PRINCETON STUDIES IN INTERNATIONAL FINANCE NO. 41

Exchange-Rate Stabilization in the Mid-1930s: Negotiating the Tripartite Agreement

Stephen V. O. Clarke

INTERNATIONAL FINANCE SECTION
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This is the forty-first number in the series PRINCETON STUDIES IN INTERNATIONAL FINANCE, published from time to time by the International Finance Section of the Department of Economics at Princeton University.

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CONTENTS

	DRAMATIS PERSONAE	*iv*
I.	INTRODUCTION	*1*
II.	CONTROVERSIES OVER STABILIZATION	*8*
	Defending the Poincaré Franc	*8*
	The United States Edges toward Stabilization	*10*
	British Resistance to Exchange-Rate Commitments	*16*
III.	THE OPENING OF EXCHANGE-RATE NEGOTIATIONS	*22*
	Mönick's Mission	*27*
	Anglo-French Discussions, July 1936	*29*
	Anglo-American Discussions on Convertibility	*31*
IV.	THE FINAL NEGOTIATIONS: SEPTEMBER-OCTOBER 1936	*33*
	Auriol's "Pre-stabilization Plan"	*33*
	The Declaration	*37*
	Exchange Rates and the Twenty-Four-Hour Gold Standard	*40*
V.	CONCLUSION	*55*
	REFERENCES	*59*

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I. INTRODUCTION

The world depression that began with the New York stock-market crash of October 1929 had many victims. Among them was international monetary cooperation, the offspring of the shared vision of two great central bankers: Benjamin Strong and Montagu Norman. Under the impetus they provided, cooperation between Britain, France, and the United States continued, despite the strains of the deepening slump, reaching a climax with the desperate efforts to deal with the financial crisis that erupted in the summer of 1931. When those efforts failed to prevent sterling from being pushed off gold, however, cooperation suffered a blow from which it did not begin to recover for five fateful years. By the time the first tentative gestures were made under the Tripartite Agreement of September 1936, cooperation among the three democracies had been fundamentally changed in both form and substance.

In a moment of euphoria, the Secretary of the Treasury of the United States, Henry Morgenthau, Jr., saw the Tripartite Agreement as the "greatest move taken for peace in the world since the World War." His history was faulty and his hope fatuous. Although the agreement was a technically useful step toward exchange stabilization, it came too late and was far too limited in scope to stem the international political and economic deterioration. Everywhere, the shattering of the hopes of the 1920s, mounting unemployment, and poverty had loosed pressures on governments to adopt measures that attempted to satisfy national needs at the expense of other countries. The nations that a few years later would form the Axis had already begun to seek remedies through changes in the political order. Japan began its long war in East Asia by the invasion of China. Germany, isolated behind exchange controls, stimulated its economy by rearming, quit the League of Nations, and in March 1936 marched troops into the Rhineland. In October 1935, Italy invaded Ethiopia, and nine months later civil war broke out in Spain. Among the

This study is based primarily on the diaries of Henry Morgenthau, Jr., located at the Roosevelt Library in Hyde Park, N.Y.; the historical records of the Federal Reserve Bank of New York; and U.K. Treasury papers, especially those of Sir Frederick Leith-Ross, Sir Frederick Phillips, and Sir Richard Hopkins, available at the Public Records Office.

In preparing this study, I have received valuable suggestions from numerous individuals, especially Lord Cobbold, Susan Howson, Donald E. Moggridge, Richard S. Sayers, and Allan Sproul. I am of course responsible both for any remaining faults and also for the views expressed, which do not necessarily reflect those of the Federal Reserve Bank of New York. Carl W. Backlund, of the Bank, was most helpful in providing archival material, and I have also benefited from the research assistance of Barry Krissoff, Ydahlia Metzgen-Bundy, and Annie McRee.

Western democracies, still weary from sacrifices of the 1914-18 War, these political upheavals were viewed with ambivalence. Hoping that incursions elsewhere would sate the appetites of the dictators, the democracies focused primarily on coping with their domestic economic difficulties. Unfortunately, their policies, too, complicated the problems of others, as tariffs and import quotas were imposed in order to protect shrinking domestic markets from foreign competition.

Inevitably, the disintegration in international political and commercial relations carried over to the monetary sphere. Not only commercial policy, but also exchange-rate policy, was frequently directed to the attainment of what was perceived to be national advantage, while the cost to other countries and possible feedbacks were accorded little importance or ignored. In the cycle of exchange depreciation of the 1930s, the fall of sterling in September 1931 was the first major move.

It is true that the British abandoned gold only when the financial resources available to them were exhausted, and that the subsequent depreciation of sterling was primarily attributable to market pressures. Yet it is also true that the British authorities, while generally offering little resistance to market forces that depreciated sterling, vigorously resisted those that appreciated it, especially in the nine months following the establishment of the Exchange Equalization Account (EEA) in mid-1932. Such resistance was particularly notable between the end of November 1932, when the sterling exchange rate hit its low for the decade, and mid-April 1933, when the dollar was unpegged from gold.[1] During this period, when sterling was under strong upward pressure, British official holdings of gold and foreign exchange increased by more than one-half.[2] Since a substantial proportion of this reserve gain reflected dollar accumulations in, and gold purchases from, the United States, the American authorities were fully convinced that the EEA, while ostensibly established merely to iron out temporary exchange fluctuations, was actually being employed to preserve as much as possible of the competitive advantage that Britain had gained after September 1931.[3]

Although the Roosevelt administration's desire to raise U.S. commodity prices was doubtless the major consideration behind its gold policy in the ten months ended January 1934, British exchange operations were

[1] Hall (1938, pp. 149-150). Howson (1976, p. 251) reports, on the basis of her study of official documents, that the British Treasury directed the Bank of England at the end of 1932 to hold sterling at about \$3.30; under strong upward pressure, the peg was raised in stages to \$3.45 in early February 1933. Howson writes that Treasury officials told Norman, at about this time, that for the sake of British industry the pound should not go above \$3.50, even though that would mean absorbing a large flow of dollars and francs.

[2] *Reserves and Liabilities, 1931 to 1945*, Cmd. 8354, London, H. M. Stationery Office, September 1951, Table 1.

[3] Blum (1959, p. 121).

seen as providing a precedent for the depreciation of the dollar. If the reduction in the gold value of sterling could start Britain on the road to recovery, the same medicine might work for the United States.[4] This logic persuaded Roosevelt to pursue the depreciation until the exchange value of the dollar in terms of sterling had been pushed back to, and even above, the pre–September 1931 parity of $4.86. Although in the spring of 1933 he toyed with a tripartite arrangement that would have temporarily stabilized sterling at about $4.00 and the French franc at $0.0466, the President finally turned against the proposal in a dramatic message that effectively ended the London Economic Conference and that Keynes described as "magnificently right."[5] Five months later, when increases in the price at which the United States bought gold had driven sterling above $5.00, the administration again put out very tentative feelers about stabilization. Although details of the scheme changed from day to day, on two features Washington was firm. The French were expected to maintain the franc at the gold value established by the Poincaré government in June 1928, and the percentage devaluation against gold could be no larger for sterling than for the dollar. The administration would try for a sterling-dollar rate of $5.00 or above; it would accept none lower than the old parity of $4.86.

The reservations with which the British authorities received this American proposal were not attributable entirely to annoyance over the torpedoing of the stabilization arrangements negotiated in June. In London, there was also skepticism that the French, even if they accepted the proposal, would be able to support the franc at an overvalued level for long. The expected collapse of the franc, along with the other gold-bloc currencies, would again throw the exchange-rate structure into confusion. Most important, the British authorities, whose recollections of the unhappy experiences under the old parity were still fresh, felt strongly that sterling itself would be seriously overvalued at the $4.86 rate. When, on December 1, Harrison stressed that it would be impossible to get Washington to agree to any temporary arrangement unless the British entered into some commitment regarding the rate at which sterling would ultimately be stabilized, Norman replied that

> there was not the slightest chance of getting anything of the sort: in fact, most people [in London], including himself, felt that the dollar was definitely undervalued. If America decided to stabilise at a discount of 40% [in terms of gold] then all his friends in [Britain] would certainly consider that we should stabilise at 40[%] + X.

[4] Morgenthau's testimony on S-910 before a Subcommittee of the Senate Committee on Banking and Currency, 67th Cong., Mar. 2, 1939, p. 20.

[5] Clarke (1973, pp. 32-36).

With the rebuff of this stabilization feeler, about the seriousness of which there must be some doubt, the Roosevelt administration proceeded to raise the gold price further, in order, as Morgenthau said, to show the British that "we mean business." The depreciation was ended only when the gold price reached $35, at which level it was fixed at the end of January 1934.

Uncertainties in the exchange markets were alleviated but far from removed by the dollar's stabilization. The law under which the President had acted provided broad authority further to change the price at which the Treasury bought and sold gold.[6] The use of this authority was vigorously advocated by various political groups that believed further devaluation would foster domestic recovery. In the mid-1930s, the possibility that such propagandists would catch the President's ear seemed real, and from time to time scares swept the markets that the gold price would again be changed.

British exchange-rate policy also contributed to the uncertainty. Although the Chancellor of the Exchequer, Neville Chamberlain, emphasized the government's intention to minimize unnecessary fluctuations in the exchange value of sterling, the authorities had no power to fix the value of the pound in terms of gold, nor did they feel that such power would be useful in the prevailing circumstances. The international economy, in the British official view, was grossly imbalanced. The exchange rates of the gold-bloc countries were seriously overvalued, while that of the United States was undervalued. Until the disequilibrium was corrected, no stabilization of sterling could be contemplated. In the meantime, it was appropriate, in case of conflict, to give British prosperity and the stabilization of domestic prices priority over the external stability of sterling.

While the markets remained nervous about the external values of both sterling and the dollar, the major source of exchange-rate uncertainty lay in the gold bloc. Conceivably, the overvaluation of the gold currencies would be corrected by deflation on the European continent, assisted perhaps by some inflation in the United States. The greater probability was that the deflation would become politically intolerable and that the international imbalance would be eliminated in the end through devaluation. This outlook, together with the darkening political climate in Europe, induced holders of gold-bloc currencies to shift their funds into sterling and much more into dollars. When the Belgian currency was devalued in March 1935, expectations increased that the French franc and other gold-bloc currencies would soon follow.

[6] In the Treasury's view, the Gold Reserve Act authorized changes in the gold value of the dollar not only between 50 and 60 per cent of the old value but without limit.

As the likelihood of devaluation increased, the French authorities were confronted with an unprecedented problem. The exchange rates of none of the major currencies could be regarded as fixed. Sterling was floating, even if within a relatively narrow range. The dollar, though pegged to gold at $35 per ounce, was subject to change. A unilateral devaluation of the franc could bring foreign retaliation in the form of further changes in exchange rates or in commercial policy that would nullify part or all of the French move. Faced with this possibility, the Paris authorities recognized the need for consultations to determine how large a franc devaluation would be acceptable in Washington and London. The era was ended when currencies were viewed as tied to gold rather than to each other. For the first time, international negotiations came into play in arranging an exchange depreciation.

While an orderly transition to a reasonably stable exchange-rate structure was the main objective, the three democracies also had other aims in common. Among these was the desire to minimize the large and sometimes violent international flows of funds that were associated with uncertainty in the exchange markets. Everywhere, such movements complicated domestic economic mangement, unpredictably aggravating deflation in France and correspondingly expanding liquidity in Britain and the United States. The gold movements that accompanied the capital flows were especially worrisome. In France, large outflows were taken as a sign of no confidence in government policy. In the United States, the authorities were aware that much of the gold inflow reflected movements of refugee and speculative capital that was subject to sudden withdrawal. Were any substantial repatriation of capital to develop during a national election campaign, the results could be politically embarrassing, especially if the voters were to accept opposition contentions that the accompanying gold outflows signified lack of investor confidence in the administration. Moreover, since shifts of such balances were not only a result but a cause of exchange-rate instability, they complicated the attainment of commercial-policy aims and generally increased the difficulties and uncertainties of international trade, whose expansion was required for economic recovery.

In these circumstances, the democracies had no difficulty in agreeing, in principle at least, on the desirability of reasonable exchange stability. The problem in applying this principle was of course that the groups working to safeguard stability frequently had little political clout, while those advocating commercially advantageous exchange rates were strong, vocal, and nationalistic. The tendency, therefore, was for each country to press for exchange rates favorable to itself and to hope that its partners would be able and willing to bear most, if not all, of the burden of adjustment. In this respect, each country's aims were similar, but tactical ad-

vantages were enjoyed by the country that had the initiative in exchange-rate management.

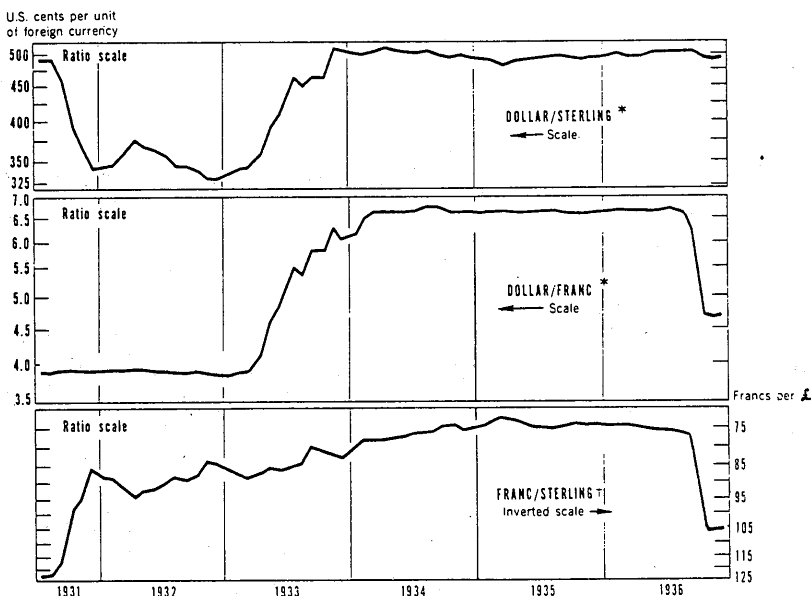
This initiative was held by Britain from the stabilization of the dollar in January 1934 until the conclusion of the Tripartite Agreement, and was made possible by the provisions of the French monetary law of June 1928 under which the Bank of France bought and sold gold without limit at a fixed price. After January 1934, the United States adopted a similar policy, except that it would freely convert dollars into gold only for gold-standard countries like France. Barred from buying gold in the United States, the EEA did not attempt to manage sterling through operations in New York but achieved its aims primarily through operations in francs. If it wished to prevent an appreciation of the pound, francs were bought and converted into gold acquired from the Bank of France. On the other hand, if the British felt that sterling was depreciating unduly, gold could be sold to the Bank of France for francs with which to support the pound. With gold-standard arrangements holding the dollar-franc rate within narrow margins, arbitrage between London, Paris, and New York tended to make movements in the sterling-dollar rate reflect those in the sterling-franc rate (see the accompanying chart).

However, even with the advantage that flexibility provided, Britain's room for maneuver in exchange-rate policy was limited. If, in attempting to serve British commercial interests, the London authorities pushed the depreciation of sterling too far, the task of the French in supporting the Poincaré franc might become intolerably difficult and the Americans might retaliate with a further depreciation of the dollar. On the other hand, attempts by the British to maintain sterling at a level that would significantly ease the task of the French would bring vigorous protests from exporting and import-competing firms in Britain and the other sterling countries. Subject to these constraints, however, the British authorities enjoyed an initiative in the management of exchange rates of which the French and Americans had deprived themselves by the stabilization of their respective currencies.

As a result of arrangements under the Tripartite Agreement, the ability of each of the democracies to manage exchange rates was significantly changed. The advantage the British had enjoyed in handling sterling had to be shared with Paris because France, having abandoned the gold standard, could now manage its currency flexibly between wide gold points. Although Britain obtained convertibility privileges not only in Paris but also in New York, the new arrangements in both quarters were on a tentative basis and involved continuing consultations regarding the management of sterling's rates against the franc and the dollar.

Under these arrangements, the improvement in the tactical position of

BRITISH, FRENCH AND UNITED STATES EXCHANGE RATES 1931–1936



* Monthly averages of daily market buying rates in New York at noon for cable transfers.
† Monthly averages of Saturday spot rates in Paris.
SOURCE: Board of Governors of the Federal Reserve System (1943). Data on franc-sterling rate calculated from figures in Einzig (1937, Appendix I).

France was greater than that of the United States. The Paris authorities gained not only a voice in consultations but, more important, a flexibility in exchange-market operations that derived from the widening of the gold points for the franc. Although the U.S. authorities retained power to change the gold price, they became increasingly wedded to the $35 price after September 1936. Having regained some of the competitive advantage they had lost after September 1931 and having obtained a voice in the management of the key sterling-dollar rate, the Roosevelt administration was understandably reluctant to expose America's fragile recovery to a new period of exchange instability. So long as changes in the major exchange rates appeared reasonable, no occasion arose to change the U.S. gold price, which came increasingly to be regarded as the foundation of the international monetary structure. The United States thus drifted into the position of the Nth country.