16. In his Budget Speech of 26th October, 1955, in conjunction with other proposals for limiting demands on resources, the Chancellor asked the Capital Issues Committee not to relax their critical attitude towards all applications.

17. On 17th February, 1956, the Chancellor asked the Committee to recommend consent only when they were satisfied that the purpose of an application had definite urgency under current requirements. This additional request was made in the context of a number of other measures designed to deal with the overload on the economy.

18. The Treasury's powers under the Borrowing (Control and Guarantees) Act 1946 cover borrowing in Great Britain but not in Northern Ireland, where the control is in the hands of the Government of Northern Ireland and is exercised by the Ministry of Finance. Applications are, however, received by the Treasury for permission to raise money in Great Britain in order to finance investment in Northern Ireland. For the purpose of dealing with such applications the Capital Issues Committee, in July 1956, were given special instructions to take account of the fact that, in contrast to the rest of the United Kingdom, there are unused resources in Northern Ireland which might be developed for the benefit of our economy as a whole.

19. As a result of these successive memoranda and requests, the guidance on which the Committee are at present operating may be summarised as follows :—

(*a*) The Committee are asked to recommend in favour of investment in goods or services judged by them to be urgent and for essential purposes, with particular regard to the production of exports, the saving of imports or the earning of foreign exchange (e.g. investment in hotels).

(*b*) The Committee are asked to recommend against investment for production or distribution or provision of services in the home market which, in the judgment of the Committee, is not urgent and can therefore be postponed (e.g. shops, offices).

(*c*) The Committee are asked to recommend against investment in projects expressly discouraged (e.g. speculation in real property.)

In considering applications, the Committee are asked to take account of any advice, favourable or unfavourable, that may have been offered by Government Departments. The Committee may also, where they think it appropriate, discriminate between the several parts of an application, in some cases recommending consent to the raising of finance only for part of a project.

20. The Committee's recommendations deal with the purpose of applications referred to them, not with the total volume of borrowing or with the method of finance, except where the source of finance is a bank. The Committee's concern with bank borrowing is dealt with in paragraphs 25–29 below.

Statistics

21. The figures for the total number and value of applications considered by the Capital Issues Committee in the five calendar years since 1951 and those to which consent was given are as follows :—

		1	2	3	4	5
Calendar Year		Total Numbers of Applications No.	Value £000	Applications Granted No.	Value £000	Proportion (in value) of applications granted
1952	...	1,159	656,623	1,087	622,278	95%
1953	...	1,396	649,398	1,346	637,209	98%
1954	...	2,181	1,103,958	2,115	1,087,820	99%
1955	...	2,075	1,088,885	2,002	1,056,184	97%
1956	...	4,340	1,054,510	3,772	964,749	92%

22. The above table represents the transactions of the Capital Issues Committee in each year but not the capital sums raised by applicants in each year, since consents may not be used or may not relate to the raising of new money. On the other hand the figures of applications granted do not include capital raised in amounts below the limit of

23. The figures for 1956 are not wholly comparable with those for the previous years because the limit of exemption from control was lowered from £50,000 to £10,000 in March 1956. The number of applications is therefore considerably greater than in previous years. Furthermore, the reduced proportion of consents is not necessarily wholly attributable to the more critical attitude of the Committee. When the limit stood at £50,000 the majority of applications were received through solicitors, accountants, and other experienced agents who would often be reluctant to put forward applications unlikely to be accepted. The lowering of the limit brought many cases from applicants unfamiliar with current credit policy.

Control of Borrowing from Banks

24. The following are the present legal limitations of the Treasury's control over borrowing from banks. Article 1(1) of the Control of Borrowing Order 1947 prohibits all borrowing in Great Britain of more than £10,000 in any twelve months without the consent of the Treasury, subject to certain exemptions ; but Article 1(2) repeats the provision in Section 1(1) of the Borrowing (Control and Guarantees) Act 1946 and declares that the control provided in Article 1(1) does not apply to borrowing by any person other than a local authority if the borrowing is in the ordinary course of his business and is from a person carrying on a banking undertaking.

25. When the Chancellor of the Exchequer announced in Parliament the terms of the Memorandum of Guidance in his letter of 4th December, 1951, to the Chairman of the Capital Issues Committee, he said that the banks were being asked " to ensure that the credit policy of the banking system should operate in conformity with the same general principles as those set out in my letter." He regarded it as most important that " the banks and accepting houses should continue to intensify their efforts to restrict credit to essential purposes and, in particular, to ensure the highest priority for our defence programme and for our exports." He also asked that " banking facilities should not be given for the speculative buying or holding of securities, real property or stocks of commodities ; that finance for hire purchase should be limited and that, notwithstanding the statutory exemption of borrowings made in the ordinary course of business, bank advances should not in general be made for capital expenditure."

26. As a result of this last request promoters of capital schemes intended to be financed out of bank advances had to apply to the Treasury (through the Capital Issues Committee) for consent. In considering such applications it was the practice of the C.I.C. to have regard not only to the purpose for which the money was required but also to the terms on which it was to be lent. In appropriate cases they would recommend consent only on condition that the bank loans were replaced within a prescribed period of time, commonly six months.

27. In 1953 it was decided to withdraw from the scope of the Capital Issues Committee the control of the terms on which bank advances should be made, leaving them to make recommendations only on the purpose. The Chancellor of the Exchequer therefore announced in Parliament (on 18th December, 1953) that the banks were to " resume full responsibility for the terms as to period and repayment " of bank advances, though it would still be open to the Capital Issues Committee to draw his attention to any special cases in which the Committee thought that the terms of the advances were so bound up with the purpose that both ought to be covered by their recommendation. This position continued until April, 1957.

28. On 25th July, 1955, the Chancellor (Mr. Butler) published his letter to the Governor of the Bank of England asking that the banks should make " a positive and significant reduction " in their advances. The letter stated that it would be for the banks to decide what steps they should take to make the policy of reducing bank credit effective.

29. Since then the succeeding Chancellors have on several occasions stressed the importance of continuing to restrict bank credit, notably in July 1956 when Mr. Macmillan met the Governor of the Bank of England and leading representatives of the Clearing Banks, Scottish Banks and other banking institutions operating in the United Kingdom, to discuss the economic situation. At this meeting, which followed the tightening of the control of the terms of hire purchase contracts (in February), the reduction of the limit

and the reduction in subsidies and the increases in indirect taxation (announced in the Budget Statement in April), the Chancellor asked " that the contraction of credit should be resolutely pursued and that there should be no relaxation in the present critical attitude towards applications for bank finance." This request was published on 25th July, 1956.

30. The next significant change occurred on 9th April, 1957, when the Chancellor (Mr. Thorneycroft) made his Budget Statement. He reversed the modification of policy referred to in paragraph 27 above by asking the Capital Issues Committee, when considering applications for consent to borrowing from banks for capital expenditure, to examine not only the purposes of such borrowing but also whether bank overdraft was the appropriate method of finance. He asked that the Committee " should not recommend consent, however good the purpose of the loan, unless it is satisfied either that there are exceptional features in the case which make it impossible for the applicant to raise the loan from non-banking sources, or that the proposed bank loan is a strictly temporary and short bridging operation, pending the completion of funding arrangements."

August, 1957

9. EXCHANGE EQUALISATION ACCOUNT

The statutory basis and the purpose of the Account

1. The Exchange Equalisation Account was set up in 1932 under Part IV of the Finance Act of that year, to provide a fund which could be used, under the control of the Treasury, for the purchases and sales of gold and foreign currencies in order to prevent excessive fluctuations from day to day in the exchange value of sterling. Sections 24(3) and 25(7) of the Act authorised the investment of the funds in the Account in securities, including securities and assets of currency of any country and in whatever form held, or in the purchase of gold.

2. These arrangements, which followed the United Kingdom's departure from the gold standard, continued until the outbreak of war in 1939 when, in common with many other wider powers taken by the Government at that time, the authority for the management of the Account was extended by Section 1(1) of the Currency (Defence) Act, 1939 to include such investments in gold or securities as might be necessary for the defence of the realm and the efficient prosecution of the war. The major part of the resources of the Account were in fact used up during the early stages of the war in securing the nation's essential needs from the dollar areas before the coming into force of lease-lend. The Account thereafter played only a limited part in the subsequent stages of war-time finance.

3. After the war, Section 1(1) of the Currency (Defence) Act, 1939 was repealed by Section 63 of the Finance Act, 1946. This Act extended the purposes for which the Account might be used to include, in addition to the purposes specified in the 1932 Act, " the conservation or disposition in the national interest of the means of making payments abroad." The Account is thus the depository for the bulk of the nation's assets in the form of gold and foreign currencies.

4. The checking of undue fluctuations in the exchange value of sterling remains an important function of the Account, and a function which has been given special significance by United Kingdom membership of the International Monetary Fund, whose Articles of Agreement provide that member countries should ensure that exchange transactions within their territories do not differ by more than 1% on either side of the parities declared to the Fund.

5. A particular example of the extended use of the Account in the post-war period may be found in the accounting arrangements for implementing the Agreement for the Establishment of a European Payments Union (Cmd. 8064), which provided, from 1st July, 1950, a multilateral system for the periodic settlement of the financial transactions arising out of trade between the various members of the Union. Authority was given by Section 1 of the European Payments Union (Financial Provisions) Act, 1950 for the funds in the Exchange Equalisation Account to be used, within certain limits, in carrying out any transactions by the United Kingdom under the Agreement.

The capital of the Account

6. The sterling capital of the Account is provided by issues from the Consolidated Fund under Section 24 of the Finance Act, 1932, the Treasury being authorised to borrow the money required for this purpose. The 1932 Act placed a maximum limit of £150 million on issues that could be made to the Account but this limit was subsequently increased to £350 million, and again to £550 million, by the Exchange Equalisation Account Acts of 1933 and 1937 respectively.

7. In order to meet the increased demands upon the resources of the Account on the outbreak of war, Section 1(2) of the Currency (Defence) Act, 1939 removed the limit to the aggregate amount which could be issued from the Consolidated Fund. Section 1(3) authorised the Treasury to apply to debt redemption any part of the sterling assets of the Account which, at any time in their opinion, exceeded the amount required for the purposes of the Account. These statutory provisions are still in force.

8. The Exchange Equalisation Account took over, under the Finance Act, 1932, the remaining assets of the old Exchange Account which had been set up during the 1914-18 war. These assets, which amounted to just under £25 million on 1st April, 1932, now form part of the capital of the Exchange Equalisation Account.

Issue Department of the Bank of England

9. The present relationship between the Exchange Equalisation Account and the Issue Department of the Bank of England is governed by the Currency and Bank Notes Act, 1939. Section 2 provides for a weekly valuation, at current prices, of the assets held by the Department and for payments to be made from the Account to the Department, or vice versa, in respect of the difference between the value of the assets so determined and the total amount of Bank of England notes outstanding. Under Section 3(2) of the 1939 Act, all profits of the Issue Department are payable into the Account.

January, 1958

10. DEBT MANAGEMENT*

Introduction

This paper is divided into the following parts :—

I. The structure and distribution of the Debt.

II. The legal basis for National Debt borrowing and repayment.

III. The transactions that make up debt management.

IV. Objectives of loans operations.

V. The debt transactions of the last five years considered in relation to the objectives.

I. The structure and distribution of the Debt

1. The structure of the National Debt is conveniently summarised at 31st March of each year in a Table of the Budget Financial Statement. A copy of the Table for 31st figures) is reproduced in Appendix I. The main divisions are :—

(*a*) Floating Debt—Treasury Bills and Ways and Means Advances.

(*b*) Market securities.

(*c*) Small Savings securities—Defence Bonds, Premium Savings Bonds and National Savings Certificates.

(*d*) Tax Reserve Certificates.

†(*e*) Other debt, internal—mainly terminable annuities.

†(*f*) Other debt, external (i.e. payable in external currencies).

* See Minutes of Evidence Qns. 2799 to 2995.

† This analysis of the debt does not distinguish between internal and external

2. The stocks which have been issued by nationalised industries and undertakings and guaranteed by the Treasury are not part of the National Debt, but are indistinguishable from Government securities for purposes of debt management. The total outstanding at 31st March, 1957 was £3,295 million.

3. Tables are attached in Appendix II showing the amount of each class of debt outstanding at 31st March in each year since 1952 compared with 1935, and analysing the market securities (Government debt and guaranteed stocks) by period in order to show the changes that have occurred in the proportions of Floating Debt and short, medium and long-term obligations. If the securities held by the Savings Banks Funds are counted under Small Savings (against the Savings Bank deposits) and excluded from the other items the maturities to-day compared with pre-war are as follows :—

	31/3/1935		31/3/1957	
	£m.	%	£m.	%
Floating Debt :				
Non-market	455	7	1,636	6
Market Bills	371	5	2,827	9
Market securities (including guaranteed stocks)...	5,254	78	17,503	58
Small Savings	658	10	4,968	16
Tax Reserve Certificates	—	—	363	1
Other debt (internal and external)	26	—	3,005	10
TOTAL ...	6,764	100	30,302	100

The holdings of Floating debt, market securities and Other debt in the Savings Banks Funds are excluded from these headings and included in " Small Savings." This heading does not, however, include the entire holdings of the Savings Banks Funds, as it excludes certain investments which are not part of the National Debt (i.e. annuities covering advances for Post Office capital expenditure and for pensions commutation, etc. (£208 million at 31st March 1935 ; £269 million at 31st March 1957).

4. The distribution of Debt as between different classes of holders (excluding debt payable in external currencies) is shown in Appendix III, insofar as the information is available. Comparative figures are given for 31st March, 1939, 1956. The important figures in the Tables, for purposes of debt management, are those of Treasury Bills and Market Stocks. It will be seen that on 31st March, 1956 the main holdings of Treasury Bills were :—

	£m.	%
Bank of England Issue Department	932	20
Exchange Equalisation Account and other Public Departments	639	13
London Clearing Banks	946	2
Discount Market	421	9
Overseas Official	920	19
Other identifiable holdings	210	4
Other (including residual errors)...	720	15

At the same date the main holdings of Market Stocks were :—

	£m.	%
National Debt Commissioners	2,702	15
Bank of England Issue Department	964	5
London Clearing Banks	2,058	11
Insurance, and other public Companies, and Provident Societies	2,135	12
Overseas Official	1,506	8
Other identifiable holdings	1,599	9
Other (including residual errors)...	7,320	40

5. As regards the maturities of market securities held by the Issue Department and the National Debt Commissioners, the Treasury by agreement with those Departments is able to give the following analysis for the main funds at 31st March, 1956 and 1957 :—

£m. Nominal Value

Holder	Treasury Bills	Market Securities: Up to 5 yrs.	5 to 15 yrs.	Over 15 yrs. (including undated stocks)	Total
Issue Dept.—					
1956... ...	932	752	163	49	964
1957... ...	1,071	561	14	351	926
N.D.C.—					
1956... ...	32	190	767	1,746	2,702
1957	25	297	726	1,843	2,866

The other Public Departments hold their funds for investment purposes and the distribution of their holdings reflects their particular needs. The Treasury is unable to give for publication an analysis of securities held by the other classes of investors shown in Appendix III. It will be for the identifiable holders (such as the London Clearing Bankers and the Discount Market) to decide what further details it is possible for them to give.

II. The legal basis for National Debt borrowing and repayment

6. All forms of Government borrowing are covered by statute. Apart from certain exceptions noted in paragraph 7(*d*) below, the total amount that may be borrowed is fixed by Parliament, but the method of borrowing is at the discretion of the Treasury. Before the 1914-18 war, Parliament customarily laid down the method of borrowing each time a fresh borrowing was authorised. The discretion given to the Treasury as to the method of borrowing dates from the War Loan Act 1914 and was put into its present form in the National Loans Act, 1939.

7. The existing authorities as to amounts and methods are as follows :—

(*a*) *National Loans Act*, 1939

Sections 1(1) (*b*) and 3(2) give the Treasury power to redeem maturing debt by the issue of such securities as they think fit. The Act provides no limit, since the power is confined to replacing maturing debt, i.e. there is no question of the Treasury using this power to add to the total of the National Debt. It should be noted that this power was not newly given in 1939. It dates from the War Loan Acts, 1915-19 and has been consistently used since that time for dealing with maturing debt, including market stocks and Treasury Bills.

(*b*) *Appropriation and Consolidated Fund Acts*

These Acts give the Treasury power to borrow temporarily to meet seasonal Exchequer deficits above the line. The Treasury is authorised to issue out of the Consolidated Fund the total of all supply expenditure voted and to borrow from any person, either by the issue of Treasury Bills, or otherwise (i.e. by Ways and Means Advances), up to the same total. The same section of each Act also authorises the Bank of England (and the Bank of Ireland) to advance to the Treasury, within the total amount specified, any sum needed to meet these temporary requirements.

The Appropriation and Consolidated Fund Acts always prescribed that any sums raised thereunder, whether by way of Treasury Bills or otherwise, shall be borrowed for limited periods only. Thus as regards Treasury Bills it is laid down that any Bills issued under the Act in question shall be repaid by the end of the financial year to which the Act relates and that Section 6 of the Treasury Bills Act, 1877, (which authorises the renewal of maturing Bills) shall not apply in this instance. Similarly, it is provided that any money borrowed otherwise than on Treasury Bills (i.e. by Ways and Means Advances) shall be repaid not later than the next succeeding quarter to that in which the borrowing took place. In practice all borrowing under these Acts now take the form of Ways and Means Advances.

Since 1916-17 no Treasury Bills have been issued under the authority of the Appropriation or Consolidated Fund Acts ; for all Bill borrowing the Treasury uses the general powers given by the National Loans Act, 1939 to raise money either to meet maturing debt, or for the specific purposes described in the next sub-paragraph.

(*c*) *Specific borrowing powers*

The below the line items in the Budget consist mainly of issues from the Consolidated Fund to meet the capital requirements of local authorities, various public boards and other bodies, which have been authorised to borrow from the Exchequer. The different statutes which authorise these issues also empower the Treasury to borrow the money required for this purpose, in any manner in which they are authorised to raise money under the National Loans Act, 1939. In all these cases, the Act specifies the

amount of the borrowing accordingly. All repayments of advances under these Acts must be paid into the Exchequer and applied by the Treasury to debt redemption.

(*d*) *Special unlimited powers*

In the case of a small number of below the line issues, mainly repayments of debt to the public, e.g. post-war credits and war damage payments, Parliament has not imposed any specific limit on the amount that the Treasury may borrow. In practices, however, the total amount that may be issued, and hence the amount of the borrowing, is determined by the extent of the liability in each case. The only other purposes for which the Treasury may borrow without any specified limit are those connected with the country's foreign exchange position—the provision of additional sterling capital for the Exchange Equalisation Account and the maintenance of the value of the United Kingdom's subscriptions to the I.M.F. and the I.B.R.D.

Repayment of Debt

8. In addition to the requirement to apply to debt redemption all repayments of below the line advances made under certain Acts as noted in paragraph 7(*c*), debt is also redeemed by the operation of various sinking funds.

9. The terms under which certain Government stocks were issued to the public (viz. 3½% Conversion Loan, 3% and 4% Funding Loans and 4% Victory Bonds) include provision for the maintenance of a sinking fund in each case, which, subject to the conditions set out in the prospectus issued at the time of the borrowing, operates by the purchase and cancellation of stocks in the case of the first three securities listed above and by means of annual drawings in the case of Victory Bonds.

10. Section 5 of the Sinking Fund Act, 1875 requires the amount of the above the line surplus realised in any financial year to be issued out of the Consolidated Fund within the following year and used for debt redemption. The Treasury's practice in relation to this requirement is to maintain the daily Exchequer cash balance at a nominal level only and to use any surplus revenue to redeem debt at the end of each day. This practice has been confirmed by Parliament in successive Finance Acts since 1947 and made permanent by Section 34 of the Finance Act, 1954 which provides that any amount applied out of revenue during any year for the redemption of debt shall be deemed to be expenditure for the purposes of the Sinking Fund Act, 1875. This effectively ensures that there is no accumulation of surplus revenue left over for debt redemption after the close of the financial year. In respect of any financial year in which a deficit is realised above the line, an equivalent sum is required to be issued out of revenue in the following year and applied to the redemption of debt in accordance with the provisions of Section 48 of the Finance Act, 1930 (as amended by the Finance Act, 1954—Fifth Schedule). This requirement has been set aside on those occasions since 1931 when an above the line deficit occurred, by means of a special provision in the Finance Act of the following year. On each occasion, in fact, Parliament has provided for the total of the National Debt to be increased by the amount of these deficits. The statutory position remains however that unless Parliament determines otherwise, a deficit above the line must be made good from revenue in the following year. In fact, there has been no deficit above the line since 1946-47.

11. The previous paragraphs show the extent to which Parliament limits the total amount of Government borrowing. The area over which Parliament has given discretion to the Treasury is the manner in which, and the sources from which, the various amounts may be raised. In particular, the Treasury has complete discretion as between Floating Debt and other debt, and as between the amounts raised from the Departments and the public. A feature of Exchequer financing is the large volume of borrowing by the Treasury from the liquid balances of the Departments, especially the Issue Department of the Bank of England and the Paymaster General. These balances, amounting to nearly £2,000 million, are invested with the Exchequer in the form of Treasury Bills and Ways and Means Advances, some of which are maturing every day. At the same time, the Floating Debt in the hands of the market (some £3,000 million) is maturing at the rate of approximately £250 million a week. As a result there is a large pool of constantly maturing debt arranging its loan operations, so that at any time the National Loans Act authority to borrow to meet maturing debt gives all the Parliamentary authority needed to increase or reduce the market Floating Debt as required.

III. The Transactions that make up Debt Management

12. Debt management consists of the arrangements for servicing the debt and of loan operations.

13. The fundamental basis of the debt servicing arrangements is that loans to the State will be honoured, both as to the payment of interest and repayment of principal. Financial provision for the service of the debt is made out of the Consolidated Fund ; the Bank of England and the Post Office, as the executive agents of the Treasury for this purpose, are organised to ensure that interest and principal (where repayment is due) are paid in strict accordance with the loan contract for each security.

14. Loan operations are of two kinds : (*a*) issues of securities, either to replace maturing debt or to add to the debt where Parliament has given authority to finance a service by borrowing ; (*b*) market operations by the Departments, i.e. buying and selling of outstanding securities in the market by the Departments.

(*a*) *New issues.* The technique varies according to the type of security. Thus National Savings securities and Tax Reserve Certificates are continuously " on tap " in unlimited amounts (subject to the limits on individual holdings in the case of National Savings securities). Treasury Bills are issued " on tap " when the Exchequer borrows in this form from the Departments (including the Issue Department of the Bank of England) but Treasury Bill borrowing from the market takes place once a week by tender. Borrowing in the form of stock normally* consists of an *ad hoc* invitation to the investor either to subscribe to a fixed amount of stock or to accept a new security in exchange† for an outstanding security due for repayment.

(*b*) *Market operations.* These operations take place when the Departments buy and sell existing securities in the market. The transactions may take place in Treasury Bills or in Government and Government-guaranteed stocks. The transactions in Bills are for purposes of money market management and so outside the scope of this paper, in which the discussion of market transactions is confined to stock transactions. The financing by the Exchequer of Departmental purchases and sales of stocks has been described in detail in the Treasury paper on Exchequer Management.

IV. Objectives of Loan Operations

15. The purchase and sale of Government and guaranteed securities in the market by the authorities have two principal objectives, the first being purely a question of debt management and the second impinging upon general monetary control.

16. The first objective is the operational one of ensuring that new issues of stock, whether in conversion of existing loans or otherwise, are sold to the public and that the redemption of maturing issues, whether in whole or in part, is effected with the minimum of disturbance to the market. For these purposes the authorities use the official funds (in practice the Issue Department) to underwrite new issues and to buy up the stock next falling due for repayment. Nowadays new Government issues of stock are so large that they cannot be fully subscribed by the public on the day of issue. To the extent that they are not, the Issue Department take up the remainder of the loan and sell it over a period in response to public demand and at the prevailing market price. On the other hand, as the next maturity approaches, the Issue Department buy in the stock concerned so that, when the time comes for the authorities to decide whether the stock shall be redeemed or converted, they have the initiative as far as possible in their hands and can ensure a successful operation. The gradual acquisition of stock in this way also avoids any very large payment of cash from

* During the war and shortly after, stocks were sold " on tap," but all issues of stock since 1945 have been for fixed amounts or limited by the amount of the existing security eligible for conversion into the new issue.

† On occasion the terms of a stock offer have entitled the investor to tender Treasury Bills in payments for the new security. Otherwise it is the rule that a

the Exchequer to the market on a single day in respect of redemption payments, which can arise from an unsuccessful conversion operation or if the whole of the stock were paid off on the due date. Thus disturbance of the money market is avoided.

17. The sale of stock by the Issue Department is not confined to new issues. Sales of any other stocks in the Department's portfolio are made in response to public demand and the portfolio is replenished from time to time by the issue of new stocks or otherwise to meet such demand. In so far as Issue Department sales offset purchases of the next maturity, the refunding of the latter may be said to be going on continuously, thus reducing if not eliminating the necessity of paying off any of the maturing stock with cash raised on the Floating Debt.

18. The second and even more important objective of loan operations at the present time consists of selling stock as an aid to monetary control, the purposes being three-fold :—

(*a*) To reduce the money supply by making stock available to the public, who thus transfer money from deposits into securities.

(*b*) To exert pressure on bankers' liquidity. This is done in two ways : the Exchequer applies the proceeds of the sale of stock to the reduction of the Floating Debt and this tends to reduce the liquid assets of the banks who are the main market holders of Floating Debt. The sale of securities direct to the banks also reduces their liquid assets.

(*c*) To sell longer term securities against the purchase of shorter, thus pushing forward the maturities in market hands. These operations strengthen the future position of the authorities and also reduce the immediate liquidity of the public.

19. Taking the two objectives together, therefore, a four-fold process in Issue Department operations is going on all the time. The next maturity is being bought at every opportunity to facilitate conversion and redemption operations ; the balance of new issues is gradually being placed in market hands ; other stocks are being sold from the Department's portfolio in response to public demand, the object being to reduce the Floating Debt ; while in the process the maturities in market hands are lengthened whenever possible.

20. No attempt is made to use official purchases and sales in the market for the specific purpose of raising or lowering the level of medium and long-term interest rates. The gilt-edged market conducts its business on the assumption that it can rely on the official funds, when they are prepared to buy and sell stocks, to do so at prices corresponding to market levels. The suggestion has been made that sales of longer-dated securities would be increased if they were offered at prices below the market. In theory, this might be possible for a time. In practice, such operations would create market uncertainty and so impair the prospects of continuing official sales of securities ; on grounds of policy, such operations would involve a serious risk of damage to confidence and to the Government's credit.

Floating Debt Transactions

21. The description of loan operations in the gilt-edged market outlined above makes it clear that one of the most important aims of the authorities at the present time is to reduce, so far as possible, their dependence on finance raised on the Floating Debt, i.e. by the sale of Treasury Bills. The essential function of the Floating Debt is to provide a means by which to raise temporary finance for the Exchequer pending the receipt of revenue. The volume of the Floating Debt was greatly increased during and in the early years after the war and since the adoption of an active monetary policy at the end of 1951 every effort has been made to reduce the outstanding volume of the Floating Debt in order to give greater control over the ability of the banking system to grant credit. An overall reduction in the Floating Debt tends to be reflected in a reduction of such Debt in market hands and the latter in turn is usually principally reflected in a reduction in the Treasury Bill holdings of the banks. The consequent squeeze upon their liquidity, if carried far enough, can effect the level of their deposits. Although changes in the total volume of Floating Debt in market hands indicate with some precision the relative success or failure of the authorities in their policy of reducing the Floating Debt, the degree of pressure on banking liquidity is a good deal more uncertain. Within the given total of Floating Debt in market hands there can be considerable shifts between the holdings of banks and other holders such as large industrial companies. These shifts are influenced by the attraction of the yield on Treasury Bills in relation to other yields, the prospective trend of interest rates and the degree of liquidity which outside holders may need.

22. It was explained in the memorandum on Exchequer Management that Ways and Means Advances from the Banking Department of the Bank of England are treated as a last expedient to be avoided as far as possible, and that when they occur they are seldom outstanding for more than a single day. It has been suggested that the Exchequer should be as ready to finance its temporary needs by such advances as by the issue of Treasury Bills. There are two main reasons why this course has not been followed. The first is the effect on public confidence both at home and abroad. Resort by Governments to their central banks is associated in the public mind, especially in countries which have had experience of it, with excessive reliance on borrowing by the Government with consequential large scale inflation. The second reason for preferring the present system is that under the suggested alternative there would be a general tendency for cash in the hands of the banks to rise, since it would not be absorbed by the issue of Treasury Bills. As a result, the banks would be looking round for short-term earning assets so that there would be a general tendency for short-term rates to fall, which the Bank of England could not effectively counteract, since it would be extremely difficult for them to make the Bank Rate effective so long as the banks were looking for opportunities to lend.

23. *Cost to the Exchequer.* · The cost of servicing new securities is reflected in the debt charge in the published Exchequer accounts. When an existing security is sold to the public from the Issue Department, the Exchequer pays interest to the purchaser instead of paying it to the Issue Department, and the change is reflected in a reduction in the Issue Department income paid to the Exchange Equalisation Account under Section 3 of the Currency and Bank Notes Act, 1939.

24. The cost of the Debt to the taxpayer therefore depends on two factors—the total amount of the Debt in the hands of the public (as opposed to the Departments) and the rates of interest effectively payable on that Debt. An important object of debt management is to keep down the total of the Debt outstanding with the public at any time. As far as possible Exchequer payments of all kinds are met out of revenue. Any surplus of revenue arising at any time is applied to the extinction of Debt. An increase in the borrowing from the public only takes place when the Exchequer has payments to make which cannot be met out of revenue or by borrowing from internal funds. This does not, however, mean that funding (in the sense of issuing or selling longer-term securities) only takes place when the Exchequer is in deficit. Funding can take place at any time, the proceeds of sales of longer-term securities being used (insofar as there is no Exchequer deficit) to pay off floating debt.

25. The other factor entering into the cost of the Debt is the rate of interest. The debt charge will vary according to (*a*) the level of Government credit in the market and (*b*) the period and other terms of the securities which the authorities sell when they raise money by borrowing. The level of interest rates is primarily determined by Bank Rate and market pressures, and it is the policy to carry out official purchases and sales of securities at market prices. A change in Bank Rate will have an immediate effect on the cost of servicing the floating debt, since on average some £250 million of Treasury Bills in non-official hands must be renewed every week. Insofar as Bank Rate and other influences extend to the gilt-edged market, they will in turn affect the cost to the taxpayer of issues or official sales of longer-term securities.

26. The probable consequences, in terms of cost to the taxpayer, are of course included in the factors that are considered before Bank Rate decisions are taken. But since monetary policy was activated in 1951, the view has been consistently taken that the need for such a policy justifies the increases in the debt service resulting from it. As regards the choice of securities sold, it has already been pointed out (paragraph 21) that it is a constant objective to keep the market floating debt to the minimum and to raise as much as possible by the sale of longer-term securities. This policy has different effects upon the cost of the Debt

as a whole, according to the state of the market. At times the Floating Debt rate is above the long-term rate ; at other time the positions are reversed. But funding—the sale of longer-term securities—remains the policy, and the cost in debt service is subordinated to it, in the sense that the authorities would not raise money by sale of Bills in preference to longer-dated securities because the Bill rate was lower than the longer-term gilt-edged rate.

27. Finally, the net cost of the Debt to the taxpayer depends, not only on the amount and cost of Exchequer borrowing, but also on the terms on which the Exchequer lends. The bulk of Exchequer borrowing, apart from the financing of the seasonal deficit, is done in order to provide capital advances for the Post Office, the nationalised industries, the local authorities, the various public corporations. These bodies service their loans from the Exchequer on terms depending on the level of interest rates when the advances were made. The Exchequer's assets in the shape of advances outstanding with these bodies stood at £4,719 million at 31st March, 1957. Their interest payments already pay for 20% of the cost of the debt service—(the figures are given in paragraph 31 below) ; while their repayments of principal should increase over the years and in time will enable the Exchequer to extinguish debt on a large scale.

V. Debt Transactions

28. The Bank of England has provided a detailed account of the loan operations during 1951 to 1957 in their paper [No. 9] entitled "Some Features of Monetary History, 1951—1957." The present paper will therefore be confined to showing the results which have followed from the application of the policy described in Part IV of the paper, as shown by the consequent changes in the structure and cost of the National Debt.

29. The first two objectives mentioned in Part IV are (*a*) to sell as much stock to the public as possible, (*b*) to reduce the market Floating Debt. The results actually achieved have been described in detail to the Committee in the Exchequer Financing Tables. The figures for each year are as follows :—

(£ Millions)

	1952-3	1953-4	1954-5	1955-6	1956-7
Exchequer surplus (+) or deficit (−) before market borrowing or repayment of market securities	− 739	− 743	− 66	− 201	+ 178
Net sales of securities in market* ...	433	459	18	232	170
Market Treasury Bills— (+ = increase/ − = repayment)	+ 306	+ 284	+ 48	− 31	− 348

*Net sales of securities in the market include transactions in guaranteed securities as well as Government debt, and cover the operations of the National Debt Commissioners as well as Issue Department.

30. The additional objective mentioned in Part IV was to sell longer-term securities against the purchase of shorter in order to push forward the maturities in market hands. An analysis of the Issue Department market transactions shows that over the last 5 years the net total of the Department's sales was £1,045 million ; within this total the Department purchased £829 million of stocks maturing in under 5 years, against sales of £694 million of stocks maturing in 5-10 years and £1,180 million of stocks with maturities of over 10 years. The figures for each of the last 5 financial years are :—

£ Millions Cash (Market Prices)

	Stocks with Final Maturity Dates			
	Under 5 Years	5–10 Years	Over 10 Years	Total
1952/3	+ 48	+ 5	+ 169	+ 222
1953/4	− 149	+ 257	+ 172	+ 280
1954/5	− 580	+ 157	+ 439	+ 16
1955/6	− 91	+ 55	+ 181	+ 145
1956/7	− 57	+ 220	+ 219	+ 382

(− = purchases/+ = sales)

31. Over the years, the changes in the cost to the taxpayer of the the service of the National Debt are shown in the following table :—

£ Millions

	1952-3	1953-4	1954-5	1955-6	1956-7
Cost of Debt Service (excluding Sinking Funds) Total debt charge ...	641	667	674	757	858
Less Receipts of interest from Exchequer loans...	64	87	104	119	147
Net debt charge on the Budget	577	580	570	638	711
Less Issue Department income and N.D.C.'s surplus revenue and payments to Exchequer	34	35	39	42	62
Net cost of service of Debt held by the public	543	545	531	596	649

November, 1957

APPENDIX I
(To Treasury Paper 10)

NATIONAL DEBT
Outstanding 31st March, 1957

	£'000	£'000
Floating Debt		
Treasury Bills	4,195,295	
Ways and Means Advances	276,890	
		4,472,185
Market Securities		
$2\frac{1}{2}$% Consols, $2\frac{1}{2}$% and $2\frac{3}{4}$% Annuities...	299,252	
4% Consols	382,857	
$3\frac{1}{2}$% Conversion Loan, 1961 or after ...	643,337	
$2\frac{1}{2}$% Treasury Stock, 1975 or after ...	482,013	
3% Treasury Stock, 1966 or after ...	58,192	
$3\frac{1}{2}$% War Loan	1,909,836	
2% Conversion Stocks, 1958/59 ...	591,940	
$3\frac{1}{2}$% Conversion Stock, 1969	340,558	
4% Conversion Stock, 1957/58... ...	676,079	
$4\frac{1}{2}$% Conversion Stock, 1962	658,157	
2% Exchequer Stock, 1960	448,347	
$2\frac{1}{2}$% Exchequer Stock, 1963/64	274,217	
3% Exchequer Stock, 1960	200,000	
3% Exchequer Stock, 1962/63	341,278	
5% Exchequer Stock, 1957	300,000	
$2\frac{1}{2}$% Funding Loan, 1956/61	796,174	
$2\frac{3}{4}$% Funding Loan, 1952/57	100,556	
3% Funding Loan, 1959/69	289,228	
4% Funding Loan, 1960/90	236,136*	
3% Funding Stock, 1966/68	540,350	
$3\frac{1}{2}$% Funding Stock, 1999/2004	443,270	
$2\frac{1}{2}$% Savings Bonds, 1964/67	752,428	
3% Savings Bonds, 1955/65	712,548	
3% Savings Bonds, 1960/70	1,024,513	
3% Savings Bonds, 1965/75	1,073,018	
$2\frac{1}{4}$% Serial Funding Stock, 1957... ...	502,920	
$2\frac{1}{2}$% Treasury Stock, 1986/2016† ...	78,457	
$3\frac{1}{2}$% Treasury Stock, 1977/80	261,966	
$3\frac{1}{2}$% Treasury Stock, 1979/81	482,967	
4% Victory Bonds (repayable by annual drawings ending 1976)	132,216*	
3% War Loan, 1955/59	302,459	
		15,335,269

	£'000	£'000
Small Savings Securities		
$2\frac{1}{2}$% Defence Bonds	97,369	
3% Defence Bonds	72,889	
$3\frac{1}{2}$% Defence Bonds	326,916	
4% Defence Bonds	93,815	
$4\frac{1}{2}$% Defence Bonds	151,071	
Premium Savings Bonds	65,458	
National Savings Certificates	1,907,383‡	
		2,714,901
Tax Reserve Certificates		362,771
Other Debt, Internal		
$2\frac{1}{2}$% Terminable Annuities	180,277	
3% Terminable Annuities	894,228	
$3\frac{1}{2}$% Terminable Annuity	42,070	
International Bank for Reconstruction and Development—Interest-Free Notes	65,575	
International Monetary Fund—Interest-Free Notes	577,025	
European Payments Union	61,710	
Government of Portugal	72,192	
Government of India	122,076§	
Government of Pakistan	5,651	
Miscellaneous	36,216	
		2,057,020
Other Debt, External		
United States—		
Government Loan	1,436,753	
E.C.A. and M.S.A. Loans	137,128	
Canadian Government Loans	431,038	
European Payments Union	57,702	
Other Debt (payable in external currency)	2,715	
		2,065,336
TOTAL, NATIONAL DEBT ...		27,007,482

* Excluding securities tendered for Death Duties and held by the National Debt Commissioners until redeemed.

† Held by the National Debt Comissioners and not marketed.

‡ Shown at issue price, exclusive of accrued interest amounting approximately to £535 million at 31st March, 1957.

§ The amount of this debt is due to be reduced when the value of certain pensionary liabilities, taken over by the Government of the United Kingdom from the Government of India, has been finally determined.

APPENDIX II
(To Treasury Paper 10)

NATIONAL DEBT*
(At 31st March)

£ Million
(percentages in brackets)

	1935		1952	1953	1954	1955	1956	1957	
Floating Debt—									
Non-Market	462	(7)	2,047	1,823	1,645	2,024	1,892	1,645	(5)
Market Bills	371	(5)	2,564	2,891	3,174	3,223	3,191	2,827	(9)
Market Securities†	5,508	(82)	13,734	13,917	14,510	14,563	14,992	15,335	(51)
Small Savings Securities‡	397	(6)	2,603	2,570	2,551	2,619	2,610	2,715	(9)
Tax Reserve Certificates	—	(—)	368	314	369	388	342	363	(1)
Other Debt—Internal	26	(—)	2,406	2,373	2,219	1,987	1,937	2,057	(7)
Other Debt—External	—	(—)	2,168	2,163	2,115	2,130	2,075	2,065	(7)
Total National Debt	6,764	(100)	25,890	26,051	26,583	26,934	27,039	27,007	(89)
Market Securities‖ Government Guaranteed	—	(—)	2,502	2,755	2,780	2,958	3,292	3,295	(11)
	6,764	(100)	28,392	28,806	29,363	29,892	30,331	30,302	(100)

ANALYSIS OF MARKET SECURITIES§
(Government and Government Guaranteed)

	1935		1952	1953	1954	1955	1956	1957	
Dated—									
Up to 5 years	180	(3)	3,595	3,700	3,583	3,534	3,946	4,577	(15)
5 to 15 years	637	(9)	2,397	3,145	3,598	4,205	5,472	4,737	(16)
15 to 25 years	302	(5)	4,188	3,566	3,702	3,662	3,063	3,484	(12)
Over 25 years	1,035	(15)	2,183	2,409	2,574	2,306	2,008	2,057	(7)
Undated	3,354	(50)	3,873	3,852	3,833	3,814	3,795	3,775	(12)
	5,508	(82)	16,236	16,672	17,290	17,521	18,284	18,630	(62)

* Excluding debt, payable in external currencies, arising out of 1914-1918 War.

† Excluding securities tendered in payment of death duties and held by the National Debt Commissioners until redeemed.

‡ National Savings Certificates (Principal only), Defence Bonds and Premium

§ Securities with optional maturity dates are classified according to final maturity date; 4% Victory Bonds are classified according to average life to maturity.

‖ Government guaranteed stocks issued by nationalised industries and undertakings (as defined by section 42 of the Finance Act, 1956). Both capital and interest on these stocks are fully guaranteed by the Government.

APPENDIX III
(To Treasury Paper 10)

ESTIMATED DISTRIBUTION OF THE NATIONAL DEBT AND NATIONALISED INDUSTRIES' LOANS GUARANTEED BY H.M. GOVERNMENT(a)
(At 31st March, 1939)

£ million, nominal values: % of total in brackets

	Treasury Bills 1		Market Securities(b) 2		National Savings etc.(c) 3		Other(d) 4		Total 5	
1. National Debt Commissioners	4	(—)	447	(8)	—		3	(5)	454	(6)
2. Bank of England Issue Department ...	209	(23)	78	(1)	—		11	(20)	298	(4)
	213	(23)	525	(9)	—		14	(25)	752	(10)
3. Exchange Equalisation Account and Other Public Departments(e)	308	(35)	201	(3)	—		25	(46)	534	(8)
4. Nationalised Industries(f)	—		—		—		—		—	
5. Local Authorities(g)	⊕		50	(1)	⊕		—		50	(1)
6. London Clearing Banks(h)	86	(10)	557	(10)	⊕		—		643	(9)
7. Discount Market...	68	(8)	62	(1)	⊕		—		130	(2)
8. Bank of England Banking Department	62	(7)	72	(1)	—		—		134	(2)
9. Scottish Banks(h)	1	(—)	172	(3)	⊕		—		173	(2)
10. Insurance and other public companies and provident societies(i)	⊕		705	(12)	⊕		—		705	(10)
11. Overseas Official(j)	106	(12)	94	(2)	⊕		—		200	(3)
12. Other (including residual errors) ...	48	(5)	3,349	(58)	385	(100)	16	(29)	3,798	(53)
TOTAL	892	(100)	5,787	(100)	385	(100)	55	(100)	7,119	(100)

ESTIMATED DISTRIBUTION OF THE NATIONAL DEBT AND NATIONALISED INDUSTRIES' LOANS GUARANTEED BY H.M. GOVERNMENT(a)
(At 31st March, 1956)

£ million, nominal values: % of total in brackets

	Treasury Bills 1		Market Securities(b) 2		National Savings etc.(c) 3		Other(d) 4		Total 5	
1. National Debt Commissioners	32	(1)	2,702	(15)	—		1,187	(53)	3,921	(14)
2. Bank of England Issue Department ...	932	(20)	964	(5)	—		11	(—)	1,907	(7)
	964	(21)	3,666	(20)	—		1,198	(53)	5,828	(21)
3. Exchange Equalisation Account and Other Public Departments(e)	639	(13)	479	(3)	5	(—)	266	(12)	1,389	(5)
4. Nationalised Industries(f)	⊕		95	(1)	—		—		95	(—)
5. Local Authorities(g)	⊕		250	(1)	⊕		—		250	(1)
6. London Clearing Banks(h)	946	(20)	1,905	(10)	⊕		—		2,851	(10)
7. Discount Market...	465	(10)	261	(1)	⊕		—		726	(2)
8. Bank of England Banking Department	163	(3)	164	(1)	—		3	(—)	330	(1)
9. Scottish Banks(h)	15	(—)	344	(2)	⊕		—		359	(1)
10. Insurance and other public companies and provident societies(i)	⊕		2,170	(12)	⊕		—		2,170	(8)
11. Overseas Official(j)	920	(19)	1,652	(9)	⊕		744	(34)	3,316	(12)
12. Other (including residual errors) ...	676	(14)	7,298	(40)	2,947	(100)	21	(1)	10,942	(39)
TOTAL	4,788	(100)	18,284	(100)	2,952	(100)	2,232	(100)	28,256	(100)

ESTIMATED DISTRIBUTION OF THE NATIONAL DEBT AND NATIONALISED INDUSTRIES' LOANS GUARANTEED BY H.M. GOVERNMENT(a)
(At 31st March, 1957)

£ million, nominal values: % of total in brackets

	Treasury Bills 1		Market Securities(b) 2		National Savings etc.(c) 3		Other(d) 4		Total 5	
1. National Debt Commissioners	25	(1)	2,864	(15)	—		1,149	(49)	4,038	(14)
2. Bank of England Issue Department ...	1,071	(25)	926	(5)	—		11	(1)	2,008	(7)
	1,096	(26)	3,790	(20)	—		1,160	(50)	6,046	(21)
3. Exchange Equalisation Account and Other Public Departments(e)	277	(7)	469	(3)	4	(—)	239	(10)	989	(4)
4. Nationalised Industries(f)	⊕		85	(—)	—		—		85	(—)
5. Local Authorities(g)	⊕		250	(1)	⊕		—		250	(1)
6. London Clearing Banks(h)	915	(22)	1,907	(10)	⊕		—		2,822	(10)
7. Discount Market...	300	(7)	402	(2)	⊕		—		702	(3)
8. Bank fo England Banking Department	174	(4)	164	(1)	—		—		338	(1)
9. Scottish Banks(h)	13	(—)	344	(2)	⊕		—		357	(1)
10. Insurance and other public companies and provident societies(i)	⊕		2,200	(12)	⊕		—		2,200	(8)
11. Overseas Official(j)	905	(22)	1,635	(9)	⊕		916	(39)	3,456	(12)
12. Other (including residual errors) ...	515	(12)	7,384	(40)	3,074	(100)	19	(1)	10,992	(39)
TOTAL	4,195	(100)	18,630	(100)	3,078	(100)	2,334	(100)	28,237	(100)

(The notes are on page 112)

⊕ = not known

ESTIMATED DISTRIBUTION OF THE NATIONAL DEBT, ETC.

NOTES

(*a*) The National Debt here excludes debt payable in external currencies (as detailed in the Finance Accounts of the United Kingdom), and Victory Bonds and Funding Loan tendered for Death Duties.

The Nationalised Industries are here defined as those Corporations to which advances have been made by the Exchequer under the Finance Act 1956, namely the Central Electricity Authority, North of Scotland Hydro-Electric Board, South of Scotland Electricity Board, Gas Council, British Transport Commission, British Overseas Airways Corporation and British European Airways Corporations. Their loans (nil in 1939, £3,292 million in 1956 and £3,295 million in 1957) fall wholly in Column 2 " Market Securities."

The figures in the tables for 1939 and 1956 were corrected (see Memoranda of Evidence Qn. 2812), and the table for 1957 was submitted after the Treasury had given oral evidence on this paper.

(*b*) Includes (£231 million in 1956 and £234 million in 1957) " unquoted " securities (mostly issued direct to the National Debt Commissioners).

(*c*) National Savings Bonds, National Savings Certificates, Defence Bonds, Premium Savings Bonds and Tax Reserve Certificates. No estimate can be made by holders.

(*d*) Consists mainly of—

(i) Terminable Annuities issued to the National Debt Commissioners in 1943/50 as a security for Post Office and Trustee Savings Banks' funds.

(ii) Ways and Means Advances to the Exchequer (£28 million in 1939, £295 million in 1956 and £277 million in 1957) largely made by Other Public Departments.

(iii) In 1956 and 1957—" Other Debt under the National Loans Act 1939 " (mostly held by the International Monetary Fund, the International Bank for Reconstruction and Development, and the European Payments Union).

(*e*) Includes public corporations [other than those listed in note (*a*)].

(*f*) As defined in note (*a*).

(*g*) Local Authorities are here defined as those public authorities or bodies who are required to make financial returns under Part XI of the Local Government Act 1933. They therefore include certain authorities with special functions (e.g., Local Harbour Boards) as well as those with more general administrative functions. Exceptionally, the Metropolitan Police (who come under the Act) are not included here but in item 3 " Other Public Departments." The figures are derived from information supplied by a sample of Local Authorities.

(*h*) Book values at the March make-up days.

(*i*) Includes—

(i) Insurance companies : estimates based on a sample analysis and on statements published by the Board of Trade under the various Assurance Companies Acts ; these relate mainly to holdings at 31st December of the previous year.

(ii) Other public companies : estimates based largely upon the samples of public companies' balance sheets at varying dates published quarterly by " The Economist."

(iii) Provident Societies : estimates of holdings based mainly on the reports of the Registrar of Friendly Societies, the reports of the Industrial Assurance Commissioner, and balance sheets of Building Societies, mainly at 31st December of the previous year.

Most figures included in this item relate to book, not nominal, values.

(*j*) Overseas Central Banks, Currency Boards and certain other official bodies.

11. THE STERLING AREA*

A. INTRODUCTORY

1. The object of this paper is to describe the Sterling Area. It is a factual paper. Clearly there arise from it problems of the first importance for domestic monetary policy. These problems are discussed in the separate paper being submitted by the Treasury entitled " Monetary Policy and External Economic Problems".

2. Section B discusses briefly the origins and present operation of the Area. Section C deals with its recent history in terms of its impact on the United Kingdom's external reserves and liabilities.

B. THE STERLING AREA AND SYSTEM

3. " The Sterling Area " is far from being a term with a precise meaning. Treated as a list of countries there is no ambiguity : it consists of the " Scheduled Territories " (including the United Kingdom) as defined in the United Kingdom's Exchange Control Act 1947 (in which the words " Sterling Area " do not, incidentally, occur). But the term is more usually and more usefully regarded as more than a geographical grouping. It is essentially a group of countries, most but not all of them members of the Commonwealth, who follow generally comparable policies in their overseas financial transactions.

4. The sterling system originated in the first half of the nineteenth century in the process of bringing some order into the heterogeneous coinage systems and rudimentary banking arrangements which then prevailed in most of the Colonies. The system which grew from these origins had four characteristics :—

First, the local currencies and bank-notes were statutorily regulated as local versions of the pound, printed or stamped with local symbols but all representing the sovereign or legally defined fractions of it, and all backed with some obligatory holding of sovereigns or gold.

Secondly, all looked to London as their metropolitan centre for the employment of surplus funds which could not be invested with the necessary liquidity in the Colonial countries themselves.

Thirdly, as trade increased, all looked to sterling as the currency for their external transactions. There were some local exceptions to this : for example, the Indian rupee had, and still has, an international validity in the countries round the Indian Ocean, but with all other areas India settles in sterling.

Fourthly, all looked to London and the United Kingdom for the raising of new capital, predominantly for private enterprise but largely also for governmental, provincial or municipal issues.

It must be noted too that, besides these monetary links with London, London was and has remained the centre for such connected commercial activities as merchanting, insurance, shipping, etc.

5. In such a system the gravitation of the foreign exchange income of the whole Area to London was a natural and inevitable consequence of normal business and banking practices. Exporters sold their export proceeds to their local banks against the local currency in which they kept their accounts and met their expenses. Most often the proceeds so sold were already in the form of sterling and any foreign exchange arising had already accrued directly or indirectly to London ; when another currency was involved, ordinary practice led the bankers to convert it into sterling as their common external currency or common source of liquidity for surplus funds, and the same result followed ; the foreign exchange gravitated to London. Exchange control played no part in this natural centralisation of foreign exchange income and surpluses at the metropolitan centre.

6. Despite the great changes of the last thirty or forty years and the establishment of exchange controls throughout the Area during the last war and their subsequent persistence, these four pre-1914 characteristics still largely hold for the

Sterling Area today. But there have been developments inside and outside the Area which have to some extent modified the characteristics of the system :—

(*a*) The free interchangeability between sterling and gold, which established a guarantee of the value and a limitation on the volume of sterling, has been removed. The first step was taken in 1931 when the United Kingdom abandoned the gold standard. A wide group of countries, including all Commonwealth countries except Canada, immediately or soon after pegged their own currencies on sterling, though some continued to maintain substantial reserves of their own in gold and all were entirely free to acquire it against sterling. In 1939 they agreed not to make use of this facility, except for essential current payments.

(*b*) In 1939, exchange controls were introduced generally in the United Kingdom and other Sterling Area countries, but they were not applied to transactions between the United Kingdom and the R.S.A. (Rest of the Sterling Area).

(*c*) Most of the independent members of the Area now have Central Banks of their own and most are members of the International Monetary Fund with par values for their currencies defined in terms of gold or the United States dollar. In most of them legislation between the wars provided for sterling having a mandatory place in the currency backing. In many cases post-war enactments have removed such provisions, and the sterling backing is now discretionary rather than mandatory. Thus the currency link is no longer a statutory obligation. But despite this, in practice it has been maintained : all R.S.A. countries devalued to the same extent as the United Kingdom in 1949, with the sole exception of Pakistan who, however, followed six years later and restored her old relationship with the £ ; moreover the R.S.A. countries have also in practice maintained a fixed link in day-to-day fluctuations of the £.

(*d*) During the 1939-1945 war, a huge accumulation of sterling balances took place. (The main growth in Colonial sterling balances and the holdings of the Middle East Oil States came later and was substantially offset by falls in other countries' balances.) Moreover, as a result of the growth of exchange controls, these balances came, to a greater extent than before, to be held in the control of Central Banks and to be treated as national foreign exchange reserves, their size and trend becoming objects of national policy just as are those of our own gold and dollar reserves.

(*e*) The widespread use in the Area of discriminatory trade restrictions against dollar, and sometimes against all non-sterling, imports has been a significant feature in the war and post-war years. This policy has of course been pursued with very varying degrees of strictness by the different members of the Area, and in the last few years discrimination has been greatly reduced. This whole evolution has been closely affected by the desire of the Area's members to preserve both the status of sterling as an international currency and the security of their sterling holdings. Hence some measure of discrimination has been for some years (though to a steadily diminishing extent) one of the practices, *de facto*, of the Area.

(*f*) London has remained the prime source of new capital for the R.S.A. and a very large outflow has been maintained since the war. This traditional position has been so far maintained despite the emergence of the International Bank for Reconstruction and Development as an increasingly large lender, of United States aid in grants and loans and of increasing United States private investment. The outflow to the R.S.A. is now distinguished from United Kingdom investment in Canada and other non-sterling countries by being free from the requirement of exchange control approval.

(*g*) Conversely, strict control of investment in the non-sterling world by residents of the Sterling Area was imposed by individual exchange controls in all parts of the Area during the war and have been maintained (though in varying degrees and with some relaxations) ever since. This broad objective of exchange control has therefore come also to be thought of as another of the Sterling Area's normal practices.

7. Thus the Sterling Area in recent years has been in many respects a continuation of the traditional set of arrangements of the pre-war sterling system. The underlying characteristics of the Area remain little changed. They have been overlaid by changed circumstances and new pressures on sterling arising in the post-war situation, which have presented special problems ; and the mechanisms of controls evolved to meet these problems may at times have appeared to be essential features of the sterling system. These have varied from time to time and from member to member. For example, for the Persian Gulf State members of the Sterling Area, exchange control is of a very limited character. But in fact the fundamental features of membership of the Sterling Area remain :—

(*a*) The members use sterling as the normal means of external settlement ;

(*b*) They hold the major part of their reserves in sterling ;

(*c*) They look to the United Kingdom as a major source of external capital ;

(*d*) They co-operate to maintain the strength of sterling.

8. World trade depends upon an adequate payments mechanism. It it vital to the United Kingdom that such a mechanism should be maintained, both because of our national interest in world economic progress and because of our dependence on international trade. Sterling plays the major role in this, and there is no substitute for it. Certain particular advantages flow from this position of sterling. First, United Kingdom citizens, because they are able to use their own currency over a large part of the world, are themselves saved the inconveniences of operating in foreign currencies, and they have access to vital raw materials on the most favourable terms on the commodity markets established in the United Kingdom. Second, sterling as an international currency brings similar advantages to the other members of the Sterling Area and to the Commonwealth as a whole. Finally, the banking, insurance and similar transactions carried out in London based upon the international character of sterling are in themselves profitable.

9. But the counterpart of these advantages is the greater risks to which we are exposed from the considerable sterling balances which other countries hold. Whenever doubt is cast on our solvency these balances come under pressure, thus tending to aggravate the very situation that caused the doubts to arise. The use of sterling as an international currency makes it inevitable that we should have large overseas monetary liabilities. But it does not explain their present size, which derives from economic developments in the war and post-war years and has little to do with the normal requirements of a centre for international finance. The international strength of sterling would obviously be greater if the balances could be reduced without any corresponding reduction in the reserves. Meanwhile that sterling is an international currency and that the countries of the Sterling Area hold large quantities are facts of the situation which have to be reckoned with in all our economic policies.

10. The cohesion and viability of the Sterling Area depend above all on the strength of sterling. The factors determining this are of the greatest complexity, but they express themselves ultimately in changes in the relationship between our gold and dollar reserves and overseas sterling holdings.* It will therefore be useful next to analyse in some detail the forces which operate upon our reserves and liabilities. This is done in the next section.

C. RESERVES AND LIABILITIES

11. Underlying the movements in our reserves and liabilities there is a pattern of flows of funds for commercial and financial reasons. Among these there is a useful distinction between those arising out of the United Kingdom's own balance of payments with the rest of the world, and those which derive from the impact on the United Kingdom's position of the use of sterling by the outside world.

* "The reserves" comprise gold and holdings of convertible foreign currencies in the Exchange Equalisation Account. At the time when this paper was submitted the only such currencies held by the E.E.A. were U.S. and Canadian dollars; hence the reserves were often (as in this paper) described as "the gold and dollar reserves". Since December 1958 a number of other foreign currencies have become convertible, and E.E.A. holdings of these currencies fall to be included in "the reserves" in the sense in which they are discussed in this paper. "Overseas sterling holdings" in this paper are as defined in *United Kingdom Balance of Payments 1946 to 1956 (No. 2)* (Cmnd. 122), page 54.