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THE POUND STERLING

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THE POUND STERLING

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I. PRESUPPOSITIONS OF EARLY POLICY

STERLING was at its heyday before 1914. It was something more than the British currency; it was universally accepted as the most satisfactory medium for international transactions and might be regarded as a world currency, even indeed as *the* world currency. Its special position was no doubt connected with the widespread ramifications of Britain's foreign trade and investment. It was also due to absolute confidence in its stability, which had been maintained with complete success and without a break since 1821, and, subject to minor disturbances, ever since England wisely decided to allow the free export of gold in 1663.

One may think of the stability of sterling as consisting in the maintenance of a fixed gold value. Fine limits between the buying and selling points were already established in the eighteenth century. Alternatively, one may think of its stability in terms of the other principal currencies; the lion's share in the task of maintaining this stability was undertaken by the Bank of England, whose wise management greatly lightened the task of all other monetary authorities. This stability, combined with the complete freedom for arbitrageurs to carry on their task, insured mutual stability as between other currencies. Sterling was thus the nucleus of a wider system of currencies in stable relations with one another. The whole group attributed the relatively smooth working of their currency arrangements to being on the gold standard. Yet we are not quite sure whether the features of this gold standard would have at all resembled those normally described in text books on the gold standard, had it not been for the focal point of management in London.*

Before 1873 the constellation of stable currencies included those on the bi-metallic standard and, through the working of the bi-metallic system, those on the silver standard also. When the bi-metallic par was broken, difficulties arose in connection with the relation of the

* The first systematic attempt to establish a world-wide gold standard, in which a large number of the adhering nations are, in theory at least, equi-pollent, has been that of the International Monetary Fund. Its troubled career to date has been attributed to the vast dislocations of the post-war period, and that is in the main correct; but it is also possible that its difficulties have been aggravated by the fact that we just do not know, for lack of experience, how a gold standard can or ought to work when adhering members are supposed to operate as if they were equi-pollent.

silver currencies to the gold currencies; the most important problem was that of the rupee, which was at the centre of monetary discussion in the last quarter of the century. The difficulties were not overcome, and India was brought on to the gold standard (variant gold exchange standard) with other immature countries following suit.

The good management of this whole system may have been due in part to favouring circumstances, such as the importance of Britain's foreign trade and the strength of the group of merchant bankers centred in London. The economist would also wish to plead that it was also due at least in part, and perhaps in large measure, to the final, albeit very reluctant, acceptance by the authorities of the theories and practical maxims of the great British economists, notably Ricardo and Walter Bagehot.

Ready convertibility was deemed essential. This stems from the older maxim already mentioned by which, when other countries were still trying to hoard their gold by legal regulation, the free export of gold from England was allowed. I would note here that the suspension by the United States in 1935 of the free convertibility of dollars into gold by individuals, and its restriction of the payment of gold against dollars to transactions between monetary authorities, may have had much wider implications and eventual undesirable repercussions than was realised at the time. The premium at which gold now stands against the dollar in free markets is often regarded as merely a tiresome and vexatious bi-product of world disorder, an irritating irregularity of no great importance. I am not inclined to dismiss the matter so lightly. The American law is based on the idea that in the modern world the primary, and perhaps the sole, proper function of gold in the monetary field is to serve as the medium for the international settlement of balances, and that it is undesirable that it should be held to any great extent by private individuals as a store of value. This is not out of line with the British thinking of the nineteenth century; but the British doctrine, held with great emphasis and often repeated, was that if you wanted to discourage individuals from hoarding gold as a store of value, the sovereign recipe was to make sterling absolutely freely convertible by individuals, without let or hindrance, into gold. By establishing free convertibility, you caused the gold hoarding propensity to wither and die. Diametrically opposed to this view is the idea that if you want to reduce the amount of gold hoarding, the right way to set about it is to make it impossible for individuals, as distinct from central banks, to convert their currencies into gold. This whets the appetite for gold hoarding—as we see at the present day.

Ricardo strongly stressed the point that to re-establish and maintain a gold standard, it was not desirable to collect a large gold reserve.

The prime method of maintaining the gold value of sterling was to limit the quantity of sterling issued. The British authorities eventually accepted this doctrine, and throughout the period of good management of sterling, which in practice meant the good management of a whole constellation of currencies, they held a very small reserve of gold. The free gold in the Bank of England was usually of the order of £20 million. It is instructive to compare this with the present reserve (September 30th 1951) of £1,167 million, which is deemed to be so low as to spell perdition. Even after allowing for the change in the value of gold, this present-day reserve is gigantic by nineteenth century standards.

Of great importance was Bagehot's doctrine, also eventually accepted by the authorities, that in a time of crisis it was needful for the Bank of England to lend freely and without limit of quantity. Lending in limited quantities only was a pure waste of resources. If private interests and expectations were such as to lead to a need for liquidity, limited sums would at once be absorbed and lost to view. It was the sure knowledge that unlimited resources would be put at the disposal of the market that converted private interests and expectations away from the view that liquidity was an imperative necessity, and thus turned the conduct of the multitudes of individuals from being perverse into being helpful. During the war, Keynes's plan for a Clearing Union was criticised by the Americans as involving unlimited liability for potential creditors. As the United States was the foremost potential creditor, the objection had to be taken seriously and was indeed accepted. That acceptance, for all that it was necessary, may have been fatal to the success of the plan. It was a question of first principles. The thinking of the American experts was not yet attuned to the Ricardo-Bagehot doctrines. I suspect that a revolution in their thinking is still required, and that a satisfactory world money will never be got going on the doctrine of limited convertibility and limited assistance. Unlimited convertibility and unlimited assistance (on an adverse turn of circumstances) are needed. I have the uncomfortable feeling that unless advocates of free enterprise are converted to that doctrine, free enterprise in the world will peter out, and that the detailed manipulation of foreign trading relations will grow ever more complex and minute, until we have fastened upon us, not perhaps a totalitarian system, but one equally rigid, the result of jarring bi-lateral bargains. In fine, I hold that the success of nineteenth century sterling management was essentially dependent upon the Ricardo-Bagehot doctrines.

I have referred to the small, one might almost say microscopic, reserve at the disposal of the Bank of England. It is fair to add that Britain's solvency was bolstered by a far larger volume of short term loans to foreigners which could be, and often were, reduced at short notice, by raising interest rates in the London discount market. The focal position of sterling amid the constellation of currencies was essentially connected with Britain's being much the largest international lender on short term account. It has been argued that this was not altogether convenient for foreigners, since the restriction of loans in London sent out ripples of deflation over the world. I doubt if the inconvenience caused was serious, or was more than a trifling price to have to pay for the advantage of the maintenance of a stable currency. Certain older academic theories have held that these monetary pressures caused widespread depression. More modern analysis attributes the successive waves of industrial depression rather to causes connected with fluctuations in investment opportunity.

I have dwelt on the presuppositions of the old historic sterling policy, because they may be relevant, both for sterling if it is to be rehabilitated, and for wider schemes for stable world currency arrangements.

II. LANDMARKS BETWEEN THE WARS

Before proceeding to the present condition of sterling, it is desirable to refer to certain landmarks of history since 1914. I need not go over the story of the troubles connected with the first war and its immediate after-math. One notable landmark in the post-war period, which by repercussion had its importance in the sterling story, was the decision by the Federal Reserve System to contract credit in the spring of 1923 despite the unprecedented magnitude of its gold reserve. London in its management of sterling had always been extremely responsive to the inflow and outflow of gold. The decision of the Federal Reserve System in 1923 deliberately made the dollar unresponsive to the gold position. I quote once more the contemporary comment of Keynes (1923):—"For the past two years the United States has pretended to maintain a gold standard; and instead of ensuring that the value of the dollar shall conform to that of gold, it makes provision, at great expense, that the value of gold shall conform to that of the dollar." I do not criticise the action of the Federal Reserve System. On the contrary, the Federal Reserve attempt to ensure internal stability for the dollar was a notable experiment in monetary reform on modern lines, and it is not to be condemned *ex post* simply because of the failures of 1929-31. But its action was the first great step in time of peace away from the notion that monetary management should be primarily related to the international situation, and tended to set up the dollar as an entity on its own account which, although still convertible into gold, had its value governed by policy measures which were determined by the internal needs or aberrations of American citizens. Sterling was also an independent entity at this time, but that was because Britain had not yet returned to convertibility; she was waiting to do so; it was assumed that, once she did so, sterling policy would be governed, as always, by international considerations. But now here was the dollar, which was of no little importance in the international scene, the value of which was governed by different considerations. In order to take account of this, it might be needful to think through gold standard theory anew and indeed to re-cast it. This was not done.

The revaluation of sterling in 1925 to its pre-war level has been widely recognised as a mistake. After a period of violent re-adjustment, the structure of British wages and prices had been settling down to a new equilibrium in the period 1922 to 1924. This equilibrium was destroyed by the upward movement of sterling against the dollar in 1924-1925, which was stimulated by an expectation of its return to the old gold parity, and culminated in that return. There was great prestige in a parity which had remained undisturbed, save for two wars, since it was established by the famous astronomer, Isaac Newton, in 1717, and had been subject only to minor fluctuations for more than a century before that. How far this unwise gesture weakened Britain's external balance may still be argued, but there can be no doubt of its unfavourable internal effect in precipitating a general strike and a coal strike, and entailing rather high internal unemployment at a time when the rest of Europe was making rapid strides forward.

The opinion that a mistake had been made spread fairly rapidly after the event, and this opinion may have done more harm in the long run on the external side than the event itself. Some exaggerated statements have been made about Britain's conduct of her external affairs in the six years which followed. The expression "borrowed short and lent long" has become an historians' cliché. It is not clear that the amount of long term lending was inappropriate to the circumstances. The use of the active verb "borrowed" is certainly misleading. The position of sterling in this period was certainly weakened by the rise in the ratio of external sight liabilities to external sight (or very short term) assets. Mention has already been made of the importance for the working of the gold standard before 1914 of the large volume of short-term lending, which could always be restricted by bank rate policy to meet a dislocation in the balance of payments. The position was obviously less strong if the short term assets were matched by sight liabilities, which the foreigner, if he so wished, could call. The growth of these liabilities is, however, ill-expressed by the active verb "borrowed."

There were probably two main causes for it. After the great world deflation of 1920-22 expert opinion became anxious lest the lack of abundance of gold might set up a chronic deflationary pressure, and it became established doctrine, as embodied, for instance, in the resolutions of the Genoa Conference of 1922, that nations returning to the gold standard should economise in the use of gold, both by abstaining from minting, and also by holding some proportion of their reserves in the form of "foreign exchange" instead of gold. In many cases "foreign exchange" meant in effect sterling. Thus this world opinion was a primary cause of the substantial growth at this time of those externally held "sterling balances" (the sight liabilities referred to above) which have subsequently had such a woeful history. The growth of these balances should by no means be described as "borrowing" by Britain, but rather as the pursuance by others of measures to economise in gold in the general interest. We should probably add as a second main cause a certain tendency at this time, which was manifested in a wider sphere than that under consideration, for traders to hold working balances in order to meet day to day obligations, rather than to rely exclusively on acceptance credits. This general tendency would automatically weaken the British position. Note of this tendency was taken by the celebrated Macmillan Committee on Finance and Industry, which recommended (1931) that in the new circumstances Britain could no longer afford to rely on so narrow a margin of gold reserve as in the old days. What would the Macmillan Committee have said of the modern situation, in which a free reserve fifty times greater than of old is sometimes regarded as altogether inadequate!

The rupture of the parity in September 1931 was, like that of September 1949, due more to the previous under-mining of confidence than to the facts or requirements of the situation. First, there was the under-mining due to the opinion that the revaluation of 1925 had been a mistake, although the great movement of world prices in 1930-1931 had entirely changed the situation. Second, there was the stupid business about the British budget. Keynes held that it would be wrong in a time of quite unprecedented unemployment either to raise taxation or to reduce governmental expenditure. But his was a voice in the wilderness, and the Labour Government, no less than everyone else, appeared to regard it as essential to have a balanced budget. A parliamentary committee outside the government (the May Committee) gave a rather foolishly lugubrious presentation of the budgetary position. Among economies canvassed was a reduction in the unemployment benefit, which was altogether unacceptable to the Labour rank and file. Thus

Britain presented a picture of herself to the outside world as a country which had a government that knew its duty, but was unwilling or unable to execute it. This naturally under-mined confidence.

The third and immediately operative cause of the breach was the German collapse and the freezing of a large proportion of those short-term assets on which Britain relied as her first-line reserve. Even this was mainly a matter of confidence, since in the normal course the discounts would have been continuously renewed voluntarily, as they were compulsorily under the stand-still agreement. But of course a banker must have his assets liquid. Cumulative under-mining of confidence entailed a run on the British bank, and the gold standard had to be suspended.

It may be well to dwell at slightly greater length on the important period from 1931 to 1939, when sterling was "free." This was an experimental period and the experiment may be deemed to have been eminently successful. Despite the lack of gold convertibility, the status of sterling was well maintained throughout the world, while at the same time Britain enjoyed a remarkable internal recovery. Her position contrasted very favourably with that of the United States—a complete reversal of their relative positions in the 'twenties.

Part of the normal functions of the Bank of England was transferred to the Exchange Equalisation Account. This was operated by the Bank of England, but the British Government became officially responsible for policy. To what extent policy was in fact shaped by the British Treasury and to what extent by the Bank of England remains anyone's guess.

The first line of policy of the Exchange Equalisation Account was to insulate the British internal economy from the effect of short-term movements in the foreign balance. This must remind us strongly of the similar policy adopted by the Federal Reserve System in 1923 and the following years. Thus on both sides of the Atlantic we observe a movement, the United States leading, towards making the internal monetary system less responsive to the international situation. It would probably be a mistake to regard this as a deliberate movement towards autarky, but it has its autarkic implications. It is fair to add that the reorientation of British policy was less radical than that of the Federal Reserve System. The latter relegated the in- and out-flow of gold to a secondary position in the determination of credit policy. The British, on the other hand, attempted to draw the distinction—with what success we cannot be sure—between unbalance due to flows of short-term funds actuated more by political than by purely financial hopes and fears, and unbalance taken to indicate a long-period disequilibrium of the economy. The former was to be offset by the operation of the Exchange

Equalisation Account, the latter to be allowed to have its due effect on the valuation of sterling in the free market. Thus the internal economy was only to be insulated from the movements of what was coming to be called "hot money." (These hot money movements are still proceeding, despite the net-work of tight controls, but the less mellow authorities of the post-war period are by no means prepared to insulate the internal economy, even from the most ephemeral movements, regarding them as justifying violent changes in the level of import restrictions, with all that those involve for the smooth working of the internal economy. One reason may be that, as hot money has at present to avoid the exchange controls, it now takes a good deal longer to diagnose that a given movement in the balance is indeed due to hot money.)

In one respect the re-orientation of British policy was more drastic than that of the Federal Reserve System. In the 'twenties the latter continued to rely on credit policy for regulating the level of internal pressure. Sterling, on the other hand, now being free, it was possible to let the long run external forces (as distinct from hot money), favourable or unfavourable, exert their effect on the internal economy, not mainly via changes in the pressure of credit policy, but via changes in the foreign exchange rates. To sum up, internal credit policy was insulated both from the long term and short term external disequilibria; the foreign exchange market was insulated from the effects of short term disequilibria, but allowed to move—in theory at least—in response to long period disequilibria. In practice even the latter part of the doctrine was probably modified in favour of stability. I personally incline to the view that the long run equilibrium may have required in the period 1932-1939 a somewhat lower foreign exchange quotation for sterling than the Exchange Equalisation Account allowed; in fact the Account should have built up an even larger gold reserve than it did.

The twin objectives of the Exchange Equalisation Account in providing stability as against short term disequilibria and flexibility for the adjustment of long term disequilibria may be deemed to be embodied in principle in the Charter of the International Monetary Fund. The mode, however, of giving effect to these objectives via changes in exchange rates is no longer to be experimental and tentative. The principles have become, so to speak, rigidified. Short run insulation is represented by fixed gold parities established with the International Monetary Fund; the long run flexibilities by changes in the parity, to be permitted, if required, from time to time. Experience has yet to show whether the double principle can be made to work when thus formalised, and, one might say, ossified. The secrecy that was maintained regarding the state of the Equalisation Fund may be deemed undesirable; it would be especially undesirable in connection with an international institution. I suspect that it was unnecessary; it may have been needful in the first year, when all was in a state of flux and uncertain, but not so thereafter. But there is another kind of secrecy, not exposed to the same objections, and that kind of secrecy may be most needful for the successful operation of such a type of system, namely secrecy as regards the *intentions* of those who operate it. Surely it was precisely this secrecy which enabled the British Account to offset the movements of hot money and at the same time to allow adjustments in the foreign exchange rate without provoking large speculative streams anticipatory of such adjustments or consequential to them. In a sense the philosophy of the International Monetary Fund may be deemed to be derived from that of the Exchange Equalisation Account; but the former may be an inanimate copy of the latter, and the question still remains whether life can be infused into it.

After 1931, the concept of a "sterling area" begins to emerge. It is one difficult to define because its content is constantly changing and may continue to do so. Prior to 1939 one could name three leading features of the sterling area as then established. (1) Its members tended to hold "sterling balances" for whole or part of their central monetary reserve. (2) They tended to have their foreign trade invoiced in sterling. I pause here to note that these two characteristics were by no means confined to members of the sterling area, nor did they come into existence only in 1931. Sterling invoicing was a much more widespread practice and dates from remote times. The holding of sterling reserves likewise dates back to before 1914, and had a fillip after the 1914-1918 war, as already described. (3) We must add the new feature that the sterling area group tended to keep their currencies fairly stable in relation to sterling rather than to the dollar. This also had precedents in the period before Britain resumed gold payments in 1925, and of course applied completely in that period to the inner core of the sterling area. The larger sterling area, as it tended to establish itself after 1931, included, as well as the British Commonwealth and Empire (except Canada), Norway, Sweden, Denmark, Portugal, Japan and the Argentine, with Greece and Turkey coming in at a later date.

British patriots, musing retrospectively upon the past, sometimes proclaim it as a triumph and a mark of progress that stability in terms of sterling should have been preferred by a group of countries, which had no legal or constitutional ties with the United Kingdom. They even represent it as a sort of British triumph. It certainly has its interest. But by comparison with the period before 1914, it marks a decline; for before that date, the whole world might with meaning be said to have been the "sterling area."