

LEADS AND LAGS IN OVERSEAS TRADE

The Committee on the Working of the Monetary System in its Report (paragraphs 639 and 640) referred to changes in the terms of commercial credit, or 'leads and lags' in the times of settlement in international trade, as being of particular importance amongst the group of short-term movements which can bring pressure to bear on the U.K. reserves of gold and convertible currencies. The Committee thought that changes in the times of settlement, by delaying or accelerating movements of foreign exchange, could have a marked effect on the reserves without there being any change in the underlying balance of visible trade and services. Because of the very large turnover of trade between the United Kingdom and the rest of the world, small changes in the times of settlement might have significant effects. The Radcliffe Committee concluded that too little was known about this and that a study of the methods by which British exports and imports were financed would throw light on the problem.

What are leads and lags? The term 'leads and lags' has come into common use in the past few years but has rarely been clearly defined, and is often used loosely to cover all those temporary and abnormal influences affecting the reserves which cannot readily be isolated and measured. It is therefore necessary to be more precise and in this note the phrase is used in a narrower sense, as indicating a displacement from normal in the time at which settlement is made in the course of international trade. Thus, if an importer delays settlement beyond the date customary in the trade this would be called a 'lag'; if he pays earlier than normal this would be called a 'lead'. Similarly, if an exporter obtains the proceeds of his exports earlier than normal this is described as a 'lead', and there is a 'lag' if settlement is delayed. The initiative may come from either the U.K. or the overseas trader. 'Leads' and 'lags' may also occur in settlement for services and, occasionally, for capital assets.

There are wide variations even in normal terms of settlement in different trades; furthermore, traders often have to arrange particular terms to suit particular contracts. Changes in the composition of trade and in the needs of individual contracts may therefore, in the ordinary course, affect the relationship between the flow of goods and changes in the reserves. Only when there are many traders who find it an advantage to make a similar change in the time of settlement will there be a significant displacement of the sort with which we are here concerned.

Other short-term movements Apart from leads and lags as here defined, there are many other complex and inter-connected financial transactions which, also without any change in the balance of visible trade and services, may temporarily affect the level of the reserves. For example, international traders might change their place of borrowing in the expectation of changes in exchange parities, or as a result of variations in the cost or the availability of credit in different centres. A foreign importer who switches his borrowing from another centre to London pays the U.K. exporter with borrowed sterling. The importer has then paid and the exporter received cash at times normal for both. For them there has been no leading or lagging. Nevertheless, the delay in the benefit to the reserves because of the switch to using London credits is much the same as that resulting from displacements in the normal time of trade settlements. In a somewhat similar way a rise in the amount of credit extended by the United Kingdom may result quite simply from an increase in those U.K. exports which are normally sold on credit as opposed to those which are not, without any abnormal delay in payment by the overseas importers.

Influences which cause traders to act in a particular way will also affect others who engage in international transactions. In particular, foreign holders of sterling may be influenced to change the level of their balances

as a result of variations in relative interest rates, or in the degree of risk judged to attach to existing exchange parities. Such short-term movements can indeed be of great importance in causing swings in the reserves.

Although these financial transactions do not involve leads or lags in the narrower sense, many of them arise because of the existence of trade contracts. Their effect on the reserves is similar to that of leads and lags and it would be useful if it were possible to make a distinction between all those transactions which arise from trade contracts, and thus affect only the timing of changes in the reserves, and other short-term transactions, unconnected with trade, which bring about a rise or fall often to be reversed later. In practice, it is impossible to make such a distinction.

This note is primarily concerned with abnormal displacements in the time of trade settlements, but it is important to remember their inter-connection with the other short-term movements.

Why leads and lags happen The most frequent cause of leads and lags is the dislike of the trader (or of anyone else who has to make a payment across the exchanges) for running any exchange risk. Where a trader has to pay or receive his own currency in settlement he is unaffected. The incentive to alter the timing of settlement can affect only the trader who carries the exchange risk and does not choose to cover it forward in the foreign exchange market.

Among the other reasons which may influence traders to alter the time of settlement is a change in the cost and in the difficulty of obtaining credit; for instance, the recent credit restrictions in this country may have encouraged U.K. importers to delay payment in order to reduce reliance on bank advances. Or again an exporter, fearing the placing of government restrictions on his customer's remittances, might encourage early payment by offering attractive terms for cash settlement, although the need for this is reduced by the possibility of obtaining insurance against such risks.

Trade practices The trader who wishes to hasten or delay payment must reckon with

the interests of his trading partner or of the bank which is providing credit. Much will depend on trade customs. They vary considerably in the extent to which, once the terms of the contract have been fixed, it is possible to change the time of settlement. Trade is often conducted on a sight basis, that is by payment against delivery of the goods, or rather the documents of title to the goods. On the other hand, a large part is done by the use of credit, and, where term bills are drawn, the most usual period is ninety days.

By far the greater part of the trade in primary commodities effected by way of international markets is transacted on the basis of cash or acceptance of bills against documents, these being the terms normally written into the standard form of contract used in the London markets. Where the contract calls for cash against documents, the terms may well specify only the final date of payment so that the purchaser is free to pay at any time between arrival of the documents and this final date. Thus, payment may possibly be advanced, sometimes against rebate, to the moment at which the documents become available, or delayed until the last day of settlement specified in the contract; and this might give a spread of as much as two or three weeks. The possibility of making a change in contracts calling for the acceptance of bills against documents is explained on page 20.

What proportion of international trade in the various commodities is transacted in the organised markets is difficult to determine, but it appears that most of the trade in tin, rubber, sisal, jute and coffee is dealt with in this way. In cocoa, copper, lead and zinc a good deal of international trade by-passes the markets but payment is probably made either in regular instalments (copper) or in accordance with specified contract terms. Much the same possibilities for variation in the time of payment exist, therefore, for these commodities except that they would be limited wherever settlement is by regular instalments.

Commodities which are auctioned are usually paid for soon after the sale but there may be scope for delay. At the wool auctions in Australia for instance the 'prompt' period for payment is a fortnight to three weeks from the date of the auction but this period may

possibly be extended on certain occasions. Similarly, at the tea auctions in London, although the documents are more often than not taken up promptly under rebate, payment can be made up to three months after the sale.

Another broad group is that in which goods are liable to loss of weight during shipment and for which settlement is frequently made in two parts. For example, with cotton, copra and feeding stuffs, it is common for the invoice to be based on shipping weights and for a first instalment of between 90% and 98% to be paid against documents (but not always before arrival of the ship), the balance being settled after weighing. Such final settlements could probably, if it seemed worthwhile, be delayed longer than if payments were made against documents, but the amounts involved are likely to be small.

In certain trades outside the primary commodity group, small discounts are frequently offered by suppliers if settlement is made in cash within twenty-eight days of receipt of documents rather than by acceptance of a bill. Trades in which this occurs most frequently are clothing, textile manufactures and some miscellaneous manufactures. Here there is probably a span of something up to one month within which settlement may take place.

There are also goods which are sold on consignment, where settlement is made after they have been disposed of on U.K. markets. Examples are imports into the United Kingdom of fresh fruits and vegetables, bacon and furs. Importers of fruit and vegetables quite often delay settlement until the end of the season.

In some trades the contracts provide for payment by the importer before shipment to cover the producers' costs in local currency; this occurs in the timber trade and to a small extent in the purchase of coffee and cotton in South and Central America. The main determining factor is the availability of credit in the producing country but interest rates may sometimes have an influence. Payments for costly manufactures such as ships, aircraft and machinery are frequently made in stages, the importer commonly providing promissory notes to mature at the required dates. Such contracts are unlikely to give much scope for variation after signature.

While primary commodities constitute an important element in U.K. imports, manufactured and semi-manufactured goods predominate in U.K. exports. The growth in the demand for capital goods in particular has led to a general increase during the last two years or so in the use of medium and long-term credit facilities. Where the prime consideration of the importer is to secure credit of this duration it is thought unlikely that the attraction of a marginal financial gain to be obtained from earlier payment would prompt him to vary the terms he had already obtained: and he would doubtless be debarred under the current contract from delay in payment. The scope for leads and lags by foreign importers is thus considerably restricted.

It is difficult to generalise about practices in manufacturing industries where the arrangements made for settlement, even within particular industries, often depend on the circumstances of individual manufacturers and their customers.

How leads and lags happen

Once the terms of a trade contract have been fixed, it seems likely that in many trades the opportunity to alter the time of settlement is limited. Even with new contracts, a trader who wishes to make a change must still reckon with the customs of the trade and the interests of the other party. Subject to this, where bank credits are used to finance the movement of goods, a trader may be able to arrange for variation in settlement by shortening or lengthening the terms of the credits. For example, an overseas importer who wanted to take a position against sterling, might, when opening credits with U.K. banks, try to do so for longer periods up to the full limit authorised by the U.K. Exchange Control.

Where trade with countries outside the sterling area is not financed through the banking system, a shift in the time of settlement within similar limitations may be possible by arrangement between the parties. Much trade is done on an 'open account' basis, especially between associated companies who, with their wide experience, are likely to be more than usually conscious of the possibility of exchange risks or of differences between interest rates in different centres. It may be relatively easy for a company in one country to arrange with

its branch or subsidiary in another to make a change in the normal time of settlement for goods supplied, again subject, so far as trade with countries outside the sterling area is concerned, to the U.K. Exchange Control regulations.

Exchange control limitations The U.K. Exchange Control regulations give a reasonable, although clearly circumscribed, degree of freedom to an importer or exporter as to the time when settlement may be made in trade with countries outside the sterling area. If an importer, who normally pays cash against rebate, finds that because of an increase in interest rates the cost of providing cash exceeds the value to him of the rebate, he is free to delay payment and forgo the rebate. Similarly, if there were a serious exchange risk in his mind, an importer could advance the time of settlement rather than make use of the forward markets.

As already mentioned, considerable variations in the use of bank credit are possible within the regulations, which permit usances up to 180 days, and there is similar scope as regards exports, where the requirement is that the proceeds must be brought home within a period of six months, although a longer period may be allowed for exports such as capital goods.

The residents of some countries, such as the United States, where no exchange control restrictions on capital transfers exist, have less need to disturb the timing of their normal trading routine. For example, a U.S. importer who feels it desirable to expedite payment in sterling under a trade contract can, instead, acquire a sterling deposit and hold it until payment is due. In other countries the importer may have to contend with exchange control regulations in his own country but in any case leading, and particularly lagging, will often mean some use of U.K. credit facilities, the limits of which, if he is resident outside the sterling area, are controlled by the U.K. Exchange Control.

Leading and lagging are not illegal activities; they are limited but not prevented by the U.K. Exchange Control regulations; this, because of

the desirability of giving a reasonable degree of freedom to traders for fixing the terms of their contracts, while restricting opportunities for speculation.

The use of forward exchange cover Whether an importer or exporter will wish to disturb his normal trading routine will depend partly on what other means there are for attaining the same ends. Excellent facilities exist in the forward exchange markets for the provision of cover against legitimate exchange risks. U.K. importers who have trade contracts calling for future settlement in foreign currencies have no need in the normal course to expedite payment, as full protection, at a relatively small cost, can be obtained by entering into a forward exchange contract. Similarly U.K. exporters who are anxious to avoid an exchange loss can cover against it by forward sales of the currency proceeds of their exports. Nevertheless, the cost of forward exchange cover, which may rise appreciably in disturbed conditions, can be avoided by advancing the time of settlement under trade contracts, if that proves possible.

Forward exchange contracts may, even before they mature, indirectly cause changes in the level of the reserves. If, for example, sterling is under pressure additional forward selling may further depress forward rates; as a consequence authorised dealers in foreign exchange may find difficulty, or face loss, in covering forward sales of foreign currency by forward purchases. They may then cover themselves by holding spot currency (within permitted limits) and this would divert spot currency from the U.K. reserves, which would thereby suffer a temporary loss. In this way, while there may have been no leads or lags by U.K. traders, their forward exchange transactions may cause a rise in the spot holdings of foreign currency in the hands of authorised dealers and mean additional immediate pressure on the reserves.^(a)

The special position of the overseas sterling area Leads and lags are generally regarded as more likely to occur in trade between the United Kingdom and countries outside the sterling area and certainly the effect on the

^(a) A fuller account of the way in which the spot holdings of authorised dealers are affected by these and other market transactions is contained in the Memoranda of Evidence, Vol. 1, page 42, submitted by the Bank of England to the Radcliffe Committee.

reserves is more direct than in trade within the area. The stability of exchange rates and the great degree of freedom for capital movements within the area mean less need for displacing the time of trade settlements. Trade between countries inside the sterling area and those outside it can be subject to leads and lags which affect the U.K. reserves in much the same way as those occurring in the trade of the United Kingdom itself.

Effect on the reserves If settlement for goods is made in foreign currency, there will be an immediate impact on the foreign exchange balances of U.K. banks. These balances move within a comparatively narrow range, any excess being ultimately sold for sterling to the Exchange Equalisation Account, and any shortfall being made good by purchases from the same source. Thus, apart from fluctuations in authorised dealers' balances, settlements in foreign currency will closely affect the level of the reserves. Consequently if many U.K. importers begin to take their foreign currency requirements earlier than usual (lead), or many U.K. exporters begin to receive their foreign exchange earnings later than usual (lag), the reserves will be correspondingly lower than would otherwise have been expected.

If settlement for goods is made in sterling (which is the more usual practice in the United Kingdom's trade), the effect on the reserves is not so direct. Sterling is extensively used for world trade, and overseas residents find it convenient to hold substantial amounts of it; so if their transactions with the United Kingdom are settled in sterling, the initial result is a change in the level of these holdings. If a large number of foreign importers decide to delay or speed up their sterling payments to the United Kingdom, overseas sterling holdings will be affected accordingly, but at this stage there will be no impact on the reserves.

Subject to a few reservations, sterling held by residents outside the sterling area is freely convertible into other currencies at official rates of exchange. The reserves and overseas sterling holdings are thus two aspects of the United Kingdom's international short-term position. They are closely inter-related and there is a striking similarity of movement, particularly where the larger fluctuations are concerned.

Experience has shown that sharp falls in the reserves are usually associated with large conversions of sterling recorded as held by overseas residents; and substantial rises in the reserves are associated—although less closely—with heavy purchases of sterling by overseas residents.

The most likely influence which would cause a U.K. importer to lead in his payments in foreign currency would be an exchange risk and this would presumably encourage overseas residents to run a short rather than a long position in sterling, so that they will tend to convert at the current rate part at least of the sterling they hold, and at the same time to delay settlement in sterling since they will hope to get the sterling cheaper in terms of their own currency. The lag in the payment of sterling to the U.K. resident is likely to mean that a larger proportion of overseas sterling holdings is available for conversion—with a correspondingly larger potential decrease in the reserves. Thus lagging in sterling settlements by a foreigner, like leading in foreign currency payments by a U.K. importer, will probably have a depressing effect on the reserves, but admittedly the connection is less direct.

Statistical evidence Although leads and lags can thus have a marked impact on the reserves and on overseas sterling holdings, one cannot distinguish from the figures available—even if overseas sterling holdings are broken down into their components, such as deposits, advances, discounted bills and acceptances—those movements which result from leads and lags and those which result from other influences such as a change in the level of trade. It is therefore interesting to see if a study of the official balance of payments estimates will provide any further clue. An account of how these estimates are compiled is included in "United Kingdom Balance of Payments 1946-1957" published by H.M. Stationery Office in March 1959, and a summary of the figures published to June 1960 appears on pages 48-49 of the Statistical Annex. (Some changes in sources and methods of compilation, resulting in revisions to many of the figures, are being introduced in the next Balance of Payments White Paper. An article describing the changes will appear in the March issue of "Economic Trends" to be published

for the Central Statistical Office by H.M. Stationery Office.)

The so-called "Balancing item" is an entry in the balance of payments estimates which equates the balances on current and long-term capital accounts with the monetary movements. It arises because of errors and omissions in all parts of the estimates, and includes differences of timing between the entry of transactions in the two accounts and their impact on the monetary movements.

As regards receipts for U.K. exports (which are entered in the balance of payments estimates on the basis of the Trade Accounts), any credit provided by U.K. banks to overseas residents is covered by the monetary movements which include such items as advances, acceptances and discounted bills (whether payable at sight or at term). So any lagging in payment by the overseas residents which results in a lengthening of these kinds of credit does not affect the "Balancing item". Credit given without the direct use of banking facilities, on the other hand, is for lack of information generally not included in monetary movements and therefore contributes to the "Balancing item".

As regards U.K. imports, the position differs as between imports from countries outside the sterling area and those from countries within the area. Hitherto the former have been based on Exchange Control records of actual payments^(a) and have therefore corresponded closely with the movements of bank balances; here leads and lags have not had any appreciable effect on the "Balancing item". On the other hand imports from the overseas sterling area have been included on the basis of the Trade Accounts; and as any credit extended by overseas residents if it is not in the form of a bill held by a U.K. bank for collection is not included in the "Monetary movements", any leading or lagging must have been reflected in the "Balancing item".

But the "Balancing item" is such a conglomeration of errors and omissions throughout the whole balance of payments estimates that it would be unreasonable to expect it to give any clear indication of leads and lags, and indeed this is borne out by experience. A rough relationship is detectable over the past few years during the periods when leads or lags might have been expected to occur but it is too indeterminate for drawing firm conclusions.

The figures comprised in the balance of payments estimates thus give little clue to the extent or even the occurrence of leads and lags except in the very broadest way.

Looking elsewhere for some indication, it might be felt that a study of the changes in the margin between Exchange Control records of U.K. payments for imports from countries outside the sterling area and the corresponding figures as shown in the Trade Accounts would yield something. But in practice there are so many reasons why these two series differ, and differ in a varying degree from one period to the next, that one could hardly expect the effect of leads and lags to be discernible, and an analysis of the figures over the past five years confirms this.

The almost complete absence of firm information thus makes it impossible to arrive at any reasonable quantitative assessment of leads and lags in the restricted sense used in this note. But it seems safe to say that there is hardly any evidence to support the large notional figures sometimes suggested; and the major explanation for the fluctuations in the monetary items in the United Kingdom's balance of payments, apart from those attributable to trade and long-term investment, can better be sought in those other short-term movements of which mention has been made and which are themselves often closely associated with leads and lags.

^(a) On the new basis of compilation of balance of payments estimates, mentioned above, this will no longer be so.