundreds of millions of dollars" and the fluctuations in the item grow out of the fact that the timing of settlements rarely coincides with physical movements as recorded in the current account. The report also notes that annual movements in the "errors and omissions" residual have been consistent with the fluctuations in the recorded elements within this payments category.

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. The Canadian authorities have 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." <sup>1/</sup> Within this limited objective, the Exchange Fund Account has operated in the market "to exercise a cushioning influence on a moderate scale." <sup>2/</sup> The Account tends to operate against any movement in rate, but only on a limited scale. It sells Canadian dollars when the Canadian dollar begins to move upward and to sell U.S. dollars when the U.S. dollar rises, as may be seen in Table 5. Where the rate movement continues in the face of moderate official offerings, the movement would seem to be more than a momentary fluctuation. <sup>3/</sup>

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 pre-occupied 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.

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<sup>1/</sup> House of Commons Debates, Feb. 19, 1953, p. 2120.

<sup>2/</sup> Governor Graham Towers, Bank of Canada, before the Standing Committee on Banking and Commerce, March 25, 1954, p. 822.

<sup>3/</sup> See, for example: "One might ask in what way excessive short-run movements can be smoothed out and how can a short-run movement be distinguished from a trend. The latter can, of course, be ascertained only by testing the market and ensuring that, when an insistent demand is exerting strong pressures on the rate in one direction, the market is not entirely devoid of supply and contrariwise that, when the weight of supply is pressing heavily in the other direction, demand is not completely lacking. The net operations of the Fund, of course, as in the days of the Foreign Exchange Control Board, are ultimately reflected in the official reserves," Turk, op. cit., page 66.



Table 5

CANADA: Selected Financial Statistics

Period	Price of Canadian dollar in U. S. cents	Changes in official reserves (Millions of U. S. dollars) <u>a/</u>
<u>I. Rising value of Canadian dollar</u>		
Period 2. September 1951 to September 1952	94.7 to 104.2	<u>b/</u> + 246
Period 4. June 1952 to February 1954	100.8 to 103.4	+ 103
Period 6. May 1954 to January 1955	101.6 to 103.5	<u>c/</u> + 111
<u>II. Falling value of Canadian dollar</u>		
Period 1. October 1950 to September 1951	94.9 to 94.7	<u>d/</u> - 217
Period 3. September 1952 to June 1953	104.2 to 100.6	<u>e/</u> - 106
Period 5. February 1954 to May 1954	103.4 to 101.6	- 31
Period 7. January 1955 to December 1955	103.5 to 100.05	<u>f/</u> - 33

Source: Bank of Canada Statistical Summary and Federal Reserve Bulletin.

a/ Changes in reserves reflect trading in the exchange market, purchases of gold from local production and foreign-currency debt operations of the Treasury.

b/ Includes \$20 million securities retired.

c/ Includes \$20 million securities retired.

d/ Includes \$50 million securities retired.

e/ Includes \$75 million securities retired.

f/ Includes \$50 million securities retired.

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. The difference between these alternative policies is found not in the gross but in the net volume of official operations -- that is to say, the extent to which the authorities decide to increase or reduce the official reserves rather than to allow a change in market price.

#### 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 anticipated and moved into sterling when a rise in the pound was in prospect. These perverse movements occurred when there was only a nominal (one-quarter 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.

Before the spread was widened -- 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. Because he expected the exchange parity to be changed, 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 balance-of-payments difficulties developed. 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. <sup>1/</sup> The relatively low level of London money rates and the easy-money policy in effect facilitated this type of speculation against the pound.

Widening the sterling rate — 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 in 1955 that:

"It is now clear that the main trouble in February (1955), which led to the big loss of gold during the month, was a change in the timing of ordinary commercial payments."

and:

"The development of such 'leads and lags' on commercial account is a normal concomitant of a bear movement on sterling." <sup>2/</sup>

Fluctuations in the sterling position of U.S. residents, shown in Chart IV, confirm the disequilibrating character of the short-term capital flows both before and after 1951, as recorded in United States statistics. <sup>3/</sup> U.S. 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

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<sup>1/</sup> Merchant speculation in the form of shifts in the timing of sterling payments is described in my article, "Leads and Lags in Sterling Payments," Rev. Econ. Stat., February 1953, XXXV, p. 53.

<sup>2/</sup> The Financial Times (London), May 2, 1955, p. 6.

<sup>3/</sup> These figures are based on reports of U.S. banks covering transactions of U.S. residents with British and Australian residents payable in sterling. Forward exchange contracts are not included. Furthermore, dollar transfers from accounts in U.S. 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 U.S. liabilities to Italy or Canada and not as an increase in U.S. claims on the sterling countries. Of course, direct transfers between Canada and Britain and between European financial centers and Britain are not covered.

early 1955 when balance-of-payments difficulties emerged once again. On the sterling liabilities side, it appears that U.S. residents took short positions by borrowing 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. <sup>1/</sup> Since the revival of monetary restraint in Britain in March 1952, there has been no resumption of sterling borrowing on the 1951-52 scale (see Chart IV). <sup>2/</sup>

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 months 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 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.

Vulnerability of exchange-rate flexibility. 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 the point where commodity-shunting became profitable (see Table 1). Even though the economic imbalance persisted, however, the British authorities were able to stabilize the discount on transferable sterling at about 1 per cent following the announcement in February 1955 that the Exchange Equalization Account was assuming responsibility for that rate.

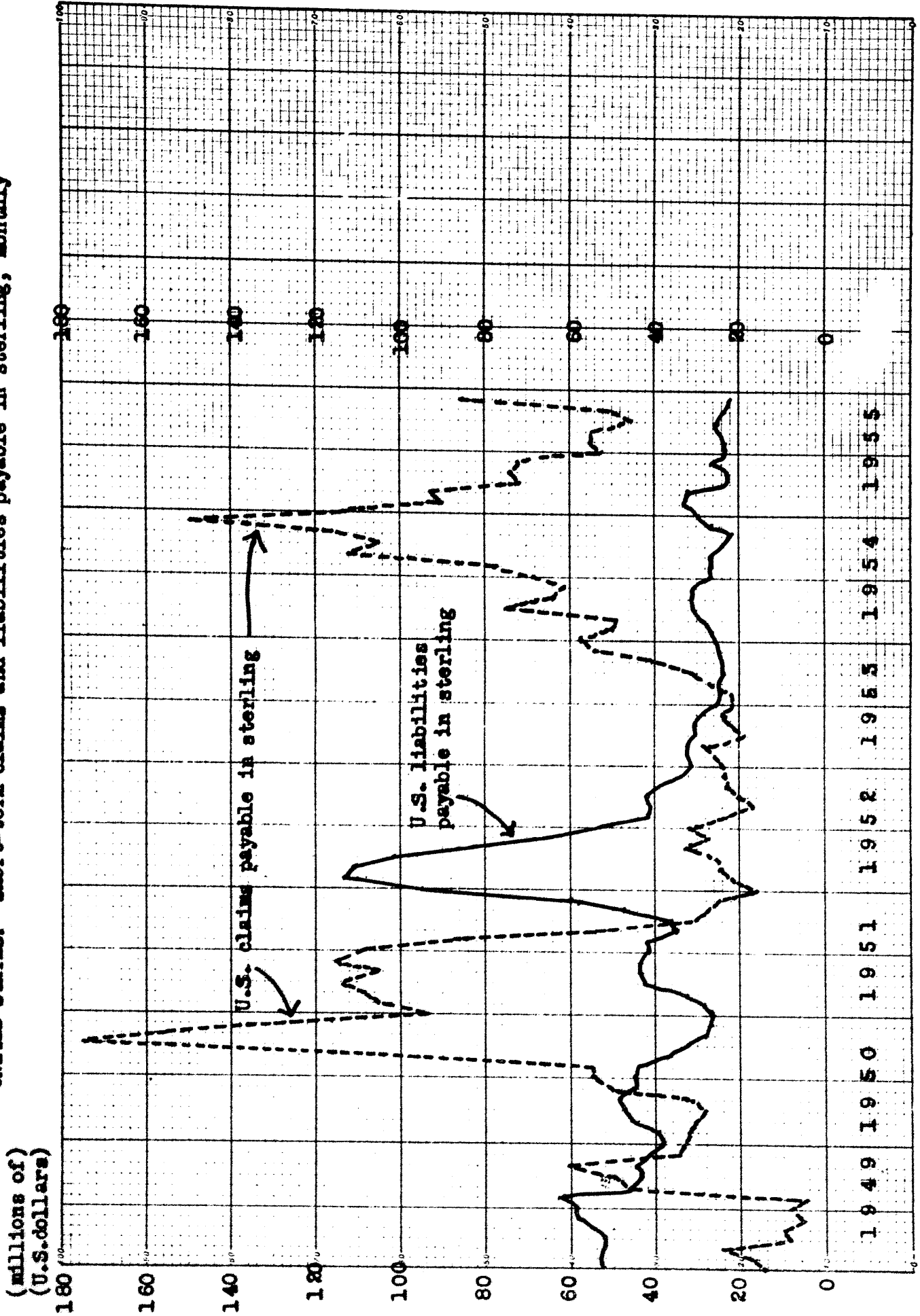
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<sup>1/</sup> For foreign residents, credits were limited to 90 days and re-finance facilities were restricted in February 1952. (See New York Journal of Commerce, February 29, 1952, p. 2 and the Financial Times (London), April 9, 1952, p. 4)

<sup>2/</sup> 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.

Chart IV.

UNITED STATES: Short-term claims and liabilities payable in sterling, monthly



Source: United States Treasury Bulletin

The second episode commenced in June:

"Continental banks and commercial houses have recently been running down their sterling balances to or below what is regarded as a bare minimum." 1/

The reasons given for the withdrawals were:

"the strikes on the railways, docks, and Atlantic liners and ... (their) delayed impact ... on the balance of payments at a time of the year where it will have to withstand seasonal stresses."

However,

"an even more important cause ... has been the echo of recent ministerial discussions ... in Paris on the renewal of EPU and the allied topic of convertibility. It transpired ... that the British authorities visualized convertibility in association with a more flexible rate of exchange ... Flexibility in the present context of the pre-autumnal weakness of sterling and of the strikes has all too readily been translated into the prospect of depreciation."

Because of fears of depreciation, this 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 Fund meetings that there would be no early change in exchange rate policy or practice in these words:

There has been some discussion recently in various quarters about the nature of the U.K. views on rate policy, so let me repeat what I said in the House of Commons on 26th July of this year. This is what I said:

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. 2/

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. The New York Times reported 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 \$2.77-1/4 -- \$2.82-3/4 to \$2.75 -- \$2.85." 1/

Britain's experience, therefore, suggests that a fluctuating exchange rate policy is vulnerable when internal inflation and external imbalance are apparent. 2/ Far from being a means by 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 can apparently be satisfied that the authorities are able to defend the spot rate, even though it is near the support level, where they would not be satisfied that the rate would be maintained if there were greater rate flexibility. Britain's experience with prospective rate flexibility in 1954 and in 1955, particularly in contrast to 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." 3/

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(footnotes, page 17, 1 and 2)

1/ The Economist, (London), July 2, 1955, page 56.

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

(footnotes, page 18, 1, 2, and 3)

1/ The New York Times, May 1, 1954.

2/ During periods of strength, the authorities are able to allow the rate to rise without formal appreciation under a flexible rate policy as an alternative to maintaining the existing upper limit or raising the par value.

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

Flexible versus fixed exchange rates

It is unexpected that the Canadian dollar and the pound have tended toward common ground after 1951 since the former has been a fluctuating and the latter a fixed par-value currency. It is usual to regard fixed and fluctuating currency systems as opposite in market behavior and in adjustment processes. <sup>1/</sup> This confluent tendency has been an outgrowth of actual post-war economic difficulties, which have encouraged attempts to devise an effective compromise between the two systems in order to minimize the particular disadvantages of each arrangement.

On the basis of post-war 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 U.K. and Canadian devaluations in 1949 and the Canadian appreciation in 1950, 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. Furthermore, 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 experience last summer when fears that the pound would be allowed to fluctuate more widely produced bear pressures on the sterling rate. Even though the disequilibrium

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<sup>1/</sup> The advantages and drawbacks of flexible exchange rates are discussed in J. E. Meade, "The Case for Variable Exchange Rates," The Three Banks Review (London), September 1955; the case against flexibility may be found in Sir Douglas MacDougall "Flexible Exchange Rates," Westminster Bank Review (London), August 1954.



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. <sup>1/</sup> A sharp clash on this point dominated the E.P.U. discussions in the summer of 1955. At a time when the British view stressed the need for greater flexibility and market freedom, Continental opinion tended to harden around the need for a fixed parity and only modest fluctuations; the Europeans wished to reduce speculative and competitive dangers which were associated in their minds with rate flexibility. <sup>2/</sup>

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 post-war experience with reference to fixed and fluctuating exchange rates. Under the Agreement, each 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." <sup>3/</sup> 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. 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.

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<sup>1/</sup> This point is elaborated in my article, "Exchange Flexibility and the Stability of Sterling," American Economic Review, March 1954, pp. 101-103.

<sup>2/</sup> The controversy over exchange-rate policy during the O.E.E.C. discussions in the summer of 1955 is discussed in "Fixed or Flexible Rate for Sterling?," The Banker, July 1955, p. 8, and "Sterling After Istanbul," The Banker, October 1955, pp. 212-3.

<sup>3/</sup> 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 compromise formula is designed to avoid the rigidities of the fixed-spread system and yet to require a commitment as to daily spread as a restraint on the local authorities. This provision is not now operative; it will come into effect only if and when the European Payments Union is terminated and only then can this attempt to compromise between a fixed and flexible exchange system be evaluated.