Mr. Thorne

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REVIEW OF FOREIGN DEVELOPMENTS

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Sterling Speculation and European Convertibility: 1955 to 1958

22 pages

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In a major breakthrough towards a freer world payments system, 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, the United Kingdom 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 3-year period; but they had the long-run consequences of forcing European countries to make adjustments in national policies in the direction of a greater degree of 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 1955-1957 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 reduced, not increased, the exchange-rate risks of the speculator; and (c) has been riskless and often costless to the speculator.

a. Exchange-rate speculation and merchant trade -- Exchange-rate speculation between 1919 and 1939 was purely a financial transaction in which the speculator transferred profits obtained 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.1/ Speculation of this character no doubt developed because short-term capital flows, unrelated to commodity trade, were blocked by exchange regulations in most countries.

b. Speculation to reduce exchange-rate risks -- After 1945, the foreign trader found that the risk of an exchange-rate change 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 ran the risk of a loss.

To the foreign trader, exchange-rate decisions under the Bretton Woods arrangements were arbitrary acts of government officials, taken with no necessary regard to opinion in the foreign exchange market. On the contrary, these decisions were clearly beyond his individual influence, and often beyond his understanding. Time after time, the merchant watched adverse conditions develop and the pound weaken; yet he could never be certain that 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, he had a substantial personal stake in the 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 also rapidly learned to use this freedom to shift as much of the financial burden as possible to the central official reserves should devaluation take place. The merchant shifted this risk by changing the timing of his foreign payments or the locale of his foreign financing. To protect himself against a weakening pound, 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

1/ 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.

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.1/ 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 consequences of these shifts in trade financing was to reduce the merchant's risks should sterling 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.

c. Limited risks and costs of speculation -- When the merchant moved out of a weak currency, his "speculation" involved little risk or cost. Even when he took a short position in a weak currency, his only risk was that the pound would cost 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 and was limited in the case of the pound to 1.4 per cent. Since the currency was weak, he could feel certain that the par value would not be raised. 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 1957 did London money rates come close to those in several continental countries and in Japan.2/

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 (see the Chart). 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.

1/ 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.

2/ As a consequence, it was common for Britain to tighten restrictions on borrowing by foreigners in London during a severe run on the pound.

UNITED KINGDOM EXCHANGE RATES AND CHANGES IN RESERVES

END OF MONTH FIGURES

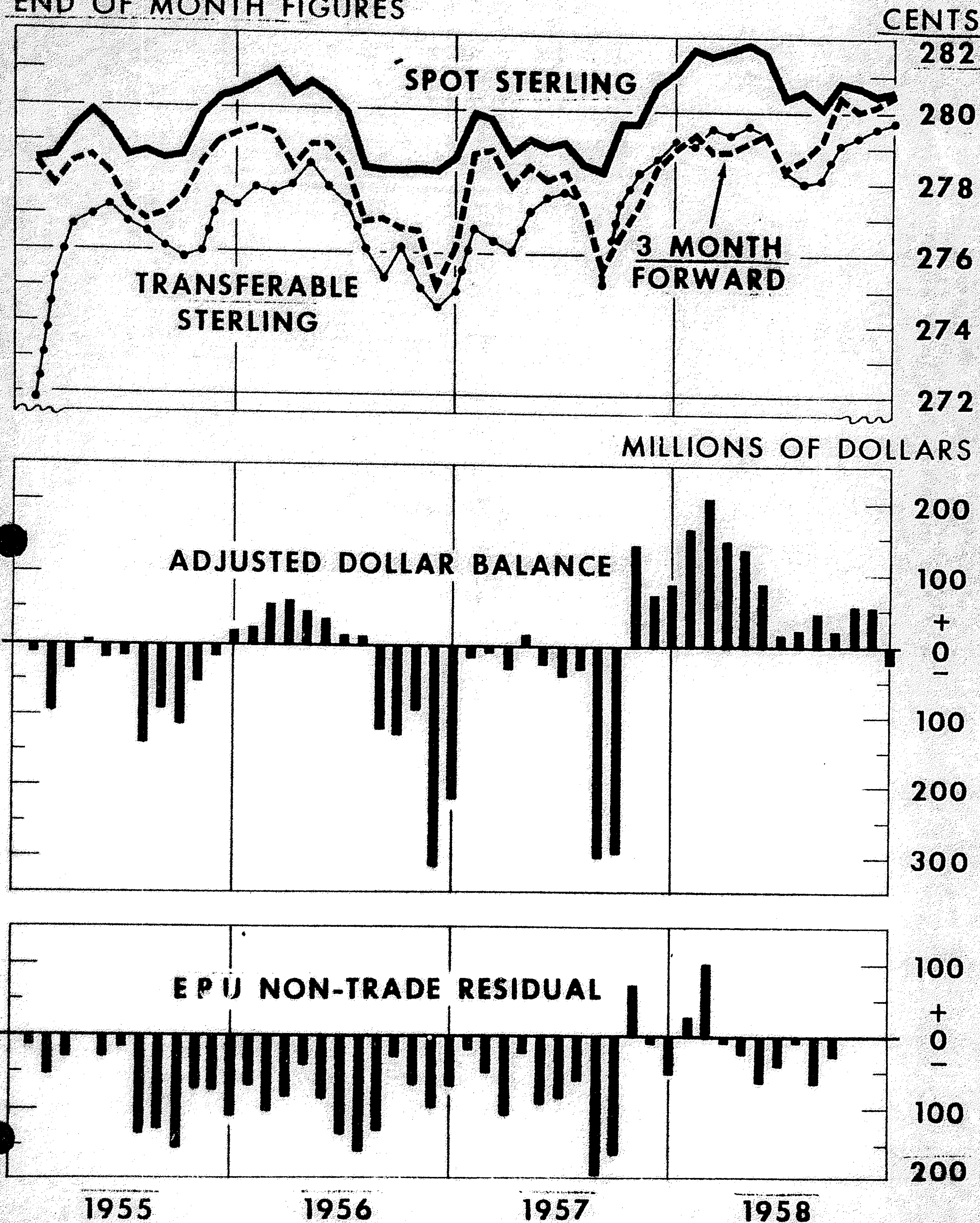

Table 1

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, July 31	278.344	276.906	276.10
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	278.656	277.65
Crisis bottom, September 19	278.281	274.281	275.60

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."1/ The Report added that this figure was "in fact nearly half the reduction in reserves that lead 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, the difference between Britain's monthly trade with European countries and its monthly payments balance as reported by the European Payments Union (called the "E.P.U. Non-Trade Residual" in the lower part of the Chart) shows a pattern of monthly fluctuation between 1955 and 1957 which seems to reflect a short-term capital factor. A negative residual figure for any month suggests a short-term capital outflow in that Britain's payments balance is less favorable than the trade balance. On the other side, a positive residual is taken to reflect capital inflow in that Britain's payments balance was more favorable than the trade balance would warrant.

1/ Cmd. 827, page 236.

Because the figures are merely a rough residual, they cannot be held to measure the volume of leads and lags.[1] Nonetheless, the behavior of the series between 1955 and 1957 clearly indicates the influence of short-term sterling speculation. As a casual inspection of the Chart will reveal, the peaks of the Residual series 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 compare in timing with a series constructed by the Bundesbank to measure speculative inflows into Germany in 1957. For this purpose, the Bundesbank[2] 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 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 3 years, 1955 to 1957, are found in Table 2.

Inspection of Table 2 reveals a close relationship in timing between speculative outflows from Britain and speculation inflows into Germany during each of the 13 months of acute selling pressures on the pound between 1955 and 1957. This correspondence becomes closer in 1956 and 1957 than it was in 1955. In 1955, the series show an opposite pattern only for the three months, July to September. We have collateral evidence that speculative inflows into Germany were limited in 1955: German balance-of-payments data show that the net errors and omissions balance for the year as a whole was small.

During 1956 and 1957, when substantial inflows into Germany are known to have occurred, the correspondence between the two series is close: the monthly signs are opposite in direction for 19 out of 24 months and the months of heavy outflow from Britain are the months of peak inflow into Germany. For 1957, the correspondence in the critical months of August and September is unexpectedly close.

1/ The residual must include a wide range of transfers on invisibles and capital accounts as well as short-term capital flows. The figures in the Chart relate only to the sterling areas trade and payments with the E.P.U. countries; they do not relate to transactions with other countries. Consequently, the seasonal payments by Britain to Europe in the third quarter (tourism and seasonal imports) contribute to the third-quarter worsening in the residual. The concept of the Non-Trade Residual and its fluctuation between January 1949 and the middle of 1951 are discussed in a paper by the author, "Leads and Lags in Sterling Payments," op. cit., pages 77-79.

2/ 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 to 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.)

Major shifts in financial policy, 1955 to 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 position at that time. These policy changes, which came about largely in response to speculative capital flows which unsettled exchange markets, helped to prepare the ground for the general European move to nonresident 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. From an analytical point of view, 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 and to the German reserve accruals both because of its own weak external payments position during the period and because of the large foreign holdings of, and borrowings in, sterling, a key international currency.

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 3-3/4 per cent below the minimum German loan rate in 1955 but was only one-half per cent higher three years later. Only in long-term bonds did German yields continue substantially to exceed British yields in early 1958. Even so, the difference in German yields was only about 1 per cent at the end of 1957 compared with about 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, domestic demand conditions 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 a higher level of money rates in Britain.

Table 3

Comparison of British and German Central and Commercial Bank Lending Rates, 1955 to 1959

Date		Central Bank discount rate: United Kingdom (in per cent)	Central Bank discount rate: Germany (in per cent)	Commercial bank lending rate: United Kingdom a/ (in per cent)	Commercial bank lending rate: Germany b/ (in per cent)	German bank borrowing from central bank (in billion of DM)
1954:	End of year	3	3	4	7-3/4	1.9
1955:	Jan. 27	3-1/2		4-1/2		1.8
	Feb. 24	4-1/2		5-1/2		2.2
	Aug. 4		3-1/2		8	1.9
1956:	Feb. 16	5-1/2		6-1/2		4.3
	Mar. 8		4-1/2		9	4.9
	May 19		5-1/2		10	4.1
	Sept. 6		5		9-1/2	2.9
1957:	Jan. 11		4-1/2		9	2.3
	Feb. 7	5		6		2.1
	Sept. 19	7	4	8	8-1/2	1.6
1958:	Jan. 17		3-1/2		8	1.3
	Mar. 20	6		7		1.6
	May 22	5-1/2		6-1/2		1.3
	June 19	5		6		1.5
	June 27		3		7-3/4	1.5
	July 21				7-1/2	1.3
	Aug. 14	4-1/2		5-1/2		1.0
	Nov. 20	4		5		.8
1959:	Jan. 10		2-3/4		7-1/4	.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*.

In Germany, different considerations were involved. International factors were adding to domestic demand and to internal liquidity. For German policy makers there was a choice 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. In this sense, international factors had a key role in fashioning the general line of domestic policy; but it is significant that credit easing in Germany proceeded only as rapidly as domestic considerations permitted.

Secondly, the working out of these policy shifts was neither orderly nor continuous. On the contrary, both the British and the German authorities proceeded only slowly to make the policy shifts required to bring their economies into better balance. Britain experienced four successive foreign-exchange crises between mid-1955 and mid-1957 before decisive stabilization action was taken. Similarly, the German authorities acted only slowly to ease credit conditions from mid-1956 to mid-1957 because of the strength of internal demand pressures.

Thus, it was not until September 1957, after several months of Europe-wide currency disorders, that the British and German authorities moved decisively to adjust domestic financial policies. These actions followed major stabilization efforts by France in August and by the Netherlands in July. At the same time, domestic demand pressures had begun to ease off as the peak of Europe's extended private investment boom which commenced in 1954 was passed and declining import prices bolstered European external payments positions. This was the environment in late September 1957 when the British authorities sharply pushed up the entire structure of their money rates and the German authorities quickened the easing of domestic credit conditions.

The extent of the rise in British money rates between 1955 and the end of 1957 is summarized in the following selected money rates (in per cent per annum):

	Jan. 1955	Jan. 1958
Bank Rate	3	7
Treasury bill yield	2.05	6.27
Commercial bank lending minimum	4	8
Long-term bond yield	4.04	5.53

By contrast, the declines in German rates from the mid-1956 peak when it was decided to reduce interest rates rather than to adjust the exchange rate were (in per cent per annum):

	May 1956	Jan. 1958
Bank Rate	5-1/2	3-1/2
Treasury bills	5-1/4	3-1/2
3-month loans	5-5/8 - 6-3/4	3-3/4 - 3-7/8
Commercial bank prime lending rate	10	8
Long-term public bonds[a]	5.9	5.4

a/ 5-1/2 per cent tax-free bonds.

Britain's four foreign-exchange crises, 1955-1957

Because Europe's progress toward better financial balance was neither smooth nor deliberate, the details of each of the four periods of speculation against the pound experienced between mid-1955 and mid-1957 differed in a number of respects. On the other hand, the episodes were similar in two important respects. First, necessary domestic policy adjustments came only after protracted disturbances had occurred in exchange markets and reserve losses or gains had forced the authorities to take steps to reduce market pressures. Britain experienced four such episodes, two of which coincided with substantial reserve accruals by Germany. Secondly, leads and lags in foreign trade financing were a major source of pressure in exchange markets: there were four periods of heavy sales of sterling and two periods of substantial purchases of D-marks.

In broad outline, the reserve losses experienced by the United Kingdom during its four crises are summarized in Table 4. Actual reserve losses, as reported by the Treasury, are shown in the first column, reserve losses adjusted for known government capital transactions (such as Fund drawings and repayments, E.P.U. repayments and transactions with the United States Government) are shown in the second column and the total E.P.U. Non-Trade Residual is shown, for purposes of comparison, in the final column. A summary of the details of each of these episodes follows.

Table 4

United Kingdom: Selected Official Reserve Changes, 1955 to 1957
(In millions of U.S. dollars)

Period	Number of months	Reserve losses: Actual	Reserve losses: Adjusted[a]	E.P.U. Non-trade residual[b]
I. 1955: July to Sept.	3	- 335	- 345	- 412
II. 1956: May to July	3	+ 77	+ 63	- 384
III. 1956: Aug. to Dec.	5	c/- 272	- 690	- 397
IV. 1957: July to Sept.	3	- 531	- 628	- 422

a/ Actual reserves adjusted for known government capital transactions.
b/ Calculated as difference between Britain's monthly trade balance with E.P.U. countries and the payments results.
c/ Includes $177 million sale of Trinidad oil shares to a U.S. company and $561 million drawing from I.M.F.

(1) "Flexible pound" crisis (July-September 1955) -- This crisis was set off by continental European opposition to a proposal by British officials for a more flexible exchange rate policy made at talks to renew the E.P.U. Agreement in Paris in June 1955.1/ The British preference for greater flexibility led "overseas observers" to conclude that "a widening of the permitted range of rate fluctuations (would mean that) a fall in sterling below its present limit of $2.78 would be inevitable."2/

The opposition of continental European countries to the British suggestion was based on distrust both of the value of the pound and of British motives. Their representatives felt that the British wished to have sterling in a reconstructed foreign exchange market replace the E.P.U. payments system; in addition, they felt that the British wanted to avoid the obligation to maintain narrow fixed rates or even a par value for the pound. Such rate flexibility placed upon the continental countries the risks of any fluctuation in the exchange value of the pound.

Even if the continentals had not in principle opposed greater flexibility for the pound, they could find in domestic British developments reasons for the fear that any widening of the spot spread could only mean a depreciation of the sterling rate. Strikes had hurt Britain's exports and the domestic business expansion was moving at a rapid pace. Later, the Radcliffe Committee formed the judgment that the authorities had in 1954 gone "too far in the direction of stimulating demand, and ... were too slow to change direction when the signs of inflation were apparent."3/ In The Banker's words, foreign concern about Britain's ability to maintain its competitive capacity in world markets was "the original foundation of the bear view of sterling, more recently so strongly reinforced by the rumors about exchange policy."4/ The Banker added: "the familiar 'leads and lags' ... (was) the dominant cause of sterling's weakness."

This foreign-exchange crisis forced the British authorities to make two major changes in policy. On the international side, the Chancellor brought to an end any notion of greater rate flexibility in a statement at the I.M.F. meeting in Istanbul in September. After reaffirming the intention to maintain the $2.80 parity for the pound "either in existing circumstances or when sterling is convertible," he went on to say that

> "we do not contemplate any early move on any -- I repeat any -- aspects of the exchange front"5/

1/ "Sterling Fixed or Flexible?" The Banker (London), July 1955, pages 7-14.
2/ "Sterling Under Strain," The Banker (London), August 1955, page 85.
3/ Radcliffe Committee Report, Cmd. 827, August 1959, pages 144-45.
4/ "Sterling Under Strain," The Banker (London), August 1955, page 87.
5/ International Monetary Fund, Annual Meeting, 1955, page 39.

On the domestic front, the Chancellor sought to bring the boom under control. At the end of July, he asked the banks to make a "positive and significant reduction in the total of bank advances outstanding." He also slowed down investment spending in the public sector and tightened installment credit regulations. By October, he found it necessary to introduce a special Budget to curtail internal demand further, to reduce housing subsidies, to check the volume of Treasury lending to local authorities, and to ease the Treasury's difficulties in raising its capital needs from noninflationary sources. Then in February 1956 a further series of measures were introduced. Bank Rate was raised from 4-1/2 to 5-1/2 per cent, installment credit controls were tightened fruther, and steps were taken to reduce public and private investment. These measures were supported by the regular budget, introduced in April, which concentrated on promoting private savings and on encouraging Treasury sales of securities outside the banking system.

(2) The First European Crisis (May-July 1956) -- The intra-European character of this crisis is underlined by the fact that, during this period, Britain actually maintained a surplus in its dollar accounts; its deficit was exclusively in intra-European payments (see Table 4 and the Chart). Unsuccessful attempts to keep the investment boom in the United Kingdom under control formed the background for pressure on the sterling rate which developed in the spring of 1956 after the German authorities took a series of restrictive measures. The Bundesbank's discount rate was raised to 3-1/2 per cent (from 3 per cent) on August 4 (1955), to 4-1/2 per cent on March 8 (1956) and to 5-1/2 per cent on May 16. The rate at which the German commercial banks increased their indebtedness to the Bundesbank during this period is a good measure of the speed with which monetary restraint was effective: their borrowings rose from DM 2.1 billion in mid-1955 to DM 4.4 million in December and to a record level of DM 4.9 million by March 1956 (see Table 3). Fiscal policy contributed to monetary tightness in that Treasury tax receipts (earmarked for defense spending) were sterilized at the Treasury's account at the Bundesbank and served to offset the D-mark liquidity created by substantial foreign-exchange purchases by the Bundesbank.1/

1/ The slowness with which German defense spending proceeded at this time was compatible with the views of European neighbors distrustful of German rearmament. Retention of current tax receipts at the central bank is from a monetary point of view the most restrictive form in which the Treasury can handle its tax receipts; it was possible to do this in Germany at that time because of the primitive character of Germany's capital markets and the absence of any outstanding central government debt. In other countries, surplus tax receipts are ordinarily used to retire Treasury debt as a matter of course; these repayments both reduce the Treasury's debt burden and avoid excessive contraction in capital markets (such as occurred in Germany at this time). However, repayment of debt serves to undo the contractive effects on bank reserves and on money supply of the original tax payment to the Treasury.

By the spring of 1956, the effect of these restraints was to induce substantial inflows of foreign funds into Germany. In its June Report, the Bundesbank stated that heavy exchange accruals of the foreign trade banks "were influenced by the persistently strained liquidity situation of the German banks and the raising of the German money market's interest rates in May."1/ The accrual of foreign exchange, together with Germany's continued trade surplus, encouraged rumors of a contemplated revaluation of the D-mark. Even though the Federal Government and the Bundesbank declared the rumors "to be entirely without foundation," the Bundesbank reported that speculative considerations contributed to the inflow of funds. In turn, the consequent exchange accruals and continued trade surplus further encouraged rumors of currency of appreciation. In this way, tight money within Germany and revaluation rumors reinforced each other in bringing foreign funds into Germany.2/

By July, the Bundesbank explained its "exceptionally large accruals of gold and foreign exchange" by two factors: "speculation on an upward revaluation of the Deutsche Mark" despite repeated official denials and shifts in leads and lags in foreign trade financing.3/ Two important ways in which leads and lags were being carried out were: (a) increased financing abroad of foreign trade by German banks; and (b) changes in the conditions of payments agreed between merchants in foreign trade (page 32).

The high point of monetary restriction in Germany came when Bank Rate was raised from 4-1/2 to 5-1/2 per cent on May 19, 1956. In the months of May, June and July, there were sizeable outflows of funds from Britain (see Table 2 and the Chart) and inflows into Germany (see Table 2).

Faced with a continuing external surplus and persistent reserve accruals, the German authorities made a major change in the direction of German monetary policy. Formal reversal of this policy took place only on September 6 when Bank Rate was reduced to 5 per cent. Even earlier,

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1/ Bundesbank, Monthly Report, June 1956, page 29.

2/ The credibility of the revaluation rumors was enhanced when the German Minister for Economic Affairs, Dr. Erhard, proposed in a letter to the British Chancellor that "a discussion of the problem of exchange rate parities" take place at the mid-July meeting of the O.E.E.C. According to The Banker, Dr. Erhard expressed the view that "the current pattern of exchange rates must be 'entirely distorted.'" He apparently proposed, as a first step, that "exchange rates should be made flexible within a total margin of 10 per cent of existing parities." Dr. Erhard's letter is reported to have received a "curt rebuff" from the British Treasury. See, "Revise Europe's Exchanges?", The Banker (London), August 1956, pages 462-3.

3/ Bundesbank Monthly Report, July 1956, page 31.

however, commercial bank borrowing from the Bundesbank had been sharply reduced. From the peak of DM 4.9 billion in March, the total declined to DM 4.1 billion in May and DM 3.4 billion in July (see Table 3). In addition, the range of 3-month loan rates in the Frankfurt money market reached a peak of 6-3/4 - 7 per cent in July and eased to 6-5/8 - 6-7/8 per cent in August. Furthermore, the resumption of new bond and share placings in Germany after the low was reached in June suggests that capital market conditions may have begun to ease by the end of July.

(3) The Suez crisis (August to December 1956) -- Nationalization of the Suez Canal late in July revealed the common vulnerability of all the European countries and temporarily brought to an end these intra-European payment stresses. Stoppage of Canal traffic forced all of them to make heavy dollar outlays. As a result, the balance-of-payments positions of all European countries with the outside world, and particularly with the dollar area, deteriorated.

The United Kingdom underwent five months of exchange crisis. At the outset, speculative capital outflows took the form of heavy withdrawals of sterling balances rather than the usual shifting of merchant payments. According to The Banker, India drew down its balances by £150 million (to prepay for capital goods orders placed on the continent), Japan withdrew virtually all its £130 million holdings built up during 1955, and China and Middle East holders (who looked on the blocking of Egyptian balances "as a warning and a precedent") made heavy sales of pounds.1/

Where earlier Britain had been running a dollar surplus, after July heavy dollar losses were incurred (see the Chart). After August, when balances had been moved out of London, Britain's deficit with Europe (the Non-Trade Residual) declined sharply (see the Chart and Table 2). At the same time, the German leads and lags inflow was lower after August than it had been in the three preceding months (see Table 2).

Britain's exchange crisis reached its culmination at the end of November when military operations were undertaken. The pound underwent selling pressures from all sides. Finally, in early December, after the military and political situations had been quieted, an international support program rescued sterling. The International Monetary Fund, making a major commitment of its resources, played a crucial role in a world payments crisis for the first time. In addition, the U.S. Export-Import Bank granted a $500 million stand-by credit.

(4) Second European Crisis (July to September 1957) -- As the Suez difficulties disappeared, the imbalance in European payments, apparent in early 1956, re-emerged. Both the pound and the D-mark were affected,

1/ "Sterling After the Run," The Banker (London), February 1957, page 83.

the pound undergoing a particularly severe crisis and the D-mark a massive speculative inflow of funds. Other European currencies were also affected, particularly the French franc and, to a lesser extent, the Dutch guilder; but our attention will be confined to the experience of the pound and the D-mark.

The consequences of the 1957 exchange crisis were to force the British and the German authorities to make major changes in domestic financial policy. The British action was to raise Bank Rate from 5 to 7 per cent and, with other measures, to raise the structure of short-term British rates above the level of German rates, as may be seen in Table 3.

Britain's difficulties during 1957 were not so much a matter of weakness in the foreign trade position but, in the words of the Cohen Council,

> "to the belief that she had lost control over the internal value of her money. Nor was that belief confined to foreigners: we now know that in the first half of 1957 there had been a marked acceleration of the rush by British residents to place their savings in dollar countries (the so-called 'Kuwait gap'); and in the summer there were times when even the British Government found increasing difficulty in marketing its longer-term securities."[1]

An international crisis was soon superimposed upon the difficult internal position. There was general talk about a possible appreciation of the D-mark in the second quarter. Finally, in August, when the French franc was devalued, a severe exchange drain developed. The run on sterling took the form of heavy shifts of funds into D-marks and to a widening forward discount on the D-mark. By September it was clear that remedial action would be required.

The British authorities decided not simply to seek to stop the gold and dollar drain but, in the words of the Cohen Council, "to produce decisive results in the sphere of home prices and costs" (page 34). As a shock action, the Bank of England raised its discount rate from 5 to 7 per cent and additional financial restraints were introduced. Because the rise in Bank Rate ran the danger of being interpreted by financial and exchange markets merely "as some sort of panic action,"[2] it was in fact an act of courage on the part of the British authorities. It moved up the entire structure of money rates in Britain to postwar highs and proved to have decisive consequences on Britain's foreign and domestic economic situations.

1/ Council on Prices, Productivity and Incomes, First Report, H.M.S.O., London, 1958, page 34.

2/ See the testimony of Mr. Cameron Cobbold before the Bank Rate Tribunal, H.M.S.O., December 1957, question 8115, page 211.

On the German side, credit conditions were relaxed only slowly after the summer of 1956 because of bouyant investment demand. Bank Rate was reduced from 5-1/2 to 5 per cent on September 5, 1956 and to 4-1/2 per cent on January 11, 1957. The domestic boom precluded further credit easing. German reserve accruals slackened off momentarily but the trade surplus remained substantial.

Finally the mid-1957 European exchange crisis, the most general foreign exchange disturbance since the 1949 devaluations, produced a massive speculative inflow into Germany. Much of the inflow seems to have been funds shifted from London. At least, the inflows into Germany during the peak months of August and September 1957 were very closely matched by outflows from London. In August, the forward D-mark went to a premium of more than 10 per cent per annum against the pound.

On their part, the German authorities reiterated their determination not to revalue the D-mark. However, they did proceed materially to ease credit conditions in Germany further. On September 19, when Bank Rate rose to 7 per cent in London, it was reduced to 4 per cent in Frankfurt and to 3-1/2 per cent on January 17 (1958). As we have seen in Table 3, German short money rates had moved below London rates by the end of 1957 and commercial bank borrowings from the Bundesbank were reduced.

Achievement of European convertibility

One year later, at the end of 1958, the United Kingdom announced the merging of American-account and transferable-account sterling. With this step, full convertibility of the pound for current earnings of non-residents was achieved. Simultaneously, Germany, France, and 11 other European countries also moved to convertibility.

A number of factors made possible this major breakthrough in European payments. Perhaps the major factor was the sharp decline in the prices of Europe's imports, especially of food and raw materials, which occurred during 1957. This decline marked a major adjustment in world price relationships and represented a structural shift, long-term in character and in significance, in the international position of Western Europe. European countries had been paying high prices for imports between 1945 and 1957, and particularly after the Korean episode pushed up primary product prices in late 1950 and early 1951. The major decline in these prices which occurred in 1957 meant that it had taken a little more than a decade after World War II for more normal supply-demand relationships to be restored for primary products and major foods; by contrast, the major decline in primary product prices after World War I occurred around 1928 and 1929, about a decade after hostilities had ceased.

Lower import prices strengthened European payments positions in at least two ways. In the first place, reduced foreign currency outlays for imports produced enlarged payments surpluses for European countries in 1958 and 1959. For example, the O.E.E.C. estimated that the current account surplus of the 17 European countries ran at an annual rate of $4 billion in 1958 and 1959 even though the value of exports was only fractionally higher in 1958 and 1959 than in 1957.1/ As a result, the combined foreign exchange reserves of O.E.E.C. member countries rose by $3.7 billion in 1958 and $1.4 billion in 1959.

The improvement in Europe's current account came in the second half of 1957. Where the combined current surplus was only $6 million in the first half of 1957, it then ran in half-year periods as follows (in billions of U.S. dollars):

1957:	II	1.5
1958:	I	1.5
	II	1.5
1959:	I	1.8
	II	2.4

The O.E.E.C. estimated that, because average import value declined by about 10 per cent, member countries had been able to increase the physical volume of their imports by nearly 10 per cent between 1957 and 1959 and yet paid an import bill of only $46.7 billion in 1959 compared with a total of $47.3 billion in 1957.2/ In the case of Britain, the 10 per cent decline in import prices in 1958 reduced foreign outpayments by about $0.8 to $1.0 billion per year.

In the second place, lower priced imports helped to stabilize domestic prices in European countries. In Britain, for example, a 10 per cent decline in basic materials prices from 1956 to mid-1958 (reflecting lower import prices) by itself was estimated to have lowered the price index of manufactured goods in Britain by 2-1/2 per cent3/ since imported materials account for about one-fifth of the cost of finished manufactures at the factory. Lower food prices also contributed to holding down wage increases.

Several other factors contributed to European stabilization after 1957. The private investment boom, which had been underway in Europe since 1954, reached its peak in 1957 and slackened thereafter. Diminishing private investment pressures helped to make effective the general efforts

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1/ Europe and the World Economy, O.E.E.C., Eleventh Annual Review, April 1960, page 9 and Table 7 page 119.

2/ Ibid., Tables 7, 27 and 28.

3/ Council on Prices, Productivity and Incomes, Second Report, H.M.S.O., August 1958, page 6.

made by most European countries during 1957 to bring domestic inflation under control. The successful French stabilization program, the major efforts made by the Netherlands in midsummer and the United Kingdom in September were examples of far-reaching efforts to deal with accumulated inflationary pressures. Specific financial measures were also taken to end one source of current inflation -- the financing of central and/or local government capital spending by the banking system.

Finally, the recession in the United States in 1957-58 calmed inflationary psychology in many parts of Europe. The appearance of unemployment in this country had a chastening impact on the wages front, particularly in the United Kingdom.

In this way, the coincidence of a number of favorable developments during 1957 made effective the measures of financial stabilization taken by European countries during the year. From the point of view of dissipating accumulated inflationary factors, the timing of the stabilization efforts in 1957 could hardly have been more fortunate. If fortuitious developments contributed to the success of these stabilization measures, however, it should nonetheless be recognized that the European countries could have dissipated these windfall advantages. The reward of their restrictive efforts was substantial balance-of-payments surpluses achieved without any significant growth in unemployment. In this situation, these countries proceeded gradually to relax trade and exchange restrictions and at the end of 1958 to achieve full nonresident convertibility.

Yet the importance of the better intra-European payments balance achieved as a result of the measures taken by major countries in 1957 should be recognized. From the intra-European point of view, the principal creditor country, Germany, had undertaken through a deliberate low interest rate policy to bring down money rates below those in near-by countries. The result of this policy was eventually in 1959 to provide temporary financing of Germany's persistent trade surplus through German capital exports; earlier it reduced the capital inflows into Germany which were disequilibrating because of the current account surplus. The capital inflows which at a time of large current-account surplus produced heavy German reserve accruals in 1956 and 1957, were reduced in 1958, and in 1959 were replaced by sizeable outflows for a temporary period just after European convertibility had been achieved.

The importance of the better balance in British and German credit conditions achieved in 1957 was by no means obvious at the time. Just two years later, in the summer and fall of 1960, the western countries again experienced widespread currency difficulties. In 1960, the specific factors which had contributed so much to European stabilization in 1957 -- lower import prices, cooling off of the private investment boom and the maintenance of financial restraints -- were still in evidence. The big difference between 1958 and 1960 was that the German authorities had found it necessary to abandon their low interest policy and returned once again to a situation where credit was dearer and tighter in Germany (despite its continued trade surplus) than in neighboring countries. This German policy shift, which upset the intra-European financial balance achieved in 1958 and 1959, was unquestionably an important element in the widespread currency disturbances in the summer and fall of 1960.

Exchange speculation and the Bretton Woods system

Merchant speculation in the form of shifts in foreign trade financing has developed in the postwar period because the Bretton Woods arrangements provided such a limited role for market opinion in the setting of exchange rates. The par value which each member is obligated to declare is determined by governmental authorities without regard for market opinion.

During the postwar period, member governments have been conspicuously reluctant to alter par values. Because government officials have been conscious of the political consequences of exchange-rate actions, exchange-rate policy has often been dominated by domestic political, rather than economic or financial, considerations. Devaluation has usually been resisted because it was a public admission of mismanagement, or at least it provided political opponents with the grounds for making such a charge. On the other hand, appreciation has been resisted because the voices of those hurt by appreciation have been loud. The Canadian Finance Minister has emphasized this aspect of exchange rate policy:

> A change in the external value of the Canadian dollar brings gains to some Canadians and losses for others.[1]

With conflicting interests involved, government officials have been tempted to avoid any change in exchange rates and thereby avoid the cross-currents of criticism which any change in par value would entail.

The reluctance of officials to act on exchange rates was reinforced by the insoluble difficulty under the Bretton Woods arrangements of determining what the new par value should be. Government officials found that there was no certain technical basis for setting a new par value. Hence, the move from one par value to another became too much a leap in the dark and involved substantial risk of human error. Furthermore, the fixed par value and narrow fluctuation for the spot rate meant that errors of judgment could not easily be reversed.

This was the context within which merchant speculation developed in the postwar period. From the merchant's point of view, his speculation was in self-protection, a means by which he shifted the uncertainty about exchange rates and about government policy actions from his shoulders

1/ House of Commons Debates, Ottawa, June 17, 1958, page 1234.

to the country's central reserves. Because he saw that government authorities were in general slow to act and often seemed to prefer to live with maladjustments rather than to change policies, he worked out ways to protect his private interests against the uncertainties of official policy-making.

The limited range of fluctuation for the spot exchange rate under Article IV (Section 3(i)) made it easier for the merchant to take the exchange risk involved in his shifts in trade financing. Because currencies under pressure are not likely to be appreciated, the merchant has been able to calculate that the maximum risk involved in an open short position was no more than 1.4 to 2.0 per cent. Furthermore, he did not have to wait until the spot rate reached the upper limit before covering. In any case, any loss could be written off against income as a form of insurance.

Yet proposals to introduce greater rate flexibility in an attempt to increase the risks to the merchant of such shifts in trade financing can be hazardous, as the United Kingdom discovered in 1955. Britain's experience reveals that there are at least three substantial objections to a policy of widening the fluctuation about the par value. Objections would presumably be even greater if a system of freely fluctuating rates without any par value were introduced. In the first place, the view seems to be widely held among the continental European banking community that greater rate flexibility is merely a certain road to steady depreciation. The National Bank of Belgium has stated this viewpoint in these words:

> Experience moreover shows that frequently in practice the exchange rate will not fluctuate about parity but will progressively depreciate because it is difficult, once the dicipline imposed by a stable exchange has been given up, to gain acceptance for the economic, monetary and financial measures that are needed for maintaining the economy's equilibrium.1/

Secondly, the European financial community has a vested interest in a narrow spread in the pound-dollar rate. Governor Brofoss of the Bank of Norway has pointed out, even with the present small margin of fluctuation "there will be some manoeuvrability as regards choice between 'following the pound' and 'following the dollar.'"2/ The wider the dollar-pound variation, the greater the problem of choice European bankers face. Since this is an insoluble difficulty for them, the Europeans must look with favor upon an arrangement which eliminates the need to choose.

1/ National Bank of Belgium, Report for 1957, Brussels: 1958, page 11.
2/ Norges Bank Bulletin, December 15, 1959, page 92.

Finally, because the British authorities are undoubtedly the most active official traders in world exchange markets, it has been noted that any system of substantial rate flexibility would give them a disproportionate influence on the structure of exchange rates established in these markets. Neither the United States nor continental European central banks are presently equipped in terms of tradition, technical resources or geography[1] to trade in comparable volume or to have a comparable influence on the world's exchange rate structure. This objection is probably more relevant to a system of freely fluctuating rates without a par value for major currencies than to a system where the spot rate is allowed to fluctuate about an established par value.

Concluding observations.

One result of Britain's "flexible pound" crisis in 1955 was to ensure that the introduction of greater flexibility was not thereafter proposed as a policy by any European country. Britain's proposal for more flexibility for sterling served to crystallize continental distrust of rate flexibility just at the time when major structural changes of a long-term character were taking place in world trading relationships. As this review has attempted to indicate, even year-to-year shifts of substantial significance did occur between 1955 and 1957.

The essential condition of international payments balance in a rapidly changing world, with a system of fixed exchange rates, must be a continuous willingness to make policy adjustments on the part of both debtor and creditor countries. The leads and lags used by merchants in trying to meet the changing conditions of international money markets between 1955 and 1957 appears to have been due to the reluctance of European countries to proceed with necessary changes in policy in the direction of greater intra-European payments balance.

The achievement of convertibility did not entirely end these adjustment difficulties. The policy shifts which took place in the second half of 1957 were soon out of date, and further international payments

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1/ The London foreign exchange market is at the center of world exchange trading today and the pound remains the principal international currency for European exchange markets. For example, Mr. Strohmeier, a leading Swiss foreign-exchange banker, told the Forex Club in London in a speech on March 25, 1957:

> "I really do not know what other currency could replace sterling if ever your currency should unexpectedly ... fail to perform its valuable function as an international currency. The dollar certainly could not replace sterling. Switzerland ... could not provide ... enough francs. The only solution ... would be the creation of a united European currency."

difficulties soon arose. By mid-1960, only 18 months after European convertibility had been achieved, the western countries once again experienced widespread foreign exchange disturbances; nine months later, in the spring of 1961, foreign exchange markets continued to be unsettled.

The re-emergence of exchange difficulties in 1960 and their continuation into 1961 reaffirms the need for continuous adjustments in national policies for the maintenance of convertible currencies. The liberal payments arrangements which have now been achieved require an adjustment mechanism to ensure continuous shifts in national policies in the direction of maintaining a tolerable balance in the pattern of world payments. In my view, speculative leads and lags made a significant contribution to the process of international adjustment prior to 1959, when they played a key role in forcing needed changes in national policies. There is every reason to believe that merchants will continue these shifts in their financing of trade, so long as national authorities are reluctant to make needed adjustments in national policies in the interest of a better international payments balance.