APPENDIX I

THE EXCHANGE EQUALISATION ACCOUNT

The United Kingdom's reserves of gold and foreign exchange had been depleted before the country was driven off gold and by the subsequent repayment of the credits. The first objective of the E.E.A. was to build up these reserves again, originally with a view to an eventual return to gold in some form. (From 1933 onwards the vague aspirations of a return to a stable sterling exchange based on gold were dissipated by the course of events, but no definite alternative emerged to fill the gap.)

The level of sterling would be determined by the Balance of Payments; a satisfactory Balance having been reached the corresponding level of sterling would be accepted. Thereafter tactics would aim at the maximum increase in or maintenance of reserves consistent with the minimum disturbance to the value of sterling.

The political events in Germany, France and U.S.A., etc., from 1933 onwards caused speculative movements of capital which the Control had to struggle with as best it could. These at first drove sterling too high (to over $5) but gave the U.K. big reserves; these were largely dissipated during the period September 1938 to September 1939, while the pound fell - though not to a figure below that which might eventually prove appropriate.

The vague terms of the E.E.A.Act were not inconsistent with the objective pursued (or with almost any objective), and the repeated assertions by Government spokesmen that the Fund would not be used to oppose a major trend in the exchange value of the pound were also consonant with events, with the possible exception of the pegging of the exchange from January to August 1938, for which fear of war was responsible.

The activities of the E.E.A. from its inception in June 1932 until 1939 fall into four marked phases.

1. The "Dollar" Phase from 1932 until the suspension of the Gold Standard by the U.S.A. in March 1933. During this phase the Fund's transactions were mainly in dollars. At the beginning of the Account the dollar/sterling rate was 3.61, and between then and March 1933 its range was 3.69 3/8 to 3.17 (about 16½%).

The most important periods during this phase were:-

July - December 1932, when sterling was subject to pressure on account of British War Debt payments to America. The E.E.A. endeavoured to support the pound, but owing to lack of devisen and gold* it was forced to abandon the attempt. The dollar/sterling rate fell to its lowest point of 3.14½ on 29th November 1932 before recovery set in.

December 1932 - April 1933. Conditions changed and the E.E.A. was called upon to acquire such large amounts of foreign exchange and gold that the Fund's sterling assetsØ had to be increased by £200 million in May 1933.

2. The "Franc" Phase from March 1933 until the devaluation of the franc in September 1936, the breakdown of the gold bloc and the conclusion of the "Tripartite Agreement". On 5th March 1933 the U.S.A. placed an embargo on the export of gold. The E.E.A. could not deal in dollars so that control transactions were diverted into francs.

The outstanding dates in this phase were:-

February 1934. America re-linked the dollar to gold at $35 per fine ounce; but since gold could only be exported to gold standard countries the E.E.A. could not operate in dollars.

September 1936. On 25th September the "Tripartite Currency Agreement" was evolved.

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*Holdings at cost 31st October 1932: Devisen £7.6 million; Gold £19.0 million

ØSterling Assets on 30th April 1933 £28.2 million.

Towards the end of this phase, as in the latter part of the first phase, sterling was in demand: thus, whereas in the first phase gold came from the U.S.A., now it came from France and, to a lesser extent, from Belgium, Holland and Switzerland.

3. The "Tripartite Agreement" Phase from September 1936 to the renewal of confidence in the franc in May 1938. Under the protocol America, France and Britain each agreed to make gold available to the Controls of the other countries. The U.S.dollar was consequently once more available for E.E.A. operations. Belgium at once and, on 23rd November, Holland and Switzerland came into line. The E.E.A. then operated in several currencies. The other parties could also operate in London, and did so through the Bank of England, so that from this time transactions of the E.E.A. became less easily identifiable by the Market.

The periods of greatest activity were concerned with two "gold scares" and two devaluations of the franc: in September 1936, when the franc was devalued from 75 to 105 francs to the £ and held until March 1937 (when the franc began to move away from 105 to higher figures); and May 1938, when the franc was pegged at 179, following which confidence in the franc returned. For a week or so in May during which time about £120 million French capital returned to France, the bulk of the Control activity was in the Gold Market rather than the Exchange Market*.

The gold scares were in April and June 1937, when fears were entertained as to possible action by the U.S.Treasury.

*The Control normally sold gold to the Market at all times as well as operating in exchange. The sterling/dollar rate could, of course, be influenced by sales of gold at prices which would leave arbitragers a profit on export.

4. The "War Scare" Phase. This began with the Munich crisis and culminated with the outbreak of war. The critical periods were -

Munich Crisis - 1st August to 28th September 1938;

Czech Crisis (German occupation of Prague) - 14th to 22nd March 1939;

August 1939.

In all four phases the E.E.A. converted into gold automatically and at once all or nearly all the foreign currencies purchased.

It is outside the scope of the present History to trace the activities of the Exchange Equalisation Account from its inception to the outbreak of war in September 1939†. The last phase, however, is relevant and indeed the whole period from 1st January 1938. It was in January that the Bank came to believe that war was inevitable; and it was also then that the reserves of the E.E.A. reached their peak, while about the same time the sterling/dollar rate touched its high point. These events prompted Sir Henry Clay∅ to write a long 5.1. and 18.1.38 in S.174 (copies C.P.130.2) memorandum on the relationship of the Exchange Fund to the Bank, from which it is of interest to give some extracts, though it does not necessarily represent the views of the Bank, not apparently formulated at this juncture. Sir Henry Clay's conclusions (given in full) were not much different from those of Professor Rist, who in the annual Revue d'Economie Politique for 1937* (and again nearly a year later in the November/December 1938 number) criticised the E.E.A. for hoarding gold to the detriment of other countries and their price levels.

Sir Henry Clay thought that there would be a great advantage in bringing the Bank's and the Exchange Equalisation Account's combined position before the public in a rearrangement which should make the published figures correspond with actualities, and that there would be an additional advantage in the severance of the amount of the note issue from gold holdings and from a fixed price for gold in an amalgamation of the Issue and Banking Departments.

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†A few tables, however, are appended to this Section.
∅Then Mr.Clay (created Knight 1946).
*According to Leonard Waight's book on the E.E.A., p.133.

The gold reserves of the U.K., Exchange Fund and Bank together, had increased as follows -

(Millions of fine ounces)

1933	1934	1935	1936	1937
25	Nil	11	29	27

and at the moment of writing he anticipated a further continued influx in 1938 of perhaps £100 million. No rearrangement of accounts would relieve the country of the necessity of dealing with such an influx either by the sale of securities or by allowing it to increase the Cash Base. The influx might be reduced, however, by a removal of the embargo on foreign lending, the resumption of War Debt payments to America, a checking of the movement of foreign short funds to London, and a request to Sterling Area countries to hold gold instead of sterling in their banking reserves. His general conclusions may be given in full -

"The E.E.A. cannot be wound up until a new equilibrium between gold production and absorption of gold is established, i.e. until current production (after allowing for use in the arts and hoarding) can be absorbed in normal monetary reserves. This new equilibrium can be established (if at all) in only two ways - either A. by restoring the status quo ante 1932, or B. by going forward and allowing new gold production to have its normal monetary effect in a higher price and cost level.

A. The E.E.A. was a stop-gap and transient device which assumed the restoration of the status quo. But it was operated in such a way as not to prevent an increase in the price and an increase in the output of gold, so that it was forced to absorb and sterilise large quantities of gold.*

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*The E.E.A. had been criticised for its alleged deflationary effects prior to the collapse of the gold bloc in September 1936. Sterilisation of gold movements in and out was, however, automatic. Responsibility for contracting or increasing the Cash Base was not the responsibility of the E.E.A. but of the Bank of England.. The Fund was insulated from the Bank in this respect.

N.B. This footnote is not part of Sir Henry Clay's memorandum.

A reduction in the price of gold would, given time, check production and would immediately reduce the monetary value of excessive gold holdings.

There are two grave objections and a number of practical difficulties in the way of this course.

It would risk precipitating a world depression. Recovery is so closely associated in people's minds with the rise in the price of gold, and recovery was so much assisted by the expansion of gold mining (which in turn is an important investment interest) that a reduction in the price of gold would be taken as a deliberate deflationary policy, and would lead, however irrationally, to a collapse in stock and commodity prices. A mere rumour had this effect in the Spring of 1937.≠ Blame for any such recession would be concentrated on the Bank.

The other objection is that it involves an even more serious risk, the risk of destroying once for all the value of gold. This value is based on pure convention, which has been sustained through all the recent disturbances by the fact that gold has never let its holders down. If now, as a result of deliberate political action, gold holders suffer a sudden and unexpected loss of a quarter or a third of their capital, faith in gold may be irremediably shaken. Last spring's rumour enforced this danger also, since it led one Central Bank to turn all its gold into dollars and led private holders to realise £70 million of hoarded gold in London.

The practical difficulties are -

(1) it involves reducing value of existing stocks, and not merely of new production. Having told Parliament that they have bought £815 million of gold, H.M.G. would have to tell Parliament that it was worth only 600 or 550. (They would probably put the blame on their advisers, the Bank):

≠The large flow of gold to the U.S.A. gave rise to a rumour that America was considering the lowering of the price to discourage a further influx. This was denied, but not at once. The gold scare was in part removed by the increase on 28th June of the E.E.A.'s borrowing powers by £200 million.
N.B. This footnote is not part of Sir Henry Clay's memorandum.

(2) the American Treasury are even less likely to face the unpopularity involved, and their action is more important than ours because, having a fixed price, they determine the world price: (Morgenthau and Sir Frederick Phillips of H.M.T. agreed last September that they did not wish to reduce the price):

(3) the Swiss, Dutch, Belgians, Swedes and others might dump their gold on us, so that we had to absorb more at 90/- or 100/- than at 140/-:

(4) there would be no immediate reduction in output. Gold production, like any other large-scale industry, can keep costs down only by maintaining a large output. The whole of the present output of the Ran could be produced at 85/-, without loss though without interest or profit. Once a shaft is sunk and equipped, actual costs of mining and crushing are covered by much less than 80/- an ounce.

B. The monetary effects of allowing new gold into the credit base have been examined.

(1) It involves the holding of larger Cash Reserves by the Central Bank and the Commercial Banks in U.S.A. and U.K.; and the holding of gold instead of sterling and dollar reserves by the Central Banks of smaller countries. All this would make for increased confidence and stability, as contrasted with the '20s when reserves in most countries were dangerously inadequate:

(2) This country and the world require progressively more money, as the variety and volume of wealth, production and exchange increase:

(3) A higher price level - at least as high as that of 1924 - is needed to balance the £6,000 million of debt incurred at or above that level; to permit industries like steel, shipping and cotton-spinning, wheat, cotton, wool, maize, tea and rubber growing to earn profits on which they can live; and to sustain the present volume of taxation:

(4) A rise in the price level, by increasing costs, would check gold-production, gradually and without shock. If that reduction were not sufficient, the Governments of U.K. and U.S.A. could still let the gold-producers know that they did not intend to sterilise any more new gold, or to absorb more than a stated amount per annum in their monetary reserves.

Note: (a) If it is feared that a sudden increase in the Credit Base would provoke dangerous developments, it would be possible to segregate the increase in a suspense account, distinct from other Public Deposits, to be drawn on only as and when a falling-off in business activity made it desirable for the Government to expand its employment-providing activity and to allow Bankers' Balances to increase - a sort of Industrial Equalisation Account:

(b) Hitherto there has been little popular or political criticism of the accumulation of gold, because there is a confused idea that gold is money and therefore costs nothing. Already in America it is beginning to be realised that gold acquisition costs as much as any other purchase, and that its acquisition in excess of monetary requirements is a waste of capital. This truth will some day dawn on Parliament, and cause a political disturbance if nothing has been done to stop the accumulation."

Until the beginning of 1938, the E.E.A. continued, on balance, to gain gold. The peak of its gains was reached in mid-January 1938, when a net total of nearly £500 millions had been taken up by the Account since its inception. Half this total could be accounted for by receipts of gold from the Bank of France in the fifteen months following upon the Tripartite Agreement.

The favourable trend had clearly been reversed before the French devaluation in May 1938 caused a sharp fall which left the Account with £50 millions less gold at the end of June than at the beginning of January. The annexation of Austria in March had produced no perceptible effects, but from the summer of 1938 onwards it became apparent that international politics were the dominant influence on the exchanges, and on sterling in particular. The autumn crisis caused a net loss of over £100 millions during the third quarter of the year. And by this time the losses of the French had been stemmed, despite the crisis. From now onwards, the French were to be a source of steady loss instead of gain. In the meantime the dollar rate had been dropped from 5.02 by 20 cents during the first seven months of the year, and by a further 20 cents during the August-September crisis.

The last quarter of 1938 reduced the remaining gold of the E.E.A. from over £150 to less than £40 millions and brought the losses for the year 1938 to a total of more than £250 millions - or half the nett gains of the previous six years. After a technical squeeze, the running off of forward sales, had been successfully applied in December, a series of restrictive measures was introduced in the early days of 1939 and voluntarily enforced by the discipline of the market. The Account was, at the same time, replenished by a massive transfer of gold from Issue. The dollar rate was maintained, and had to be more and more rigidly pegged, at a little above the level touched during the autumn crisis.

The position looked much more satisfactory during the first quarter of 1939. Temporary gains from Belgium and Holland compensated for the loss of gold to France, which had now become continuous; and by March 11th the E.E.A. had actually gained a few millions of gold on balance since the beginning of the year, though about £20 million had been lost to America. But with the invasion of Czechoslovakia on 15th March the position was suddenly reversed. The E.E.A. began to lose gold uninterruptedly. In the four months to 1st August net losses amount to £75 million. If comparison is made with the 1st January total net sales of gold amounting to £110 million were practically accounted for by the loss of £103 million to the Federal Reserve Bank.

Various financial and economic factors contributed to this result. But gold hoarding was not one of them; on the contrary, some £75-85 million of gold were dishoarded in London from the beginning of 1939. The visible balance of trade shifted to the disadvantage of the U.K. and political fears reduced the tourist traffic. But whereas all the familiar economic elements were present, their traceable variations were in most cases not significant in comparison with the movements in the E.E.A. figures. The big items - such as gold dishoarding or the withdrawal of foreign balances, over £100 million since August 1938 - were the result not of economic pressure but of initiatives and decisions prompted almost exclusively by international politics. Sterling became weak because the relative strength of the U.K. - compounded of ability and will - was more and more distrusted.

Faced with this position the Bank had recourse to tactical rearguard actions. The pegging of sterling, which they had always opposed in principle, was excusable because of the state of increasing weakness and the existence of what nearly amounted to a state of war.

A more detailed account of the year and eight months from 1stJanuary 1938 follows.

1938 - 1st Quarter

The chief disturbance in the first quarter was the annexation of Austria by Germany on 12th February. This made Europe look a bad risk and sterling dropped to a level at which exports of gold were profitable. Before this, gains had been made up to the middle of January, and since November 1937, when there had been a rumour that an increase in the price of gold was contemplated by the U.S.A., there had been a movement out of dollars into gold. The premium on gold in London indeed had risen at one time to the point at which arbitrage shipments from the U.S.A. became profitable, and the premium in London over dollar parity persisted up to the time of the invasion of Austria.

Both influences probably were responsible for an increase in hoarding in London, which was estimated to have risen during the quarter by £25 million or by twice as much as in the 'gold scare' of 1937, and to have reached a total of about £120 million.

Net receipts for the quarter were £7 million only. £58 million or more than half the total purchases came from France. For a long time previously the influence of transactions with the French had been predominant, their losses and the E.E.A. gains amounting to much the same figure. But from the fall of the Chautemps government in mid-January, while the French continued to lose gold, the Exchange Account was selling to Holland and Switzerland nearly as much as it received from France.

Not only was there a premium on gold but an additional special premium on gold coins, a matter which gave rise to some discussion, and eventually to action on the part of the Bank. (This subject is dealt with in the chapter on "Gold-Distribution").

Advances against gold, which since the establishment of the E.E.A. the banks had been asked to discontinue, were still being discouraged but the banks were now given some latitude and on 19th April the embargo was removed altogether. It had been found to be inequitable in application and it was thought that the reasons put forward by the Treasury (L.9.6.32) were no longer operative. Events were to cause the reimposition of the embargo after the Munich crisis.

From the Spring of 1938 the Bank were drafting general financial and trade requirements in the event of war. A comprehensive memorandum dated March/April 1938 (F.E.221 Vol.1) advocates a large number of war measures, many of which were subsequently adopted. This already includes the recommendation that all foreign accounts in sterling should be blocked on the outbreak of war, with the proviso that partial or complete release of foreign or allied balances might thereafter become possible in certain conditions.

1938 - 2nd Quarter

Until the French devaluation the position of the Exchange Account was fairly well maintained.

The Tripartite Agreement had been interpreted favourably to France, as was only reasonable since she was undergoing a process of natural readjustment. The Agreement, however, pledged its members to maintain "the greatest possible equilibrium in the system of international exchanges". Moreover, there did not seem to be any grounds for thinking that the franc needed any further depreciation. Indeed it seemed under-valued at 167 to the £, the lowest point reached before it was arbitrarily moved to 179 on 5th May under the Daladier government. The Chancellor of the Exchequer, the Bank, and the U.S.Treasury had been assured that no higher figure than 175 was under consideration. The French action was, however, taken with an idea of subsequently improving the rate, and indeed some indication of this seems to have reached the market, for not only was the bear position closed, but a bull position ensued. The amount repatriated is variously estimated by the Bank at £75 million and $75 million and by others at £120 million in all; but the influx was exhausted in the short space of about 10 days, and it was thought that genuine refugee capital had not been tempted home. It was professional money that was repatriated and this was the first large-scale opportunity for speculators since the Tripartite Agreement.

This disturbance was a danger to other currencies and Belgas and Swiss francs became weak. The Belgian authorities took adequate measures, but the Exchange Account gained £29 million from Belgium in May.

The net reduction in the E.E.A. reserves for the quarter was £45 million (loss to France £70 million), with the result that at the end of June about the same amount of gold was held as a year earlier.

The premium on gold coin was reduced, but did not vanish. The Bank's operations were handicapped by the supposed need to make the process look natural: they therefore sold coin gradually and for the account of clients only.

1938 - 3rd Quarter

The Munich pact, which temporarily removed the fear of immediate war, caused big movements of capital during August and September, and the Exchange Account lost £94½ million gold in the three months, or including forward dealings £117 million of reserves. Nearly £30 million gold was lost in one week to 17th September. Net gold losses were £5½ million in July, £26 million in August and £63 million in September. It was possible that some of the loss in July and August was due to a feeling that sterling was over-valued. American prices in 1937 and 1938 had fallen more than British, and the U.K. Balance of Payments had become increasingly adverse. In part, too, the drain may also have been due to another rumour that the price of gold was going to be raised by the chief parties to the Tripartite Agreement.

There were also, in August, fears of a further devaluation of the franc from 179 or the imposition of exchange control. The troubles of the French arose partly, in their view, from the weakness of the £. They asked the U.K. for help and M. Daladier talked of stabilisation. Neither the British nor the American Government had sufficient confidence in France to buy and hold francs. The U.S.Treasury, indeed, thought of supporting the forward market, but do not appear to have done so. The Bank of England thought that such a course would only assist speculation.

The sterling/dollar rate which had been above the old gold parity of $4.86 almost uninterruptedly from November 1933 fell below it in the third week of August to $4.82, and on the morning of 28th September dropped to the low point of $4.61. On an average during the six weeks to 10th September the rate passed from a level definitely above to one definitely below the old par. It was suggested that the Control had taken little advantage of the psychological advantage of this rate, but in the critical week ending 23rd September, when $4.86 was passed, intervention by the Exchange Account was three times as great as the average of intervention in the previous four weeks.

In the two years from September 1936 to September 1938, under the Tripartite Agreement, the Exchange Account received £286 million from the French and lost £243 million to other countries, but in the crisis months of August/September 1938 it received £67 million, of which £48 million came from France and again was balanced by sales. The net loss was nearly all caused by sales to the Federal Reserve Bank. Gold holdings after Munich had dropped to £160 million.

Hoarding stopped about the middle of August: estimated London stocks had then reached £200 million, or an increase of £135 million on the year. In the next few weeks there was some dis-hoarding to acquire dollars and perhaps partly from fear that gold would be requisitioned if war broke out. The price of gold at the end of September touched 147/- per fine ounce, but by then had no relation to arbitrage parities owing to the cancellation of war risk insurance which stopped exports.

1938 October to 1939 April

Although sterling recovered a little from the low point touched just before Munich, losses of gold continued for some time without interruption and almost without diminution. They amounted to about the same in the last quarter as in the 3rd quarter of 1938. The expectation abroad that the British would have to accelerate their rearmament programme and that the Anglo-American Trade Treaty might involve a lower rate for sterling are said to have increased the demand for dollars: £68.7 million gold went to the Federal Reserve Bank in the last quarter of 1938. Much of the remaining loss in the same period was to France, where the advent of M. Reynaud as Prime Minister had restored confidence. He made no change in the franc rate; which, however, firmed up a little from 179 to about 177 at the end of the year.

The French had suffered big losses of gold in the course of the two years and three months from the date of the Tripartite Agreement to the end of 1938, and in the same period the franc had lost 42% of its value. After each of four recoveries lasting a few weeks some £20-40 million had returned to France. The movement in May 1938, however, had been much stronger, and the Reynaud Government also produced in the last two months of 1938 an efflux from the Exchange Equalisation Account of £53 million.

After the Munich crisis the Bank desired to put various war measures partly into force as a precaution, but by the middle of November it was clear that nothing much would be done. (See Minutes of Committee of Treasury, November and December).

This left the Exchange Fund to fight a rearguard action. From the beginning of May to the middle of November the sterling/dollar rate had fallen 23.7 cents and the reserves of the Fund had dropped by £226 million, or a loss of about £10 million for each cent fall in the rate. If it was not to be merely a rearguard action the initiative would have to be recovered.

The Tripartite Agreement seemed to require that the Bank should not withdraw from the market (which would cause abrupt movements); besides which, the Fund had the primary obligation to maintain a wide and orderly exchange market in London. To use up reserves at any constant rate as the exchange fell would only encourage a flight from sterling. The drain would not be corrected by a fall in the rate, nor exhaust itself, because the fall by its persistence would create new fears which would cause losses to continue. It seemed impossible to peg the exchange, since the right rate to defend could not be chosen with any confidence, and such a course would involve supporting action of various kinds, including credit restriction, etc.; measures which would be politically difficult or impossible.

There was, however, one additional measure which the Bank had decided to try (on or shortly after 13th October). They began to sell dollars forward. This would reduce the forward premium while protecting the spot rate, and the Bank hoped that their action would be regarded as a mark of confidence at home and a welcome sign in foreign markets that the Bank still possessed initiative. In a few weeks the Bank built up a considerable position in forward sales, and this stood them in good stead at the end of November.

For, in the middle of November, the decision to increase the fiduciary issue in December without making any transfer of gold from the Issue Department made it necessary to gain time for the Exchange Account over the turn of the year. The

Bank had about £25 million of forward dollar sales maturing in December, which they could run off by delivering gold to the Federal Reserve Bank. If they could secure the agreement of the seven or eight principal banks to use none of their own funds in the forward market, the Bank could force up the forward premium on dollars to a level representing a substantial negative rate of interest in New York. This would reduce the existing forward position as a result of forced covering and prevent new speculation except on the part of those prepared to pay a much higher price on the chance of a much more substantial fall in the rate.

December was an ideal time for this manoeuvre in view of the end of year window-dressing. The total short position was estimated to amount to some £70-80 million in exchange and £30 million in advances against gold. In the last days of November* the scbeme was agreed with the U.S.Treasury, explained to the selected banks, accepted and put into immediate operation. In the last week of September the sterling/dollar rate averaged 4.73½, but after some slight improvement to mid-November declined to about 4.65½ in the last week of the year. The plan put into effect by the banks enabled this rate to be held or slightly improved.

The measures taken at the end of November were only intended to provide a breathing space. During December much discussion took place as to what the next step should be. One had already been envisaged. A transfer of gold from the Issue Department to the Fund would clearly be necessary and was originally intended to amount to £60 million (reversing a previous operation of like amount). At the end of the year, however, the Treasury proposed to revalue the gold in the Issue Department and this was done by the Currency and Bank Notes Act of 28th February 1939. In anticipation, £200 million

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*H.M.Treasury were advised on 24th November. See letter from the Governor to Sir Richard Hopkins.

gold was transferred at par on 6th January, at a time when the gold and exchange holdings of the Fund had fallen to about £20 million. When revalued this transfer strengthened the Account by about £350 million.

Advances against gold had again been stopped at the end of November, and a decision to continue this policy was reached with the banks on 5th January*. There was also some tightening up on capital issues following a loss of £6 million to the Fund arising from a Woolworth issue in the U.S.A.

At the B.I.S. in January warnings were repeated by the Belgians, Swiss and Dutch that a further depreciation of sterling would be likely to lead to a depreciation of their currencies also.† In fact, the average mean weekly quotations for the sterling/dollar rate were steady, varying from 4.65½ in the first week of January to 4.68 21 in the week ended 1st April.ø

Net losses were less than £12 million, or allowing for forward dealings £19 million. Gold lost to France was balanced by gains from Belgium, and to the market by gains from Holland. Turnover was about the same as in the 1st quarter of 1938 - not very active.

In the first half of January further measures were taken in the shape of an embargo on forward gold dealings and on speculative exchange transactions: all sections of the market, including Insurance companies and the Stock Exchange, were notified. The general lines of procedure were drawn up by the Bankers' Foreign Exchange Committee and their authority as a regulating body was established.

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*On the receipt of a letter (2.1.39) from the Chancellor to the Governor.

†The Bank were, of course, well aware that a fall in the sterling/dollar rate would no longer have the effects which it had in 1932, when a large part of the world was linked by gold to the dollar and gold prices were forced down by the efforts of gold standard countries to compete with Sterling Area producers. Now the deflationary effects would be confined to the dollar area.

øOn daily rates the range was from 4.62 25 - 4.69 37.

At one time it looked as if speculative transactions might be transferred to other markets, but the co-operation of the Central Banks in France, Belgium, Holland and Switzerland had been enlisted, and the American Treasury offered to intervene if necessary. The reaction in London was excellent, and it seemed that the market in forward sterling was so much concentrated that if London were kept under control the other centres were not likely to cause trouble. Even during the Czechoslovak crisis in March there was little sign of any recrudescence of speculation.

It may be that even before the invasion of Czechoslovakia the prospect of war, which had seemed likely ever since the previous September, had the effect of discouraging speculators. After the March crisis movements represented in the main a flight of capital. That flight had of course continued throughout the existence of the E.E.A. and had been the primary cause of the weakness of sterling through most of 1938, and similarly the main cause of U.K. gains in the previous years.

1939 - April-August

After the invasion of Czechoslovakia war seemed not far distant, and it was followed by further untoward events in rapid succession: the occupation of Memel by Germany on 22nd March, the invasion of Albania* by Italy on 7th April, Germany's denunciation of the naval agreement with Great Britain and of their Non-aggression pact with Poland on 28th April.

The trend became steadily instead of intermittently adverse to sterling, and the immobility of the market due to restrictions imposed in January became a state of semi-paralysis. With conscription introduced into the U.K., 26th April, there was a brief change for the better but on 3rd May Litvinov resigned his position as Russian Foreign Minister, and on 12th June the Japanese blockaded Tientsin. The estimated dollar turnover in London in the first three months averaged no more than about $50

*This led to a question concerning the acceptance of Italian names. The Treasury ruled that the Bank should be restrictive rather than expansive, a decision which led to a protest from the Banca Commerciale Italiana.

million a week, or about half the average in the same quarter of 1937 and 1938.

The Bank held the dollar at about 4.68, the extreme range of fluctuation during the second quarter being between 4.68.62 and 4.68.00. Losses in gold were high; in April £26.3 million, in May £11 million and in June £14 million, or £51.3 million in the three months. Losses to the French were continuous and in the nine months after the Munich Pact amounted to £83 million (£70?),of which, however, only £14 million occurred in the second quarter of 1939. In May and June Belgium recovered about £17 million of £28 million lost to the U.K. in the previous six or seven months. Holland, on the other hand, became a steady loser and contributed about £28 million (£22.3?) to the stocks of the E.E.A. during the four months to the 1st July.

A sharp diminution in hoarded gold in London provided some £70 million in the first six months of the year, and to that extent made the position appear more favourable. Nevertheless, the publication at the end of June of the Fund's position at the end of March came as a shock to the Market.

Movements of gold were on an unprecedented scale, exports to North America amounting to over £160 million* during the second quarter as compared with less than £100 million in the first.

The Bank felt they had no choice but to make a stand either at the rate level chosen, or at some other figure. Towards the end of 1938 there had been talk of adopting $4.50 (believed to be psychologically a good rate to defend), and a shift overnight to this rate, after warning France, Belgium and the U.S.A., was again considered towards the end of April. A Bank memorandum of 24th April gives reasons against this course. It would add about 4% to the cost of most imports without doing much to help exports; would probably produce a further flight of domestic capital; the Belgians, Dutch and Danes would be likely

*£190 million including gold held for Central Banks.

to peg their currencies to sterling at the new level; the Swedes might shift to the dollar and the French would probably maintain the gold value of the franc while moving their sterling rate to about 170. The rise in the price of gold would once again justify hoarding and stimulate gold production. The first results to the E.E.A. would probably be an increase in losses from about £10 to, say, £20 million a week with not much reason to hope that they would afterwards fall back below the former figure. At even £10 million a week the Fund could not hold out very long. There would be no convincing explanation to offer to the Americans. The conclusion was that any drastic change in the rate should be reserved for the outbreak of war.

In May the Governor drafted a letter to the Chancellor suggesting the diversion from the U.S.A. to the Balkans or the Argentine of a part of our tobacco and wheat purchases, a matter which seems to have been also debated at an earlier stage. After reviewing the movements of the Exchange Equalisation Account he continued:

> "So long as the present state of international political uncertainty persists, the possibilities of lessening the insistent demand for dollars are very limited, and in this regard let me say that a reduction in the rate by (say) 20 or 30 points would be likely to cause much disturbance on all sides, rather than any improvement in our fundamental position. This makes it all the more necessary to consider any means which might assist us to conserve our resources .....
>
> We ..... are using large amounts of sterling (£24,000,000 in 1938 for tobacco and wheat alone) in making indiscriminate purchases in dollars in America ... I do not of course suggest a wholesale diversion from America of wheat and tobacco purchases but in the present large total there does at any rate seem ample scope for some diversion ....."

The letter was not sent but the subject may have been discussed with the Treasury.

On 26th June another letter to the Treasury on the exchange situation was drafted, and this was talked over with Sir Richard Hopkins on 30th June. The Governor recorded that the Treasury -

(a) were "aware of impending difficulties over losses of gold and dollars";

(b) did not require from the Bank any more facts concerning the Exchange Equalisation Account;

(c) did not desire "a forecast as to how far down the E.E.A. would go by a certain date at present pace of loss".

The draft pointed out that in the previous three months the Account had incurred a net loss of £50 million; the only reliable source of gold was now South Africa; and the loss in the ensuing quarter might be nearer £80 million as the dishoarding of gold in London (£50-£60 million in the first six months of 1939) might have reached its natural limit.

In July there was a net loss of £29 million, but this included £20 million transferred to the Issue Department on the 12th. The big loss came in August, £71.8 million net, of which £65.4 million went in the week ended 24th Augustø, the date on which the Bank removed the peg from the sterling/dollar rate (at the close of business)/ and raised the Bank Rate to 4%*.

When support of the exchange ceased the sterling/dollar rate fell quickly from 4.68 to 4.38, but recovered and closed at about 4.48. On the next day, Friday, it opened at this rate and closed at 4.40 to 4.50. On Monday, 28th, it had fallen at 12.30 p.m. to 4.10-4.20, but opened on 29th at 4.28. On 30th it recovered a little but on 31st closed at about 4.30.

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*This was also the date of the Russo-German pact.

øNet loss 1st-24th August was £76.7 million net.

/The Bank informed the Dominions and India that H.M.G. had decided that the gold reserves of the U.K. and Empire must be conserved intact. "It is hoped that after a short period of transition the Market will re-establish itself .." No notice or explanation was issued at home.

On 1st September it opened at 4.-4.30 and at the time when the price of gold was fixed it was 4.21.

But on each day from 26th to 31st August the Exchange Fund gained a little gold, £6.2 million in all.

A memorandum of 9th August shows that the Bank were anxiously considering means of defence other than that of unpegging the rate; such as a control of exchange dealings, the restriction of imports and the subsidy of exports and, if hoarding should begin again, possibly the closing of the free market for gold in London.

On the day before the peg was removed another memorandum summed up the position. Although it would be impossible to allow losses to continue at the existing rate, it was to be remembered that sales did not all represent final losses. Continental speculation was again rampant, and a large amount of switches completed by a spot transaction to establish a short position would eventually have to be covered. If war broke out, requisitioning would restore much of the losses being incurred in this country, in Allied countries, and even in neutral countries to the extent that they were speculating.

But there was nothing to be said for continuing to peg the exchange. The choice lay between control, devaluation and depreciation. Control was not suitable except as a permanent arrangement (besides being scarcely compatible with the Tripartite Agreement); devaluation would imply that the Exchange Equalisation Account as a system had broken down and would commit the U.K. to staking its resources and reputation on the defence of the rate chosen: depreciation was the only course open, in spite of the fact that the imminence of war confused the issue between that and control. But as the date of the outbreak of war could not be predicted and some time might intervene, action could not be safely postponed.

On 27th June 1939 the gold and devisen resources of the Fund had been £274 million; by 29th August they were just under £103 million. From 16th to 21st August losses ranged from £5 to £8.7 million daily. On 22nd, 23rd and 24th they were £12.4, £14.6 and £16.4 million.

At the close of business on 2nd September the spot position of the E.E.A. (gold taken at 168/-d.per fine ounce, U.S.$ at 4.03 and Can.$ at 4.45) was £493,854,000 of which £479,039,000 was gold (including Issue Dept.)

U.K. gold exports to the U.S.A. from 1st October 1938 to 26th August 1939 were £459 million; from 1st January 1939 £349 million. In the longer period the Exchange Account's direct sales to the Federal Reserve Bank were £172 million.

The choice of $4.03 (middle rate) was apparently empirical. Various considerations influenced the Bank. As H.M.Government would be purchasers out of reserves, the rate would not affect essential imports; and non-essential imports should be discouraged. The rate might encourage exports, which would be desirable; and it would stimulate bears to cover. More generally it was felt that this would be a rate which could be held. It was near the rate, $4, at which it was said the £ should have been pegged in 1925 and it avoided that exact figure, which the Governor thought it would be advisable to do. [Mainly from conversation with Mr.Bolton. Mr.Hawker says it sounds all right to him. Mr.Bolton has passed it 27.7.45.]

EXCHANGE EQUALISATION ACCOUNT GOLD IN 1938

(Ignoring forward deals)

Net loss 262.4 £ millions @ 168/- per fine ounce

Receipts from:		Sales to:	
S.A.R.B.	74.5	Market	159.8
Bank of France	7.3	Federal Reserve Bank	173.5
U.S.S.R.	22.0	Holland	59.0
Argentine	20.0	Switzerland	24.9
Belgium	21.7	Rest of Europe	12.6
B.I.S.	10.3		
Canada	8.2		
Others	3.4		
	167.4		429.8

SECRET

PURCHASES AND SALES OF GOLD FROM 1ST JANUARY 1939 TO 31ST AUGUST 1939

In £ millions @ 168/- per fine ounce

PURCHASES

In London

From Issue Dept.	396.4	
S.A.R.B.	47.3	
De Nederlandsche Bank agst.$	35.8	
Banque Nationale de Belgique	19.0	
do. agst.$	13.6	
Bank of France	8.2	
B.I.S.	8.1	
Market	6.7	
Banque Nationale Suisse	4.7	
U.S.S.R.	4.1	
Czechoslovakia	3.3	
Hungary	1.4	
Bank Polski	1.1	
Miscellaneous	2.8	552.5

Abroad

In Ottawa from Issue Dept.	34.3	
Pretoria	22.8	
do. from Issue Dept.	11.4	
Bombay agst.Rps.	9.2	
Buenos Aires	4.6	
Brussels agst. Belgas	2.8	
Miscellaneous	2.0	87.1
		639.6

SALES

In London

To Fed.Res.Bk.of N.Y. agst.$	83.3	
Bank of France	65.3	
Market	48.7	
do. agst.$	6.0	
Issue Dept. agst.gold in Ottawa and Pretoria	45.7	
Banque Nationale de Belgique	34.4	
do. agst.Belgas	5.3	
Issue Dept.	22.6	
do. o/a Revaluation	6.6	
N.P.Bk.o/a Royal Siamese Govt.agst.$	6.7	
Sveriges Riksbank	6.1	
B.I.S.	5.2	
Fed.Res.Bk.of N.Y.	1.6	
De Nederlandsche Bank agst.$	1.1	
Miscellaneous	6.1	
		344.7

Abroad

In New York agst.$	124.9	
Paris	2.0	
Buenos Aires to Banco Centrale de la Republica Argentina	2.2	
Miscellaneous	1.1	
		130.2
		474.9

Net gain: £164.7

Dealing & Accounts Office,
Gold Post,
28th August 1945.

In the next table is shown the value in sterling at cost of the gold and devisen in the Exchange Equalisation Account at the end of each month from July 1932 to August 1939. The amount of sterling assets is also shown.

It is difficult to interpret changes in these figures as both gold and exchange were of course bought at varying rates for sterling. The devisen held consisted almost entirely of U.S.dollars so that the difficulty in this case can be nearly eliminated by showing in a separate table the holdings of U.S.dollars at the end of each month.

The gold figure includes a considerable amount of profit, if it be assumed that the gold value of sterling fixed during the war will continue to be held (or lowered) since the gold was mostly acquired at higher rates for the dollar than $4 to the £. Changes in gold holdings can be approximately measured only at periods when the sterling/dollar rate was substantially stable. For this purpose the following notes are appended:

<u>1932</u> From the end of April the rate fell fairly steadily from 3.75 to 3.27.

<u>1933</u> In this year the rate rose steeply to 4.65 at the end of July, and after a fall to 4.50 by the end of August it rose to a little over 5 by the end of November, and remained there until the end of the year.

<u>1934</u> The rate varied between 5.04 and 5.15 to the end of August and then fluctuated between 5.06 and 4.95 in the last four months. The year may be said, therefore, to exhibit stable rates in two periods covering the first eight months and the last four, as there was only 10 cents variation in each of these periods.

<u>1935</u> The rate fell from 4.95 to 4.77 at the end of March and then rose gradually to 4.96 at the end of August. In the last four months it remained at between 4.96 and 4.92, a period of stability.

1936 The sterling/dollar rate remained fairly stable for nine months until the franc broke and the Tripartite Agreement was made. It ranged from 4.93 to 95 at the end of February and was back to 4.95 by the end of April. By the end of June it was 5.02 and 5.05 at the end of September. By the end of October it was 4.90 but remained at this level to the end of the year. Except for September and October the exchange may be said to have maintained stability throughout the year.

1937 In this year too the rate was fairly stable with a rising tendency. It dropped from 4.91 at the beginning of January to 4.88 at the end of March, after which, with slight recessions at the end of June and September, it came near 5 towards the end of the year.

1938 The first seven months were stable. The rate moved from 4.99 at the beginning of January to 5.02 at the end of February. It then declined gradually to the end of June at 4.96; then more rapidly to 4.92 at the end of July, after which it fell to 4.66 by the end of the year.

1939 The rate was pegged at about 4.68 until 24th August.

The rates mentioned are the monthly average of daily rates. The monthly range would show less stability.

See page 316

1932/9 Exchange Equalisation Account Assets at end of each month, at cost, to nearest £1,000

000's omitted

	Gold at cost	Devisen at cost	Total at cost	Sterling assets
1932				
July	26,922	22,835	49,757	112,684
August	31,954	21,191	53,145	109,351
September	28,068	17,406	45,474	116,874
October	19,013	7,572	26,585	136,090
November	24,043	21,029	45,072	117,829
December	29,340	37,307	66,647	105,253
1933				
January	35,090	67,995	103,085	65,910
February	50,234	56,135	106,369	53,599
March	67,268	40,984	108,252	40,897
April	68,585	47,116	115,701	28,200
May	68,075	45,120	113,195	230,845
June	82,252	38,734	120,986	221,708
July	40,110	36,070	76,180	266,253
August	32,679	32,824	65,503	276,843
September	34,913	28,509	63,422	278,839
October	47,751	24,123	71,874	270,333
November	76,621	16,515	93,136	248,979
December	84,444	17,185	101,629	240,428
1934				
January	94,821	17,564	112,385	229,593
February	105,057	16,218	121,275	224,641
March	110,173	16,108	126,281	219,626
April	120,784	16,431	137,215	208,608
May	117,170	18,912	136,082	209,688
June	108,292	16,118	124,410	221,279
July	106,002	15,679	121,681	223,916
August	85,824	16,343	102,167	243,347
September	79,282	16,210	95,492	249,934
October	76,576	16,377	92,953	252,421
November	83,289	16,063	99,352	245,892
December	84,967	16,244	101,211	243,965
1935				
January	88,364	17,006	105,370	239,729
February	90,102	16,091	106,193	238,867
March	88,369	16,245	104,614	240,410
April	102,424	16,344	118,768	226,233
May	116,713	16,452	133,165	211,768
June	128,171	16,105	144,276	200,626
July	146,646	18,555	165,201	179,669
August	164,434	19,001	183,435	161,062
September	162,351	16,194	178,545	165,769
October	133,412	16,559	149,971	193,354
November	142,595	18,640	161,235	180,158
December	150,103	17,331	167,434	172,649

1936

	Gold at cost	Devisen at cost	Total at cost	Sterling assets
1936				
January	173,392	18,143	191,535	148,226
February	178,503	17,094	195,597	144,110
March	192,610	11,658	204,268	135,289
April	234,159	11,839	245,998	92,076
May	255,981	15,003	270,984	64,533
June	252,310	16,418	268,728	58,201
July	220,435	16,975	237,410	75,946
August	220,525	15,878	236,403	74,842
September	236,740	15,574	252,314	56,811
October	219,164	15,512	234,676	74,435
November	247,808	15,829	263,637	45,453
December	168,011	20,660	188,671	76,940
1937				
January	210,362	18,160	228,522	37,078
February	204,231	16,304	220,535	45,065
March	176,505	15,704	192,209	73,392
April	176,756	21,640	198,396	67,204
May	182,132	19,274	201,406	59,222
June	240,420	16,826	257,246	-
July	236,694	16,892	253,586	203,658
August	245,270	17,579	262,849	194,398
September	269,082	17,864	286,946	170,307
October	260,424	17,591	278,015	179,241
November	251,361	16,883	268,244	188,988
December	280,161	19,215	299,376	157,862
1938				
January	299,292	17,301	316,593	140,650
February	285,829	19,912	305,741	151,507
March	287,770	18,299	306,069	151,183
April	291,250	19,777	311,027	146,228
May	248,803	20,387	269,190	188,026
June	242,688	19,713	262,401	194,818
July	236,193	19,834	256,027	201,201
August	210,152	19,704	229,856	227,362
September	139,141	20,103	159,244	297,868
October	99,840	18,318	118,158	338,867
November	61,880	22,179	84,059	372,923
December	18,698	22,335	41,033	415,899
1939				
January	319,452	16,156	335,608	237,055
February	326,774	26,764	353,538	219,121
March	312,579	30,572	343,151	313,871
April	2 ~~3~~84,965	18,170	303,135	353,153
May	275,290	26,354	301,644	356,547
June	260,894	37,173	298,067	360,051
July	222,028	21,423	243,451	414,652
August	130,606	28,124	158,730	514,181
	- 91,472		- 84,321	

($000's)

EXCHANGE EQUALISATION ACCOUNT

1932

End	July	55,418
	August	23,589
	September	46,477
	October	22,037
	November	67,785
	December	100,226

1933

End	January	156,893
	February	146,775
	March	131,184
	April	150,915
	May	140,197
	June	111,179
	July	103,429
	August	86,031
	September	58,238
	October	35,109
	November	4,071
	December	3,126

1934

End	January	1,712
	February	1,911
	March	2,047
	April	3,490
	May	979
	June	1,008
	July	1,445
	August	1,181
	September	1,679
	October	1,302
	November	1,307
	December	2,082

1935

End	January	1,836
	February	1,504
	March	1,920
	April	2,282
	May	2,037
	June	1,929
	July	2,711
	August	2,371
	September	2,056
	October	4,221
	November	12,505
	December	4,754

1936

End	January	5,729
	February	4,445
	March	4,219
	April	3,289
	May	3,968
	June	4,237
	July	6,600
	August	1,424
	September	909
	October	869
	November	2,396
	December	25,527

1937

End	January	12,996
	February	4,077
	March	1,181
	April	30,023
	May	18,856
	June	7,411
	July	7,305
	August	10,795
	September	12,382
	October	11,146
	November	8,099
	December	17,892

1938

End	January	9,611
	February	20,337
	March	12,333
	April	18,845
	May	18,762
	June	19,429
	July	21,150
	August	19,580
	September	24,021
	October	14,418
	November	31,795
	December	30,903

1939

End	January	4,536
	February	54,671
	March	71,610
	April	11,398
	May	52,162
	June	102,659
	July	29,537
	August	54,310