PRINCETON STUDIES IN INTERNATIONAL FINANCE
No. 46, November 1980

Sterling's Managed Float: The Operations of the Exchange Equalisation Account, 1932-39

Susan Howson

INTERNATIONAL FINANCE SECTION
DEPARTMENT OF ECONOMICS
PRINCETON UNIVERSITY

PRINCETON STUDIES

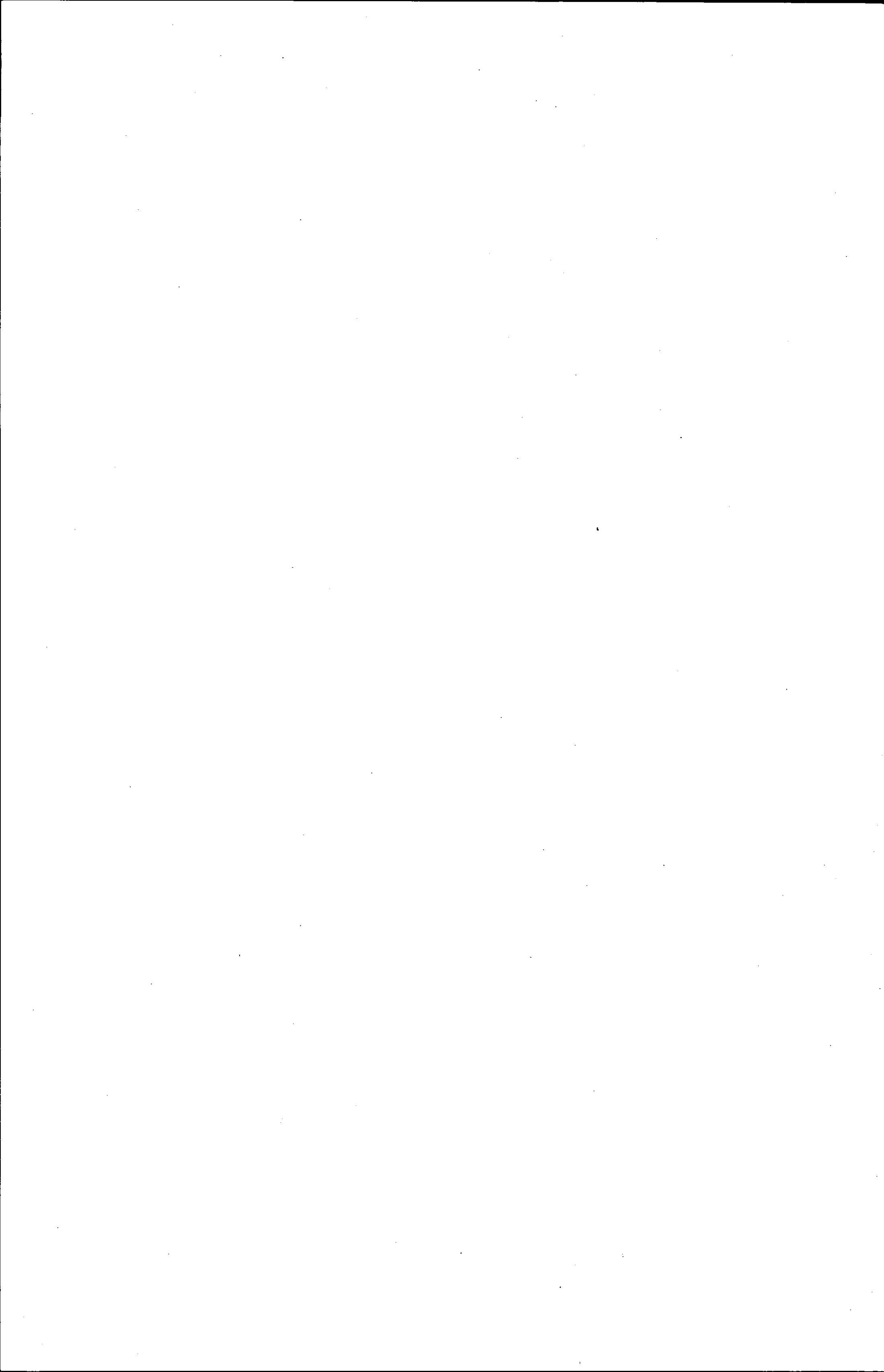
IN INTERNATIONAL FINANCE

This is the forty-sixth 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.

The author, Susan Howson, is Associate Professor of Economics at the University of Toronto and was previously a research fellow at Wolfson College, Cambridge. She is the author of *Domestic Monetary Management in Britain 1919-38* (1975) and, with Donald Winch, of *The Economic Advisory Council 1930-1939* (1977). Since submitting this study for publication, she has joined the Bank of England as Research Economist in the International Division while on leave from the University of Toronto.

This series is intended to be restricted to meritorious research studies in the general field of international financial problems that are too technical, too specialized, or too long to qualify as ESSAYS. The Section welcomes the submission of manuscripts for the series. While the Section sponsors the studies, the writers are free to develop their topics as they wish

PETER B. KENEN, *Director*
International Finance Section



PRINCETON STUDIES IN INTERNATIONAL FINANCE
No. 46, November 1980

Sterling's Managed Float: The Operations of the Exchange Equalisation Account, 1932-39

Susan Howson

INTERNATIONAL FINANCE SECTION
DEPARTMENT OF ECONOMICS
PRINCETON UNIVERSITY

INTERNATIONAL FINANCE SECTION
EDITORIAL STAFF

Peter B. Kenen, *Director*
Ellen Seiler, *Editor*
Susan Ciotti, *Editorial Aide*
Kaeti Isaila, *Subscriptions and Orders*

Library of Congress Cataloging in Publication Data

Howson, Susan, 1945-
Sterling's managed float.

(Princeton studies in international finance; no. 46 ISSN 0081-8070)
Includes bibliographical references.
1. Foreign exchange—History. 2. Foreign exchange problem—Great Britain—History. 3. Monetary policy—Great Britain—History. I. Title. II. Series.
HG3852.H68 332.4'5'0941 80-23197

Copyright © 1980 by International Finance Section, Department of Economics, Princeton University.

All rights reserved. Except for brief quotations embodied in critical articles and reviews, no part of this publication may be reproduced in any form or by any means, including photocopy, without written permission from the publisher.

Printed in the United States of America by Princeton University Press at Princeton, New Jersey.

International Standard Serial number: 0081-8070

Library of Congress Catalog Card Number: 80-23197

CONTENTS

1 INTRODUCTION 1

2 THE EXCHANGE EQUALISATION ACCOUNT 4

Exchange-Market Intervention, September 1931–February 1932 4
The Invention of the EEA 7
The Mechanism of the EEA 9

3 EXCHANGE-RATE TARGETS 15

The First Year 15
Dollar Depreciation and Stabilization Discussions 19
1934-36 23
After the Tripartite Agreement 29
Internal and External Balance 32

4 INSTRUMENTS AND OPERATING TACTICS 34

Spot-Market Intervention 34
Forward-Exchange-Market Intervention 39
Other Measures 41

5 ASSESSMENT AND CONCLUSIONS 45

The Adoption of a Managed Float 45
A Dirty Float? 50

APPENDIX: U.K. Gold and Foreign-Exchange Holdings, 1932-39 57

REFERENCES 63

LIST OF TABLES

1. Balance of Payments on Current Account, Annual, 1930-38 5

2. Treasury Bills, Quarterly, 1932 I to 1936 II 11

3. Gold and Foreign-Exchange Reserves and High-Powered Money, Quarterly, 1931 III to 1939 II 12

4. Published Official Gold Reserves and Note Issue, Quarterly, 1931 III to 1939 II 49

5. Monthly and Annual Changes in Gold and Foreign-Exchange Reserves, 1925-36 52

6. Annual Changes in Balance of Trade, Current Account, and Gold and Foreign-Exchange Reserves, 1930-38 52

7. Gold and Foreign-Exchange Reserves and Net External Liabilities in Sterling, Annual, 1931-39 53

8. Gold and Foreign-Exchange Reserves as a Percentage of Imports and of Half the Sum of Imports and Exports, Annual, 1930-38 54

A-1. Gold and Foreign-Exchange Holdings, Monthly, September 1931 to December 1936, April 1937, November 1938, March-August 1939 58

A-2. Bank and Treasury Holdings of Gold and Foreign Exchange, Monthly, September 1931 to June 1933 61

A-3. Gold and Foreign-Exchange Holdings, Quarterly, September 1931 to August 1939 62

1 INTRODUCTION

> There shall be established an account, to be called the Exchange Equalisation Account, which shall be under the control of the Treasury . . . [who] may cause any funds in the Account to be invested in securities or in the purchase of gold in such manner as they think best adapted for checking undue fluctuations in the exchange value of sterling (U.K. Finance Act of 1932, Part IV; reproduced in Sayers, 1976, Appendix 25).

The Exchange Equalisation Account (EEA) thus established by the Finance Act of 1932 constituted an essential part of British economic policy after Britain's departure from the gold standard in 1931, and it remains an essential element in Britain's monetary arrangements today. The EEA enabled the monetary authorities (the Bank of England and the Treasury) to direct monetary policy in the 1930s toward domestic objectives and to manage the floating pound by intervention in the gold and foreign-exchange markets.

The EEA's operations were secret, with the result that the motives and methods of its managers were open to interpretation and dispute. Within a year of its establishment, American observers in particular came to regard the EEA as an ingenious but somewhat sinister device for manipulating the sterling-dollar exchange rate. This interpretation owes much to the large increase in the published gold holdings of the Bank of England and small increase in the exchange value of the pound in the face of large capital outflows from the United States early in 1933.[1] British government spokesmen, on the other hand, claimed then and later that the EEA was merely attempting to smooth out short-term exchange-rate fluctuations due to seasonal or speculative factors. Doubts and differing interpretations, on both sides of the Atlantic, remained unresolved at the end of the decade (Waight, 1939; Brown, 1940; Pum-

I should like to thank the Controller of Her Majesty's Stationery Office for permission to cite documents in the Public Record Office, London; Mr. J. W. Ford, Mr. H. A. Standen, and Mr. D. R. Collinson of H. M. Treasury and Miss R. Heather of the Bank of England for their invaluable assistance in locating data on foreign-exchange reserves; the Houblon-Norman Fund and Scarborough College, University of Toronto, for financial assistance; and Professor S. F. Kaliski for permission to cite an unpublished paper. I should also like to thank Professors Richard Sayers, Ian Drummond, Donald Moggridge, Leslie Pressnell, and Michael Edelstein, Drs. Steve Clarke and Charles Goodhart, and members of the Economic History Workshop, University of Toronto, for helpful comments and criticism on earlier drafts of this paper. The research for this study was completed before I joined the Bank of England.

[1] For a shrewd contemporary assessment by an American academic observer, see Comstock (1933); see also Hall (1935).

phrey, 1942), when this particular experiment in the management of a floating pound was brought to an end by wartime pegging and the imposition of exchange controls.

United Kingdom exchange controls were to last for forty years—until October 1979. More important, the perceptions lying behind the postwar Bretton Woods system concentrated on the virtues of fixed exchange rates to the neglect of the possibility of managed floats. The 1930s were viewed as the classic example of the dangers inherent in floating exchange rates (Nurkse, 1944). Subsequent proponents of flexible exchange rates emphasized the benefits of *freely* floating rates, arguing on *a priori* grounds that private speculation would be stabilizing, so that official intervention would be unnecessary (Friedman, 1953, 1969; Johnson, 1969).

Developments in the 1970s invite another look at the operations of the EEA in the 1930s. The moves to floating exchange rates by the major industrial countries have not only revived interest in earlier experiences with floating exchange rates but have led to the development of new criteria for judging the acceptability of the various techniques of exchange management. Like sterling in the 1930s, the major currencies have not been floating freely; furthermore, recent theoretical and empirical work on the determination of exchange rates suggests that managed floating will persist for as long as floating does because of the possibilities for instability in floating exchange rates (Dornbusch and Krugman, 1976; Dornbusch, 1978; McKinnon, 1979). The resulting need to distinguish between "clean" or "dirty" management has been recognized in the International Monetary Fund's 1974 guidelines and its 1977 decision on surveillance of members' exchange-rate policies, as well as in several academic contributions (International Monetary Fund, 1974, 1977; Black, 1973, 1977; Mikesell and Goldstein, 1975; Ethier and Bloomfield, 1975; Tosini, 1977; Artus and Crockett, 1978). It will therefore be of interest to apply the new criteria to the behavior of sterling in the 1930s.

A less well-known development provides another reason for looking at the 1930s experience: British government records of the time have recently become available. The Bank of England carried out EEA operations on behalf of, and with the advice and consent of, the Treasury—in itself a major innovation in peacetime policy-making. As a result, Treasury papers reveal many of the motives behind EEA operations and much about the methods used to manage the exchange rate.[2] Not only do these records permit a reassessment of the role of exchange-rate policy in

[2] They can be supplemented, as they have been here, by the recent official history of the Bank of England (Sayers, 1976).

British interwar economic management, but they provide us with more detailed information on the targets and tactics of exchange-market intervention for the 1930s float than we have for more recent floats.

Chapter 2 describes the reasons for the establishment of the EEA in 1932 and for the form it took. These reasons were a desire to prevent an appreciation of the pound after its initial depreciation following the suspension of the gold standard, and the authorities' perceptions of their problems with respect to intervention in the foreign-exchange market in the winter of 1931-32. Chapter 2 also outlines the mechanism by which the EEA could be used to sterilize partially the effects of inflows or outflows of foreign exchange on the domestic money supply when the authorities were intervening in the foreign-exchange markets.

Chapter 3 continues the historical narrative by utilizing Treasury records to identify the exchange-rate and balance-of-payments targets chosen at various times between 1932 and 1939. An important concern here is to trace the evolution of the authorities' attitudes toward the management of sterling over the period in response to the major events in the international economy.

Chapter 4 examines the tactics by which the Treasury and the Bank of England sought to achieve their targets. Here the analysis also draws on the data on gold and foreign-exchange holdings that are described in the Appendix.

Chapter 5 reflects preoccupations of the 1970s. It begins with an assessment of Britain's reasons for adopting a managed float in the 1930s and moves on to consider whether and to what extent that float should be regarded as "clean" or "dirty" on modern criteria. The discussion lends support to the view that there is no unambiguous way to gauge the dirtiness of a managed float without detailed knowledge of the authorities' intentions and the international environment in which they are operating.

2 THE EXCHANGE EQUALISATION ACCOUNT

Britain formally abandoned the gold standard on September 21, 1931, in the wake of a political crisis at home, a financial crisis in Europe, and two years of world slump. Since 1929, prices in Britain had fallen by approximately 10 per cent, real incomes by 5 per cent, and exports by 42 per cent in value and 30 per cent in volume. Unemployment was over two million (15 per cent of the labor force and over 20 per cent as officially measured), and the balance of payments was in deficit on current account (Feinstein, 1972, Tables 3, 4, 57, 58, and 65; see Table 1). Increases in Bank rate and official borrowing abroad failed to halt a capital outflow, and, with little in the way of planning for future policy, the authorities decided to leave the gold standard (Moggridge, 1972, pp. 193-198; Howson, 1975, pp. 75-82; Sayers, 1976, Chap. 17).

By March 1932, when the pound had depreciated by 30 per cent from its par value of U.S. \$4.86, to \$3.40, the Treasury had formulated the main lines of medium-term economic policy. Senior officials, notably Sir Richard Hopkins and Frederick Phillips, recommended to Chancellor of the Exchequer Neville Chamberlain and to the Cabinet that the authorities should not commit themselves to a return to gold, should institute a "cheap money policy" of low long-term and short-term interest rates, and should maintain the exchange rate at about \$3.40 until British wholesale prices had risen by at least 25 per cent. They expected that low interest rates would stimulate domestic investment and hoped that a low external value for the pound would arrest the decline in exports and improve both employment and the balance of trade (Howson, 1975, pp. 82-86). The Treasury put its principles into practice by converting the 5% War Loan 1929/47, which constituted nearly a third of the outstanding national debt, into 3½% War Loan 1952 and After and by establishing the EEA. The conversion was announced on June 30, 1932, and was accompanied by a lowering of Bank rate to 2 per cent; the EEA was announced in the budget on April 19, 1932 (Howson, 1975, pp. 71-74, 88-89; Sayers, 1976, pp. 430-447).

Exchange-Market Intervention, September 1931–February 1932

Meanwhile, the Bank of England had to cope with more immediate problems, including repayment of the foreign credits obtained by the Bank and the government in August 1931 in their unsuccessful attempt to maintain the gold standard. These credits amounted to £130 million at the old par rates of exchange, payable in U.S. dollars and French francs. When the gold standard was suspended, the Bank was holding

TABLE 1

Balance of Payments on Current Account, Annual, 1930-38
(in millions of pounds)

Year	*Imports*	*Exports*	*Net Invisibles*	*Current Balance*
1930	£953	£670	£298	£ 15
1931	786	464	208	−114
1932	641	425	154	− 62
1933	619	427	174	− 18
1934	683	463	188	− 32
1935	724	541	196	13
1936	786	523	223	− 40
1937	950	614	279	− 57
1938	349	545	220	− 65

Source: Ware (1974, p. 79).

only £134 million in gold and £16 million in foreign exchange, the bulk of it in the Issue Department as backing for the domestic note issue, and the rest in the Banking Department undisclosed to the Treasury (Sayers, 1976, pp. 217-218 and Appendix 37; Moggridge, 1972, pp. 183-184). The first question to be discussed by the authorities, however, was whether the pound could or should be pegged and, if so, at what rate. The initial opinion—not surprisingly, in light of the reserve figures—was that pegging did not seem feasible. Indeed, the Bank was worried by the fact that the pound did not fall below $4.00 immediately after the suspension; fearing a large fall later, it decided on September 24 to give the pound a nudge downward by selling sterling. According to Sayers (1976, p. 419), "this . . . was the real beginning of the policy that only found its way on to the statute book when the Exchange Equalisation Account was established in mid 1932."

At the end of September, when the pound was down to $3.75, the Bank, with the cooperation of the Treasury, began deliberately to build up foreign-exchange reserves for the purpose of future exchange support as well as for repayment of the August credits. Hopkins reported to the Chancellor of the Exchequer on October 6 that the Bank had already bought a small quantity of dollars and francs. Further, "J. P. Morgan and Co. [in New York] have advised the Bank that they believe that, if so authorised they could pick up a very substantial sum of dollars. . . . The Deputy Governor [of the Bank] hopes you will be prepared to give secret authority to J. P. Morgan and Co. . . . to undertake the operations on behalf of the Treasury." The dollars were to be bought for the Treasury's existing Exchange Account, which had previously been used to accumulate dollars for war-debt payments to the United States

and for which Morgans had been the Treasury's agents. In this way, the amount of the Bank's reserve accumulations would be hidden, because "Morgans would then be (secretly) acquiring dollars technically for the Treasury. . . . The dollars would pass through the . . . Exchange Account to the Bank but no question of publication of the Exchange Account transactions would arise."[1]

In the following six months, besides building up its own gold and foreign-exchange holdings, the Bank purchased dollars for a Treasury Special Account formed from part (£20 million) of the Exchange Account, holding the dollars in new accounts opened with the Federal Reserve Bank of New York, Morgans, and First National City. The Exchange Account, which held gold and dollar securities, continued to be used for its original purpose of accumulating dollars for war-debt repayments.[2] The resulting holdings of the authorities are shown in Appendix Tables A-1 and A-2.

When the first opportunity for exchange support occurred in November 1931, the Bank did not intervene, preferring to conserve the newly acquired reserves to repay the recent overseas borrowing. Most of the borrowing was, in fact, repaid by March 1932. Total reserves fell by only £11 million in November despite the repayment of £20 million (Table A-2). The pound fell to \$3.24 on December 2. When the Government expressed alarm, the Bank responded to the Treasury that the weakness was due to "the narrowness of the market and the general lack of confidence in the positions of institutions at home and abroad" and to switching by French asset holders from sterling to dollars. Governor Montagu Norman, summoned to discuss the position with the Chancellor, said, "it must be recognised that we have not the means to peg exchange."[3]

When the outflow reversed itself early in December, the Bank resumed purchases of dollars for the Treasury Special Account, stepping them up in January when a sustained inflow began.[4] This inflow led directly to the invention of the EEA, as well as to a Bank-rate reduction in February.

[1] Hopkins to Chancellor of the Exchequer, Oct. 6, 1931, T.160/444/F12899; see also Sayers (1976, pp. 419-420). In this and succeeding footnotes, a document or a series of documents in the Public Record Office is followed by the call number of the file in which it is to be found.

[2] Treasury Special Account and Exchange Account assets, Mar. 31, 1932, T.160/409/F1454; Treasury Deposit Accounts ledgers, T.252/6; British Government Foreign Accounts, Apr. 1, 1929 to Mar. 31, 1932, T.253/5. On the earlier use of the Exchange Account, see files T.160/414/F6779/1 and 2.

[3] Waley to Leith-Ross, "Sterling Exchange Movements," Nov. 27, 1931, T.160/403/F12600/09; "The Exchange Position," Dec. 8, 1931, T.175/56 and T.160/403/F12600/09. See also Sayers (1976, pp. 420-422).

[4] "Treasury Special Account," T.160/444/F12899.

The Invention of the EEA

Late in February, when the pound was at $3.48, Sir Charles Hambro, on the Bank's Exchange Committee, suggested that the Bank should prevent a rise in the pound beyond $3.65 and should then allow a further reduction in Bank rate (Sayers, 1976, p. 425). By this time, however, Treasury officials had decided they would prefer a lower pound. The capital inflow was "a nuisance," threatening to undo a reflationary policy. Although Phillips agreed with the Bank that the authorities should build up their gold and foreign-exchange reserves, which had long been inadequate given the increase in London's short-term liabilities in the 1920s, and that they could buy reserves more cheaply if the pound were to rise, he did not agree with the proposal that the pound should be allowed to appreciate. He therefore suggested a rapid reduction of Bank rate from 5 to 3 per cent and the continued purchase of both gold and foreign exchange by the Bank, with the Treasury taking financial responsibility for any exchange losses incurred by the Bank. He went on: "If the reduced Bank Rate, the loosening of credit in this country and the purchases of foreign exchange do not cure the inflow it will be necessary to let the pound respond in some degree. But I should keep any rise slow. . . ."[5]

This memorandum, written on March 5, 1932, was followed by an undated outline, in Phillips's handwriting, of two alternative plans for a new Treasury account to enable "the Bank and/or the Treasury . . . [to] acquire additional foreign exchange and/or gold up to a total of say (£150) millions."[6] According to Sayers (1976, p. 425), these notes reflected discussions with the Bank beginning in mid-March.

The Bank of England regarded its ability to purchase foreign exchange and gold as limited by its small sterling assets, by a desire to keep foreign-exchange operations secret, and by the possibility of loss on large foreign-exchange holdings if the pound were to appreciate. These problems were interrelated, involving both technical legal difficulties and more important economic considerations. The Bank was still a private institution in 1932. It could hold foreign exchange in either the Banking Department or the Issue Department and gold in the Issue Department; profits and losses on assets held in the Issue Department as backing for the Bank of England note issue accrued to the Treasury. The Bank was obliged to publish a weekly return, which included the amount of gold (valued at the statutory price of 77s. 10½d. per standard ounce, equivalent to 85s. per fine ounce) and securities held in the Issue Department as backing for the note issue. If the Bank held foreign exchange in the Banking De-

[5] Memorandum by Phillips, Mar. 5, 1932, T.175/57.
[6] Phillips, "Objects Sought," no date, T.175/57.

partment, as it had done to some extent in the 1920s, it would have to bear any exchange losses itself; if it held foreign exchange in the Issue Department, the published figures would betray the existence of the operations (for evidence that they did, see Brown, 1940, pp. 1108-1110). Furthermore, purchases of gold and foreign exchange would increase high-powered money unless the Banking Department conducted offsetting open-market operations. The Bank's small holdings of domestic securities, compared with the possible size of capital inflows, restricted both its purchases of foreign exchange and its ability to offset the effects of the inflows on the monetary base. The plans described by Phillips were designed to get round these problems.

Under the first plan, all purchases and sales of foreign exchange and gold would be brought into a single account under the Treasury's control. The account would be an enlarged version of the old Exchange Account with the power to borrow up to £200 million. The practical advantages of this plan were "very great": it was simple and it surmounted all the technical difficulties. The Bank would not need to hold foreign exchange but could do so in the Issue Department and also, at its own risk, in the Banking Department. The objection to the plan was that "on the face of it it appears to dissociate the Bank from its natural functions as the holder of the main reserves of the country and to imply a greater degree of interference by the Treasury in banking matters than most people would think desirable."

Under the second plan, therefore,

> . . . an Exchange Equalisation A/c would be established under the control of the Treasury. It would replace the existing Exchange Account and it would be increased by borrowing say an additional £100 millions.
>
> The purpose of this account would be two fold. The plan contemplates that substantial amounts of exchange will be held by the Bank of England and the Exchange Equalisation A/c would as its name implies act as a buffer absorbing all gains or losses on exchange transactions and leaving the Bank accounts to function in a perfectly normal manner. But in addition the Exchange Equalisation A/c could itself hold quite substantial amounts of foreign exchange.
>
> The main advantage of this plan is that on the face of it it leaves the main control of the operations in the hands of the Bank of England. It involves, or at any rate appears to involve, much less direct interposition of the Government than Plan I.[7]

A more formal version of the second plan was sent to Deputy Governor of the Bank Sir Ernest Harvey on March 18 and recommended to the

[7] Phillips, "Plan I" and "Plan II," no date, T.175/57.

Chancellor a few days later for inclusion in the forthcoming Finance Bill (the budget). The plan would provide additional resources with which to buy foreign exchange, transfer the losses and profits on foreign-exchange transactions to the government, and avoid the complications related to the Bank's accounts. The Bank was expected to purchase gold and foreign exchange for its own account as well as for the EEA. The arrangement was originally intended "merely to supplement action by the Bank,"[8] although in subsequent years the practice of the authorities turned out to be more like that envisaged in Plan I.

The Treasury originally suggested that the borrowing limit of the EEA should be £100 million; the continuing heavy inflow in April 1932 led the Bank to propose £150 million. In recommending the latter sum to the Chancellor, Hopkins pointed out that it would allow an increase in total gold and foreign-exchange reserves on the order of £275 million. The EEA could hold up to £175 million, after allowing for the addition of the Exchange Account's dollar holdings and deduction of the Bank's loss on repayment of the central-bank credits, and the Bank could hold £100 million in the Issue Department and the Banking Department (on top of the existing £120 million). Hopkins also pointed out that the rationale was "the desire to keep *down* the pound," although "we cannot . . . put it quite as bluntly as that" to Parliament.[9]

During the budget's passage through Parliament, the Bank built up substantial holdings of dollars and francs in the Issue Department while the Treasury Special Account was being run down (Sayers, 1976, p. 428; Appendix Table A-2). The Bank also sold some of its dollars and francs to the Treasury for the purchase of gold in New York and Paris, and the Treasury sold an equivalent amount of gold to the Issue Department.[10] The Bank thus built up its gold reserves substantially during this period. It also continued to hold significant amounts of foreign exchange in the Issue Department for a year after the EEA officially came into operation on July 1, 1932 (Table A-2; Sayers, 1976, p. 430).

The Mechanism of the EEA

On its opening, the EEA was provided with the assets of the old Exchange Account, which by then amounted to £20 million, and with the £150 million authorized in the budget. The transfer of funds was made

[8] Memorandum marked "Sent to Sir E. Harvey, 18/3/32"; memorandum by Phillips, Mar. 22, 1932, T.175/57.

[9] Memorandum by Phillips, Mar. 22, 1932, T.175/57; Hopkins to Chancellor of Exchequer, "Exchange Equalisation Account Proposals," Apr. 6, 1932, T.175/57, T.188/48, and T.171/301.

[10] Foreign-exchange statements of May 27 and June 10, 1932, T.175/71; note by Hopkins, May 25, 1932, T.175/57.