The Foreign Exchange Business of the Australian Trading Banks

Exchange Rates and Other Charges.

The trading banks' income from foreign exchange business is made up of three components. As dealers in foreign exchange they derive a trading profit by charging more for foreign exchange than they pay for it. As suppliers of credit they charge interest. And for some of their other services they charge commissions. With the exception of some commissions, however, all three types of charge are customarily compounded and quoted in one price, the cashed exchange rates for different kinds of transactions.

The basic exchange rate between the Australian pound and the pound sterling is the TT buying rate Australia on London, that is to say, the rate which an Australian bank will pay a customer for sterling for immediate delivery. This is the rate which economists have in mind when they speak of the exchange rate in connection with exchange rate policy. There has been such an exchange rate ever since financial market transactions began between the Australian colonies and England. But until 1906, it was not generally recognised as such. The Australian pound was not distinguished from the (British) pound sterling. The exchange rate quoted by Australian banks was regarded merely as the rate for the same currency in another place, London, and was therefore expressed by saying that sterling in London stood at so many pence premium or discount. The operation of the sterling exchange standard ensured that the rate did not diverge greatly from par. The Australian banks fixed the actual rate, within the limits of gold export and gold import point, from time to time by consultation in accordance with the condition of supply and demand in the market which reflected movements in Australia's balance of payments.

The fiction that the Australian and British pound were one and the same currency had to be given up during the depression of the early nineteen-thirties. The deterioration in the balance of payments resulting from falling export prices and cessation of capital imports was such that the banks were unable to meet the demand for overseas exchange from their depleted holdings of London funds. At first, the trading banks, with the full concurrence of the Commonwealth Bank Board, preferred to ration exchange rather than raise its price. But when it became apparent that they were unable to control the market and were losing more and more business to an outside market,
The exchange rates for sterling remain stable, with the Australian banks quoting the basic exchange rate of £1.25 for $100, and the Bank of New South Wales quoting $1.00 for £1.25. The interest in foreign exchange business by various dealers in different transactions indicates the importance of foreign exchange in commerce.

For any receipts or deficiency in sterling transactions, the New Zealand banks quote a range of exchange rates based on the basic rate of £1.25 for $100, which remains unchanged from previous years.

The Australian banks remain closed on weekends, and the interests of the banks in foreign exchange business are expected to continue.

The foreign exchange business is expected to continue with various dealers and banks in New Zealand quoting exchange rates based on the basic rate of £1.25 for $100, and the Australian banks quoting $1.00 for £1.25.

In conclusion, the foreign exchange business is expected to continue as before, with various dealers and banks in New Zealand and Australia quoting exchange rates based on the basic rate of £1.25 for $100, and the Australian banks quoting $1.00 for £1.25.
for a 30 days sea mail after sight bill and £112.8.3 less for a 120 days sea mail after sight bill. By February 1956, the deductions had increased to £112.3 for sea mail sight bills and £126.6 for 120 days sea mail after sight bills. The charges represented by these deductions covered interest, commission and, in the case of usance bills, English stamp duty. The banks' commission for handling export bills has in recent years been 2/6d. (1/4%) or 5/5d. on £125,000. Stamp duty has been 1/30th (1/15th) per cent. Interest is charged for the period that the bank is out of funds on the transaction. In the case of O/D air mail, the bank pays the customer in £A receives sterling on arrival of the draft in London an assumed 14 days later, and therefore charges interest for 14 days. In the case of sea mail, it is out of funds for the longer period that the draft takes to reach London and charges interest for 45 days. For usance bills, additional interest is added for the term in question, 30, 60, 90 or 120 days.

In every case, the rate of interest is based on the ruling money market rate in the country on which the bill is drawn. The reasoning behind this principle is that this is the rate at which the bank would need to borrow to meet its commitment while it is waiting for usance bills to mature or sight bills to arrive, or at which it could rediscount bills in the country in which they are held. A lower rate might involve the bank in loss, while a higher one would induce importers to arrange for cheaper domestic finance and remit by TT. In practice, the interest factor in the Australian banks' buying rate on London is traditionally based on the Bank of England's official bank rate. It is variations in British bank rate which account for the occasional changes in the Australian banks' buying rates on London in the last few years, such as the large differences between the two dates in the Table.

The banks' Australia on London TT and mail selling rates apply to all sterling pur-
are unable to marry more than a small proportion of the day's forward sales and purchases, they will cover forward sales by spot purchases and forward purchases by spot sales in an overseas exchange market (11).

The Australian trading banks began to provide forward exchange facilities in the early thirties, helped by the Commonwealth Bank which enabled them to hedge their forward contracts with itself. In the first few years, demand for these facilities seems to have been small and to have come from exporters rather than from importers, perhaps because the banking era a return to parity with sterling in official and unofficial circles seemed to make an appreciation more likely than further depreciation. Turnover was much too small for a free forward market. The banks charged a fixed premium of 2/6d. per £500.100 per month for forward sales (to exporters) and a corresponding discount for forward purchases (from exporters). The Commonwealth Bank's charges to them were the same, but since its spot rates to the banks were less favourable than the market rates, most of the trading banks seem to have hedged their forward contracts, where possible, with one another or in the London market, rather than through the Commonwealth Bank (12).

With the outbreak of World War II, the Commonwealth Bank assumed legal control of forward exchange, as of all other foreign exchange transactions. Since then, the margins or loadings for forward deals in sterling by the trading banks for their customers have been prescribed by the Commonwealth Bank which also carries the exchange risk. Each contract entered into by the trading banks must be approved by the Commonwealth Bank, and such approval constitutes a covering contract between the trading bank and the Commonwealth Bank, the forward loading collected from the customer being paid over to the Commonwealth Bank. In writing forward contracts, therefore, the trading banks act in effect as agents of the Commonwealth Bank.

The sterling forward loadings laid down by the Commonwealth Bank have been changed from time to time, broadly in the direction indicated by market conditions. During the war, when the majority of Australian exports were purchased in Australian currency by the Commonwealth Government for sale to the British Government under bulk trading arrangements, there was little demand for forward contracts from exporters and forward buying rates quoted were the same as spot rates. Forward selling loadings were initially (April 1940) fixed as high as 5/1 per £500.100 per month, but were reduced to 2/6d. in June 1941. These rates were maintained until February 1948 when the Commonwealth Bank responded to the growing demand for forward contracts from exporters anxious to protect themselves against the risk of an appreciation of £A by first spreading the 2/6d. spread between buying and selling evenly, giving a 1/3d. premium for sales and a 1/3d. discount for purchases, and a few months later doubling both loadings. The banks have since then stood at the figure of 2/6d. per £500.100 per month.

It is clear that the system of fixed rates has enabled Australian traders to obtain sterling forward facilities when they wanted them, more cheaply than would have been possible in a free forward market. During the years 1948-51, when appreciation of £A was widely expected, a one-sided demand for forward facilities from exporters would almost certainly have pushed the discount on forward sterling sold by exporters above the Commonwealth Bank's Rate. With the deterioration in Australia's balance of payments position since 1951, expectations have been reversed, and demand for forward contracts from exporters has largely disappeared. In the event of a serious depreciation scare, importers would seek forward cover on a large scale, and the Commonwealth Bank would probably be compelled to raise the premium on forward sterling. Meanwhile the substantial reserves which it must have built up during the years when traders covered against an appreciation which did not take place enables it to provide cover for importers at a relatively low rate. Whether a procedure which assists exporters in periods of export surpluses and importers in periods of import surpluses is altogether desirable is another question.

The Australian trading banks also provide forward exchange facilities in currencies other than sterling. For these contracts, no rates are laid down by the Commonwealth Bank, and the banks are free to quote their own rates. In practice, they base their rates on those obtainable overseas, mainly in London. Until the re-opening of the London forward exchange market in December 1951, the Bank of England quoted fixed rates of forward loading for the main overseas currencies and the Australian trading banks were able to quote stable rates based on these. Since then, the Australian banks' forward loadings for non-sterling currencies have fluctuated with market rates and conditions in London. For forward contracts in U.S. and Canadian dollars, and other major currencies, the Commonwealth Bank enables the trading banks to hedge with itself, in much the same way as with sterling. Forward contracts in other currencies have to be hedged in London.

London Funds.

Foreign exchange dealers, like dealers in any other commodity, need stock-in-trade to carry on their business. Their stocks consist of balances of foreign exchange. The Australian trading banks' stock-in-trade for their foreign exchange business has always consisted predominantly of sterling balances, £ London funds. The practice arose naturally from the growth of the monetary and banking system of the Australian colonies as a more geographical extension of the British system centred on London, of which the conduct of all colonial trade in sterling was just another reflection. Since almost all exchange transactions handled by the Australian banks were sterling transactions and London offered incomparable facilities for deposits and remunerative but liquid investment of funds, there was every reason for the Australian banks (several of which were, in any case, London banks operating in Australia) to hold working balances in London.

Until 1939, however, the importance of the Australian trading banks' London funds far exceeded that of working balances of foreign exchange dealers. They were also Australia's international reserves. A national economy needs reserves of foreign exchange on which it can draw to cover temporary deficits in its balance of international payments. Because of her dependence on exports of primary products, Australia's balance of payments has always been subject, not only to regular seasonal fluctuations over the year, but also to the risk of sudden large deficits resulting from slumps in export prices and in the rate of inflow of overseas capital. Until 1939, the maintenance of adequate international reserves was the responsibility of the Australian trading banks. They discharged it, not so much by any conscious national foreign exchange policy, as by the generalizing their banking business according to liquidity rules empirically evolved. In effect, they operated a sterling exchange standard in such a way as to allow their London funds to fluctuate seasonally, but to ensure an average level from year to year by appropriate adjustments in domestic credit conditions.

The system broke down under the strains of the Great Depression. Steeply falling export prices and sudden cessation of government long-term borrowing overseas in 1932 produced a balance of payments deficit so large that no practicable domestic deflation could restore the balance. Despite emergency import restrictions, tariffs and short-term borrowing in London, the trading banks' London funds fell to the point where serious difficulty was found in meeting the substantial overseas interest bill on the public.
debts. If default was to be avoided, the Commonwealth Bank, to which the Government looked for exchange to meet its requirements, had to be given a prior claim on the available supplies of sterling. This was the object of the voluntary exchange mobilization agreement concluded between the Government, the Commonwealth Bank, and the trading banks in August (1939) (13).

Under the agreement, each trading bank undertook to sell to the Commonwealth Bank month by month a proportion of its receipts of foreign exchange. In the first week of each month, the trading banks informed the Commonwealth Bank of their gross receipts in London for the previous month. On this information, each bank (including the Commonwealth Bank) was assigned a quota sufficient to provide an aggregate contribution to the exchange mobilization pool which was initially fixed at £50,000,000 a month and was later adjusted as the amount needed for Government requirements changed.

The rate of exchange applied to the monthly settlements was the so-called selling rate at the date of each transaction, less one-eighth of one per cent. From December 1931, when the Commonwealth Bank assumed control of the exchange rate by buying sterling at the rate of £1 = £125.000, the rate applied to the monthly settlements became, according to this formula, £1 = £125.000 at which it has remained ever since. Incidentally to its assertion of control over the exchange rate, the Commonwealth Bank at the same time agreed to buy from the trading banks, at the same rate as in the monthly settlements, any surplus it wished to sell above the amount held by each bank on 31st August, 1931, and to sell sterling to them on application (14).

Voluntary mobilization worked reasonably smoothly (15) until it was superseded in August 1939 by a compulsory scheme introduced under exchange control regulations. The threat of war caused a serious immediate drain on Australia's external reserves and made the compulsory exchange receipts in the hands of the Central Bank seem essential, at least for the duration of the war. The arrangements introduced in August 1939 were maintained substantially unchanged after the war under the Banking Act of 1945. They are maintained at present under Exchange Control Regulations issued under Section 29 of the Act, but should these expire at any time, the Commonwealth Bank has power to acquire sterling from the banks under Section 23.

Under the new scheme, the trading banks, conducting all foreign exchange business as agents of the Commonwealth Bank, settle monthly with the Commonwealth Bank for the difference between their receipts and payments of sterling on Australian account. Each month, they submit a return to the Commonwealth Bank showing total receipts and total payments of sterling on account of their Australian business. If receipts exceed payments, they sell a sterling TT for the excess to the Commonwealth Bank. If payments exceed receipts, they buy of sterling TT from the Commonwealth Bank. Interim settlements are permitted during a month as necessary. The rate of exchange either way remains at £125.000. The reason for this rate, rather than the mean rate of £125.500, has been lost in the mists of history. It may have been to provide an incentive to the banks to err on the side of a surplus rather than a deficit if they could not balance their foreign exchange transactions.

The effect of the scheme is to concentrate all net changes in Australia's London funds in the Commonwealth Bank's official holdings. The trading banks retain at each month's settlement only balances which have remained at much the same level since 1939, despite the very great increase in the value of foreign exchange business (16). All the major trading banks participate in the monthly settlement, including (since December 1953) the Commonwealth Trading Bank. So do the branches of the foreign banks operating in Australia. Overseas receipts and payments of the State banks are for the most part included in the Commonwealth Trading Bank's returns. Receipts and payments of the purpose of the monthly settlement include the sterling involved in the trading banks' forward transactions when the transactions are completed. Items in transit and unmatured drafts are, with minor exceptions, excluded.

An important feature of the post-1939 arrangement is that the Commonwealth Bank carries all exchange risks arising from movements in the sterling exchange rate on the exchange business handled by the trading banks. Until 1939, the trading banks carried the risk on their London funds themselves, profiting on their severely depleted holdings from the depreciation of the £A in 1930-31 and making a loss on their rather larger holdings when the Commonwealth Bank moved to £125.000 (from £126.000 to £125.000) in December 1931. Under the present arrangement, the Commonwealth Bank would bear any losses on the trading banks' sterling holdings (other than working balances) in the event of an appreciation of £A.

While the monthly settlement prevents the trading banks' London funds from rising above (or falling below) the level of their working balances from month to month, most sterling assets received by Australian residents (and sterling liabilities contracted by Australian residents) in the course of Australian overseas business continue to pass into the hands of the trading banks. In the intervals between monthly settlements, therefore, the banks hold sterling balances which, in months in which Australia's balance of payments is favourable, greatly exceed their working balances. Balances in London are held mainly on current or deposit accounts with English banks and as money lent on short call to the discount market. The banks with London head offices also continue to hold a fair amount in British Government securities, but these are regarded as capital reserves rather than as working balances.

In the course of exchange business, the banks acquire titles to sterling in the form of (export) sight and term bills on London. These, together with mail transfers and other items on the way to London, appear in their balance sheets as receivables and remittances in transit. Net of sterling liabilities (such as acceptances under import credits), they are included, together with the trading banks' working balances and the Central Bank's gold and foreign exchange holdings, in the Commonwealth Bank's official statistics for Australia's gold and foreign exchange reserves (17). In these statistics, it might be thought that the London offices of the Australian trading banks are treated as 'non-resident', that is to say, as London banks. The London offices of Australian trading banks included in the statistics, therefore, are not the net foreign assets held by the London offices, but the balances to the credit of Australian account in the London offices' inter-branch accounts. This procedure, of course, makes no significant difference to the figures (18).

In addition to their funds in London, the Australian banks hold small working balances in all the more important foreign currencies, mostly one bank account with foreign agent banks. For U.S. and Canadian dollars, the Commonwealth Bank provides covered facilities, both spot and forward, which at the same time automatically ensure that


(14) How the Commonwealth Bank was recognized to be selling sterling on application is not clear; in any case, none of the banks seem to have been under the impression that there was such a commitment; cf. Reserve Commissioner, Money of Medicine, pp. 116, 139.


(16) D. G. Beazley, 'Australia's Holdings of Gold and Foreign Exchange', Economic Record, May 1953, p. 25, 30, 31 shows a figure of £6,600,000 for Australia's holdings in June 1936, but this appears to be the result after deducting net central reserves from the official figure for Australia's gold and foreign exchange holdings, and including in its total other items, besides working balances. The latter were probably a good deal smaller.

(17) Ibid., p. 25.

(18) Ibid., p. 25.
it meets all net dollar payments and receives all net dollar receipts arising from the trading banks' business. It also buys forward to cover the trading banks' dollar working balances. For transactions in foreign currencies other than dollars, cover purchases and sales are generally made in the London market. Their sterling equivalents are included in monthly settlements, and the Commonwealth Bank covers the exchange risk in respect of the Australia/London rate. But the banks must cover or carry themselves the risk on the London/foreign rate.

The small but growing portion of Australian overseas transactions, which is expressed in Australian currency, somewhat anomalously, does not affect the banks' overseas assets or liabilities, as recorded either in their own balance sheets or in the official statistics of Australia's gold and foreign exchange reserves. For although the liabilities are to non-residents, and the assets obligations of non-residents, they do not appear as overseas assets and liabilities by the conventional criteria, in Australian currency in which they are expressed. This also applies to the balances held with the Australian banks by overseas banks. During the years 1949-51, when these balances were temporarily swollen by inflow of specie for speculation on an appreciation of £A, they represented a substantial debit item that needed to be borne in mind in interpreting the official figures for Australia's international reserves.

When the Royal Commission in 1937 recommended a procedure for centralising Australia's international reserves not unlike that adopted in 1936, the trading banks strongly protested. They argued that their financial standing overseas and in Australia depended on their holdings of large London funds and that a compulsory mobilisation scheme would involve them in a severe loss of interest income and exchange profit (19). These fears have proved unfounded. Indeed, it is by no means certain that, even from their own business point of view, the trading banks would now wish to go back to the old system. They have lost their former status as custodians of the country's international reserves. But they have gained automatic protection from exchange risks on most of their overseas balances, and in other respects the change has made little difference to them.

The rate of exchange paid by the Commonwealth Bank in a monthly settlement does probably have some effect in reducing the exchange profits of the banks, compared with what they would have been under the pre-1939 regime; especially for those banks which have, on the average, more import than export business. On the other hand, the banks would certainly have lost a good deal of income in the post-war years had they been compelled to hold Australia's huge accumulation of sterling at low rates in London, instead of being able to employ a fair portion of their counterpart profitably in Australia. (Much of the counterpart, of course, earned low rates on special accounts). The change, finally, has made no difference at all to the role of London funds as a source of liquidity to the trading banks, since for every pound sterling they sell to the Commonwealth Bank they receive the Australian equivalent in cash in Australia.

The Foreign Exchange Business of the Australian Trading Banks

Foreign Exchange Policy.

This leads us to the wider question concerning the role that remains to the trading banks in foreign exchange policy.

Until 1914, and to a lesser extent until 1926, Australia's foreign exchange policy—in so far as there was a policy and not merely a semi-automatic system working through business responses to market forces—was conducted by the trading banks. Today, foreign exchange policy in Australia, as in most other countries, is entirely the prerogative of the Central Bank. The continuing difficulties of the external financial position of Australia, as a national currency area and as a member of the Sterling Area, have rendered necessary the retention, in the conduct of foreign exchange policy, of direct administrative controls which, in most fields of domestic economic policy, were gradually abandoned after the war.

The Central Bank fixes the exchange rate. It holds the country's international reserves. Through its exchange control powers, supplemented from time to time by Government import licensing, it determines in large measure for what purpose and where foreign exchange may be spent. Does this leave any margin for independent influence on foreign exchange policy by the trading banks?

The banks certainly no longer exercise any influence on the balance of payments as exchange dealers. They no longer fix the price of foreign exchange, the exchange rate, and they no longer bear any responsibility for rationing it in periods of scarcity. Their functions as dealers are confined to buying all foreign exchange offered to them by customers and selling it to those entitled to buy under exchange control and import licensing regulations.

Whether the same is true of their function as suppliers of credit for foreign trade is not so certain. We should not expect the banks to attempt to regulate the demand for credit for overseas trade, any more than for domestic credit, by changes in interest rates (exchange rates). Exchange rates, as we see, are adjusted quite automatically to British (or other relevant) discount rates in the case of export bills and to domestic overdraft rate in the case of import bills. The question is rather how far the banks apply to credit for overseas trade the credit rationing procedures they employ, in periods of stringency, to domestic advances. In the absence of any information on the volume of credit supplied by the banks in their foreign exchange business from time to time, the question cannot be answered with any confidence. But one's impression is that, however tightly the banks may at times ration domestic advances, whether at their own initiative or under Central Bank directives, demand for credit for foreign exchange business is invariably met freely; in other words, it receives top priority, whether because the banks regard this as being in the national interest or because competition for profitable exchange business is too strong to allow of any other policy. The banks may ration overdrafts to importers, as they were asked by the Commonwealth Bank to do in 1955. But there is no evidence that they ever refused to establish letters of credit or to negotiate bills for eligible customers, up to the maximum terms conventionally accepted or laid down by exchange control.

The question is of some importance in two connections, for its effect on the overall level of exports and imports and on the timing of receipts and payments. The credit needs of exporters would probably always be regarded as deserving top priority in the national interest, though even here the question might arise whether unrestricted supply by the Australian banks does not at times enable overseas importers to escape domestic credit stringency in their own countries by taking advantage of the liberality of the Australian banks. On the import side, however, it might be thought illogical that attempts should be made to restrain import spending by limiting overdraft accommodation to importers while meeting freely all demands for credit for the finance of import shipments. The banks no doubt take the view that any measures of control of such credit, if they should indeed be desirable or practicable, are the responsibility of the Central Bank, and some control has in fact been exercised in recent years by laying down maximum limits for advances. The freedom from restraint of exchange credit, even in periods of severe domestic stringency, however, deserves more attention than it generally receives.

The second aspect concerns the notorious problem of 'leads and lags' in overseas receipts and payments. When an appreciation of the Australian pound was expected, importers were anxious to defer payment, while

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(9) R. C. Royal Commission, Minutes of Evidence, pp. 319-321.
overseas buyers of Australian exports widely adopted the practice of pre-paying for their purchases. Similarly, fears of depreciation are liable to induce importers to pay as soon as possible and overseas buyers of exports to defer payment as long as possible. Such shifts in the timing of payments and receipts (which in the balance of payments accounts appear as ‘unidentified’ private capital movements) can be very troublesome because they add to the forces which are exciting pressure on the balance of payments and can assume very large dimensions. While exchange control regulations continue to permit pre-payment or post-payment by as much as six months, the shift could, in an extreme case, be equivalent to a capital outflow of more than the country’s annual import bill.

The banks, as far as our knowledge goes, have consistently adopted the attitude that it is their job to meet their customers’ demand for overseas payment facilities. They readily facilitated deferral of payment by Australian importers in 1948-49 and would no doubt be equally prepared to meet exporters’ credit requirements in the reverse situation. They may well be right in assuming that the Central Bank is adequately informed of the facts and has the power to impose what controls it regards as desirable. At any rate, we may conclude that, as suppliers of credit for the finance of overseas trade, the trading banks retain some scope for a policy of their own; but that their policy seems to be, to a much greater extent than in domestic advance policy, simply to meet to the full the demand of eligible customers at the conventionally determined charges.

If the Australian trading banks still exercise an important influence on the country’s external financial position, it is not so much through their foreign exchange business as indirectly through their domestic credit policy. Australia’s exports, and even more so Australia’s imports, as well as capital movements, are strongly influenced by monetary conditions in the Australian economy. Conditions of boom and inflationary pressure, such as prevailed in the years 1948-49 and again in 1954-56, cause balance of payments difficulties, immediately by stimulating excessive import expenditure and in the longer run by raising domestic costs and making domestic products less competitive. Domestic deflation, however undesirable, its domestic effects, tends to improve the balance of payments. Although the Central Bank has responsibility for domestic monetary policy, its controls in this field are less direct and effective than in foreign exchange policy. They leave the trading banks a substantial margin for independent influence on the course of events. It is through their advance policy that the trading banks still, consciously or unconsciously, play a part in determining the country’s external financial position.

Conversely, the transfer of control over the exchange rate and London funds from the trading banks to the Central Bank has, as such, made no difference to the influence of changes in Australia’s balance of payments on domestic monetary conditions. An improvement in the balance of payments, by increasing London funds, still increases the cash reserves and liquidity of the trading banks in the same way as it did before 1930. And the trading banks, in their advance policy, react to the improvement in their liquidity, broadly speaking, in the same way as they did before 1930.

The change which has occurred in this respect, such as it is, has resulted not from the Commonwealth Bank’s assumption of control over foreign exchange but from its new powers of control over bank liquidity, especially of course the special accounts procedure. Before 1930, the trading banks did something to insulate the Australian economy from external fluctuations through the balance of payments. They did so by not adjusting the volume of domestic credit fully to all changes in their London funds and rather allowing their liquidity ratios to fluctuate. To-day it is the task of the Commonwealth Bank to bring about this insulation, as far as it regards it as desirable and practicable, by using the special accounts power (and in extreme cases changes in the exchange rate) to offset the effects of changes in the balance of payments on the liquidity of the banking system.

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