The Exchange Equalisation Account: its origins and development

The origins of the E.E.A.

In 1925 the United Kingdom, with a number of other countries, returned to the gold standard, which had been suspended since the outbreak of war in 1914. Under the Gold Standard Act 1925 the Issue Department of the Bank of England was required to exchange sterling for gold bullion at a fixed price.[1] This obligation effectively re-established a system of par values between sterling and other currencies whose values were fixed in terms of gold. The key rate, against the U.S. dollar, was set at £1=$4·86⅔, the same as in 1914.

Over the next few years, what are now called balance of payments difficulties developed on a significant scale. Views can still differ about the extent to which they initially stemmed from the fixed parity chosen in 1925; but there can be no doubt that the circumstances of currency stabilizations and industrial reconstruction in continental Europe added to sterling's difficulties. In September 1931, after a sustained loss of gold, the United Kingdom suspended the gold standard. The gold loss stemmed from a worsening trade balance aggravated by an outflow of short-term capital, particularly to France, as confidence deteriorated. In two months the Bank of England lost some £60 million of gold and foreign currency reserves, while the proceeds, amounting to £130 million, of borrowing by the Bank and H.M. Treasury under dollar and franc credits hastily arranged with the Federal Reserve Bank of New York, the Bank of France and commercial banks abroad, were used up. By the middle of September the gold remaining no more than covered this borrowing.

In these circumstances there was little option but to suspend the Bank of England's obligation to sell gold for sterling. Though there was discussion subsequently about fixing a new price for sterling in terms of gold, the difficulties of doing so at that time were enormous. Prospects for international trade were extremely uncertain, for protectionism was increasing and the terms of trade were changing rapidly and unpredictably. If the value of sterling were not sufficiently reduced, speculation against the pound would probably continue, and – as arrangements for international monetary co-operation were still in their infancy – might force a second devaluation. If, on the other hand, the value were set too low, a sustained inflow of speculative funds might prove equally embarrassing and oblige other countries to devalue.

Sterling was therefore left to float in international exchange markets, with official intervention limited to smoothing day-to-day fluctuations in the rate. At first the rate against the U.S. dollar fell sharply, to below $4·00, and by early December 1931 it had declined to a low point of $3·25. But at that level the market considered that sterling was undervalued, and prospects for the trade balance looked

1 The regime after 1925 is conveniently described as a 'gold bullion standard'. Gold coins were not in circulation and the Bank were not required to redeem bank notes in gold coin on demand; their obligation was to sell gold in bars of about 400 ounces.
The selling price for gold bullion was 77*s*. 10½*d*. per standard ounce (11/12ths fine) and the buying price 77*s*. 9*d*. per standard ounce.

much better; so the rate reacted favourably. With the return of confidence the speculative outflow of capital dwindled away and gave way to an inflow. Before long the inflow had become persistent, and the Bank's policy of day-to-day smoothing operations in the market led almost inevitably to an accumulation of gold and foreign currency. This was used in the first instance to repay the dollar and franc credits mentioned earlier.

Even so, the rapid appreciation of sterling brought new problems; while undoubtedly good for confidence in the short term, it threatened to delay the recovery of the United Kingdom's trade balance by making British exports dearer and imports cheaper. Clearly, the policy of merely smoothing exchange rate fluctuations had to be modified, and the speculative inflow absorbed without the rate rising much further. The problem was how to intervene on the required scale; a large amount of sterling would be needed, as would a vehicle for holding the resulting gold and foreign currencies. Three possibilities were considered: leaving exchange operations with the Issue Department of the Bank of England; building upon a small exchange account that had been maintained by H.M. Treasury since the 1914-18 War; or creating a new fund to be managed by the Bank.

From one point of view, the Issue Department seemed the obvious instrument of intervention. Before 1931 it had been responsible for buying and selling gold, and since the abandonment of the gold standard it had used its gold and sterling assets to intervene as necessary in foreign exchange markets to check fluctuations in the rate for sterling. But there would have been drawbacks. Probably the strongest practical objection at that time was that the sterling assets which the Issue Department held against the fiduciary issue would have been inadequate to absorb an inflow of foreign exchange on the scale that seemed to be developing.

There would have been other problems in continuing to use the Issue Department for foreign exchange operations: it was required to publish a weekly return, which would have allowed speculators to make informed guesses about its dealings and might have encouraged further speculation; it had to value its gold holdings at the fixed gold standard price – a procedure which would have given rise to large accounting losses at times when it was acquiring gold;[1] and the fiduciary issue could not be increased without formality.[2]

The Treasury's own exchange account was fairly small; it had a capital of £25 million and its assets were mainly gold, and dollar securities. Doubtless this account could have been expanded if necessary, but there would have been some obvious disadvantages if the Government had involved themselves in day-to-day operations in foreign exchange markets; while there were psychological as well as practical advantages in setting up a new piece of machinery to deal with a new situation.

It was therefore decided to establish a new fund, to be known as the Exchange Equalisation Account, which would be controlled by the Treasury but operated by the Bank. Powers to set up such a fund were incorporated in the 1932 Finance Act, and the E.E.A. began operations on 1st July

1 Because the statutory price was considerably below the market price.

2 The Treasury had power to increase the amount of the issue for periods not exceeding six months; such increases might be extended on the same authority, but not so as to remain in force for more than two years unless Parliamentary sanction was obtained.

of that year. While the Finance Bill was before Parliament the demand for sterling became so strong – the Issue Department's sterling resources that were available for intervention were reduced in May to £100 million, and a further £250 million seemed likely to be needed – that an emergency bill was contemplated. However, the inflow slackened and the Finance Bill was allowed to take its normal course. The funds in the E.E.A. were to be used "for checking undue fluctuations in the exchange value of sterling".

The mechanism of the E.E.A.

The Account was provided with £150 million of sterling from the Consolidated Fund, and most of this was invested in tap Treasury bills.[1] Its other assets were those transferred from the Treasury's exchange account, amounting to £21 million; the Treasury account was wound up. The E.E.A. was not endowed with any other gold or foreign currency, and so would not be in a position to counter speculation against sterling until it had acquired gold or foreign exchange through sales of sterling. As already explained, however, the overwhelming need at the time was for a fund with large enough sterling assets to absorb the prospective inflow of gold and foreign exchange. If it were later to prove necessary, gold held by the Issue Department could be sold to the E.E.A. as a special transaction, and subsequently used for intervention in exchange markets without the loss of operational secrecy which frequent direct dealings in foreign exchange by the Issue Department would have entailed.

As noted earlier, the sterling holdings of the E.E.A. were lent to the central government against Treasury bills.[2] When the Account purchased foreign currency from the banks it ran down its Treasury bills to provide the sterling; and conversely when it sold foreign currency it used the sterling it received to take up more Treasury bills. The crucial point was that, in either case, the central government's need to borrow from other sources was altered, and this had to be allowed for in the authorities' issue of, or market dealings in, Treasury bills. Substantial changes in the E.E.A.'s gold and foreign currency holdings would ultimately be reflected in an increase in or a reduction of its capital, by means of a sterling transfer from or to the central government. Until 1939 each increase in capital had to be sanctioned by Act of Parliament.

It had become official policy to moderate the effects on the domestic economy of international flows which were not necessarily connected with the state of the trade balance. An inflow of gold or foreign exchange added both to the cash reserves of the banks and to their deposits – enabling them to increase their domestic lending – unless offset by open market operations carried out by the authorities. Conversely, an outflow might lead to a reduction in the banks' lending.

An inflow resulting from a trade surplus could thus be expected to produce an expansion of domestic credit, which in turn would alleviate the deflation that supposedly was often one cause of the surplus. Similarly, an outflow caused by a trade deficit would lead to a contraction of domestic credit and would help to end the inflationary conditions to

1 Tap Treasury bills are issued at any time at a rate of discount fixed by H.M. Treasury. Those taken up by the E.E.A. carry interest at the rate of 1s. per cent. Originally, the Account held three months' bills, some of which matured on each working day. Now, however, bills are for a variety of tenors.

2 Some sterling was (and is) also lent to the Government, through the Paymaster General, in the form of ways and means advances.
The term 'central government' is used here, and throughout the article, in preference to 'Exchequer' (as the Government's central cash account is known) because of the recent change in government accounting – see "The effects of the National Loans Act 1968 on central government accounts" in the September *Bulletin*.

which the deficit might sometimes be attributed. These might often be desirable effects. But in practice gold and foreign exchange did not move only in response to surpluses and deficits on the balance of trade; nor did the balance of trade simply reflect domestic deflation or inflation. As was seen in 1931 and 1932, shifts of confidence were liable to cause heavy outflows and inflows, producing effects on the credit base that were often at variance with the needs of the domestic economy and indeed with the underlying trade balance.

It seemed, however, that because the E.E.A.'s need for more or less sterling gave rise to a corresponding need for the central government to issue more or fewer Treasury bills, the effect of an inflow or outflow on the amount of cash held by the banking system, and hence on its ability to lend, would in practice be much reduced. In the first instance the E.E.A. would pay sterling to the banks, or take in sterling, against foreign exchange; this in conjunction with the inflow or outflow would add to or diminish both the cash reserves and the deposits of the banks. At the next stage the authorities would increase or reduce by a roughly equal amount the Treasury bills (or other government debt) that they marketed; and whether or not the Treasury bill holdings of the banks themselves were changed, the increase or decrease in the Government's borrowing would effectively restore the cash position of the banks to where it was before the inflow or outflow of exchange had taken place. This process by which the initial impact on the cash position of the banks is modified is discussed in greater detail later in this article.

The early years

As a matter of policy, the E.E.A. dealt only in currencies which it could exchange for gold at fixed rates; and, apart from working balances, it converted all the foreign currency it acquired into gold. At first, most of its transactions were in dollars. This was partly because the dollar was the most important foreign currency for British trade, and partly because, with the main currencies linked with each other through gold, it was simpler to concentrate transactions on one key currency. For a short time after it was established the E.E.A. took in dollars; but as the dollar became stronger the value of sterling declined – for the E.E.A. had not yet acquired sufficient gold to check a depreciation. The rate fell from about \$3·60 at the beginning of July 1932 to \$3·14½ at the end of November.

However, the fall in the rate was temporary. Early in 1933 the internal financial situation in the United States deteriorated, and the E.E.A. again found itself taking in large quantities of dollars. In March 1933 the United States too left the gold standard and the E.E.A. ceased to deal in dollars, which it could no longer convert into gold at a fixed rate. For a time it conducted most of its operations in French francs.

The flow of funds into the United Kingdom grew still larger and the E.E.A.'s sterling resources were seriously depleted. They were replenished in two ways: over a period of four months some £80 million of gold was sold to the Issue Department for sterling;[1] and, as the capacity of the Issue Department to buy gold was limited and too large an

1 These and subsequent transfers of gold between the Issue Department and the E.E.A. are set out in Table A at the end of this article.

increase in the gold backing of the currency might in any case have further encouraged the inflow of foreign funds, an increase of £200 million (to £371 million) in the E.E.A.'s capital was authorised by the Exchange Equalisation Account Act 1933. Meanwhile, the inflow continued and the rate for sterling against the U.S. dollar briefly exceeded $5·50 in November 1933.

In February 1934 the dollar resumed its link with gold, at a price of $35 per fine ounce; but the United States would exchange gold only with countries whose own currencies had fixed gold values, and this continued to prevent the E.E.A. from operating in dollars, which it would still have had no way of converting into gold.

During the first half of 1936, political and economic troubles in France aggravated the doubts that had developed about her ability to maintain the gold parity of the franc. There was a large outflow of capital from France – the United Kingdom intervened heavily in the market from day to day in support of the franc, acquiring thereby a large amount of gold – and smaller outflows from other gold bloc countries, about whose currencies there were similar doubts. When it became evident that the franc would have to be devalued, there were widespread fears of a round of competitive devaluations. Negotiations between the United Kingdom, the United States and France led to the so-called Tripartite Agreement of 25th September 1936. The three powers (joined at once by Belgium[1] and later by the Netherlands and Switzerland) accepted the devaluation of the franc which occurred simultaneously,[2] but expressed the desire to avoid competitive devaluations. Thereafter, each country undertook to make gold available day by day to the others in exchange for its own currency. As a result the U.S. dollar again became the principal currency in which the E.E.A. dealt; and though the Account held working balances in the currencies of the other parties to the Tripartite Agreement, gold remained its main external asset. More generally, the co-operation established between governments in September 1936, and thereafter between central banks, was important in maintaining comparative exchange stability in the late 1930's.

Though the E.E.A. was less concerned at this time to amass reserves than to moderate fluctuations in the rate, the flow of gold from France to the United Kingdom (and to the United States) continued for about sixteen months after the Tripartite Agreement. Some £50 million of gold was sold by the E.E.A. to the Issue Department for sterling in the spring and summer of 1936; and £110 million was sold in December. In May and June 1937 further sales totalling some £20 million were made, and in July the E.E.A.'s capital was again increased by £200 million, to £571 million. By the end of the year the gold holdings of the E.E.A. and the Issue Department together had reached £825 million; of this, the E.E.A. had taken in over £500 million, nearly half of it from France after the collapse of the gold bloc in September 1936.

But the peak was reached shortly afterwards. From then on fear of war in Europe dominated foreign exchange and gold markets, and the E.E.A. started to lose gold – principally

1 The Belga had been devalued in March 1935.
2 The Swiss franc and the Dutch guilder were also devalued.

to the United States – at first intermittently and then continuously, until the outbreak of the 1939-45 War. The Munich crisis in the late summer of 1938 alone cost the E.E.A. some £100 million in gold, even though the rate was allowed to fall by 20 cents, to \$4·61. To permit a larger fall in the short term might have seemed inconsistent with the aims of the Tripartite Agreement so, to secure a temporary breathing space, the Bank began in October 1938 to sell dollars forward on a substantial scale. The immediate object was to reduce the forward premium and so relieve the pressure on the spot rate, and in a few weeks the Bank had built up a considerable forward position. In December it was decided to reduce this position and to oblige speculators to cover in the spot market; with the help of the principal banks in the market, who agreed not to make sterling available, a squeeze was carried out, and the spot rate improved slightly for a time.

Even so, the loss of gold continued, and in January 1939 £350 million of gold was transferred from the Issue Department to the E.E.A.[1] The increase in the E.E.A.'s external resources was intended to demonstrate that it could meet any immediate drain, and so revive foreign confidence. But the international climate continued to worsen, and it became clear that conditions were no longer amenable to ordinary financial controls. Rather than allow sterling to reflect fully the fears of war, the authorities decided to peg the rate and it was stabilised in April at \$4·68. A possible alternative – to introduce a system of exchange control – would have been impracticable at that time as well as politically difficult; but contingency plans were prepared.

The rate was held at \$4·68 for several months, though at the cost of heavy gold losses. When these increased during August, and war seemed to have become inevitable, the need to conserve the country's reserves became paramount. On 24th August, therefore, the E.E.A. ceased to give support, and until the outbreak of war sterling was allowed to float – falling to about \$4·20.

In assessing the contribution of the E.E.A. during its early years to the stability of sterling, it should perhaps be borne in mind that from the time when the dollar resumed its links with gold early in 1934, until shortly before the outbreak of the 1939-45 War, the rate against the U.S. dollar remained generally within a range of 5% either side of the old parity of \$4·86$\frac{2}{3}$.

The E.E.A. in wartime

With the outbreak of war the E.E.A.'s role changed; the Currency (Defence) Act 1939 required it to use its resources in "... securing the defence of the realm and the efficient prosecution of any war"; other clauses removed the restrictions on the amount of capital which the E.E.A. could draw from the Consolidated Fund, and provided for the repayment of surplus funds.

Under the Defence (Finance) Regulations a system of exchange control was instituted to conserve and increase the gold and foreign currency reserves, and to ensure that they were used to the national advantage.[2] All gold and exchange held by residents had to be offered for sale to the

1 The transfer anticipated the provisions of the Currency and Bank Notes Act of February 1939. This Act provided for the weekly revaluation at current prices of the remaining gold and the securities held by the Issue Department. The E.E.A. was to carry the gains or losses arising from the weekly revaluation and to receive the income earned on the Issue Department's assets; (these provisions were repealed by the National Loans Act 1968, under which the profits of the Issue Department now accrue to the National Loans Fund. The N.L.F. also replaced the Consolidated Fund as the provider of the E.E.A.'s capital.) As a result of the 1939 Act the remaining gold held by the Issue Department was shown at its true value in sterling terms.

2 See the article "The U.K. exchange control: a short history" in the September 1967 *Bulletin*.

Treasury as part of the concentration of the country's external resources. A first step in the channelling of reserves to the E.E.A. was to transfer to it some £280 million of gold still held by the Issue Department – leaving only a nominal amount in the currency backing.

Later, under vesting orders, a substantial part of the holdings of U.S. and Canadian dollar securities owned by private U.K. residents was purchased by the E.E.A. for sterling on behalf of H.M. Treasury. Some of these dollar securities were later sold to finance the war effort, and others were used as collateral for loans obtained by the United Kingdom from the U.S. Reconstruction Finance Corporation.[1] (Other securities deposited as collateral were borrowed from U.K. residents.)

The London foreign exchange and gold markets were closed and the Bank were authorised to determine exchange rates; the sterling/U.S. dollar rate was fixed at £1 = $4·03 – well below the previous market rate of around $4·20. Dealings in foreign exchange were limited to 'authorised dealers', who had to operate in most currencies at the official rates, charging their customers a commission.

The E.E.A. became the ultimate buyer and seller of foreign currencies, and was also responsible for providing the exchange required for the prosecution of the war, when and where it was needed. Before the outbreak of war, part of the gold reserves had been shipped to centres abroad, particularly in North America, where it could be converted into currency as necessary. From this time, the E.E.A.'s original policy of converting its foreign currency receipts into gold was modified, and currencies, mainly dollars, were allowed to accumulate in excess of working balances.

Sterling was still traded on a few markets, the largest being New York, where the E.E.A. intervened on occasion to hold the rate within certain limits; but otherwise the role of the Account was largely passive and most of the transactions it handled were at fixed rates.

The post-war period

As the war continued, much thought was given in the United Kingdom and elsewhere to the kind of international monetary arrangements that might be appropriate when peace was restored. The experience of devaluations and widespread floating exchange rates in the 1930's had been most unhappy, and in July 1944 the United Nations Monetary and Financial Conference at Bretton Woods agreed to establish an International Monetary Fund based on a system of fixed exchange rates. A country adhering to the I.M.F. Agreement was required to fix the par value of its currency in terms of gold or U.S. dollars (of the weight and fineness in effect on 1st July 1944) and to keep exchange rates in spot markets in its own territories to within 1% of this value. It might change the par value of its currency only to correct conditions of 'fundamental disequilibrium' in its balance of payments.

Full convertibility of currencies for current transactions was to be an ultimate goal for Fund members. For the United Kingdom and for most other members, however, this would have to wait until they had recovered from the war. In the United Kingdom the wartime system of exchange

1 The vested securities which were not sold later became the official portfolio of dollar securities.

control was retained [the Defence (Finance) Regulations were largely replaced by the Exchange Control Act 1947] along with the wartime parity of £1=$4·03. Meanwhile, the Finance Act of 1946 widened the E.E.A.'s functions to include "... the conservation or disposition in the national interest of the means of making payments abroad".

Under post-war conditions, therefore, official reserves would have to be sufficient, not only to moderate day-to-day fluctuations in exchange rates, but to keep rates within the quite narrow limits permitted by the I.M.F. Agreement. In practice, moreover, it could be expected that after convertibility had been restored the E.E.A. would need to deal with the consequences of volatile movements of speculative funds across the exchanges, often on a large scale. Experience, both in 1947 and after the final restoration of convertibility in 1958, was to confirm this expectation. Thus the E.E.A. needed to supply and absorb greater amounts of foreign exchange than in the pre-war years;[1] and, in particular, to accumulate sufficient reserves in times of balance of payments surplus to provide for a prolonged (and magnified) outflow of funds in times of deficit. In fact, adequate reserves never were built up in the post-war period, and the United Kingdom has frequently found it necessary to supplement the E.E.A.'s own resources by means of short-term borrowing.

The failure of the first post-war attempt, early in 1947, to make sterling convertible once more in terms of the U.S. dollar strengthened the feeling that the pound was overvalued at its wartime parity. In September 1949 sterling was devalued – the rate against the U.S. dollar became £1=$2·80 – along with most other European and sterling area currencies. During the gradual approach to convertibility that followed, the creation of the European Payments Union[2] in 1950 helped significantly to extend the free flow of exchange. The E.E.A. was the channel for U.K. transactions with the E.P.U. and was authorised to hold European units of account for this purpose.

Its role became more active still in 1951 when the London foreign exchange market was reopened – in company with others in Western Europe. Authorised dealers were then allowed to deal with their customers and among themselves at market rates inside the official buying and selling rates; and to maintain open positions in foreign currency, both spot and forward, and to hold spot currency against forward commitments within limits laid down by the Bank. The E.E.A. thus ceased to be a party to most receipts and payments, and became the residual supplier or purchaser of foreign currency. To give the E.E.A. greater flexibility in its operations the official dealing limits for the U.S. dollar were widened from $\frac{1}{8}$ cent either side of parity to 2 cents – still inside the spread officially permitted by the I.M.F. At the same time, the E.E.A. ceased to quote fixed forward exchange rates – which it had done since the beginning of the 1939-45 War – and forward rates were left to be determined by normal market forces.

During the next few years the United Kingdom took a leading part in a general European movement to restore the convertibility of currencies, and the area within which ster-

1 There were some marked fluctuations in the United Kingdom's balance of payments in the early post-war years, and some large swings in the reserves. For example, in the twenty-one months after devaluation of sterling in September 1949 the reserves rose by some £900 million; but in the next ten months when the balance of payments deteriorated sharply, they fell by nearly £800 million.

2 The members of the E.P.U. participated in a clearing arrangement in which surpluses or deficits incurred between them were settled through the Bank for International Settlements, partly in gold or U.S. dollars, and partly by the accumulation of credit or debit balances in European units of account.

ling was freely transferable by non-residents and (for current purposes) by residents was steadily enlarged. As part of a concerted move by the members of the E.P.U. to establish convertibility of their currencies, sterling held on non-resident account became fully convertible into any currency from 29th December 1958.

Supplementing the E.E.A.'s resources

It was noted earlier that once convertibility was established in an international system of fixed exchange rates national reserves would need to be sufficient to deal with speculative movements of funds, as well as balance of payments losses. The United Kingdom whose short-term liabilities, greatly enlarged by wartime expenditure, were far in excess of the foreign exchange resources held by the E.E.A. – as may be seen from Table B at the end – was particularly vulnerable.

Like many other countries, the United Kingdom has drawn on the I.M.F. to supplement her reserves in times of temporary balance of payments difficulties. The first drawings, in 1947, followed the unsuccessful attempt to make sterling convertible; the next occasion, in 1956, was at the time of the Suez crisis; and the third was in August 1961, when a protracted balance of payments deficit and an outflow of short-term funds had brought sterling under heavy pressure. By the early 1960's, however, it was becoming apparent that the United Kingdom's drawing rights on the Fund alone were inadequate to ride out a major crisis of confidence in the pound resulting from a heavy and persistent balance of payments deficit. Since then, the need for additional resources has been met through the establishment of various short-term credit arrangements between the Bank of England and other central banks. The first such arrangements were made in March 1961. An outstanding example of central bank assistance is the reciprocal swap facility with the Federal Reserve Bank of New York; this was first established for an amount of $50 million in May 1962 and, after several increases, is now available for a total of $2,000 million.

When sterling came under heavy pressure in 1964, the Bank of England had immediate access to short-term facilities with other central banks totalling $1,000 million, with which to augment the gold and dollar reserves held by the E.E.A.; during 24th and 25th November 1964 additional assistance, mainly short-term, was assembled with the help of overseas monetary authorities to bring the total up to $3,000 million. On several occasions since that time comparable credits of varying amounts have been made available to the United Kingdom by central banks, generally acting in concert.

Drawings under central bank facilities – in the arrangement of which the Bank for International Settlements at Basle has played a prominent part – have been of the greatest importance in supporting sterling in the recurring periods of intense pressure over the last four years – a task which would have been quite beyond the unaided resources of the E.E.A. During part of this period the E.E.A.'s operations to support the exchange rate and to protect the reserves were widened, as in 1938, to include intervention on a substantial scale in the forward market.

The E.E.A. and domestic credit

When the E.E.A. was set up, the view was widely held that the Account would help to moderate some of the effects of inflows and outflows of foreign funds. It would do this – in conjunction with official operations in Treasury bills – more or less automatically by transferring the impact of the flows from the cash reserves of the banks to their Treasury bill holdings.

The mechanism through which external flows impinge on the economy is now recognised to be very complex.[1] Also, since the 1930's markets in London have become much more varied and sophisticated: whereas foreign funds seeking a haven in London in 1932 might have naturally turned to British government securities, there are now many other possibilities open to the foreign investor. Moreover, one of the assumptions which is now implicit in official policy is that it is the total liquid assets[2] of the principal deposit banks and not their cash alone, which influences their ability to lend to the private sector.

Given the way in which the authorities respond to an inflow or outflow, the effect on bank liquidity depends to a large extent on the assets into which, or out of which, funds are moving and on who holds those assets. As described earlier, an inflow of exchange resulting from, say, a trade surplus will cause the authorities to issue or sell more Treasury bills (or other government debt) to pay for the foreign currency that they are offered – for the Government's own cash balance is minimal. The overall effect on the banks' cash reserves is likely to be small, but the effect on their liquid assets (and their deposits) will depend on who takes up the additional government debt and what form it takes. To the extent that there is no additional demand from outside the banks, the Government will have to borrow more from the banking system. If the additional government debt taken up by the banks is in the form of Treasury bills, the total of the banks' liquid assets and their liquidity ratio will be larger than before the inflow. Subject to official credit restraints, the banks could then expand their lending to the private sector or to local authorities. On the other hand the Government may cover their need for additional finance in whole or in part from outside the banking system. If the whole requirement is met in this way, the rise in both deposits and the banks' liquid assets which the inflow would initially have caused will be offset, and accordingly no scope for the expansion of credit will be provided.

In the case of an outflow of funds, the sequence of events outlined above is reversed; the Government's need for finance is reduced, and to the extent that their repayment of domestic borrowing leaves the banks with a lowered liquidity ratio, the ability of the latter to provide domestic credit will be reduced. Nevertheless, both for inflows and outflows, a complete description of the effects on the domestic economy would have to cover a much wider field than is the concern of this article.

Flows of exchange also take place independently of the underlying balance of trade and payments, though movements of short-term funds – particularly those of overseas residents – will clearly be influenced by it. In assessing the

1 See, for example, the article "Inflows and outflows of foreign funds" in the June 1962 *Bulletin*, which examines some of the effects that flows of private short-term capital may have on banks and others in the United Kingdom.
2 Cash, money at call and short notice, Treasury bills and commercial bills.

effect on bank liquidity of such flows, what matters – so far as the banks' response in expanding or contracting domestic credit is concerned – is again the ultimate effect on the demand for government debt from outside the banking system. If the demand for government debt from outside the banks rises by the extent of an inflow (or falls by the extent of an outflow) then the flow, together with the change in the Government's financing requirement, will have no direct effect on the liquidity of the banking system. This would be the case, for example, if an overseas resident bought sterling from the E.E.A. and invested it in British government securities; the Government would in effect be borrowing the amount of the inflow to finance the E.E.A.'s purchase of exchange, so the inflow would be self-financing for the Government and would leave the banks' position unchanged.

If the overseas resident did not invest in British government securities but in some other type of asset – for example bank deposits or local authority debt – bank liquidity would increase in the first instance. However this itself would be likely to have consequences either through the displacement of other funds or through its effect on the banks. What is relevant here is the extent to which, when the chain of consequences is completed, a larger holding of government debt is in the hands of investors outside the banking system. Only if the demand from outside the banks for government debt was unaffected by the capital flow would the initial impact on bank liquidity remain unaltered.

Summary and conclusion

The original function of the E.E.A., of checking undue fluctuations in the exchange value of sterling, was later extended to include the conservation or disposition in the national interest of the means of making payments abroad. Since the war the E.E.A. has operated in an international system of fixed exchange rates, and fluctuations in the exchange value of sterling have had to be confined within quite narrow limits. Because the E.E.A. has never managed in the post-war period to accumulate sufficient foreign exchange resources to cope with the United Kingdom's much enlarged short-term external liabilities, the burden of financing fluctuations in the trade account and countering capital flows has in recent years fallen more and more on international credit facilities.

The functioning of the E.E.A. mechanism and consequent changes in the Government's borrowing requirement help to moderate the impact of an inflow or outflow of foreign exchange on the banks' capacity to lend. The extent to which they do so, however, depends on how far the change in the borrowing requirement is met, directly or indirectly, from outside the banking system.

Table A
Official gold reserves 1932-39

£ millions

	Transfers of gold between the E.E.A. and the Issue Department (sales by the E.E.A. −)	Gold holdings[a]		
		Exchange Equalisation Account	Issue Department	Total
1932 2nd qtr.		15	184	199
3rd ,,		30	196	226
4th ,,		32	174	206
1933 1st qtr.	− 65	68	246	314
2nd ,,	− 15	86	275	361
3rd ,,		41	299	340
4th ,,		88	284	372
1934 1st qtr.		116	305	421
2nd ,,		117	311	428
3rd ,,		90	319	409
4th ,,		96	319	415
1935 1st qtr.		102	329	431
2nd ,,		139	321	460
3rd ,,		175	322	497
4th ,,		161	332	493
1936 1st qtr.		198	333	531
2nd ,,	− 15	260	360	620
3rd ,,	− 35	245	411	656
4th ,,	−110	180	523	703
1937 1st qtr.		190	525	715
2nd ,,	− 20	252	540	792
3rd ,,		280	541	821
4th ,,		289	536	825
1938 1st qtr.		298	538	836
2nd ,,		254	541	795
3rd ,,		156	554	710
4th ,,		40	575	615
1939 1st qtr.	+350	368	226	594
2nd ,,		316	226	542
3rd ,,	+280	463	—	463
4th ,,		491	—	491

a End of period shown.
— nil or less than ½.

For explanatory notes see page 390.

Table B

U.K. official reserves and net external liabilities in sterling, 1932-67[a]

£ millions

End of:	Official gold and currency reserves			Net external liabilities in sterling	*Official reserves as a percentage of net external sterling liabilities*
	Gold	Currency	Total		
1932	206	37	243	468	*53*
1933	372	—	372	538	*69*
1934	415	—	415	580	*72*
1935	493	—	493	600	*82*
1936	703	—	703	721	*98*
1937	825	—	825	808	*102*
1938	615	—	615	598	*103*
1939	491	54	545	517	*105*
1940	70	38	108	680	*16*
1941	126	15	141	1,170 - - - - - 1,272	*12* *11*
1942	192	62	254	1,642	*15*
1943	252	205	457	2,350	*19*
1944	422	179	601	3,015	*20*
1945	489	121	610	3,688 - - - - - 3,567	*17* *17*
1946	598	66	664	3,636	*18*
1947	494	18	512	3,856	*13*
1948	396	61	457	3,497	*13*
1949	472	131	603	3,669	*16*
1950	1,022	156	1,178	3,989	*30*
1951	776	58	834	4,031	*21*
1952	529	130	659	3,716	*18*
1953	808	91	899	3,935	*23*
1954	903	83	986	4,077	*24*
1955	719	38	757	3,944	*19*
1956	633	166	799	3,965	*20*
1957	555	257	812	3,771	*22*
1958	1,003	93	1,096	3,846	*28*
1959	898	79	977	4,078	*24*
1960	1,000	154	1,154	4,324	*27*
1961	810	375	1,185	4,342	*27*
1962	922	80	1,002	3,940 - - - - - 3,769	*27* 25
1963	887	62	949	3,889	*24*
1964	763	64	827	4,296	*19*
1965	809	264	1,073	4,856	*22*
1966	693	414	1,107	5,149	*21*
1967	538	585	1,123	5,346	*21*

a For explanatory notes see page 390.
— nil or less than ½.
- - - figures above and below are not strictly comparable.

Tables A and B: sources and notes

Official gold and convertible currency reserves

Sources

Apart from the breakdown between gold and currency for the period 1940-54, the figures are extracted from White Papers "Reserves and Liabilities 1931-45" and "United Kingdom Balance of Payments 1946-50" (Cmd. 8354 and Cmd. 8201 respectively) and the statistical annex to the *Bulletin* (for 1951 onwards).

Notes

Gold

Holdings are valued at the dates shown as follows:

Until 1939 2nd qtr.; market price

3rd qtr. 1939 – 1944; 168*s*. per fine ounce

1945 – 1948; 172*s*. 3*d*. per fine ounce

1949 – 1966; 250*s*. per fine ounce

1967; 291*s*. 8*d*. per fine ounce

Currency

Values are at the prevailing fixed or par rates of exchange. Holdings of the E.E.A. were negligible during most of the period to 1939, though holdings rose to about £40 million during the first year of operation of the Account, declining to an insignificant amount by the end of 1933. During the first half of 1939 there was another increase, to about £25 million by the middle of the year.

Net external liabilities in sterling

Sources

For the period up to 1945 the sources are Cmd. 8354 and Cmd. 8201. For the post-war period: "U.K. external liabilities and claims in sterling: 1945-62 (old series)" published by the Bank in May 1968; and from 1962 the new series in the annex. For a description of the contents of these two series and the differences between them, see the article in the June 1963 *Bulletin*.

Notes

a Up to 1941 the figures show net liabilities whether expressed in sterling or in foreign currencies; thereafter only net sterling liabilities are shown. For further notes on coverage up to 1945, see Cmd. 8354.

b Figures for 1964 onwards include the sterling counterpart of drawings by the United Kingdom under central bank swap facilities. (Assistance received in this way and in the form of currency loans and deposits increases the official gold and convertible currency reserves.)