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THE INTRODUCTION OF EXCHANGE CONTROLS AND THEIR IMPLICATIONS FOR THE LESS DEVELOPED COUNTRIES IN THE OVERSEAS STERLING AREA.

A note by the Overseas Development Institute.

The new measures.

1. The introduction of exchange controls on transactions with the Overseas Sterling Area (OSA), on Friday, 23rd June, accompanied the decision to float the £ sterling. Both measures were described as temporary with the aim of reducing speculative pressures on sterling, which, during the preceding week, had precipitated a crisis approaching 1967 proportions: the outflow of funds is estimated to have been the equivalent of $2,500m.

2. Before the latest sterling crisis the OSA territories were treated as Scheduled Territories and were not subject to exchange controls, which related only to the External Account Area, i.e. the rest of the world outside UK and the OSA. The OSA consists largely of the Commonwealth countries [excluding Canada] together with South Africa, Eire and some Middle Eastern territories. Effectively, the extension of exchange controls to OSA territories shrinks the Sterling Area to include only the UK (plus the Channel Islands and the Isle of Man) and Eire. All other Scheduled Territories, i.e. the OSA, are now part of the External Account Area[1].

3. The exchange control system involves administrative surveillance of all payments to, or on behalf of, or for the credit of residents outside the Scheduled Territories. Surveillance does not always entail restriction. For example, transactions concerning goods and services [current account transactions in balance of payment terms] are not restricted: the purpose of the exchange controls is to provide a means of regulating capital movements. Different rules apply to the three main types of capital movements: portfolio investment, direct investment and personal capital movements.

Exchange Controls for the OSA.

4. The exchange control regulations now applied to the OSA differ from those applied to the External Account Area (EAA) and are, on the whole, considerably less restrictive than the latter.[2] The major change in the treatment of the OSA lies in the requirement to obtain permission to carry out transactions with the OSA territories, rather than in the limits imposed on such transactions. Thus bona fide direct investment in the OSA is not subject to restriction and foreign exchange for this purpose can be obtained at the official rate. In contrast, foreign exchange for direct investment in the EAA has to be borrowed abroad, bought through the investment currency pool at a premium (see para 6) and only in special cases may it be acquired from the Bank of England. And although personal capital movements to the

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[1] Rhodesia continues to be treated as a special case for exchange control purposes. For the purpose of this note, the External Account Area refers to those territories subject to Exchange Controls before 23 June 1972.

[2] It should be noted that from 1966 to April 1972, UK company investment in the developed OSA countries had anyway been subject to 'voluntary restraint'.

OSA are now subject to an upper limit, this is well in excess of that applied to the EAA.[1]

5. It is with regard to portfolio investment that the introduction of exchange controls directly affects UK capital movements to the OSA. Instead of being allowed to obtain foreign exchange freely from the Bank of England, UK investors now wishing to buy or sell OSA securities have to do so through the investment currency pool. The foreign exchange available in this pool is limited. Consequently investors wishing to acquire it have to pay a premium - which varies with supply and demand - over and above the ruling rate of exchange. Investors who sell their foreign assets benefit from the premium when they convert the proceeds into sterling. If the investment was in EAA securities, however, the 25 per cent surrender rule applies and the seller effectively forfeits 25% of the premium on the sale of securities to the Bank of England. <u>The new rules do not impose this penalty on investors in OSA securities.</u>

<u>Effect on UK portfolio investment in the OSA.</u>

6. The maintenance of a degree of privilege for OSA portfolio investments may, however, be more apparent than real. And there are reasons for believing that there will now be a deflection away from the OSA to the EAA. The availability of the full premium on the sale of OSA securities is likely to lead to an increase in their sales. On the other hand, the waiving of the 25% surrender rule for OSA securities will only act as an attraction to potential buyers to the extent that they expect that they will be able to take advantage of it: if they expect the exchange controls to end quickly, they may prefer to invest their funds elsewhere. In particular, they may prefer to buy OSA securities that are registered in London, which purchases are therefore not subject to the dollar premium. Both these factors in turn will tend to increase the supply of investment currency in the pool, and, other things being equal will, depress the level of the investment currency premium. The downward float of the £ sterling should also exert downward pressures on the premium to the extent that non-sterling short term investment becomes less attractive in consequence. The investment currency premium has, in fact, fallen from roughly 30% pre-float to approximately 22% post-float.[2] The effect of this is to reduce the importance of the 25% surrender penalty, thereby improving the relative attractiveness of EAA investment. One would expect, therefore, a reduction in UK holdings of OSA securities which will have a depressive effect on OSA stock markets. Further, in the short term, it is unlikely that the resultant capital outflows from OSA territories to the UK will be fully reversed.

<u>Implications for Less Developed Countries in the OSA.</u>

a) <u>Short term</u>

7. The exchange controls at present applied to the OSA chiefly affect portfolio investment. Their extension to other kinds of transactions is mainly intended to close loopholes for speculative short term capital outflows. Since most UK portfolio investment in the OSA is directed towards developed OSA countries, chiefly Australia and South Africa, it is unlikely that the less developed countries (LDCs) will be significantly adversely affected by the exchange control measures. Nevertheless, those OSA LDCs with stock markets, e.g. Hong Kong, Singapore, Malaysia, in which UK investment takes place will be adversely affected - to an extent which is difficult to determine in the absence of detailed data but which is generally thought to be small. Non-OSA LDCs with stock markets may, in turn, benefit - though again one would expect the gain to be slight. These conclusions, however,

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[1] For details, see the Bank of England circular EC 83 dated June, 1972.

[2] The actual quoted figure is lower but it is based on the pre-float parity: thus on 4th July, the premium was 19 7/8% based on the $2.60 exchange rate. The actual par value was $2.42 so that the premium was in fact 21.3%.

depend on the view that the exchange controls for the OSA are temporary and that when the £ sterling returns to a fixed parity, the OSA will return to its previous privileged position vis à vis the rest of the world.

b) Long term

8. The extent of exchange controls is consistent with the Treasury statement that they are a temporary measure designed to curb speculation. While this may be true, two other factors, both connected with Britain's entry to the EEC, make it unlikely that there will be a return to the status quo ante.

9. First, it is well known that Britain's future partners in the EEC, particularly France, would like to see Britain rid of its Sterling Area commitments, for they are apprehensive of the possible adverse repercussions on the EEC economy which could follow from having a member nation made exceptionally vulnerable by the international role of its currency. [The viability of Common Agricultural Policy, for instance, is very much dependent on the maintenance of exchange rate parities between member countries.] The decision to float the £ sterling broke the newly made European monetary agreement on exchange rate parities and must have reinforced their fears. In this context, the introduction of the OSA exchange controls may be seen as a move to allay European fears and to indicate Britain's firm intention to weaken its sterling area commitments.

10. Secondly, the EEC is committed to the removal of exchange controls between member countries. Exchange control on direct investment, personal capital movememts and portfolio investment are to be progressively removed, in that order, by 1978. Britain has already made a move in this direction for direct investment in the enlarged EEC countries: up to £1m per investment project per year in these countries may now be obtained at the official rate of exchange.

11. So far as LDCs are concerned, the most important aspect of the preferential treatment accorded to the OSA lies in the absence of exchange controls on UK direct investment in these countries. Under the new arrangements, the latter is,as yet, unaffected. However, even if this continues to be the case, the progressive removal of exchange controls between EEC countries will effectively remove the preference accorded to OSA territories. Thus one would expect the LDCs (and the developed countries) within the OSA to receive a reduced share of UK overseas investment. And this share will be further reduced if the removal of intra-EEC exchange controls is accompanied by the imposition of exchange controls between the EEC and the rest of the world. Non-OSA LDCs may not be expected to benefit from this reduction via any corresponding shift of UK direct investment in their direction. On the contrary, they, together with the rest of the EEA (excluding EEC countries), will become relatively unattractive to the UK overseas investor, when compared with the EEC.

12. The extent of the reduction in OSA LDCs' share of Britain's overseas direct investment as a result of an erosion of their exchange control privileges depends on the real significance of exchange controls in affecting the direction of overseas investment. In fact when compared with other factors, such as profit expectations, historical, commercial and cultural ties, it seems likely that exchange controls have only a limited significance. Indeed it is what they symbolise rather than what they determine that is probably more important. Thus, the imposition of exchange controls vis à vis the OSA and the relaxation of these controls vis à vis the EEC may be taken as a further sign of the shift of Britain's economic interest away from the OSA towards the EEC.

13. Indirectly, if the present measures do indeed presage the end of the Sterling Area, there may be a gain for LDCs as a whole. This will occur to the extent that 1) the British economy is strengthened by the reduction of its Sterling Area commitments, 2) the latter paves the way to effective international monetary reform. These possible future indirect gains, following from an increase in Western prosperity, have, however, to be set against the very real prospect that capital movements, and specifically direct investment, will become relatively more attractive within Europe than between Europe and the rest of the world.

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