The balance of payments and the exchange rate: developments in the first half of 1976

Introduction

During the four months from March to June sterling came under recurrent downward pressure, which at times was intense. The pressure was reflected both in a fall of some 12% in the exchange rate – whether against other main currencies weighted together or against the US dollar alone – and in heavy official borrowing and drawings on the reserves, which together amounted to nearly £2,800 million.

This article first refers to the balance of payments accounts in order to identify, by main category, the flows which in fact took place and which form the statistical counterpart of the official financing that was supplied. It then examines in a broader context various ways in which pressure on sterling can, in principle, develop. A further section discusses the difficulties of identifying and measuring particular sources of pressure, and notes the limitations of balance of payments accounts for this purpose. The conclusion is that it is difficult to identify precisely the sources of pressure on sterling, but it is unlikely that events would have run the course they did had there not emerged a widespread view that sterling was overvalued.

The balance of payments accounts

Full balance of payments accounts are compiled only quarterly; the figures for the first and second quarters are summarised in the table.

Counterparts and components of official financing[a]

£ millions: *not seasonally adjusted*

	Line	1976 1st qtr	1976 2nd qtr
Current account (deficit –)	1	–250	– 500
Sterling holdings in the United Kingdom (increase +):	2		
Oil-exporting countries		–210	– 690
Other		+130	– 230
UK banks'[b] sterling claims on overseas (increase –)[c]	3	–460	– 400
UK banks'[b] net borrowing (+) or lending abroad in foreign currency[d]	4	+160	+ 130
Other identified capital flows[d]	5	+ 70	+ 10
Balancing item	6	– 80	– 240
Balance for official financing	7	–640	–1,920
Financed by:			
Foreign currency borrowing (net) by public sector bodies under exchange cover scheme (+)	8	+280	+ 580
Drawings on IMF (+)	9	+570	+ 440
Drawings on other monetary authorities (+)	10	–	+ 580
Drawings on the reserves (+)	11	–210	+ 320

[a] This table is consistent with Table 19 in the statistical annex except that it contains a separate entry (line 3) for sterling claims: in Table 19 these are allocated between export credit and other short-term flows.

[b] Includes certain other financial institutions.

[c] Includes export credit refinanced by the Export Credits Guarantee Department.

[d] Excludes the public sector's net borrowing under the exchange cover scheme.

Sterling was quite steady during January and February, and the balance for official financing (line 7) was in surplus by about £200 million. But this changed to a deficit of almost £2,800 million over the next four months, when sterling declined sharply. Of the net £2,560 million of official financing provided in the first half of the year, about £1,000 million was drawn from the International Monetary Fund (line 9), of which £570 million was borrowed in January (under the oil facility) and the remainder – from the United Kingdom's first credit tranche – in May. In June some £580 million was drawn from other monetary authorities overseas (line 10) under the newly-arranged standby facility.[1] Also during the first half of the year, public sector bodies borrowed £860 million in foreign currencies under the exchange cover scheme (line 8).

The current account deficit (line 1) widened during the period under review. Helped by seasonal influences, the deficit was only £120 million

[1] See the June *Bulletin*, page 163.

in the fourth quarter of 1975, and sterling was then comparatively steady. But in the first quarter – which is seasonally unfavourable – the deficit doubled, before widening further to £500 million in the second.

Sterling holdings in the United Kingdom (line 2) – i.e. exchange reserves in sterling of central monetary institutions and banking and money-market liabilities to other holders overseas – fell by £80 million in the first quarter and by £920 million in the second. These holdings are reduced by any transfers into euro-sterling deposits when – as usually happens – such deposits are subsequently swapped out of sterling or on lent to other non-residents for spending in the United Kingdom, rather than redeposited in London. Sizable transfers in both directions have occasionally been made by oil-exporting countries, but during March to June the evidence so far available suggests that the net movement was quite small.

As the table shows, total sterling holdings were little changed in the first quarter; more detailed figures[1] show that they actually rose between mid-February and end-March – the period when pressure on sterling began to develop. However, the decline in the second quarter was much steeper than in previous phases of disturbed confidence. Sterling balances held privately were virtually unchanged in total: the fall was entirely in the holdings of central monetary institutions – mainly in the oil-exporting countries, which are the largest holders – and was confined to banking and money-market liabilities; their holdings of British government stocks were little changed. Part of the overall decline probably represented a run-down of sterling reserves by some countries to finance their balance of payments deficits. And a small part of the fall in oil-exporters' balances reflected the purchase of other investments in the United Kingdom, such as equities: such acquisitions appear in line 5 of the table and there is no net effect on the balance of payments. These purchases are estimated to have been in the region of £100 million during the first half of 1976.

In both the first and second quarters, the sterling claims of banks in the United Kingdom on customers overseas (line 3) increased strongly – by as much as £860 million over the six months. At least three quarters of this rise can be attributed to credit for the finance of UK trade which was growing rapidly in this period: such credit relates mainly to UK exports, but import-related credit also contributes where a UK bank in effect pays an exporter abroad and retains the claim until the UK importer has made full payment. Some of the remaining rise in claims reflected credit to finance the trade of members of the overseas sterling area.[2] Although partly determined by the size of trade flows and by conventional trading arrangements, the demand for sterling credit is also influenced by interest rate and exchange rate considerations.

Net foreign currency transactions of UK banks with overseas residents (line 4) led to a small inflow in the first and second quarters of this year. Other identified capital flows (line 5) are estimated to have been roughly in balance. Finally, the accounts show a negative balancing item of £240 million in the second quarter (line 6): this covers errors and omissions throughout the balance of payments statistics, including unidentified capital flows.

Possible sources of pressure on sterling

The word 'pressure' in this context simply means that, for whatever reason, sellers (actual and potential) of a currency outweigh buyers at the prevailing exchange rate. The rate will remain steady, without official intervention, only if these two parties are exactly matched. This

[1] Table 20 in the statistical annex shows sterling holdings in greater detail, and at monthly reporting dates.

[2] A recent modification to exchange control rules requires banks to seek documentary evidence that such trade credit relates to actual movements of goods, and limits the period of credit to 180 days.

section discusses possible sources of pressure on sterling. For illustrative purposes, pressure is assumed to generate balance of payments outflows, though in practice the result may instead be a fall in the exchange rate or a combination of the two. However, it may be useful beforehand to outline briefly the scope of UK exchange control, to which all UK residents are subject in their financial transactions with non-residents,[1] and which is designed to minimise pressure on sterling from various sources, while at the same time allowing commercial business to proceed as normally as possible. This can be shown by the following abbreviated list of controls.

UK residents have a duty to collect debts promptly from non-residents: payment for exports must be received within six months unless longer credit has been authorised; and foreign currency must be offered for sale to an authorised bank immediately upon receipt – except in limited cases where specific permission to retain foreign currency has been granted. Payments for imports cannot, without authorisation, be made before the goods are ready for shipment. UK merchants, acting as principals, may give only limited credit for trade between other countries. Capital investment overseas by UK residents is strictly controlled and cannot be financed by recourse to the official foreign exchange market, unless such investment satisfies stringent criteria designed to protect the balance of payments. Strict limits are applied to UK residents who, because of the nature of their business, are permitted to hold trading balances in foreign currency. All banks operating in the United Kingdom are allowed to maintain positions in foreign currency, but these are also subject to strict limits (see the December 1975 *Bulletin*, page 355). UK residents (in practice, mainly authorised banks) require permission to lend sterling to non-residents: such lending generally represents trade credit, mainly for UK trade, but also – though the conditions have recently been tightened – for the external trade of countries of the overseas sterling area; in certain circumstances, banks may also lend sterling to non-residents overnight.

Turning now to the possible sources of pressure, a worsening current account is in itself certainly one. But the deterioration may be accompanied by offsetting capital inflows, particularly if it is widely believed to be only temporary.

Weakened confidence in sterling can itself be transmitted to the exchange rate in ways which affect the current account. For instance, if sterling is expected to depreciate, UK importers may endeavour to hasten, and exporters to delay, the movement of goods in anticipation of higher prices in sterling terms. Similar action may be taken in anticipation of policy measures such as restrictions on imports or an improvement in export credit facilities. The current account, which is assembled mainly by recording physical movements of goods, would then worsen. This process is termed 'physical leading and lagging'.

Similarly, there is scope for leading and lagging of payments for goods. Thus, if confidence in sterling is weakening, UK importers will tend to settle their foreign currency debts more quickly to avoid having to pay more sterling to acquire the requisite foreign exchange. Conversely, overseas residents may seek to delay settlement of their sterling debts in the hope of being able to buy sterling more cheaply at a later stage; and foreigners in receipt of sterling will want to exchange it for foreign currency sooner than they otherwise would.

Leading and lagging is primarily an attempt to avoid or minimise losses from movements in the exchange rate as a matter of normal commercial prudence. On the payments side, the potential scale of leads and lags depends on many factors, including invoicing practices, the relative power of different parties to a transaction to influence settlement dates, and the extent to which conventional, prudential, or

[1] Exchange control rules are summarised in *A Guide to United Kingdom Exchange Control*, Bank of England, July 1973. An article in the September 1967 *Bulletin* (page 245) provided a short history of exchange control.

statutory (e.g. exchange control) limits to the terms of payment have already been reached. As mentioned above, terms of payment are governed on the UK side by exchange controls, which are already as tight as is reasonable in relation to normal international commercial practices. Physical leading and lagging by UK residents is not subject to control, but there must be operational limitations on the extent to which shipments can be speeded up or slowed down. The scope for pressure on sterling from all forms of leads and lags may be considerable, given that imports and exports of goods and services together average at present around £200 million in a single day. But over a period of time, at least part of any effect is likely to be reversed.

Pressure can also mount on sterling from capital movements which are in no way related to current account transactions. But again, UK residents are allowed to participate only within the limits of exchange control. Thus, there is little opportunity for a UK company or individual to switch sterling assets into foreign currency. On the other hand, non-residents are free to buy and sell British government stocks or transfer funds to or from UK banks.

A foreign currency transaction between a UK bank and its domestic customer (who are both subject to exchange control) changes the bank's overall foreign currency position but does not directly affect the balance of payments accounts. But the accounts are affected when the bank itself enters the market, whether to match a deal with its UK customer or for any other purpose (within its permitted range).

The above refers to spot deals; the role of transactions in the forward exchange markets is now considered.

Forward deals by UK residents, including banks, are subject to exchange control. This will generally allow a UK importer to cover his exchange risk by buying foreign currency forward from his bank. A non-resident, on the other hand, is free to engage in outright speculation by selling forward to a UK bank sterling which he neither owns nor is owed. Both of these transactions are likely to be more frequent when confidence in sterling weakens. In each case there is initially a change in the UK bank's forward position. The bank will react in one of three ways. First, it can choose to carry the position, if this can be accommodated within its open limit. Second, it may match its forward purchase of sterling with a spot sale (thereby effectively arbitraging out of sterling), so long as this does not breach its spot against forward limit. Third, it may match its forward purchase of sterling by a forward sale – usually by means of a swap deal (involving a spot purchase of sterling and a forward sale), combined with an offsetting spot sale.

In the first case there is no direct effect on spot sterling. In the second, the forward pressure is transmitted immediately to the spot rate by the bank. In the third, the effects on the spot rate effectively cancel one another, but the bank chooses not to absorb the forward pressure which is thus passed to the forward rate in the market – widening the forward discount and so encouraging others to arbitrage out of sterling, with resulting pressure on the spot rate.

Exchange control limits the extent to which UK banks (or other residents) can transmit forward pressures to the spot market. But non-residents are able, for example, to arbitrage out of sterling to the full extent of their holdings. In so far as forward pressure is, in fact, transmitted to the spot rate, any resulting balance of payments flows will be included indistinguishably in the relevant components of the accounts.

Identifying pressures

There is no way of fully identifying which of the possible sources of pressure described above contributed – and by how much – to sterling's weakness in the period from March to June. The balance of payments accounts merely indicate the components, by broad category,

of the deficit that was officially financed. In the extreme example, if there was no intervention in the form of official financing and the exchange rate was left to find its new equilibrium, surplus entries would exactly balance deficit entries in arriving at the (zero) balance for official financing, without necessarily revealing anything about the excess selling pressure which forced down the rate. At the other extreme, if unlimited intervention was used to hold the exchange rate steady, the statistics would clearly identify the components of the deficit that would have been officially financed, but these would not necessarily correspond to the original sources of the pressure.

One problem is that within, say, a calendar quarter, transactions may be reversed. For example, a crisis might develop partly from sales of UK investments by certain holders. If these holders subsequently repurchased within the same quarter, neither of their transactions would show up in the quarterly statistics. Although this type of problem could be eased by additional information (such as monthly data),[1] the more serious difficulties are conceptual and could not be entirely resolved in this way. A further problem is that certain types of transaction cannot be separately identified in the statistics. In particular, leads and lags in payments will be included indistinguishably either within the various components of the capital account which cover trade credit or in the balancing item.

The essential problem, however, is that the balance of payments statistics do not explain why particular flows develop. For example, an increase in export credit may represent a delay by UK traders in collecting export receipts, to the extent that the rules allow, or it may be the counterpart of (and, perhaps, the reason for) a rise in exports; again, if sterling holdings decline, the figures by themselves do not reveal whether the withdrawal was induced by, say, a lack of confidence, or the need to finance a balance of payments deficit or, indeed, to finance other investments in this country.

Movements in the exchange rate are sometimes reversed without official intervention. If, for example, the current account moves into a deficit which is widely believed to be temporary, and the market considers the original exchange rate to be fundamentally 'correct', any decline in the exchange rate will attract capital inflows – provided that changes in relative interest rates do not inhibit such inflows. Official intervention (in either direction) can assist in smoothing out such short-term pressures on the rate.

On the other hand, if downward pressure originates from the view that the prevailing exchange rate seems too high, events may run a different course. Lack of confidence can be infectious, with an initial fall in the exchange rate generating expectations – not easily displaced – of further successive falls. The process is exacerbated by the immediate adverse effect of the depreciation on the current account, as foreign currency payments rise relative to receipts.[2] Partly because of this, the exchange rate often tends to fall below the point at which it will eventually settle once a firm view as to the new 'correct' rate has been established. Official intervention in the foreign exchange market, or other measures such as a change in interest rates, can be directed towards restoring stability, largely by influencing market views as to the rate which is likely to prove sustainable.

Conclusion

The sequence of events from March to June conforms to this pattern in certain respects.[3] After several months in which sterling had been comparatively steady, pressure on the rate developed early in March

[1] Tables 20 and 21 in the statistical annex show monthly figures for sterling holdings and for banks' external positions in foreign currencies; overseas trade statistics, the official reserves and certain items of official borrowing are also released monthly.

[2] This is the so-called 'J-curve' effect. Recently, its influence may have become less pronounced: export earnings appear to be responding rather more promptly than in the past to a depreciation of sterling, either because sterling prices are being adjusted more quickly, or because invoicing in foreign currency is now more widespread.

[3] Movements in the sterling exchange rate during this period are described on page 302 and in the June *Bulletin* (page 171).

and persisted until the middle of the year. The market appeared to consider a reappraisal of the exchange rate to be appropriate in the light of the United Kingdom's current and prospective economic performance.

Changes in expectations associated with such periods of pressure are transmitted to the market in various ways which, however, cannot always be identified. As noted earlier, the balance of payments statistics by themselves are not a reliable guide to sources of pressure. Nevertheless, the continuing current account deficit clearly contributed to the weakness of sterling, as did the large fall in sterling balances of overseas holders. Leads and lags in commercial transactions (as described earlier), together with speculative forward sales of sterling by non-residents, are also likely to have exerted pressure on the rate, but their effects cannot readily be assessed. In these and other activities affecting the foreign exchange market, UK residents (including banks) are subject to exchange controls which limit their ability to exert pressure on the exchange rate; and there is no evidence that these controls have not been observed. In contrast, non-residents have considerable scope to influence the rate by their transactions, because they are naturally not subject to our exchange controls and can buy and sell sterling freely.