CAMBRIDGE
Cambridge University Press
978-1-316-61171-5 — The History and Mechanism of the Exchange Equalisation Account
Leonard Waight
Excerpt
More Information

# PART I

## CHAPTER 1

On 21 September 1931 the gold bullion standard operated by Britain since 1925 was suspended. In April 1932 the Exchange Equalisation Account was set up and has remained in force ever since. In order that we may properly understand the connection between these events we must go back a little and enquire into the circumstances which led up to them.

The gold standard suspension was an act of supreme importance in Britain's financial history and one that has had far-reaching repercussions not only in this country but throughout the world. In other countries it gave rise to much bewilderment, bitterness and nervousness. If the foundations of the citadel of financial probity were unsound and the structure about to tumble, other centres could not remain for long unaffected.

At that time there was considerable controversy concerning the necessity for such a drastic step and many criticisms from abroad were erroneously based on the assumption that it was a Machiavellian plot to capture world trade. The passing of time enables a better perspective to be drawn, and with it an understanding of those deep-seated forces which made the suspension inevitable. It is necessary for our purpose to make a rapid review of those forces.

The war of 1914–18, with all its terrific strain on the financial structure of this country, was maintained without suspending the gold standard *de jure*. The dollar-sterling ratio was pegged at just under the gold standard parity. Britain was able to ensure this rate, firstly, by borrowing to finance war purchases instead of selling sterling and buying dollars; secondly, by mobilising British holdings of American securities; and finally, when



© in this web service Cambridge University Press www.cambridge.org

CAMBRIDGE

Cambridge University Press
978-1-316-61171-5 — The History and Mechanism of the Exchange Equalisation Account
Leonard Waight
Excerpt
More Information

America entered the war as an associate, by United States Government loans. In effect the gold standard, internally and externally, was inoperative.

After the war the pound sterling was left to find its own level and it fluctuated considerably. In 1925 the pound was put on its pre-war gold basis and with it the pre-war dollar-sterling ratio. The unwisdom of that step was not generally recognised at the time, though there were a few far-seeing persons who protested vigorously against the decision. The fact that Britain was still a large creditor nation had a great bearing on the decision. If the pound had been devalued the nation's income from foreign investments would have been correspondingly reduced. The authorities did not overlook the fact that by restoring the pound to its pre-war parity with the dollar some over-valuation of the pound would result. But they had reason to believe that the initial over-valuation would be corrected by the intensive reorganisation—in those days it was called rationalisation—of industry which was in progress at that time. In the event, these hopes were not fulfilled. The over-valuation of the pound—which some economists estimated as something of the order of 15%—persisted because it was found impossible to reduce wages, taxes, overheads and other fundamental costs beyond a certain point. This rigidity of the cost structure was not comprehended sufficiently until some time after the restoration of the pound.

One of the fundamental differences between the pre-war and post-war conditions was in regard to the nature of the basis of the London Money Market. London's pre-war financial supremacy was based on three main factors. It was an international lender with unsurpassed knowledge; it operated the gold standard with a freedom which was unique, and it had developed a bill market which held the admiration of the world. The sterling bill was backed up by the unrivalled facilities of the acceptance and discount market in London and the high traditions and integrity of the names forming that market. London was the acceptance banker for the world, and the bill of exchange was the instrument. That instrument is an ideal one because, being



© in this web service Cambridge University Press www.cambridge.org

Cambridge University Press
978-1-316-61171-5 — The History and Mechanism of the Exchange Equalisation Account
Leonard Waight
Excerpt
More Information

based on wanted goods or services the bill of exchange is self-liquidating. The short-loan fund* of the London financial market was vitalised by the bill of exchange; by its use it combined in a high degree the greatest safety consistent with the greatest liquidity.

The destruction by the war of a large part of Britain's international trade and the financing of international trade, as well as the piling up of a huge internal and external debt occasioned by the war, considerably reduced the volume of the bills of exchange in London. Their place was taken by Treasury Bills. A large part of the enormous legacy debt of the war was unfunded short-term debt, of which a considerable part was in the form of Treasury Bills. We shall have occasion in later chapters to refer to the great part which the Treasury Bill has had in the post-war history of the London Money Market, especially in regard to the Exchange Equalisation Account. Here we are concerned with it as the instrument which has largely replaced the bill of exchange. The Treasury Bill converted London's position of international acceptance banker to international deposit banker. London arrived at that position after the return to the gold standard in 1925. So long as sterling was not interchangeable with gold there were definite risks attached to the holding of that currency by foreigners. They could not be sure what the exchange rate would be when they wished to repatriate their money. The attachment of sterling to gold removed that risk, and foreign funds poured into London to be employed in what was regarded as the safest short-term security in the world —the British Treasury Bill.

It was simple enough and very attractive for the foreigners to remit funds to London where they could be left on deposit with the banks and, more important, could be withdrawn at will without capital loss. That was possible because Britain, having returned to the gold standard, had rendered the pound sterling interchangeable with gold. The London banks which received their deposits would normally employ their funds or a proportion of them in the short-loan market, the basis of which was the

* For definitions of technical terms used in the work see Glossary on p. 182.



© in this web service Cambridge University Press www.cambridge.org

CAMBRIDGE

Cambridge University Press
978-1-316-61171-5 — The History and Mechanism of the Exchange Equalisation Account
Leonard Waight
Excerpt
More Information

bill of exchange, but as there were insufficient bills available, the banks sought another outlet, which was the British Treasury Bill.

Britain's return to the gold standard in 1925 was followed by many other countries which had suspended or rendered it inoperative on the outbreak of war. Some of them adopted what is known as the gold exchange standard, which means in simple language that the Central Bank of the country adopting the standard was authorised to hold gold and/or gold standard currencies as a basis for the note circulation. As London had acquired a reputation for operating the gold standard without any restrictions on the withdrawal of gold*—a feature that was not common to all gold standard operating countries—it was chosen by many countries as the centre in which the currency assets of the Central Banks concerned should be held. Sterling held on deposit in London could be exchanged for gold at any time. Deposits provide an income, gold does not.

London became a magnet for funds from all over the world, and, if the owners of those funds were content to leave them here, bankers who were the recipients of them were hard put to it to find outlets. It was perhaps not unnatural that some part of those funds was employed in more remunerative ways than by the purchase of Treasury Bills. In a post-war Europe needing capital reconstruction, and other parts of the world needing capital of which they had been starved during the war years, there were profitable or what seemed to be profitable outlets for employment of money. London was quick to resume its former role as a supplier of capital, and considerable amounts were so exported. In view of subsequent events to which we shall refer later, the export of that capital was, in some cases, unwise. London was borrowing on short term and lending on long term. The export of capital on such a scale and the growing adverse balance of trade might have easily brought about the breakdown of the gold standard much sooner than 1931 but for other factors which served to mask the real position. We must consider those factors.

* Cf. p. 7.



© in this web service Cambridge University Press www.cambridge.org

CAMBRIDGE

Cambridge University Press
978-1-316-61171-5 — The History and Mechanism of the Exchange Equalisation Account
Leonard Waight
Excerpt
More Information

America made great efforts during the war and especially in the years just after the war to replace Britain as the world's supplier of capital. She embarked on a policy of foreign lending on a great scale to countries all over the world. In the years from 1923 to 1929 Continental Europe was able to borrow many millions of dollars from America; Germany in particular borrowed more from America and Britain than it paid in reparations. There was a two-way flow of funds. The westward flow, creating buyers of dollars, had its origin in the large adverse trade balance between Europe and America. The latter country sold more products than it bought from Europe. In addition large amounts of dollars were wanted by Europe for payment of the semi-annual instalments on war debt account. The eastward flow, creating sellers of dollars, had its origin in the large amount of loans made by America to many European countries. The westward and eastward flow did not exactly balance; the difference was made up by shipments of gold to America where, in the post-war years, huge quantities were amassed. Without the eastward flow Britain would have had great difficulty in maintaining its currency on a gold basis.

All this time large sums of money were being transferred on War Debt account. Britain was receiving payments from France, Italy and others, and America was receiving larger sums from all the Allies. From 1923 to 1932 Britain paid to America £400 millions on War Debt account. There were therefore huge displacements of funds in and out of Britain, on commercial as well as Government account, constituting a perilous position because a balance could be maintained only so long as *all* those movements of capital continued to be made. The cessation of one would bring about a collapse of the whole structure. That in fact happened.

Internally, the position of Britain steadily deteriorated. There was considerable labour unrest; prolonged strikes and growing unemployment and other signs of economic disorder which were aggravated by the return to gold. The British price level was much above the world level, and in consequence export markets were steadily lost to us. Employers found that beyond



© in this web service Cambridge University Press www.cambridge.org

CAMBRIDGE

Cambridge University Press
978-1-316-61171-5 — The History and Mechanism of the Exchange Equalisation Account
Leonard Waight
Excerpt
More Information

a certain point the wage structure was too rigid to be compressed further. Production was therefore curtailed. Meanwhile Britain had become a free trade island in a world of protected markets. Not only were goods of other countries imported in increasing quantities but the proceeds, i.e. pounds sterling, were offered against other currencies requiring ultimately a settlement in gold. Thus the economic position of Britain was out of balance and a breakdown somewhere was only a question of time.

Perhaps the drying up of American loans to Europe started the long train of events, each more serious than the last, leading up to the culminating point of Britain's suspension of the gold standard. Cause and effect were hopelessly mixed. It may have been the French occupation of the Ruhr, or the general strike in Britain, or the Wall Street crash in America, or the Credit Anstalt crash in Austria which lighted the trail leading up to the Hoover moratorium and the greatest depression the modern world has known—a depression unique inasmuch as not one country in the whole world escaped its blight.

As for Britain, first there was the Macmillan Committee's report on finance and industry which drew attention to the vulnerability of the London Money Market, and then the May Committee's report which shouted to the world that we were living beyond our means and caused a wave of apprehension abroad which did not quite give way to panic. Britain, it was thought, would somehow muddle through again. The Bank of England obtained franc and dollar credits to a total of £50 millions, but they were not sufficient to stem the flow of gold. In addition, and for the same purpose, the Treasury obtained credits for £80 millions, but the loss of gold continued. The Labour Government gave way to a three-party Government which enforced a drastic cutting of expenditure, including the pay of Judges, Civil Servants and of the armed forces. The "mutiny" of Invergordon caused by inequalities in sailors' pay was the culminating incident, magnified by the Press, that convinced foreigners that their money in Britain was no longer safe. The funds lent by Britain on long term could not be recalled against the rapid withdrawal of the short-term funds



© in this web service Cambridge University Press www.cambridge.org

borrowed. There ensued a run on the diminishing stock of gold of the Bank of England. In two months £200 millions of foreign-owned funds were withdrawn from the London market. At the end, the gold remaining with the Bank of England amounted to £130 millions, equal to the amount of the recently arranged credits of the Bank of England and Treasury. There was not enough cash available either in the large banks or in the Bank of England to meet the sight liabilities which were being hastily realised.

Britain had no option but to suspend the gold standard.

Much that has happened since has restored the pride and prestige which were so humbled on 21 September 1931. We have learned since what should have been apparent in 1925 when the decision was taken to restore the pre-war value of sterling, that even strong nations like Britain cannot participate in a four-years' world war without running up a bill of a size that effectively prevents a return to former conditions. In particular we have learned that London as a world financial centre has changed its essential characteristics. It is vulnerable to an extreme degree unless measures are designed and actively pursued in its defence. The needed design and action arrived in April 1932, and it was called the Exchange Equalisation Account.



© in this web service Cambridge University Press www.cambridge.org

CAMBRIDGE
Cambridge University Press
978-1-316-61171-5 — The History and Mechanism of the Exchange Equalisation Account
Leonard Waight
Excerpt
More Information

## CHAPTER 2

THE period between the suspension of the gold standard in September 1931 and the establishment of the Exchange Equalisation Account in April 1932 was a critical one. The pound sterling in terms of gold currencies fluctuated violently. In terms of the dollar the rate plunged to $3{\cdot}25\frac{3}{8}$ and in terms of the franc to $83\frac{1}{8}$ as against the gold parities of \$$4{\cdot}86\frac{2}{3}$ and fr. 124 respectively. Later, when it was seen that resolute efforts were being made to balance the budget and to correct the adverse trade balance by the imposition of a tariff, confidence in the British currency returned. The violent oscillations of the exchange rates, largely caused by the operations of the currency speculator, were very disconcerting to importers and exporters, who were unable to find a firm base on which to make prices for their trading. This was inimical to a situation in which everything that was calculated to assist industry and employment in this country formed part of the declared policy for which the Government was returned to power by such an overwhelming majority.

In the early months of 1932 confidence in sterling returned with such force that unless steps had been taken to counteract the movement sterling would have been forced back to a level which would have deprived the economic and financial fabric of the advantages accruing from a proper valuation *vis-à-vis* foreign currencies and gold. This appreciation in the value of sterling continued although large purchases of dollars and francs were being made by the British Treasury and the Bank for the purpose of repaying the credits obtained from America and France referred to in the previous chapter. When it became known that these credits had been repaid, the movement was accentuated. All this was very flattering to this country, but it was inconvenient and even harmful, and something had to be done about it.

The Bank of England in its capacity as agent for the British



© in this web service Cambridge University Press www.cambridge.org

CAMBRIDGE

Cambridge University Press
978-1-316-61171-5 — The History and Mechanism of the Exchange Equalisation Account
Leonard Waight
Excerpt
More Information

Treasury and as the institution called upon "to keep the financial structure on an even keel", within its limited scope, endeavoured to control the fluctuations of the pound in terms of other currencies. It operated in the market as buyer or seller of foreign currencies, with the object of reducing the fluctuations in range and frequency. It soon proved to be a task beyond its powers, for reasons of which we must here take note.

The Bank had definite statute limitations. The Gold Standard (Amendment) Act 1931* expressly relieved the Bank of England from the obligations laid upon it by the Gold Standard Act 1925† to sell gold at 77*s.* 10½*d.* per standard ounce, but the obligation to buy gold offered to it at the fixed price of 77*s.* 9*d.* per standard ounce remains. As the market price was at that time about 113*s.* per fine ounce the Bank could not hope to acquire any gold at its fixed price; so that it could not operate in the market as a buyer. As a seller the Bank was not free, since the gold holdings of the Issue Department constituted the cover for the repayment of the balance outstanding of the French and American credits‡ which had been contracted on a gold basis. If it obtained gold through the purchase of gold currencies, the transaction would eventually have to be expressed in the Bank of England's balance-sheet in terms of sterling, and as the currencies would have been acquired at varying prices the gold equivalent in terms of sterling would have been necessarily at varying prices too, importing undesirable complications of accountancy in the Bank's books. Moreover, the Issue Department of the Bank of England was not authorised to hold foreign currencies as part of its assets.§ The capital and other resources of the Bank of England being limited, any further purchases of foreign exchange were not possible without expanding the credit base unduly. It was felt that the main thing at that time was to prevent a rise in prices which, with an expanding credit base, might have led us into a spiral of inflation, of which we were all afraid, having become unanchored from an automatic exchange

* See Appendix C. † See Appendix A. ‡ Cf. p. 6.

§ The ambiguity of the Currency and Bank Notes Act 1928 in this connection was removed by the Exchange Equalisation Account clauses of the Finance Act 1932, q.v. p. 166.



© in this web service Cambridge University Press www.cambridge.org

CAMBRIDGE

Cambridge University Press
978-1-316-61171-5 — The History and Mechanism of the Exchange Equalisation Account
Leonard Waight
Excerpt
More Information

regulator. The abyss of inflation into which fell some Continental countries in the post-war years was remembered, and there is little doubt that the authorities at that time were haunted by this fear. These were the compelling reasons for the continuance of a high Bank Rate (although on other grounds perhaps illogical) and for the seeking of a solution to the formidable problem of devising an instrument which by its power and resources would draw the respect of speculators and possess the means and ability not only to control the external value of sterling but also to insulate the domestic credit structure.

It is permissible to claim that the solution decided upon was a masterpiece of British improvisation. The requirements were simple: a fund large enough to draw the respect of speculators, and authority to act, widely and secretly. Parliament granted the authority and provided the funds in the Finance Act of 1932.* Many Members of Parliament strongly objected to the operations of the Act and the results of those operations being withheld from Parliament until after the authority was terminated. Much of the newly created power would have been lost if the operations undertaken were made common knowledge. Such knowledge in the possession of world speculators could have enabled them to defeat the objects for which the authority and the public funds were granted. The possibility of large losses being made while carrying out authorised operations was made use of to support the objection to secrecy, and although that point of view is quite understandable, much of the criticism of this kind was based on incomplete knowledge of the essential requirements and of the technical conditions under which the authority would act. Subsequent statements made by the Chancellor of the Exchequer on Budget day have reassured Parliament. Little, if any, criticism of this nature now finds expression. Moreover, in 1937, five years after the authority was set up, the Chancellor of the Exchequer announced that the gold holdings henceforth would be given twice yearly but three months late, a concession much welcomed as being useful information without giving any benefit to speculators.

* For the relevant clauses of the Finance Act see Appendix D.



© in this web service Cambridge University Press www.cambridge.org