The investment currency market

There are two recognised foreign currency markets in the United Kingdom: the official market, through which most payments between residents and non-residents pass; and the investment currency market, in which the 'dollar premium' arises. The investment currency market is available for certain specified capital transactions, and only residents of the Scheduled Territories[1] have access to it. The purpose of this article is to explain what is meant by 'investment currency' and the 'dollar premium', and to show how the investment currency market works.

It should be mentioned at the outset that payments through the investment currency market are subject to the provisions of the Exchange Control Act 1947, just as much as are payments through the official market. In particular, residents need permission to purchase any foreign currency and are required to sell any foreign currency in their possession on the official market unless they have been given permission to sell it on the investment currency market or to retain it for some particular purpose. Moreover, any permissions given may be conditional. It is these and other powers in the Act which provide the legislative basis of the investment currency market and enable it to be controlled.

What is investment currency?

Investment currency is foreign currency which has originated in the main from the sale abroad of foreign currency securities owned by UK residents, and which may be used by residents of the Scheduled Territories to acquire foreign assets, for which currency from the official market is not made available. The investment currency market is primarily a mechanism to enable portfolio investments in foreign currency securities to be transferred among UK residents; other permitted uses include the purchase of properties abroad for private use and, to a very small extent, the financing of direct investments abroad. The investment currency market is not available to non-residents of the Scheduled Territories, and foreign currency owned by them never ranks as investment currency.

The so-called investment currency pool does not form part of the United Kingdom's official reserves but instead represents certain privately-owned foreign currency assets. Only a small proportion of these assets is at any one time held in liquid form; by far the largest part is represented by resident-owned foreign currency securities, with holiday homes abroad accounting for a small, but growing, proportion in recent years. Residents can buy and sell investment currency among themselves for sterling at freely negotiated rates of exchange. For many years transactions in investment currency – the supply of which is limited to the sources described above – have taken place at a premium over the exchange rate in the official foreign exchange market.

Size of the pool

The potential size of the pool at any particular time depends on the prevailing market value of the resident-owned foreign assets which go to make up the pool. According to statistical returns provided to the Bank, the liquid element, i.e. the total of investment currency balances held pending reinvestment, has fluctuated from less than £50 million to over £150 million during the last few years. Information is not available as to the total market value of UK-owned properties abroad; and the available estimates of the value of UK portfolio investment abroad are

[1] The Scheduled Territories at present comprise the United Kingdom, the Channel Islands, the Isle of Man, the Republic of Ireland and Gibraltar. For exchange control purposes, the Channel Islands and the Isle of Man are treated as part of the United Kingdom.

no more than broad indications of magnitude. An article in the June *Bulletin* (page 206) estimated such portfolio investment at around £6,600 million (excluding the value of the investment currency premium) at the end of 1975. But, as stated in the article, there are problems of identification and valuation; and the figure is overstated for the present purpose by including securities which are not 'premium-worthy' and which were financed by foreign currency borrowing. Although the amount of outstanding borrowing is known – it was around £1,000 million at the end of 1975 – the current value of securities purchased in this way is not. In short, the potential size of the pool can be measured only in very broad terms.

The investment currency premium

As mentioned earlier, investment currency normally changes hands at a premium over the price for official exchange. The size of the premium reflects the amount which residents are prepared to pay other residents in order to acquire part of the limited supply of investment currency. Essentially, it is determined by the attractiveness of investments abroad relative to those in the United Kingdom, which is influenced of course by views on the future of both the sterling exchange rate and of the premium itself. Changes in exchange control rules have also exerted a strong primary influence from time to time, e.g. the application of the 25% surrender requirement (explained on page 317); reductions and increases in the type of asset eligible for sale with the benefit of the premium; and the need for premium-worthy assets to be held as partial cover for foreign currency loans to finance portfolio investment abroad (see below).

The rate is quoted in the market not in terms of so many US dollars to the pound but as a percentage. The investment currency premium most frequently published in the press is based on the last fixed official parity between the US dollar and the pound sterling ($2.60571 = £1), rather than on the current rate of exchange between the two currencies. As sterling has depreciated against the dollar, so this quotation has increasingly overstated the true premium on the current rate. The quoted premium, based on the last official parity, was around 111% at end-August, whereas the true or 'effective' premium in terms of the current rate of exchange was about 44%. Thus, to buy investment currency cost 44% (not 111%) more in sterling terms than buying currency at the prevailing rate in the official market. Expressed as a rate of exchange, a buyer of investment currency would have received US $1.23 for £1, compared with US $1.78 on the official market.

How did the investment currency market originate?

The market originated as a direct result of exchange control regulations governing dealings in foreign currency securities by UK residents. When exchange control was introduced at the beginning of the Second World War, many foreign currency securities owned by UK residents were vested in the Government, i.e. they had to be sold to the Treasury for sterling, while others were borrowed and subsequently returned. Since the war, official exchange has never been made available for portfolio investment in foreign currency securities.

In the early post-war years UK residents could sell foreign currency securities held as portfolio investments to other residents for settlement in sterling. Residents were also allowed to switch most foreign currency securities into quoted investments payable in the currency realised, or alternatively to sell (via dealers) the foreign currency capital proceeds of their portfolio investments to other residents; the funds were described variously as reinvestment dollars, switch dollars or security dollars, though in practice they might be denominated not only in dollars but in any foreign currency.

By 1954, although the entire capital proceeds of non-dollar securities (known as 'soft' dollars) could be reinvested in quoted foreign currency securities of any kind, the proceeds of North American securities ('hard' dollars) could be reinvested only in similar securities. This had led to the development of two distinct markets in reinvestment funds, one for soft dollars and one for hard. However, from 1959 the distinction between North American and other securities became less important as more currencies became convertible; and in May 1962, following growing UK interest in European and some other overseas securities, the two markets were amalgamated into one investment currency market through which residents could invest in quoted foreign currency securities without distinction – as they can today.

How does the investment currency market work?

Market dealings in investment currency are closely linked with transactions in foreign currency securities.

The market in liquid investment currency comprises some half a dozen main dealers in London who maintain 'books' in investment currency and are prepared to quote rates in terms of the US dollar at which they will, as principals, buy and sell investment currency for sterling. Although the market deals primarily in US dollars, in practice almost any foreign currency can be bought or sold. There is normally a minimum difference of about one quarter to one half of a US cent between the buying and selling rates, representing the dealers' turn, but the spread can vary considerably depending upon the size of the bargain and the amount of turnover in the market. The dealers, some of whom are banks, operate within ground rules framed by exchange control and, as makers of the market, are exempt from the 25% requirement on transactions passing through their books. They have to make regular statistical returns to the Bank of England, but the Bank do not seek to influence the day-to-day operations of the market. The size of the premium reflects supply and demand by the public. As in the official foreign exchange market, dealing is done by telephone.

Similarly, UK professional dealers in securities (e.g. jobbers on the stock exchange) maintain books in foreign currency securities as principals. They are not allowed official exchange to finance such books but have to purchase investment currency for sterling or borrow foreign currency. These dealers are also exempt from the 25% requirement on sales from their books.

Dealers in investment currency and those who make a market in foreign currency securities (e.g. jobbers) are allowed to treat trading profits (after repayment of any borrowing and payment of charges) entirely as investment currency; similarly, any losses have to be met by the purchase of investment currency.

Forward transactions in investment currency

UK dealers in the investment currency market can normally buy and sell investment currency not only 'spot' (i.e. for settlement two working days ahead), but also 'forward' (i.e. for settlement beyond two days ahead). However, because of the volatility of the investment currency premium, dealers are normally reluctant to deal forward for more than a short period ahead.

If a dealer were to buy or sell investment currency forward, and did not wish to maintain uncovered forward positions on his book, he could try to arrange matching forward sales or purchases on the market. Alternatively, he could protect himself against the risk of exchange rate loss by a variety of means. For example, in the case of a *forward sale*, the dealer could buy a similar amount of investment currency spot and either hold it for delivery on maturity of the forward sale or, with the prior consent of the Bank, swap it forward on the official foreign exchange market by selling it spot and buying it forward for delivery as investment currency when the forward sale matured.

In the case of a *forward purchase* of investment currency, however, the dealer is not allowed to undertake the converse of the operation just described – buying spot exchange in the official market for immediate sale as investment currency, then selling forward a similar amount of official exchange, and meeting that forward sale by delivering the investment currency originally bought forward. Instead, he can protect himself by selling an equivalent amount spot in the investment currency market, either from his investment currency book or, with the consent of the Bank, by drawing on his authorised foreign currency borrowing facility. In the latter case, the borrowing would be repaid when the forward purchase matured.

Transactions in securities by, or on behalf of, UK residents

As a general rule, UK-owned foreign currency securities may not be held directly by their owners but instead must be placed in the custody of authorised depositaries (e.g. banks, stockbrokers and solicitors) to whom various authorities have been delegated, enabling them to carry out most day-to-day transactions in such securities without reference to the Bank of England. Authorised depositaries thus play a key role in the investment currency market.

Furthermore, whenever a UK resident sells a foreign currency security (the proceeds of which are eligible to be treated as investment currency), 25% of the proceeds have to be offered for sale at the current rate of exchange in the official market – thus providing a benefit to the balance of payments or to the exchange rate – leaving only 75% available as investment currency. This surrender requirement applies whether the proceeds are converted into sterling or switched into another security; but liquid investment currency temporarily invested in short-term money market paper (such as government bonds, Treasury bills or certificates of deposit) may be treated in the same way as holdings of cash: the sale or maturity proceeds of such temporary investments are then exempt from the 25% requirement.

Some examples of transactions in securities are given below.

Sales and purchases for foreign currency

If a UK resident wishes to sell a premium-worthy foreign currency security and collect the premium, the security, which would already be in the custody of an authorised depositary, would be sold by that depositary either in London or in a foreign centre. Assuming that the security were sold in New York for $1,000 (net of charges), the depositary would have to ensure that, in order to meet the 25% requirement, $250 were sold for sterling to a UK authorised bank at the current market rate in the official foreign exchange market. The remaining $750 would be sold as investment currency by the UK authorised depositary to a UK dealer in investment currency for settlement in sterling; the dollars would be credited to the UK dealer's investment currency account in the United States.

If, however, the UK seller wishes to use the entire proceeds of his sale for investment in another quoted foreign currency security, the depositary would be able to reinvest the $1,000 but, in order to satisfy the 25% requirement, would need to purchase $250 of investment currency in the market and sell it to an authorised bank at the rate prevailing in the official market; the net cost of this transaction would have to be met separately by the UK seller.

The next example assumes that a UK resident asks a UK broker to purchase for him a quoted American security as a portfolio investment. After arranging the purchase, the broker settles with the American market in foreign currency acquired for sterling from a UK dealer in the investment currency market, having charged his client in sterling with the entire cost of the purchase. If, however, the investment currency dealer had been asked to supply, say, French francs to cover a purchase on the Paris Bourse, but only had US dollars on his investment currency book, those dollars would need to be converted into francs through a bank at the appropriate cross rate in the official foreign exchange market.

Sales and purchases for sterling

Many foreign currency securities are quoted in sterling terms on the London market, the price including the current investment currency premium. For example, if the effective investment currency premium were 50%, the price of an American security in London would be some 50% higher than the New York price for that same security, using the current rate of exchange in the official market as a link between the two prices. So a UK resident buying a foreign security on the London market is obliged to pay the investment currency premium and, equally, a resident seller receiving the benefit of the investment currency premium when selling in London would have to satisfy the 25% surrender requirement. Thus, if a resident sold a premium-worthy security in London for a cum-premium price of £1,000 (net of charges), the authorised depositary responsible for the sale would have to use £250 of the proceeds to buy investment currency which would then be sold to an authorised bank at the current rate in the official market, so realising a smaller amount of sterling. The seller would thus receive a net price somewhat lower than £1,000, with the difference depending on the size of the investment currency premium at the time.

Transactions in securities by, or on behalf of, non-residents of the Scheduled Territories

Foreign currency owned by non-residents is never eligible to be sold as investment currency. Furthermore, non-residents may neither receive the benefit of the investment currency premium when selling foreign currency securities in London nor be charged the premium when buying such securities. This does not mean, however, that the investment currency market is completely unaffected by transactions by non-residents. Indeed, whenever a non-resident buys or sells a foreign currency security on the London market, the investment currency market could be involved.

The sterling prices of foreign currency securities quoted in London reflect the investment currency premium; and it was the rule up to June 1972 that dealings through London by non-residents should be settled in foreign currency: the broker simply obtained a foreign currency price from the jobber and settled in foreign currency. Where the non-resident purchased securities, the foreign currency received by the jobber could be used either as investment currency to buy more securities for his book or as funds to repay his borrowing. Because the non-resident was not required to buy his foreign currency on the investment currency market, he would not have paid the investment currency premium when purchasing the security, as would have been the case if he had paid the London cum-premium sterling price. Where the non-resident sold securities, the jobber merely settled with investment currency, or with borrowed funds, neither of which attracted the premium in the hands of a non-resident.

In June 1972, however, securities payable in currencies of the overseas sterling area (mainly Australian, Hong Kong and South African securities) became foreign currency securities. Many of these securities had been quoted for years on the London market as sterling securities, and transactions in them had traditionally been settled in sterling. Although the quoted prices of such securities were inflated by the investment currency premium, it was decided to allow the market to continue to effect transactions with non-residents in sterling on condition that the premium element was excluded from the sterling price before settlement was made. This concession was not extended to transactions in non-OSA foreign currency securities, such as American and Dutch shares, for which settlement continued to be made in foreign currency.

Accordingly, when a non-resident sells an OSA security on the London market for settlement in sterling, the broker uses the sterling received from the jobber (and inflated by the premium) to buy investment currency from a UK dealer, which he then sells for sterling to an authorised bank at the current rate in the official foreign exchange market; the proceeds are credited to his client's external sterling account. The premium is thus effectively excluded from the sterling proceeds paid to the non-resident client.

When a non-resident buys an OSA security on the London market, the broker uses the external sterling received from his client to buy foreign currency on the official foreign exchange market. The currency is then sold on the investment currency market, and the sterling proceeds (which include the premium) are paid over to the jobber. The broker might well need to arrange the relevant foreign exchange deals in advance – by working back from the sterling price quoted by the jobber – in order to establish the precise amount to charge his non-resident client.

The increase or decrease in UK holdings of foreign currency resulting from these particular foreign exchange transactions is balanced by a corresponding increase or decrease in the United Kingdom's liabilities on external sterling account. But the size of the investment currency premium can be affected: if, for example, non-resident sellers of OSA securities through London exceed non-resident buyers, then UK residents must be net buyers and, accordingly, demand for investment currency (and hence the premium) increases.

The above transactions are complex, but the approximate ex-premium price which a non-resident may expect to pay or receive for a foreign currency security quoted on the London market can be calculated merely by multiplying the quoted sterling price by a single conversion factor. The latter is published in the daily press and is based on the prevailing effective investment currency premium.

Foreign currency borrowing and the investment currency market

Although UK residents are not allowed access to official exchange in order to invest in foreign currency securities, they are able to make such investments not only through the investment currency market, but also (with the Bank of England's prior consent) by foreign currency borrowing. Securities acquired with such borrowing are not premium-worthy and may not be sold for sterling, but are exempt from the 25% surrender requirement both on outright sale for foreign currency and on switching.

When residents borrow foreign currency for portfolio investment, they are normally required to meet any shortfalls arising on such borrowing (both capital and interest) with investment currency, but on the other hand any capital profit may be sold on the investment currency market, subject to the application of the 25% requirement. Furthermore, such borrowers are required to maintain, during the lifetime of the borrowing, cover equivalent to not less than 115% of the amount of each outstanding loan. Most of this cover normally takes the form of the securities purchased with the borrowed funds (i.e. the loan portfolios), together with any liquid loan funds awaiting investment, but the balance has to be made up with premium-worthy securities or liquid investment currency. When security prices are falling, the value of the loan portfolios is reduced, thus increasing the amount of the cover requirement which has to be 'topped up' from the investment currency market. In some years demand for this purpose has had a significant impact on the size of the investment currency premium.

Changes in exchange control affecting the investment currency market

The market has always been dominated by demand for portfolio investment in foreign currency securities, but over the years a number of exchange control measures have also affected other uses of the market. The main changes are outlined below.

From May 1962, the market was made available for direct investment abroad by UK companies where such investment was not allowed with official funds. From April 1964, residents who wished to buy properties for private use outside the Scheduled Territories were required to use investment currency, and sellers of such properties could treat the proceeds as investment currency.

Radical changes took place in April 1965, which were designed to benefit the UK official reserves by diverting into the official market foreign currency which would otherwise have formed part of the investment currency pool. The first, and most far-reaching change was the introduction of the 25% surrender requirement, which remains in force as a means of transferring part of the sale or redemption proceeds of resident-owned foreign currency securities to the official market (see table). The requirement had to be met not only on sales and redemptions of premium-worthy securities, but also – to discourage speculation in investment currency itself – on holdings of liquid investment currency where such currency was held for six months in the same beneficial ownership. The currency required to be surrendered loses its identity as investment currency when it is sold at the prevailing rate in the official market. Needless to say, no windfall profit can accrue from such a transaction, either to the purchasing bank or to the Bank of England, from the difference between the investment currency rate and the rate in the official market, because the currency is taken by the purchasing bank as official exchange and so can only be passed on at the current rate of exchange in the official market.

Transfers to the official market from the 25% surrender requirement

£ millions

	Amount
1965	53
1966	70
1967	88
1968	104
1969	109
1970	87
1971	128
1972	138
1973	158
1974	265
1975	180
1976 1st half	85

The second major change was that UK residents were no longer permitted to dispose of the proceeds of certain capital items (such as legacies and gifts from abroad) on the investment currency market, but instead were required to sell them in the official market. Also, purchases and sales of private foreign properties by UK residents had to be effected through a separate 'property currency' market instead of the investment currency market.

In January 1968 UK residents were no longer allowed to hold liquid investment currency for continuous periods of more than twelve months. However, the application of the 25% requirement six months after the date of acquisition of the currency had, in fact, already proved to be a strong disincentive, if not a virtual bar, to longer periods of ownership.

In August 1970 the property currency market was amalgamated with the investment currency market. Thus, UK residents who wished to purchase, with foreign currency, properties for private use outside the Scheduled Territories were again required to obtain such currency through the investment currency market – as they still are today.

In June 1972 the United Kingdom introduced exchange control over transactions with most of the countries of the sterling area, whose currencies were thereafter regarded as foreign currencies. One effect of this was that securities payable in the currencies of former Scheduled Territories (e.g. Australia, Hong Kong and South Africa) were thereafter regarded as foreign currency (rather than sterling) securities, and were described as overseas sterling area (OSA) securities. UK residents who at that time owned OSA securities as portfolio investments were normally allowed to regard them as eligible for sale with the benefit of the investment currency premium, thus swelling the size of the pool; this concession did not, however, extend to direct investments. Initially, sales of OSA securities were exempt from the 25% surrender requirement, but in March 1974 the rules for OSA securities were brought into line with those for other foreign currency securities. Also in March 1974, the sales proceeds of direct investment projects outside the OSA ceased to be eligible for disposal on the investment currency market.

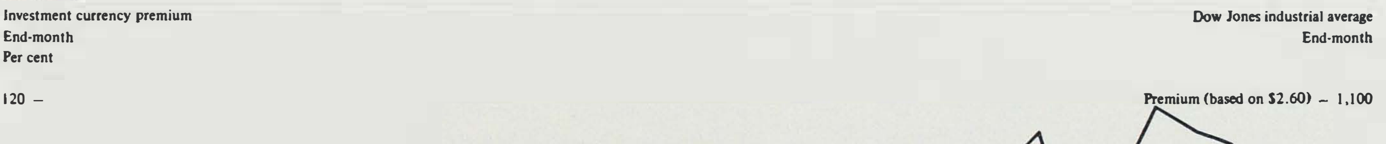
Another comparatively recent change affected residents of Scheduled Territories other than the United Kingdom who had acquired foreign currency securities as portfolio investments before the introduction of the 25% requirement in April 1965, and who were exempt from that requirement when switching such investments into other foreign currency securities. This concession (which had not applied to outright sales for sterling) was withdrawn in December 1974. Switches of foreign currency securities through the UK market by residents of the two remaining Scheduled Territories (the Republic of Ireland and Gibraltar) are now authorised on the same terms as those by UK residents.

Some minor administrative changes were made in April 1976, under which certain assets owned by immigrants or by foreign nationals resident in the United Kingdom, or which had been acquired by UK residents working abroad, were no longer potentially eligible to be sold with the benefit of the investment currency premium; commission received by UK underwriters of new issues of foreign currency securities also ceased to be eligible.

Finally, in June 1976 dealers in the primary market in foreign currency securities (i.e. those who act as members of selling groups for new issues) were no longer required to transfer funds from the investment currency market to the official market in respect of certain earnings from such business.

Recent movements in the investment currency premium

In 1973 UK residents became net sellers of overseas securities, and selling increased substantially in 1974, when prices on most overseas stock markets fell sharply and world economic prospects deteriorated. Nevertheless, as may be seen from the chart, the investment currency



premium rose fairly steadily throughout that year, indicating that demand was still outstripping supply. One major factor explaining this apparently contradictory movement was related not to premium-worthy investments, but rather to portfolios financed with foreign currency borrowing. Where such a portfolio was sold at a loss,

Use of investment currency to support loan portfolios

£ millions

	Amount
1973	60
1974	241
1975	154
1976 1st half	30

investment currency had to be bought in order to repay the loan in full; alternatively, where the securities were not sold, the investor was still obliged to buy investment currency in order to 'top up' the 115% cover requirement. At the same time, the pool was reduced by unusually large surrenders under the 25% rule: these amounted to some £265 million in 1974, over £100 million more than in the previous year when the 25% requirement did not apply to OSA securities.

The effective premium rose from nearly 25% at the beginning of 1974 to 70% at the end. The rise continued throughout the first quarter of 1975: although the rate of disinvestment was then falling sharply, institutions were still buying investment currency to repay earlier borrowing or for 'topping up' purposes: the effective premium reached a peak of just over 90% in late April 1975.

However, prices on the main overseas stock markets had reached their lowest points by the end of 1974; Wall Street in particular then began to recover strongly, and by the second quarter of 1975 demand for investment currency to make good shortfalls on loan portfolios had been sharply reduced: the premium fell equally sharply to just over 50% at the end of July 1975. For the next few months the premium fluctuated between 50% and 70% in a generally thin market.

Towards the end of 1975 and early in 1976, when economic prospects in the United States and Western Europe seemed more favourable, the premium remained fairly steady at around 65%. However, the political situation in Angola, Rhodesia and South Africa subsequently unsettled the markets by triggering sales of South African shares; and a number of investors who wished to maintain, or even increase, their stake in the US market, but feared that the premium might fall, decided to take the profit on some of their shares bought with investment currency and to refinance part of their portfolios with additional borrowing. As a result, the premium declined to 45% in early March, the lowest since September 1974. The premium recovered to nearly 60% by early May, largely reflecting the weakness of sterling; but with extra investment currency becoming available from sales of resident-owned holdings in Australia and New Zealand Banking Group Limited and London Tin Corporation Limited after these companies had emigrated, it fell back to around 44% at the end of August.