Chapter I

EXCHANGE CONTROL: 1915-1939

The London Exchange Committee

There was little exchange control during the war of 1914-18. Both the Treasury and the Bank wished to preserve the liberty of the exchanges and maintain a normal free gold market in London. Reserves were frittered away and no systematic control of any kind, apart from sundry trade restrictions and the discouragement (but not prevention) of gold exports, was instituted until the formation of the London Exchange Committee in November 1915: though between February and August 1915 the Bank of England supported the dollar exchange apparently on its own initiative, and the Government subsequently experimented in it for a time. Any restrictions imposed were rather a last resource than a preventative measure, and the policy adopted was founded on the conviction that the benefit derived from any avoidable curtailment of the traditional freedom of British monetary and commercial intercourse would be rendered nugatory by the blow to British prestige and consequently to our credit abroad.

The system of Exchange Control adopted was therefore inadequate and the cost of the war to the national reserve was undoubtedly greater than it need have been because of the maintenance of free capital movements until the last war year, the absence of any check on speculation, the lack of co-operation between Government Departments and the Exchange Committee, and the partial preservation of a free gold market.

The Committee* was set up on 17th November 1915 and was given

*The Committee consisted of the Governor of the Bank, Lord Cunliffe; the Deputy Governor, Mr.Cokayne (afterwards Lord Cullen); Sir Edward Holden and Sir Felix Schuster. Sir Edward Holden soon retired and his place was taken by Mr.Gasper Farrer. In 1917 Mr.Baldwin, then Financial Secretary to the Treasury, joined the Committee, later he was succeeded by Mr.Levick, and in the same year, 1917, Mr.Sydney Peel of the Foreign Office was added. There was a Bank of England Secretary (Mahon Hater Lefeaux) given wide powers which, however, they were never able to exercise. Apart from the reluctance of Government Departments to co-operate and misunderstandings arising from divided authority, the Treasury's gold was never more than nominally at the Committee's disposal, and throughout the war the Treasury kept their own account in New York and conducted their own transactions without reference to the Committee.

The Committee was not in direct touch with the Exchange Market, and a Sub-Committee of four outside experts was appointed to advise them. This Sub-Committee appears to have urged more drastic control, but the Governor was against interference with the freedom of the Exchange Market and carried his Committee with him. Their chief field of interest was the sterling/dollar exchange which, with some minor fluctuations, was raised to and pegged at 4.76 7/16 for the rest of the war: intervention was almost entirely in New York through J.P.Morgan & Co. Later (until Oct.1917) the guilder rate was maintained (through Amsterdam) at varying levels; and at one time or another the Committee operated (through agents in London) in Swiss francs, Scandinavian currencies and Pesetas. Other Exchange Agreements (with Italy, Roumania and Russia) were outside the Committee's jurisdiction. There was no co-ordination of control in the different exchanges; and while sterling was pegged at a discount of 2% in New York it ultimately fell to 25% discount in Amsterdam. In Madrid the peseta went to 35% discount before action was taken.

The Committee found themselves largely in the dark as to arrangements in the U.S.A. for financing the British Government and "had reason to believe that the information was being withheld by the Treasury", (Minute 5 July 1917). They found it impossible to carry out the purposes for which they were appointed, and the Committee was wound up in 1919.

Eventually, in spite of great efforts to maintain free markets, many forms of control had to be adopted; but piece-meal

and

and without co-ordination. Credit did not entirely break down and the Government and Banking syndicates on their behalf were able to raise loans in the U.S.A., Holland, Scandinavia and Argentina.

No steps to set up an Exchange Section in the Bank were taken until 1926, when to the valuable experience of the two Secretaries who had been provided for the London Exchange Committee (one of whom ~~later~~ became a Chief* Cashier and the other a Deputy Chief Cashier) was added some training in the exchanges given to two other officials. * Mahon became Comptroller

In 1929, for the first time, the Bank intervened directly in the American Exchange, employing a small stock of dollars to steady the sterling/dollar rate. On 1st July 1929 an exchange expert, Mr.Kay, joined the Bank; operations began to expand and various activities connected with the exchanges were added to the Section.

After the 1931 Crisis and the departure from the Gold Standard the Bank began to operate on a much larger scale and through more banks. An internal Advisory Committee on the exchanges was formed in September 1931 and continued to meet until 1934. The Exchange Equalisation Account was set up in June 1932 in order "to check undue fluctuations in the exchange value of sterling".

An account of the objectives and working of the E.E.A/c forms the subject matter of Appendix I. A brief summary of its operations from its formation in 1932 until the outbreak of war in 1939, when it continued under the same title to be the repository of the national reserves, seems not out of place here.

These activities fall, as Apendix I shows, into four marked phases:-

(i) The Dollar phase, ending with the suspension of the Gold Standard by the U.S.A. in March 1933, which may be conveniently sub-divided into two periods:

(a) from July-December 1932, when British War Debt

payments

payments to the U.S.A.caused pressure on sterling. British Government's attempt to support the pound then failed for want of sufficient gold and dollars and the pound/dollar rate fell to its lowest (3.14½) on 29th November;

(b) December 1932-April 1933: recovery and heavy receipts of gold and foreign exchange, at the end of ~~each~~ this period the Fund's sterling assets had to be increased by £200 million.

(ii) <u>The Franc phase</u> (March 1933-September 1936).

In February 1934 the U.S.A.linked the dollar to gold at $35 per fine ounce; this phase ended with the evolution of the "Tripartite Currency Agreement". These 3½ years saw an increase of nearly £170 million in the Account's gold, a decrease in foreign exchange of about £25 million and a rather smaller increase in sterling, with total funds up by about ~~£155~~ 144 million.

(iii) <u>The Tripartite Agreement phase</u> (September 1936-May 1938) during which the Fund first lost gold and then recovered it, showing a net increase of about £17 million in gold and foreign exchange over the whole period of about twenty months.

(iv) <u>The War Scare phase</u>.

This begins, officially, with Munich in September 1938; and ~~the~~ figures for 11 months thus leave out of account the period from the renewal of confidence in the French franc in May 1938 until the outbreak of war. Between the end of May and the end of August 1938 the Account lost some £40 million gold, and over the final year to the outbreak of war a further £80 million.

Negotiations with H.M.T. : July 1937 - August 1939

The Bank had formed a definite opinion on the possibility of war and the need for Exchange Control as early as the Winter of 1936. The Treasury, however, in a long sequence of discussions, exchanges of memoranda and letters with the Bank, displayed reticence, if not nervousness, towards the idea of control. As late as May 1938 a Treasury memorandum argued that a tight control of credit would very likely make detailed Foreign Exchange Control completely superfluous.

The Bank's earliest recorded communication on Exchange Control is in a letter (8 July 1937) from the Deputy Governor (Mr.Catterns) to Sir Frederick Phillips, covering a number of measures to be taken in the event of war. The paragraphs on Exchanges began by recalling the exchange restrictions imposed at the time of the 1931 Crisis. Broadly speaking these disallowed: operations other than for own clients' accounts; purchases of foreign securities in foreign markets, and of foreign currencies except for definite imports under contract; the import of securities and subsequent remittance abroad of the proceeds of their sale; sterling advances against foreign balances and forward market operations as distinct from operations for customers. Normal trading and the fulfilment of pre-Crisis contracts as well as reasonable travelling and personal expenses were permitted.

The letter then proceeded to outline suggested measures to be taken immediately on the outbreak of war, though these would depend on the type of conflict in which the country became involved. If it were a minor war there would probably be little need to interfere with the normal business of the gold and exchange markets, except as regards credits, etc. to the enemy. These proposals, and the Treasury's resistance, are recorded here in some detail in order to show how comparatively little the Bank's considered views at the time will be found to have been modified when they became the basis of Regulations which the country had ultimately to accept.

The function

The function of the Exchange Control would be purely technical and monetary in scope; it would administer the country's gold and foreign exchange reserves and carry out the instructions and requirements (within the limits of its resources) of the Treasury and the Foreign Trade Controller. (At this stage the establishment of a Foreign Trade Control Office was envisaged).

The machinery already available in the Foreign Exchange Department of the Bank would probably be found convenient in practice, with the London Banks acting as agents.

With the automatic closing of the London Gold and Foreign Exchange Markets H.M.Government (now the sole market) would call for returns from British nationals of all their foreign assets and liabilities. After examination of these all bona fide liabilities to non-enemy countries would first be met and the balance then surrendered to the Exchange Control at rates and/or prices to be fixed. Definition of the various types of exchange assets would need to be precise.

British nationals would be required to surrender all gold and foreign exchange, whatever the source, coming into their hands after the outbreak of war.

Foreign Credits might be dealt with as under "Sanctions" (e.g., against Italy in the war with Abyssinia).

As to assets of enemy nationals, H.M.G. would doubtless find it necessary to decide as soon as possible between sequestration and surrender to the Exchange Control.

Under "General Comments" were included the constitution, under a War regime, of the legal position of the E.E.Account (if still in existence) as regards purchases and sales of gold, exchange and foreign securities; the wisdom, on psychological grounds, of taking all gold out of the Issue Department immediately on the outbreak of war; the importance

of securing

of securing first call on the gold output of the whole Empire, coupled with arrangements for the setting aside in London and other Empire centres of gold for the account of countries from whom the U.K. bought supplies, such elasticity avoiding the many risks attendant on shipment.

Continual and close co-operation between the Bank of England (as Exchange Controller) and the Foreign Trade Control Office would be essential. Finally ...."the Bank of England would be responsible for arranging that the means of payment were in the right place at the right time, and would therefore need to be kept closely advised by H.M.G. of the amount, date and currency of all payments."

It is sufficient to say here that from their reply (3 Sept.1937) it was clear that the Treasury were unlikely to see eye to eye with the Bank. The following extracts from letters, etc. are intended to illustrate the Bank's patient insistence on the essentiality of control and the need to have powers and procedure ready against the actual outbreak of war.

The next time the matter was taken up in writing was in a letter from Mr.Cobbold to Sir Frederick Phillips (28 April 1938) in which he said that the Bank felt strongly that central control would be essential in the field of external commercial and financial relations, and that time would be saved and the waste of reserves prevented if the Government took the necessary powers at the outset instead of piecemeal as in the last war; and from a different position, ..."since the Government already intervenes in exchanges and in the direction of foreign trade to an extent unthought of when the last war broke out." ......"In

the Exchange

the Exchange Account the Government has an organisation which can be adapted immediately to the purposes of a general Exchange Control." The letter stressed the ideal of freedom in exchange transactions between Empire and Allied countries, but the method must be "to take comprehensive powers at once, making all deals subject to control, and subsequently to restore freedom wherever desirable and possible."

This letter produced a Treasury memorandum (9 May 1938) which argued that the system outlined by the Bank would mean "a very great interference with the existing free institutions of the City of London".

The Deputy Governor wrote again (23 May 1938) reaffirming the Bank's view that comprehensive control of gold and foreign exchange would be inevitable, and suggesting that powers should be taken to control any export of gold or transfer of sterling balances, while allowing gold held by foreigners before a certain date to be exported under licence. After discussion with the Treasury agreement was reached on several points, but the Treasury again resisted the Bank's arguments in favour of blocking the sterling balances of non-residents. (Meeting at Treasury on 27th May, followed by note by Bank and reply by Sir F.Phillips).

The Bank contended that "with more fugitive balances than ever before" in London, if foreigners were

free

free to sell their sterling balances the alternatives were either a heavy depreciation of sterling or a free sacrifice of reserves. Sir Frederick Phillips in a lengthy reply said that he, Waley and Hawtrey could not convince themselves that the Bank were right. The war would not last for ever; we had increased in power and reputation over the past 150 years .... and he likened the position to one in which a banker, impounding in his own interests his customers' deposits, is unlikely to find many customers in future. Moreover, a substantial proportion of foreign balances would probably be withdrawn during the period of severe alarm before the war broke out.

In his reply (8 July 1938) the Deputy Governor said that while recognising the incidental disadvantages of Exchange Control the Bank took the view that "an extremely high degree of State interference with the control of every branch of economic life will be inevitable in the event of a major war". An elaborately centralised Control was not proposed; on the contrary "a decentralised administration as much as possible through the Banks as agents". Their object was to conserve the limited resources available to pay for essential imports and to make other essential payments. They did not agree with the Treasury's contention that a large proportion of foreign-owned sterling was not "hot" but was here for the carrying on of business. In their opinion the offers of sterling might in the early stages of an emergency be such as "to render the sterling exchange chaotic, undermine confidence in British currency and credit, and seriously prejudice our future capacity

to

to pay for essential imports and services". They disagreed with the Treasury that the imposition of Control or liquidation of foreign assets at the outbreak of war could be interpreted as lack of faith in sterling by the authorities. The points on which they regarded early governmental decision as essential were:-

1. That there should be a general prohibition of the export of money in any form except for specified purposes and by Treasury licence, whatever the domicile or nationality of the holder.

2. That, in conjunction with 1. a monopoly of dealing in gold and foreign exchange should be granted to the Bank of England for account of the Treasury.

3. That gold, foreign exchange and foreign securities in the possession of U.K.residents should immediately be either requisitioned or immobilised until requisitioned or released. ~~realised.~~ They also thought that non-resident sterling accounts should be temporarily immobilised.

The latter apparently had little effect, and ~~since~~ at a meeting between the Treasury and the Bank (2 Aug.1938) the conclusions of the Chancellor were stated to be:-

1. That there should be no hindrance to the withdrawal of foreign balances.

2. He was not in favour of imposing a comprehensive scheme of Exchange Control at the outset of war, and much less so in the period of uncertainty preceding.

3. He had no objection to compulsory requisition of U.K.owned foreign assets.

4. He expressed no opinion as to whether Control, if adopted, should be in the hands of a Government department or in those of the Bank of England, using the Clearing Banks as agents.

After discussion.

After discussion the Treasury representatives proposed to adopt measures which embodied compulsory requisition of foreign securities owned by U.K.residents, and an appeal to the public not to use existing foreign exchange balances except for normal trading and reasonable personal requirements.

About this time the Bank met the Clearing Bankers, who had nominated a sub-Committee of three: Sir Charles Lidbury* (Westminster), Mr.F.C.Ellerton (Barclays) and Mr.A.W.Gurney (Nat.Provincial) to assist the Bank of England. Sir Charles Lidbury handed in a memorandum advocating tight Exchange Control, though he assumed that non-residents (if not enemies) would be allowed to export their capital. The Bank gave the Committee their skeleton scheme of Control (including a proposal to block foreign balances) and promised to work out one in greater detail.

On the 10th August, in face of the deadlock reached with the Treasury, the Governor said that "he had no doubt in his own mind that statutory control would prove inevitable on the outbreak of war." He agreed that we should continue to go ahead with Control plans, which should be worked out in as much detail as possible in agreement with the Clearing Bankers' Committee. After obtaining their considered opinion he was prepared to take the matter up in Whitehall. In the meanwhile Sir F. Phillips had been informed of the first reaction of the Bankers, viz., that "patriotic appeal would be inadequate."

The Munich Pact was signed on the 29th September 1938 and on the next day the following memorandum of War Measures was sent to the Treasury:-

"War Measures

Foreign Exchange - Foreign Balances

It has been decided by H.M.Government that no restraint should be placed on sterling balances owned by non-residents.

To the extent to which non-residents wished to liquidate sterling they would have the following alternatives:-

(a) To buy

*Mr.Lidbury, created a Knight in 1941.

(a) To buy capital assets and goods in the United Kingdom;

(b) To obtain foreign exchange or gold from authorised dealers (i.e., from the Exchange Fund);

(c) To sell their sterling on a foreign market to another foreigner for what it would fetch.

Experience in the last few days confirms the view that in the event of a European war the vast majority of foreign holders of sterling balances would want dollars. It would obviously be impossible for us to undertake to supply all dollars or other currencies required by non-residents immediately. It is very likely that application would be made for a greater quantity of dollars than was available, and anyhow we should have enough difficulty in getting dollars for our own requirements and should certainly not, in the early days, have any to spare for foreigners. The only thing we could do would be to offer foreigners gold in London for their sterling balances. We could not, however, give any guarantee as to the possibility of shipment of such gold since we should need priority for our own shipments on all available transport.

Even if we were prepared to give gold on the nail (which might make heavy inroads on our resources), foreigners would have to choose between taking gold in London with little hope of exchanging it into a useful currency, or hawking their sterling about foreign markets and selling it for what it would fetch.

The consequent creation of a depreciated black market abroad, and the possibility of heavy gold losses in early days, would be an unattractive feature for us. At the same time, foreigners are unlikely to be pleased with either of the alternatives offered, and the psychological effect of leaving sterling balances free is unlikely to be great if there is no satisfactory way of realising them.

It therefore seems that in the light of recent experience there is a case for reconsidering the question of blocking foreign balances. If it is still held impossible to block foreign balances as a whole the magnitude of the problem could be considerably reduced by arranging with allied countries to assist their requisition laws by blocking balances owned by their nationals. The blocking of French sterling balances, for instance, would, if it could be arranged, doubtless be welcome to the French authorities."

1938 On 30th September the Stock Exchange was consulted on the registration of securities.

In August the Exchange Account had lost £26 million and 1938 in September £63 million in gold entirely on account of sales to New York, and the Bank again pointed out to the Treasury (Letter 19 Oct.) how a similar experience would be repeated in the event of another crisis, and asked for a reversal of their decision not to block foreign balances. It was essential that exchange plans should be linked up closely with the control of imports and exports. Better estimates of exchange requirements and consultations with European Monetary Authorities were needed.

Writing on 29 December, Sir F.Phillips referred to discussions with the Board of Trade on imports, exports and stocks of commodities. In this letter the extraordinary statement occurs, "we adhere to the view, which you had put forward and we accept, that no restraint should be placed on sterling balances owned by non-residents." The Deputy Governor (replying on 4 Jan.1939), accepting this as an error, nevertheless took occasion to refer to numerous previous occasions on which the Bank had insisted on the exact opposite, adding "without prejudice to this question, on which our views remain unaltered, I agree that the best method of transfer will be to offer gold in London for shipment when opportunity arises; it would of course be necessary to arrange priority of shipment for our own requirements".

Meanwhile the Bank, the Clearing Banks and Treasury were proceeding with innumerable drafts of regulations, public announcements, etc. The Bank also drew up plans to control imports (complete control by licence of which they had previously urged at least as long ago as the middle of 1938) and exports in their connection with Exchange Control.

Incidentally, during this drafting, Sir F.Phillips wrote in March that he was "reluctantly convinced" by the Bank's argument that it was too

difficult

difficult to give non-residents "privileges by the terms of the regulations". He was still finding it difficult to decide whether we were endeavouring to prevent capital movements adverse to this country or to keep up the exchange value of sterling.

By April 1939 the financial Regulations were ready to be sent to Dominion Governments, and the Bank began to inform the individual Banks who were to act as authorised dealers, and later other interested parties. The Deputy Governor (letter 6 April 1939) suggested that it would be necessary for a Junior Minister to act as referee when foreign exchange questions became matters of Parliamentary or public interest, i.e., mainly matters concerning publicity or law; and further that, to derive administrative authority for the Bank there should be set up a Committee, to be located at the Bank, on which the Treasury, Bank and Market should be represented. Questions of policy would be outside its scope. The Treasury assented in general.

In spite of the dishoarding of £50-60 millions of gold in the first five months of 1939, after Germany had invaded Czechoslovakia on the 14th March, there had been a net outflow of £52 million in 2½ months to the end of May, and the Bank anticipated parting with a further

£90-100 million

£90-100 million by mid-September. In mid-January total U.K.Deposit Liabilities to overseas holders were estimated at £400 million, of which £160 million might be due to Europe. But the amount of foreign money which could be withdrawn was of course far greater.

In the Bank's view the maintenance of a rigid exchange rate in face of pressure would enable foreign balances to be withdrawn without difficulty. The maintenance of cheap money would enable British funds (exporters' funds left abroad and importers' anticipated requirements) to be expatriated without creating a domestic shortage of working capital. As against which only a "shadow" system of control was already operating in the form of moral restraints such as those introduced in 1931.

A month later there was even a suggestion to suspend the Bank Return on the outbreak of war, since the Issue gold would have to be made available. On the 28th July, in a memorandum given to Sir F.Phillips, the Bank proposed the blocking of non-residents' sterling immediately on the outbreak of war as "the most complete measure to avoid haphazard and embarrassing withdrawal of foreign-owned balances and at the same time to prevent their use in the black market". There would be exceptions to meet pre-zero contracts and to enable persons temporarily resident in the U.K. to obtain foreign exchange necessary for travelling expenses. Authorised dealers, etc. would receive general instructions to await arrangements,

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on a reciprocal basis, with the governments concerned before considering applications from non-residents for transfer into foreign exchange or gold. Applicants for foreign exchange would be given the exchange for which they applied where possible, otherwise gold in London.

Aug 1939 During the last month before the outbreak of war the Bank further expanded their idea of canalisation. " At zero" all foreign governments would be informed of the impossibility of providing exchange immediately. Negotiations would follow with a view to reciprocal arrangements. The [redacted] U.S.A. might have their demands satisfied in full. In other countries (e.g., countries with exchange control) sterling belonging to their nationals might be canalised through a Special Account of the country concerned with the Bank of England, into which nationals of each country could pay their sterling against payment in their own currency at their Central Bank - a procedure already [redacted] agreed with the Bank of France. Time, however, was too short to complete such arrangements before the war broke out, and in the event such canalisation came only in the Summer of 1940.