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CHAPTER 30

Following the Leader, September 1931 to April 1933

In order to emphasize the general contrast between the pre-war and post-war international gold standard systems we stated in Chapter 21 that the existence of a separately definable sterling area after the war was evidence of the decline in the importance of sterling as a world currency. Nevertheless, the influence of sterling over the world's exchanges was still tremendous, and a logical first step in a study of the Disintegration period is to present a statistical picture of this influence as reflected in the world's exchange rates, and thus to justify and give precise meaning to the statement that the world was divided after September 1931 into a world of sterling and a world of gold.

Such a procedure has definite advantages over other methods of picturing the disintegration of the international gold standard. An attempt, for example, to classify the countries of the world on the basis of the legal provisions defining their monetary standards after September 1931, or on the basis of the techniques by which their exchanges were controlled, would not yield very fruitful results. The whole tenor of our study of the post-war period has shown that classifications of monetary systems based upon external forms do not assist very materially in the analysis of what was happening to the international gold standard as a world institution.[1] Classifications according to the techniques of management are hardly more helpful. According to the foot-rule of the writer the record of the official regulations restricting the freedom of deal-

[1] Cf. in particular our examination of the lack of substantial meaning of outward adherence to the gold standard by periphery countries in Ch. 24 and in the section on Argentina in Ch. 14.

ings in the exchanges in various countries, compiled by the Bank for International Settlements, had reached in October 1937 a thickness of two and a half feet. The student who attempts to thread his way through this maze will find his attention equally divided between gold standard and non-gold standard countries. This is shown by a table compiled by Leo Pasvolsky.[2] The interpretation of such a table is subject to

Monetary Standard Position of 50 Countries, January 1, 1933

OFF THE GOLD STANDARD AND WITH DEPRECIATED CURRENCIES		NOMINALLY ON THE GOLD STANDARD WITH OLD PARITIES MAINTAINED THROUGH OFFICIAL CONTROL	ON FULL GOLD STANDARD
Without Official Control	With Official Control		
Australia	Argentina	Austria	Albania
British India	Bolivia	Bulgaria	Belgium
British Malaya	Brazil [a]	Czechoslovakia	Danzig
Canada	Chile	Estonia	Dutch East Indies
Egypt	Colombia	Germany	France
Finland	Denmark	Hungary	Italy
Great Britain	Ecuador	Latvia	Lithuania
Irish Free State	Greece	Rumania	The Netherlands
Mexico	Japan	Yugoslavia	Poland
New Zealand [b]	Persia [c]		Switzerland
Norway	Portugal		The United States
Palestine	Spain [a]		
Peru	Turkey [a]		
Siam	Uruguay [b]		
Sweden			
Union of S. Africa			

[a] The gold standard was never officially resumed after the World War.
[b] The gold standard was never officially reestablished after the war, but there was a de facto return to pre-war gold parities.
[c] Persia had a silver standard until March 1932, when a gold parity was legally adopted, although the exchange rate followed the pound sterling.

many difficulties. By no means all forms of exchange control are embodied in official regulations. Consequently not even the area within which the gold standard continued to be a reality as well as an ornament is clearly defined. Moreover, the currencies of many countries not on the gold standard were in fact pegged to gold standard currencies in much the same

[2] *Current Monetary Issues* (Brookings Institution, 1933), p. 8.

way as were countries nominally on the gold standard. Therefore such a classification does not reveal the full extent of the world of gold. Finally, it gives no hint of the relation of the various currencies to sterling. This can be seen only by a study of the exchanges.

From April 1929 to April 1933 35 countries left the gold standard in the order indicated.[8] To plot the exchanges of

1929
April
 Uruguay

November
 Argentina

December
 Brazil

1930
March
 Australia

April
 New Zealand

September
 Venezuela

1931
August
 Mexico

September
 United Kingdom
 Canada
 India
 Sweden
 Denmark
 Norway
 Egypt
 Irish Free State
 British Malaya
 Palestine

October
 Austria
 Portugal
 Finland
 Bolivia
 Salvador

December
 Japan

1932
January
 Colombia
 Nicaragua
 Costa Rica

April
 Greece
 Chile

May
 Peru

June
 Ecuador
 Siam

July
 Yugoslavia

1933
January
 Union of South Africa

April
 Honduras
 United States

these countries according to the single criterion of their depreciation in gold would not, however, clearly disclose the real divisions established in the world's currency system. In introducing our analysis of the behavior of exchange rates during the war we drew attention to the very different aspect of the war-time rates when observed from the point of view of Zurich and from that of London or New York. Similarly after 1931 the choice of a base is all important. Many essential facts concerning the grouping of the world's exchanges after September 1931 would be obscured by a simple plotting

[8] Bank of Nova Scotia, *Monthly Review*, September 1933.

of the depreciated currencies in terms, let us say, of the French franc. Another method of picturing the behavior of the world's exchanges has therefore been adopted which carries forward the analysis presented in Chapter 11.

The Boundaries of the World of Sterling and of the World of Gold

In an unpublished manuscript on the sterling standard, Charles Wilson has studied the exchange rates of 36 countries from the abandonment of the gold standard by Great Britain in September 1931 to the abandonment of the gold standard by the United States in March 1933. In order to facilitate comparisons between these currencies, both as to their fluctuations and their general position in the world system of rates, he has expressed all the rates in terms of percentage deviations from the gold parities prevailing before the disintegration of the international gold standard system began. Since rates on New York are expressed in cents per unit of foreign currency, and rates on London in units of foreign currency per pound, he first worked out the reciprocals of the London quotations and then multiplied these reciprocals by 240 in order to get a series of quotations in the form of pence per unit of foreign currency. When London rates in this form are expressed as percentage deviations from the old parities they become strictly comparable with the New York rates similarly expressed.

In Appendix Table 5 the exchange rates of the 36 countries on London and New York as compiled by Mr. Wilson are given. By plotting these rates and combining those with similar characteristics, a graphical picture of the grouping of the nations in accordance with the behavior of their exchanges is obtained and the boundaries of the world of sterling and of the world of gold are defined. Before presenting the results of this procedure two preliminary observations should be made. First, the classification of countries is strictly on the

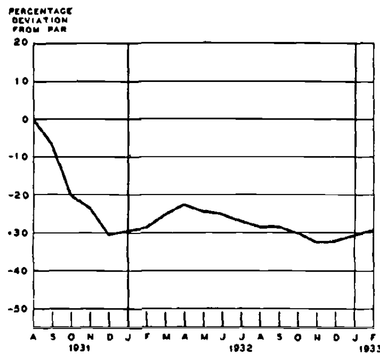
basis of the behavior of the exchange rates, with one exception. At the sacrifice of strict logical consistency the countries whose exchanges were kept stable in terms of gold [4] have been divided into two groups to bring out the area within which traditional gold standard procedures continued to be observed without substantial modification. Second, as Mr. Wilson is careful to point out, a grouping of this sort, based solely on the behavior of the exchanges, does not disclose the full extent of the sterling area, if by that term is meant all the countries bound more closely to Great Britain than to other center countries by economic and financial ties.

Sterling Countries

In Chart 61 the sterling-dollar rate, expressed in percentage deviations from the old parity of 4.8665, is shown monthly from September 1931 to February 1933. The exchanges of 10

CHART 61

Sterling-Dollar Exchange August 1931–February 1933, Monthly Averages of Daily Quotations as Percentage Deviations from Par



of the 36 countries studied by Mr. Wilson were sufficiently stable in London to repeat in their fluctuations on New York the pattern of the sterling-dollar rate. There is therefore no difficulty in classifying them as sterling countries, but they fall naturally into two groups (Charts 62 and 63).

[4] The writer relies upon the discussion elsewhere, particularly in Ch. 34, to give to expressions of this kind the connotations intended by him.

STERLING STANDARD AND STERLING AREA COUNTRIES

Of the 10 sterling countries 6 remained completely stable in sterling as far as their fluctuations were concerned, though this stability was maintained at different levels for various periods. These 6 countries may be callėd sterling standard coun-

CHART 62

Sterling Standard Countries, Exchange Rates on London and New York, August 1931–February 1933, Monthly Averages of Daily Quotations as Percentage Deviations from Par

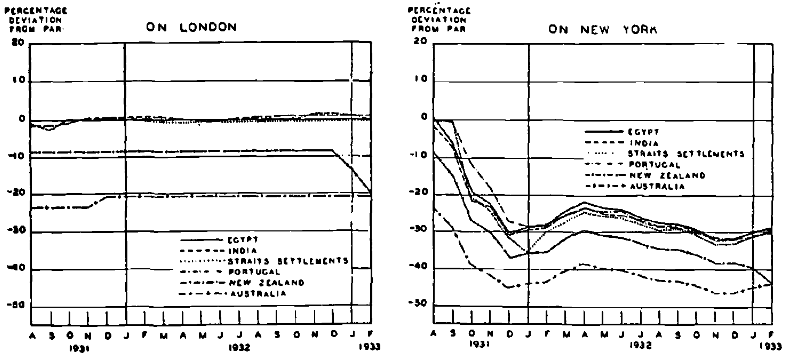
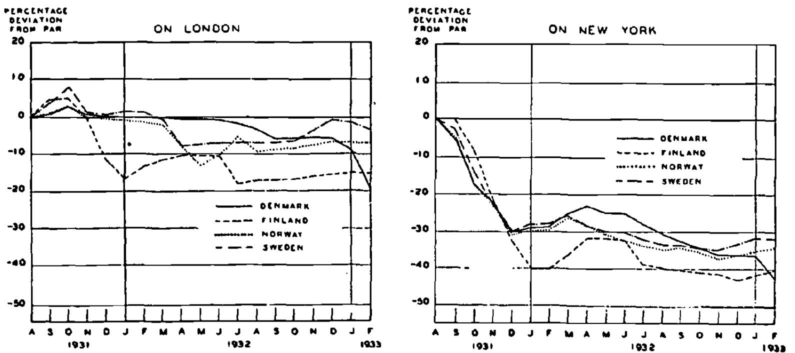


CHART 63

Sterling Area Countries, Exchange Rates on London and New York, August 1931–February 1933, Monthly Averages of Daily Quotations as Percentage Deviations from Par



tries. The other 4 were far from stable in sterling; nevertheless they showed a strong tendency to conform to the general level of sterling depreciation in terms of the dollar and to move for months together in general harmony with sterling. They may therefore be classified as sterling area countries.

GOLD STANDARD COUNTRIES ATTRACTED INTO THE STERLING GROUP

The 10 sterling standard and sterling area countries do not include two important members of the British Empire, South Africa and Canada. Yet the exchange rates show that these

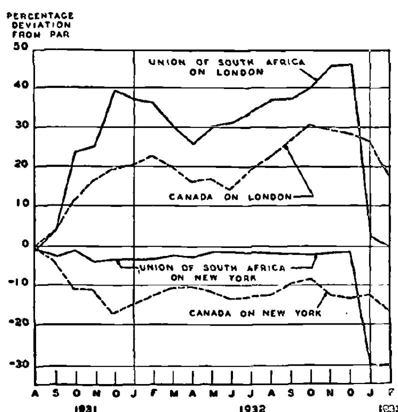


CHART 64

Countries attracted into the Sterling Area, Exchange Rates on London and New York, August 1931–February 1933, Monthly Averages of Daily Quotations as Percentage Deviations from Par

also were in a sense sterling countries (Chart 64). Until December 1932 the exchange of the Union of South Africa remained stable in New York and fluctuated in London in strict accordance with the rates of other gold standard countries. But in December 1932 South Africa abandoned the gold standard and joined the sterling group. The internal conflict between the gold mining interest and other parts of the South African economy, to which we refer in Chapters 9 and 10, was renewed in a different form after September 1931. By remaining on gold South Africa deprived the gold mines of the substantial benefits of a high sterling price of gold in London that they had enjoyed from 1919 to 1924. Pressure from this

source was early brought to bear on the government and was finally strong enough to force South Africa off the gold standard. Unlike South Africa, Canada did not actually move from the gold standard to the sterling standard group. In its *level* the Canadian dollar remained throughout in a position intermediate between sterling and the American dollar, but in its *fluctuations* it reflected faithfully the course of sterling in New York. Without straining the meaning of the term unduly both these Empire countries may be classified as gold standard countries attracted into the sterling group.

From Charts 62–64 it is clear that there were wide variations in the fidelity with which the sterling countries adhered to sterling. Mr. Einzig has pointed this out (*The Sterling-Dollar-Franc Tangle,* Macmillan, 1933, pp. 56–7):

"When in 1931 sterling was depreciating fast, at one time the Portuguese Government decided to prevent the escudo from following it any further. Again, in 1933, when sterling was rising gradually in spite of resistance by the British authorities, the Swedish Government considered it inexpedient that the crown should follow sterling indefinitely in its upward course. Again, in 1932, yielding to the pressure of Danish exporters, the Danish Government agreed to allow the crown to depreciate to 22.50 from its then rate of 19. Even within the Empire there were no fixed relations between sterling and other Imperial currencies. The Canadian dollar fluctuated somewhere half-way between sterling and the dollar, changing its allegiance from time to time. Until the end of 1932 the South African pound remained on a gold basis; while the Australian pound remained remarkably stable at a 25 per cent discount, the New Zealand pound underwent a drastic adjustment in 1932. It may be said without exaggeration that there was hardly one member of the so-called sterling bloc which remained consistently faithful to sterling."

The forces that held these countries in the sterling group were also very diverse. The motives that pulled South Africa into the sterling group were certainly not identical with those which kept Australia within it at a 25 per cent depreciation in

sterling, or those that were controlling in the preservation, by the Council Bill System, of the 1 s. 6 d. rupee in India. Denmark was powerfully influenced in adhering more closely to sterling than to the dollar by her direct competition with New Zealand in the British market. Sweden was strongly influenced by the fact that a large part of her export trade was, at the time England left the gold standard, being carried on by sterling contracts. Some of the sterling countries were more dependent than others upon London for short and long term capital accommodation, while some were more in need than others of the general benefits derived by periphery countries from a depreciation of their exchanges on the gold standard countries.

Notwithstanding these diversities, the formation of a sterling group was the outgrowth of long historical tradition and fundamental trade and financial relationships. In spite of the psychological and emotional bias of all 'sound money' advocates the world over in favor of gold, many countries, in the regulation of their exchanges, were obliged to regard stability in sterling as more important than stability in gold. The powerful pull of sterling over other countries was written plainly in the rates.

Gold Countries

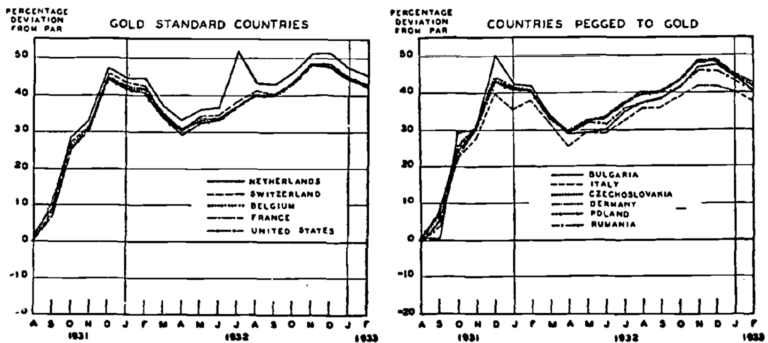
Of the 36 countries whose exchanges were studied by Mr. Wilson, 16 remained in a stable exchange relationship to one another, and exhibited a common fluctuation in terms of sterling. Since this stable exchange relationship was in harmony with the gold parities established by law these 16 countries clearly fall under the classification of gold countries. Indeed if they were to be judged solely by the behavior of their exchanges according to the rule applied above in distinguishing between sterling standard and sterling area countries they would all fall under the classification of gold standard countries. This designation, however, can be applied strictly to only a few of them.

GOLD STANDARD COUNTRIES AND COUNTRIES PEGGED TO GOLD

Of the gold countries 5, the United States, France, the Netherlands, Belgium, and Switzerland, constituted a core of genuine gold standard countries. Countries in this group allowed gold to move in and out as required by gold standard practice,

CHART 65

Gold Standard Countries and Countries pegged to Gold, Exchange Rates on London, August 1931–February 1933, Monthly Averages of Daily Quotations as Percentage Deviations from Par



though even here there were some impediments and modifications. For example, the Netherlands limited the free export of gold to countries also on the gold standard, and Switzerland was unwilling to purchase gold freely whenever offered to her. Attached to this central core were 6 Central and East European countries whose exchanges were kept relatively stable in terms of the major gold standard currencies by various forms of exchange restriction, ranging from the informal and unofficial control exercised in Italy by the banks [5] to the rigid and elaborate system of regulation built up in Germany. These countries have been grouped separately under the classification, Countries Pegged to Gold. Their exchange

[5] Cf. 'Regulations adopted by the Italian Federation of Credit and Insurance (in force Sept. 1931–May 1934)'; B.I.S., *Foreign Exchange Regulations, 1st Issue.*

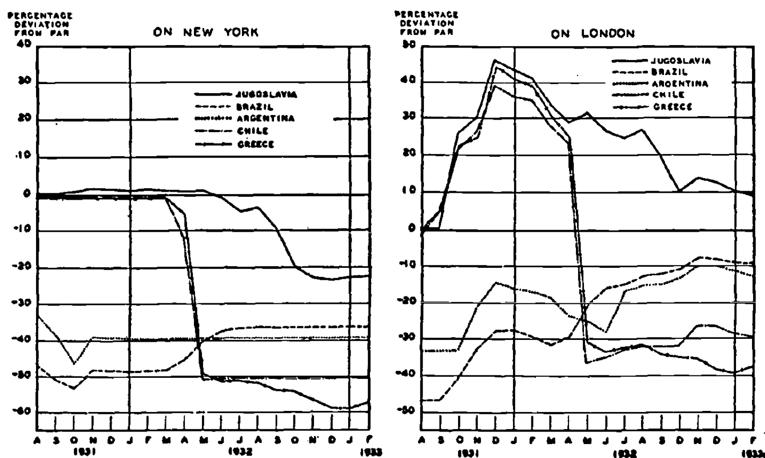
rates on London and those of the gold standard countries proper are presented in Chart 65.

COUNTRIES ADHERING TO GOLD AT DIFFERENT LEVELS

Among the countries included in the gold group on the basis of the behavior of their exchange rates are some whose relation to gold was similar to that of the sterling area countries to sterling (Chart 66). Of these five are included in Mr.

CHART 66

Countries adhering to Gold at Different Levels, Exchange Rates on London and New York, August 1931–February 1933, Monthly Averages of Daily Quotations as Percentage Deviations from Par



Wilson's analysis, two in Eastern Europe and the three ABC countries of South America. All were under a regime of foreign exchange control. Argentina and Brazil had already passed under such control before England suspended the gold standard and had begun a new stabilization in terms of gold at a 40 to 50 per cent depreciation. Chile, after maintaining the old parity until the spring of 1932, fell into line with the other two ABC countries for similar reasons. This group of countries, however, at no time followed the fluctuations of sterling in terms of the dollar. Like Australia in the sterling

group they attempted to achieve an economic balance by a general depreciation of their exchanges in terms of the currencies of the center countries, but at the new level they chose stability in francs and dollars in preference to stability in sterling.

THE TWILIGHT ZONE

Of the 36 countries 5 fall into neither the sterling nor the gold group. All these were subject to exchange control and the behavior of their exchanges clearly indicates that the fundamental conditions of membership in a triangular system of rates as described in Chapter 29 were not realized. Arbitrage did not play its accustomed role in determining their relationship to sterling and to the gold standard currencies. They occupied a sort of twilight zone between the world of gold and the world of sterling.

COUNTRIES ATTEMPTING STABILIZATION IN BOTH STERLING AND GOLD

In Chart 67 the exchanges of Austria, Uruguay, Spain, and Turkey on London and New York are plotted. The Austrian exchange on New York remained stable at a very slightly depreciated level throughout the period, but the rate on London did not reflect the movement of the sterling-dollar rate. The Austrian crown did not begin to appreciate rapidly in sterling until one month after the appreciation of the other gold standard currencies. When it did, the appreciation was only about one-half as great as that of the other gold standard currencies. Then during the first six months of 1932 the Austrian crown depreciated steadily in sterling until in June 1932 it stood practically 'at par' with both the dollar and the pound, though in the same month the dollar was at a 33⅓ per cent premium over the pound. This position could not be maintained. The crown continued to be steady in terms of the dollar, and began once more to appreciate in sterling. But

Austria did not as a consequence join the group of gold countries. In February 1933 the crown stood at a 'premium' of only 15 per cent over sterling as compared with the 42 per cent 'premium' of the American dollar in London. Nor did the behavior of the Austrian crown conform to that of the

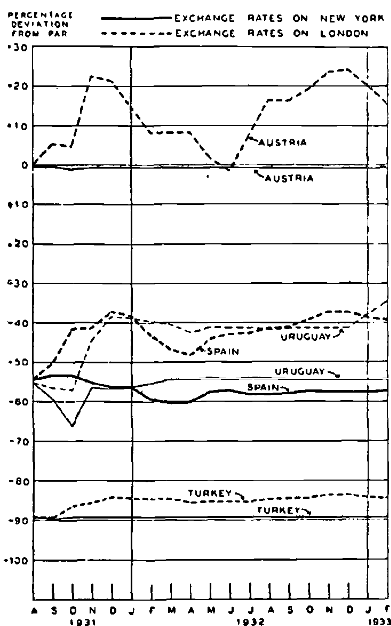


CHART 67

Countries attempting Stabilization in both Sterling and Gold, Exchange Rates on London and New York, August 1931–February 1933, Monthly Averages of Daily Quotations as Percentage Deviations from Par

Canadian dollar, which also failed to share the full appreciation of the gold currencies in sterling. The Canadian dollar, as has been shown, experienced a substantial depreciation in dollars and also followed the fluctuations of sterling in New York closely. This was not true of the crown, and the behavior of this exchange can be accounted for only by the elimination of arbitrage. The behavior of the Spanish, Uruguayan, and Turkish exchanges, which were more completely stable in both London and New York, shows the presence of the same phenomenon in even more marked degree.

COUNTRY DEPRECIATING IN BOTH STERLING AND GOLD

Japan continued as a member of the gold standard group for only two months after September 1931, but when she abandoned the gold standard she did not enter the sterling group.

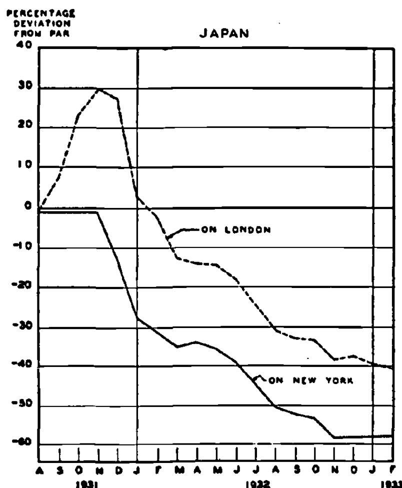


CHART 68

Country depreciating in both Sterling and Gold, Exchange Rate on London and New York, August 1931–February 1933, Monthly Averages of Daily Quotations as Percentage Deviations from Par

The common depreciation of the yen in both dollars and sterling until November 1932, while these two currencies were fluctuating in terms of each other, places Japan also in the twilight zone (Chart 68).

The Grouping of the Nations

In bringing about this division of the world's currencies two major forces were at work: (1) the economic pressure that led to the disintegration of the gold standard facade at the periphery; (2) the breakup of the nucleus to which the rest of our discussion of the Disintegration period will be devoted. As a result of the operation of these two forces the former international gold standard system was divided into a world of sterling and a world of gold whose boundaries, as disclosed by Mr. Wilson's study of the exchange rates, may be summarized as follows:

Classification of 36 Countries according to the Behavior of Their Exchanges September 1931–April 1933

GOLD COUNTRIES

1) Gold Standard Countries

United States	France
Netherlands	Switzerland
Belgium	

2) Countries pegged to Gold

Bulgaria	Estonia
Czechoslovakia	Germany
Lithuania	Hungary
Latvia	Italy
Poland	Roumania

3) Countries adhering to Gold at Different Levels

Greece	Brazil
Argentina	Yugoslavia
Chile	

STERLING COUNTRIES

1) Sterling Standard Countries

Great Britain	North and South Rhodesia
Australia	New Zealand
Portugal	Straits Settlements
India	

2) Sterling Area Countries

Norway	Sweden
Finland	Denmark

3) Gold Standard Countries attracted into the Sterling Group

Canada	Union of South Africa

COUNTRIES ATTEMPTING STABILIZATION IN BOTH STERLING AND GOLD

Uruguay	Turkey
Spain	Austria

COUNTRY DEPRECIATING IN BOTH STERLING AND GOLD

Japan

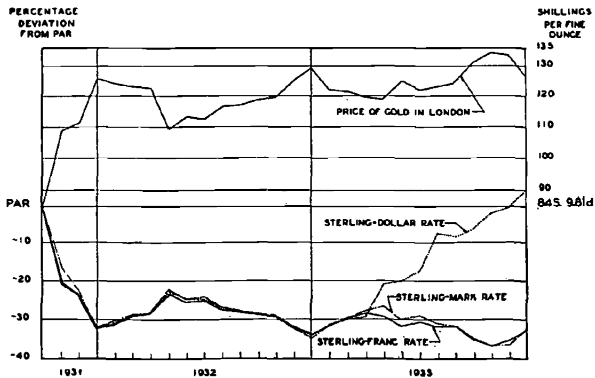
The Sterling Exchange and the London Price of Gold

The simplest and most general single statistical measure of the new exchange relationships established among the center countries by the breakup of the nucleus is the open market price of gold in London. In Chart 69 and Table 79 the fluctuations in the sterling-dollar, sterling-franc, and sterling-reichsmark rates and in the London open market price of gold from September 1931 to December 1933 are indicated.

To show the relation of the gold price to the three rates, the four series are presented for the first Tuesday of each month and in the following form: the pound sterling is expressed as a percentage of its par value in the three currencies and the Bank of England's buying price for gold is expressed as a

CHART 69

Relation of London Price of Gold to American and Continental Exchange Rates, September 1931–December 1933, First Tuesday



percentage of the market price. These figures reveal the closeness with which the London price of gold corresponded to the exchange rate of sterling in that one of the three currencies in which its depreciation was the greatest. The omission of other gold standard currencies, such as the guilder and the Swiss franc, and the presence in the bullion market at certain times of a demand from hoarders prevent this correspondence from being exact.

In conjunction with Chart 11, presented in connection with the discussion of the role of New York as a residual buyer of gold from 1919 to 1924, Chart 69 completes a graphical presentation of the depreciation of sterling in terms of gold during the post-war period as a whole. These two charts may serve as a text for further emphasis upon the changing meaning of the phrase 'depreciation in gold' and the pit-

falls surrounding its interpretation. As pointed out in Chapter 10, the London open market price of gold from 1919 to 1924 was based upon the New York T/T parity price, and whatever affected the sterling-dollar exchange affected the price of gold. Basically, the fluctuations in the gold price reflected the great

TABLE 79

Relation of London Price of Gold to American and Continental Exchange Rates, September 1931–December 1933, First Tuesday

	POUND STERLING AS PERCENTAGE OF PAR IN			BANK OF ENGLAND BUYING PRICE OF GOLD AS PERCENTAGE OF MARKET PRICE
	Francs	Reichsmarks	Dollars	
1931				
Sept.	99.8	100.4	99.8	100.1
Oct.	79.3	83.2	79.6	78.4
Nov.	76.4	77.0	76.6	76.1
Dec.	67.8	67.9	67.8	67.9
1932				
Jan.	68.9	69.7	69.1	69.3
Feb.	70.9	71.4	70.9	71.0
March	71.3	71.6	71.6	71.6
April	76.9	77.8	77.6	77.5
May	74.7	75.4	75.3	75.1
June	75.0	75.9	75.5	75.4
July	72.7	73.4	72.9	72.9
Aug.	72.2	72.3	72.2	72.6
Sept.	71.4	71.6	71.5	71.6
Oct.	70.9	71.1	71.0	71.1
Nov.	67.6	68.0	67.8	67.7
Dec.	66.0	65.5	65.8	65.7
1933				
Jan.	68.8	68.5	68.6	68.6
Feb.	70.7	70.5	70.4	70.6
March	71.3	72.4	70.6 [1]	71.0
April				
May	68.2	70.1	80.0	68.0
June	69.3	71.0	82.6	69.3
July	68.5	69.2	92.4	69.1
Aug.	68.4	68.3	91.7	68.5
Sept.	65.0	64.7	93.8	65.0
Oct.	63.4	63.3	97.9	63.3
Nov.	63.9	63.7	99.2	63.7
Dec.	67.2	67.0	104.9	67.4

Calculated from data published in the *Bankers', Insurance Managers' and Agents' Magazine; The Economist; Financial News*

[1] March 14.

process of economic readjustment between Great Britain and the United States to which we gave the general caption, the Dance of the Price Levels. They did not reflect accurately the position of sterling in the world system of exchange rates, for in those years the currencies of the center countries other than Great Britain were not bound in a stable exchange relationship under the gold standard. Depreciation in gold, as measured by the difference between the Bank of England buying price and the London market price, meant depreciation in dollars alone. The pattern of the world's exchanges could be brought out only by the type of analysis given in our section on Following the Leader in Chapter 11. After September 1931 the London price of gold was based on the T/T parity price of that gold standard country whose exchange on London happened to be highest. When the dollar was weak in Paris, as in October 1932, it was based upon the sterling-franc rate,[6] and when the franc was weak in New York, it was based on the T/T parity rate on New York, unless both dollars and francs were weak together in terms of some other gold standard currency. As long as England was the only center country that had left the gold standard, and the boundaries of the worlds of sterling and of gold were fixed as shown in the preceding section, then the fluctuations in the London price of gold did give a definite measure of the position of sterling in the world system of exchange rates, allowance being made for the depreciation of certain periphery countries in terms of sterling. After April 1933, when the United States left the gold standard, the bid of those wishing to buy gold in London and ship it to the United States for sale to the United States Treasury was no longer effective in the London market. After that date, the London price of gold was based upon the buying prices of the countries still remaining on the gold standard, and the exchange rates of their currencies on London. So predominant was France in this group that the franc parity price became in fact the basic price in the London gold

[6] Samuel Montagu & Co., *Weekly Review*, Oct. 18, 1932.

market (Chart 69). Under these circumstances the sterling price of gold, though still a measure of sterling depreciation in gold, once more ceased to be a true indication of the place of sterling in the world's currency system.

The observer of the history of the world's currencies who examines his subject from the point of view of gold is forced under such circumstances to make sudden shifts in his base of observation, whereas an examination of the central foreign exchange triangle as a whole provides an approach that necessitates no such shifts. In considering the period September 1931 to April 1933, however, no great practical difference arises in approaching the problem from the viewpoint of sterling depreciation in gold, or that of the common movement of two legs of a major foreign exchange triangle, the third leg of which is a rate between two gold standard countries. In either case the first step is to examine British policy, and the second, to study its repercussions upon the world of gold.

CHAPTER 31

The Reorientation of British Policy after September 1931

The suspension of the gold standard was followed by a remarkable reorientation of British economic and financial policy. Like Candide, Great Britain resolved to accept, without rejoicing, the results of the concatenation of past events and to cultivate her garden. This garden was an extensive one. It consisted, first, of the home market; second, of the wide, but no longer world-wide, area of dominant British financial and economic influence. Four major tools were used to cultivate it: the abandonment of free trade principles, the forging of closer economic ties with the countries within the sphere of British influence, the provision of cheap and abundant credit, and the control of the sterling exchange.

The techniques adapted to this new attitude were developed in the empirical way characteristic of British temperament. In no field was this more true than in foreign exchange policy. In discussing the post-war changes in the London money market we said that it was characteristic of the peculiar British business genius to work out by trial and error a method of doing business that gave satisfactory results and to experiment no further. It was by an analogous process that gradually, after September 1931, a profound, and in view of the preceding history of British finance, an epochal change in the British attitude toward the international gold standard was worked out.

Easing the Shock

The decision to leave the gold standard was probably made at the Bank of England on Wednesday, September 16, or on the

following day. The Bank then took the view that the mounting withdrawals had exhausted its reserves, for it regarded the gold that still remained as earmarked for the repayment of its foreign credits. Friday, Saturday, and Sunday were spent in preparing for the actual suspension on the following Monday. The B.I.S. and other central banks were notified, a duty very distasteful to the Bank of England because of the losses about to be imposed upon its foreign depositors. By an inconvenient coincidence, the London Stock Exchange on September 19 held its first Saturday morning session in fourteen years. Selling was active and all prices fell heavily. On Saturday afternoon the Stock Exchange Committee was notified of the impending action, and arranged to close the House on Monday and Tuesday. The Bank, being apprehensive that runs would follow the suspension, informed the clearing banks on Saturday after closing and arranged for them to obtain additional cash to send to points where it seemed likely to be needed. The Bank was also apprehensive lest the idea should spread that a low rate of sterling was pleasing to it, for its chief concern was not to gain advantages for British export trade by exploiting the new situation, but to conserve the international utility of the London money market. This concern was expressed both in the terms of the official announcement of the suspension of the gold standard and in the preparation of certain measures for defending sterling under the first shock of that announcement.

The note of defense and the note of reassurance were therefore strongly accented in the following passages of the government's official statement of September 21:

"His Majesty's government have no reason to believe that the present difficulties are due to any substantial extent to the export of capital by British Nationals. Undoubtedly the bulk of the withdrawals have been for foreign account. They desire, however, to repeat emphatically the warning given by the Chancellor of the Exchequer that any British citizen who increases the strain on the exchanges by purchasing foreign securities himself or assisting others to do so is deliberately adding to the country's difficulties. The banks have undertaken to cooperate in restricting purchases

by British citizens of foreign exchange, except those required for the actual needs of trade or for meeting existing contracts, and, should further measures prove to be advisable, His Majesty's government will not hesitate to take them.

. . . .

His Majesty's government are securing a balanced Budget, and the internal position of the country is sound. This position must be maintained. It is one thing to go off the gold standard with an unbalanced Budget and uncontrolled inflation; it is quite another thing to take this measure, not because of internal financial difficulties, but because of excessive withdrawals of borrowed capital. The ultimate resources of this country are enormous, and there is no doubt that the present exchange difficulties will prove only temporary."

The measures of defense were the imposition of high interest rates, the enforcement of exchange restrictions, and the restriction of speculative activity on the London Stock Exchange. On September 21 Bank rate was raised from 4½ to 6 per cent, and market rates immediately followed. On the next day the following brief Treasury Order was issued:

"The Lords Commissioners of His Majesty's Treasury, in pursuance of Section 1 (3) of the Gold Standard (Amendment) Act, 1931, hereby order that until further notice purchases of foreign exchange or transfers of funds with the object of acquiring such exchange, directly or indirectly, by British subjects or persons resident in the United Kingdom shall be prohibited except for the purpose of financing

1) Normal trading requirements
2) Contracts existing before September 21, 1931
3) Reasonable travelling or other personal purposes." [1]

The Stock Exchange was closed on September 21 and 22. Since this resulted in the appearance of a street market, trading was resumed without restriction on Wednesday, September 23. The next day gilt edged securities were sold heavily and equity shares rose. The action of the market was apparently interpreted by the Treasury as evidence of public

[1] B.I.S., *Foreign Exchange Regulations, 2d Issue.*

apprehension and fear of currency inflation. Three days later the Committee, probably at the suggestion of the Treasury, prohibited all dealings except for cash.[2]

The life of the three defensive measures was roughly five months. Bank rate was reduced from 6 to 5 per cent on February 18 and from 5 to 4 per cent on March 10, 1932. No elaborate code governing private dealings in the exchanges or obliging foreign exchange to be cleared through official agencies was promulgated, and not even a beginning was made toward the regulation of international commerce for the purpose of conserving foreign exchange. The exchange regulations were issued under temporary powers and were directed against speculative transactions tending to depress the pound and against the flight of capital. They were soon relaxed in practice and were officially withdrawn on March 2, 1932. The restrictions on the London Stock Exchange were relaxed and finally abolished even earlier. By November 16, 1931 the Treasury's fear of panic selling by the public was sufficiently allayed to allow the partial removal of restrictions. The Committee felt able to permit the resumption of dealings for the Account, but still prohibited option business and carrying over from one Account to another. That this was at the suggestion of the Treasury may be inferred from the action of the Glasgow Stock Exchange which decided at this time to permit continuation business, but was compelled to rescind its decision "at the request of the Treasury." [3] Just before Christmas option business was again permitted, and on January 26, 1932 the normal procedures of the London Stock Exchange were fully restored.

The Defense of Sterling, September 1931 to February 1932

The disappearance of these defensive measures marked a genuine turning point in the history of the pound sterling. By March 1932 the special obligations incurred in defense of

[2] *The Economist,* Sept. 26, 1931, pp. 572, 576; Jan. 30, 1932, p. 246.

[3] *Ibid.,* Nov. 14, 1931, p. 922.

the gold standard were paid off or provided for. The experiment of the gold exchange standard without a focal point was liquidated. The home market had received the stimulus of a protective tariff. British industry had begun to taste the sweets of an undervalued exchange. The boundaries of the sterling area were disclosed. Confidence in sterling was reestablished. These developments profoundly influenced the sterling exchange. They account for the fact that in March 1932 there was a remarkable change from a policy of defending to one of controlling sterling. This may be made clear by a brief review of the forces playing upon sterling during these five months.

On Monday, September 21, 1931, the foreign exchange markets of the world were very nearly demoralized. Quotations for sterling were almost nominal. The market in London was very thin and such quotations for francs and dollars against sterling as were available were established in Paris and New York. The spread between cables and demand was at times very wide, and fluctuations were extremely erratic. This condition continued for several days, as is evidenced by the accompanying quotations for sterling in New York given in the *Commercial and Financial Chronicle.*

Sterling Rates in New York, September 18-26, 1931

			DEMAND	CABLES
Closing,	Friday,	Sept. 18	$4.85\frac{7}{16}$	$4.85\frac{13}{16}$
Range	Saturday,	19	$4.84\frac{1}{8}$ @ $4.85\frac{11}{16}$	$4.84\frac{1}{2}$ @ $4.85\frac{15}{16}$
	Monday,	21	3.70 @ 4.35	3.85 @ $4.32\frac{3}{4}$
	Tuesday,	22	4.05 @ 4.25	4.12 @ 4.22
	Wednesday,	23	4.07 @ 4.20	4.09 @ $4.14\frac{3}{4}$
	Thursday,	24	3.79 @ $3.93\frac{1}{2}$	3.80 @ $3.94\frac{1}{2}$
	Friday,	25	3.46 @ $3.84\frac{1}{2}$	3.54 @ 3.85
	Saturday,	26	3.78 @ 3.86	3.79 @ 3.87

The situation, in fact, was characterized by confusion and uncertainty rather than by a concerted large scale offer of sterling. Many transactions were kept off the market by the common policy of the London banks and acceptance houses in opposing bear raids on sterling and flights of capital. Their

policy was to deal only with their own clientele in both spot and forward exchange transactions, to discourage the sale of foreign currency notes, to refuse to sell exchange to clients who did not offer proof that the transaction was of a purely commercial character, to refuse all requests of stock brokers for foreign exchange except to settle debts incurred before September 21, to carry out no foreign exchange transactions for foreign account that would produce sterling overdrafts, to review all overdraft and acceptance facilities offered to foreigners and to prohibit the transaction known as 'forward swaps.' [4] The formal exchange restrictions of the Treasury were an official statement of, and sanction behind, this policy. The restrictions on speculation on the London Stock Exchange supported it. In the main, however, it was effective because it did not have to withstand the great and sustained pressure of a genuine flight of capital. The authorities were not able to discover any seepage of British capital abroad by devious channels, and the way in which British subjects met all the requirements of the government in this respect was very impressive.

The first week of wild fluctuations in the exchanges was followed by a week of relative dullness with sterling quoted around 3.90, a depreciation of about 20 per cent. The situation seemed, however, still rather precarious. A large amount of foreign balances and foreign held acceptances still remained in London subject to quick withdrawal unless confidence in sterling could be maintained. These were estimated by *The Statist* in its issue of October 3, 1931 (p. 455) at about £125 million: £80 million of French official balances and bills, £5 million of private French balances and bills, £10 million of private American balances and bills, and £30 million of other foreign assets. If confidence in sterling could be restored there would be a strong motive for keeping these assets in London. Their withdrawal would have meant the actual realization of large paper losses and destroyed all

[4] *Financial News* (London), Sept. 23, 1931.

prospect of benefiting from a later improvement in the rate. The possibility of extending the £130 million French and American credits secured to defend sterling was also bound up in the question of confidence in the pound. So also was the capacity of London to prevent the crisis from causing acceptance and other international financial business from being shifted to New York and other centers. For these reasons the 6 per cent Bank rate was of peculiar importance, for it was a sign of a determination to resist incipient inflationary influences. The whole tenor of British official and banking comment was intent upon reinforcing this impression, and pressure was brought to bear quietly but firmly to prevent any sudden increase in prices.

The weakness in sterling immediately after the abandonment of the gold standard was added to by the effect of sterling depreciation on the movement of gold from South Africa. For several weeks newly produced gold was held back in South Africa until it could be determined whether, under existing marketing arrangements (cf. Ch. 19), the gold producers could secure the full benefits of the 'premium' that appeared in the price of gold. As employed in South Africa the term 'premium' on gold meant the difference between the market price of gold and Bank of England buying price. During Restoration the existence of such a 'premium' had played a great role in the South African economy.[5] At that time, however, the South African pound had followed sterling, and the 'premium' was translated into a larger number of South African pounds received by the gold producers. After September 21, 1931 the situation was quite different. South Africa remained on the gold standard and the South African pound appreciated in sterling approximately[6] to

[5] Cf. W. A. Brown, Jr., *England and the New Gold Standard* (London, King, 1929), pp. 22–6, 75–82, 127–30, 181–6.

[6] As shown in Ap. Table 5, the South African exchange appreciated in terms of sterling less than did the American dollar, and consequently was at a small discount in terms of the dollar. The appreciation of the London market price of gold over the standard price was correspondingly greater than

the same degree that the market price of gold rose above its statutory price. Consequently if the gold producers had changed their method of marketing their product and, instead of selling their gold to the Reserve Bank of South Africa, had sold it directly in the bullion market, as they did from 1919 to 1924, they would have received more sterling, but on remittance home their 'gain' on the 'premium' would have been offset by their 'loss' on the exchange. As far as meeting their South African costs of production was concerned they would have been in the same position as before, but they would have benefited by the higher sterling value of their product so far as they used the proceeds to purchase equipment in England or to remit dividends to London. This would also have been true, however, had they continued to sell their whole output to the Reserve bank of South Africa, for they would have received the same number of South African pounds as before, and these South African pounds had an increased power to purchase sterling. It soon became evident, therefore, that nothing was to be gained by altering the existing marketing arrangements as long as South Africa remained on the gold standard. The technique of handling South African gold in London, in fact, remained entirely unchanged except that no Reserve Bank gold was sold to the Bank of England whose bid was not competitive, and that the sales were no longer carried out on Tuesday of each week but were spread throughout the week. This was a natural consequence of wide daily fluctuations of the sterling exchange in terms of gold currencies.

The interruption of the gold flow from South Africa was therefore short. When shipments were resumed they came forward in about the same volume as before the abandonment of the gold standard (Table 80), but were not regularly

the appreciation of the South African pound. Moreover the South Africa-London rate, as fixed by the London banks, did not follow the often substantial day to day changes in the market price of gold. The relation described in the text was therefore only approximate.

made available for sale in the open market until March 1932,[7] being bought for the most part by a 'special buyer.' This special buyer was undoubtedly the Treasury, which was under obligation to accumulate in advance the resources needed to meet the £80 million French and American credits secured in September as the final measure taken in defense

TABLE 80

Major Components of the Gold Movement through London October 1931–February 1932 (millions of dollars)

	U.S.A.	FRANCE	HOLLAND	SWITZER-LAND	BRITISH INDIA	SOUTH AFRICA	ALL OTHER COUN-TRIES
1931							
Oct.	1.1	−6.7	−9.4	−2.5	8.3	21.6	3.1
Nov.	−4.6	−63.5	−14.1	−9.9	26.5	16.0	4.1
Dec.	−7.5	−25.9	−4.5	−18.3	22.8	20.1	.5
1932							
Jan.	−4.1	−64.9	−3.5	−.2	45.9	17.0	2.5
Feb.	2.2	−52.7	−7.5	−3.7	30.6	20.8	3.9
March	−.1	−40.8	−3.4	−7.3	24.3	20.6	4.1
Total	−13.0	−254.5	−42.4	−41.9	158.4	116.1	18.2

Total Net Exports, $59.1 million

SOURCE: *Federal Reserve Bulletin,* April 1933, p. 236

of the pound as a gold standard currency. This did not mean, however, that England's gold income from South Africa no longer supported the sterling exchange. It did so in a special way when utilized by the Treasury to build up balances abroad. The export did not necessarily follow at once upon the import or go necessarily to the same destination as if it had been sold in the open market. Table 80 strongly suggests that during October the major portion of gold imported from South Africa was temporarily detained in England.

By this time, however, England was already in receipt of a substantial gold income from another source. India remained a sterling-standard country, and the rising sterling price of gold in London was consequently translated into a rising rupee price of gold in India. All the forces promoting a gold

[7] Samuel Montagu & Co., *Annual Bullion Letter, 1932.*

export movement from India were greatly strengthened (cf. Ch. 23). Large shipments were sent to London. Much of this gold was sold forward, so that the support given the sterling exchange was felt before the gold itself arrived in London.

By the beginning of October 1931 the rapid decline in sterling encountered a double check. The export of British capital from August to September 21 had been considerable,[8] but in less than two weeks after the suspension this movement was reversed. As early as the last days of September British insurance companies and investment trusts and other foreign holders began to sell securities heavily in New York. Time loans placed in New York by British interests were allowed to mature and the proceeds remitted home, and French rentes were also being sold and the proceeds sent to London.[9] The main influence, however, in strengthening sterling was the covering of the bear position built up before September 21, which amounted to between £40 and £60 million. The Bank of England took advantage of this bear covering and began to accumulate dollars and francs to meet its foreign loans. This was the beginning of the Bank's activity in smoothing out daily fluctuations in the sterling exchange. The technique employed was both to buy and sell, but to buy more than it sold, and was a revival of the methods used by the Dollar Exchange Account in accumulating dollars to meet the American war debt payments. The Treasury was still able to operate in the market, and did so to accumulate francs and dollars to meet its own obligations, but its trading funds were now limited to £25 million and therefore could not be an effective stabilizing factor when the market was active and daily transactions were occasionally as large as £10 million or more. The tendency of the sterling exchange was upward during October (Chart 70), and at the end of the month confidence was further restored by the announcement that the Bank of England had arranged to pay £20 million

[8] Cf. *Commercial and Financial Chronicle,* Sept. 26, 1931, p. 1967.

[9] Samuel Montagu & Co., *Weekly Review,* Oct. 1, 1931.

of the £50 million credits obtained in France and America in advance of the due date, November 31, and to extend the balance for another three months. Payment was partly made by a shipment of £15 million in gold taken from the Bank's reserve, which was reflected in a loss of reserve of this amount in the Bank's statement of November 4, 1931.[10]

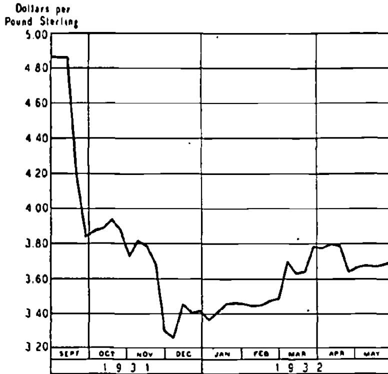


CHART 70

Sterling-Dollar Exchange September 1931–May 1932, weekly

By this time, however, another new element had entered the situation. On October 7 Parliament had been prorogued and on October 27 a new national government pledged to a protective tariff policy was overwhelmingly elected to office. This election was followed by a great increase in the importation of goods to escape impending tariff charges, and at the same time the cost of imports was being increased by rising prices for cereals, cotton, and wool. Sterling consequently was again weakened, but the government acted immediately to counteract the import movement. On November 19 an act known as the Abnormal Importations (Custom Duties) Act was passed giving the Board of Trade the power to place an additional duty up to 100 per cent of the value of the article on a wide variety of commodities if it was satisfied that imports were in 'abnormal' quantities. Empire goods, however, were excluded from this Act. The first order, imposing a 50

[10] *Ibid.*, Nov. 5, 1931.

per cent duty on many articles, went into effect on November 25.

Sterling was at this time under seasonal pressure, the 'abnormal' imports did not at once cease to cause offers of sterling, and the effect of exchange restrictions in other countries was already seriously impeding the remittance home of the proceeds of British exports. In addition, the continent was still alert for any signs of inflation in Great Britain. On November 30, 1931 fears that there would be a further increase in the Fiduciary Issue at the Bank of England resulted in withdrawals of foreign, especially French, funds. Coming on a weak market this contributed to a sharp decline of sterling which on November 30 closed in New York at 3.43. This decline itself gave rise to further fears of inflation, and the next day sterling fell to 3.27. This sharp decline, carrying the depreciation in gold currencies to 33 per cent, took place in a very thin market. The turnover was small and relatively small transactions moved the rate substantially. On December 3 sterling was strongly supported by one of the Big Five. Speculative sales ceased and the decline was checked. On December 14 sterling was very strong and reached 3.46½, a movement caused by a sudden drive against the dollar owing to fears of unfavorable news to be disclosed in President Hoover's forthcoming budget message to Congress. On December 19 sterling again declined sharply, falling 11½ cents in one day and closing at 3.34. This decline was due to the reaffirmation by the American Congress, in ratifying the Hoover Moratorium of June, that the United States was unalterably opposed to any reduction or cancellation of war debts. This was followed by an almost equally sharp recovery. Clearly the prestige of the pound was still far from fully reestablished when the sterling-dollar rate—usually the broadest exchange market in the world, capable of taking care of very large transactions with very small concessions in price—could be moved about in this fashion by relatively small speculative dealings. The weakness of sterling, however, was

partly due to causes directly connected with a restoration of its international prestige. A portion of the Bank of England's foreign credits had still to be paid off, and during the December declines the Bank of England was probably a seller in the market.[11] Again in January and February 1932, when seasonal factors were in favor of sterling and a rising tendency appeared, this was counteracted by further official sales. Funds were being accumulated first by the Bank and then by the Treasury also to repay their French and American credits. By this time, however, the situation was changing rapidly, and a series of constructive steps soon put an entirely new complexion upon the whole foreign exchange position.

On January 28, 1932 the Bank of England announced that arrangements had been completed for the repayment of the remaining £30 million of the August French and American credits without further drafts on the Bank's reserve. Early in February the bullion brokers announced that they were willing to purchase sovereigns from the public at market prices and before long exports of gold obtained from this source were taking place at the rate of £1 million per week.[12] Early in February also a new tariff bill was passed which established a general protective tariff of 10 per cent ad valorem and other duties, and which was equipped with various 'fighting' provisions. This measure came into effect on March 1. Finally it was announced on March 2 that arrangements had been made to pay £43 million of the £80 million French and American credits three months before their due date. Simultaneously the official exchange restrictions were dropped.

Immediately following the announcement concerning the Treasury credits large amounts of dollars and francs were bought on 'special' account, and the general feeling was that as soon as these purchases were completed sterling would go

[11] The *Financial News* infers this from a rise of $34 million in acceptances bought for foreign central banks by the Federal Reserve banks (Dec. 16, 1931).
[12] Samuel Montagu & Co., *Annual Bullion Letter, 1932*, and *Weekly Review*, March 3, 1932.

up and a long period of easy money would begin. The signal that they were completed was given on Tuesday, March 8, when South African gold was once more made available in the open market and was taken for France. On March 9 the bulk of the Treasury credits was repaid.[13] A rapid inflow of foreign funds followed at once. Sterling immediately rose 7 per cent, money became very easy in London, and on March 10 Bank rate was reduced from 5 to 4 per cent.

The period during which sterling had to be defended against the consequences of the shock of leaving the gold standard thus ended abruptly. With remarkable suddenness a new phase of British currency history began and with it a new British attitude toward sterling depreciation.

The Control of Sterling, March to December 1932

On December 4, 1931, when sterling stood in New York at 3.35, the British Chancellor of the Exchequer spoke of the depreciation of sterling in terms entirely free from any emphasis or outlook at variance with tradition: "I have no doubt," he said, "that foreign holders of sterling balances who have been taking their funds away from London will presently find that they have made a bad bargain. I see no reason why depreciation in the value of sterling *should be substantial or prolonged.*"[14] The withdrawals of sterling balances referred to by Mr. Chamberlain had included a large scale liquidation of gold exchange standard balances[15] and had helped to substitute for the last traces of sterling over-

[13] Samuel Montagu & Co., in their *Weekly Review*, April 7, 1932, said: "Of the $200,000,000 banking credit arranged last August in favor of H. M. Treasury for the purpose of strengthening the sterling exchange, $150,000,000 was paid off on March 9, $30,000,000 on March 29, and $20,000,000 on April 5. The U.S. Treasury does not cancel the credit which will consequently remain available till August 29, next, should occasion arise. Credits totaling Fcs. 5,000,000,000 were arranged in France in August. Half of this amount consisted of banking credits which have already been paid off. The other half was in the form of one-year Treasury Bonds, and cannot therefore be repaid before maturity."

[14] *Ibid.*, Jan. 7, 1932 (our italics).

[15] Cf. Ch. 32, The Fate of the Gold Exchange Standard.

valuation a definite undervaluation in many currencies, in particular, in dollars.[16] At this time no strong economic interest was opposed to an improvement in the rate. The chief, if not the only concern of the Bank of England and the Treasury about the economic, as distinct from the financial, effects of sterling depreciation was lest it should increase the cost of living. They had not, nor had anyone in England, expected gold prices to decline as sharply as they did under the shock to confidence occasioned by Great Britain going off the gold standard. Consequently the decline in sterling was more fully offset by falling gold prices than was expected. The general trend of retail prices before September 21 had been downward, and after that date cost of living had not risen very much, but a low exchange rate was still thought to be undesirable from this point of view. The first substantial rise in sterling, in March 1932, was therefore not opposed on economic grounds. On the contrary, it was greeted with jubilation as evidence that the pound was about to resume its ancient role as a world currency and that London was to continue as a great international financial center. As the rise continued, however, this jubilation gave way to another feeling. When, on March 31, 1932, sterling touched 3.80 in New York, Samuel Montagu and Company expressed this feeling as follows:

"Sentiment which was all against this country at the end of last year has turned in our favor, and large amounts of foreign money have been offered in this market; the problem is how *to keep sterling* from *rising at too rapid a rate to be healthy.*"[17]

[16] With the breakup of the nucleus almost insuperable obstacles were encountered in making any estimates of under- or overvaluation of sterling. Such estimates usually assume, by implication at least, that the comparison is with dollar prices, but much the largest part of British trade, and the most subject to competition, was with countries outside the dollar area. From the point of view of British exports the most important sterling rates were those with Empire countries and Western Europe. Though recognizing these difficulties fully, N. F. Hall concludes that in November and December 1931 sterling was undoubtedly undervalued somewhat. *The Exchange Equalisation Account* (London, Macmillan, 1935), Ch. VI, passim, especially p. 73.

[17] Samuel Montagu & Co., *Weekly Review,* March 31, 1932 (our italics).

Apprehension lest sterling continue to rise was partly, if not wholly, based on disappointment at the effects of a low exchange rate in stimulating British exports. The protective measures taken by other countries in the form of tariffs, quotas, and exchange restrictions, increased costs due to higher sterling prices for imports, and the lack of any exchange advantage within the wide sterling area were all combining to counteract the expected stimulus to exports. Great Britain was already encountering the obstacles that prevented world production for export from showing any improvement in 1932 as compared with 1931. These are described by the *World Economic Survey, 1932/3* (p. 86):

"Exchange instability has . . . been a disturbing influence [on production]. In some of the countries which abandoned the gold standard the export industries received an immediate, but in most cases, temporary stimulus. The stimulus was limited by further falls in prices, increasing trade restrictions, and the generalization of currency depreciation. On the whole it was the home markets which were best sustained in the countries which abandoned the gold standard."

There were also grounds for believing that if an undervaluation of sterling had existed at the close of 1931 it had been eliminated by the rise of the pound from a 30 per cent to a 20 per cent depreciation. This was the view of N. F. Hall, who based his belief partly on the initial fact of an overvaluation at the time sterling left the gold standard and partly on the subsequent effect of continued declines in prices in gold standard countries while the influence of high cost imports was being felt in the British price structure.[18]

In addition, certain technical considerations made a further appreciation of sterling caused by a continued inflow of foreign funds seem undesirable and even dangerous. Mr. Hall has described these as follows (*op. cit.*, p. 38):

"In the absence of 'speculative' influences, the spread between spot and forward rates in the exchange rate between any two

[18] *Op. cit.*, p. 3.

large money centers ought to cancel out such differences as may exist between their money rates. When the premium on the forward dollar is less than that which is necessary to offset a rate of interest higher in London than in New York, there must be a speculative position in spot sterling. The only period after the suspension of the gold standard when the forward dollar was at a sufficient premium to equalize realizable earnings in London and New York was at the end of November and early in December 1931. Thereafter, the forward rate tended to go at a discount and the discount increased as the spot rate rose. The size of the discount meant that balances in London must also have risen quite substantially and that the exchange risk involved had not been covered. As the forward contracts matured some fall in the rate for spot sterling was inevitable, so that the general external value of the pound was extremely unstable. The fall in spot sterling caused by the covering of the unbalanced forward contracts might, if it was allowed to develop unchecked, have caused a second withdrawal of balances from London, and in consequence, a rise of bill rates there. To prevent disturbances on a large scale occurring, steps had to be taken to fortify confidence in the pound so that balances *bona fide* required in London, and not present there only in anticipation of a further rise in sterling, should not be frightened away."

The rise in sterling in the spring of 1932 therefore provided substantial grounds for a transition in foreign exchange policy from one of defending to one of controlling or managing sterling.

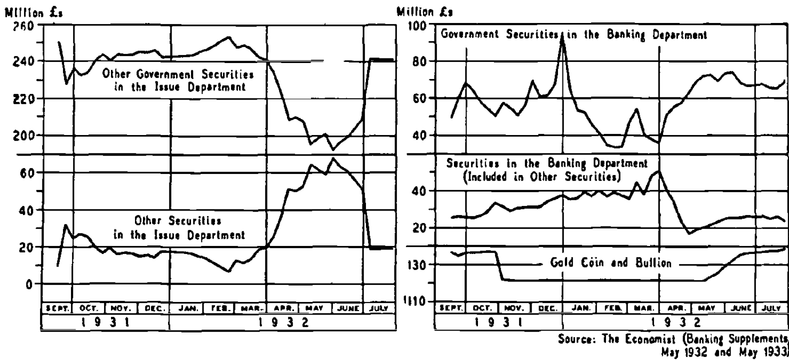
Exchange Control through the Bank of England, and the Concept of Gold as Standard and Gold as Reserve in England

In April 1932 the rising trend of the sterling exchange received a definite check (Chart 70), and there was evidence in the published statements of the Bank of England that this was at least partly due to sales of sterling by the Bank. Under the Currency and Bank Notes Act of 1928 foreign exchange had been included for the first time among the securities against which Bank of England Notes could be issued (cf.

Ch. 19). This foreign exchange was included in the item 'other securities' in the Issue Department. From September 23, 1931 to February 24, 1932 this item declined £26 million, while the item 'other government securities' in the Issue Department increased by a corresponding amount, indicating that the Bank was disposing of its foreign exchange. From February 24 to June 1 the general movement of these two items was reversed, 'other securities' in the Issue Department rising £62 million and 'other government securities' falling correspondingly. During March there was a gradual change, indicating purchases of foreign exchange by the Banking Department, their exchange for government securities at the Issue Department, and probably the sale of the government

CHART 71

Bank of England, Selected Balance Sheet Items
September 1931–July 1932



Source: The Economist (Banking Supplements, May 1932 and May 1933)

securities in the market to offset the domestic effects of the purchase of foreign exchange. In March 'other securities' in the Banking Department increased substantially, suggesting further accumulations of foreign exchange by the Bank. These last inferences cannot be drawn with confidence, for the securities items on the balance sheet of the Banking Department are very diverse and their net movement reflects the resultant of many different types of transaction. They are

borne out, however, by the clear indications of a substantial transfer of foreign exchange from the Banking Department to the Issue Department in April (Chart 71). During that month sterling ceased to rise and the very substantial changes in the securities held by the Issue Department were attributed by the market to the Bank's foreign exchange operations. In their *Weekly Review,* April 21, 1932, Samuel Montagu and Company said (our italics):

"The Bank of England Return continues to show heavy changes in the securities of the Issue Department. In the last three weeks Other Government Securities have fallen from £240,864,396 to £208,680,635 and Other Securities have risen from £19,314,668 to £51,486,758. The securities items in the Banking Department have also varied considerably. This week government securities have increased £2,229,000 while Other Securities have fallen £11,620,961. *All these changes are generally assumed to be occasioned by the Bank's operations in the foreign exchange in behalf of the Treasury and itself.*"

Intervention in the foreign exchanges by the Bank of England on such a scale as a permanent policy encountered serious technical and psychological difficulties. At least six such difficulties may be distinguished:

1) When the Banking Department sold government securities to make room in its portfolio for foreign exchange, or to offset the domestic effects of its purchases of foreign exchange, it diminished its power to deal effectively with purely domestic credit control problems in the future. Part of its portfolio could not be sold to contract credit at home without simultaneously strengthening sterling abroad. These two aims might often be jointly desired, but not necessarily so at all times and in all circumstances.

2) To the extent that the Issue Department sold government securities to the Banking Department and received foreign exchange in return, it had to assume an exchange risk on a portion of the assets against which Bank of England Notes were issued. To the extent that the Banking Department

bought and retained foreign exchange it had to assume an exchange risk on a part of its portfolio. This exchange risk was of a twofold character:

a) the risk involved in the possibility of a *general* appreciation of sterling in terms of the group of currencies held by the Bank so that the Bank could not sell any of its foreign exchange holdings without taking a loss in sterling;

b) the risk involved in the possible depreciation of one or more of the foreign currencies held by the Bank in terms of other foreign currencies, as well as in sterling.

As long as the world was divided into a world of gold and a world of sterling the exchange risk taken by the Bank was of the first type alone. But to the extent that there was a possibility that some gold standard country in whose exchange the Bank had invested might become detached from the world of gold, the Bank had to assume a risk of the second type also. This was similar to the risk involved in the Experiment of Operating a Gold Exchange Standard without a Focal Point, which had brought actual losses to many central banks after September 1931 and had ended that Experiment.

3) The Bank could escape from the particular exchange risk involved in the holding of individual foreign currencies by converting its foreign exchange portfolio into gold. However, it could not thus escape from the general exchange risk of the first type as long as the London market price of gold was a function of the sterling exchange rate in gold standard currencies. The Bank, moreover, under the terms of the Gold Standard (Amendment) Act of September 1931, could convert foreign exchange into gold only by assuming a bookkeeping loss in sterling in exchange for a hidden asset. At the moment of conversion this bookkeeping loss and this hidden asset were equal. If, however, the price of gold in the market were to fall below the market price prevailing when the gold was bought, the hidden asset would become less than the bookkeeping loss. If the market price of gold were to return to an equivalence with the Bank of England's statutory

buying price, then the hidden asset would entirely disappear and there would be no offset against the bookkeeping loss. This requires some explanation. The Gold Standard (Amendment) Act of 1931 had simply relieved the Bank of England of its obligation to redeem its notes in gold bullion at a fixed price in sterling. It had not changed the definition of the sovereign as 113.001 grains of fine gold. It did not empower the Bank of England to buy gold at above its statutory price. It restored the position existing from September 1919 to April 1925 under which England was operating a domestic gold standard. The Bank of England reserve was expressed in terms of the pre-war gold sovereign, and being so constituted, it became a *limiting fund* pure and simple. As such it continued to be used in the technical administration of British credit policy. It was subject to arbitrary increase or decrease by purchases or sales of gold at the Bank's initiative, but the Bank's proportion was in no way influenced by changes in the sterling market price of gold.[19] Therefore if the Bank wished to convert its foreign exchange into gold, or to buy gold instead of foreign exchange, it could do so only by paying for the gold at market prices and carrying the gold on its books at the statutory price. A bookkeeping loss had to be absorbed by this transaction, but the gold could be sold again at market prices. As long as the market price was not less than the price at which the gold was bought, there was an offset in the form of a hidden asset. But the London market price of gold was a function of the sterling exchange on countries that still maintained the gold standard obligation of buying all gold offered at a fixed price and were able to outbid the Bank of England in the bullion market. By converting foreign exchange assets into gold therefore, the Bank of England could not escape an *exchange* risk, for the loss in the sterling value of the gold bought by the Bank of England as sterling appreciated in gold standard currencies was a foreign exchange

[19] Cf. Ch. 9, Gold as Reserve.

phenomenon.[20] The only exchange risk eliminated was that incurred by holding particular currencies, for the holding of gold gave the Bank of England a claim on that gold standard currency which at any given moment happened to be strongest in terms of sterling.

The possibility of an ultimate revaluation in sterling of all the gold held by the Bank of England provided a source from which all these possible losses could be made good—not only the losses on gold purchased at prices higher than that at which such a revaluation was made, but also losses on holdings of foreign exchange. It did not alter the fact that the Bank of England could not escape an exchange risk by purchasing either gold or foreign exchange as long as sterling was not held in a stable relation to the world's principal currencies.

4) If the Bank of England did convert its foreign exchange holdings into gold or bought gold as a result of its operations in the control of the foreign exchanges, it could do so only by reducing its Fiduciary Issue or by increasing the proportion of the Banking Department. Mr. Hall points out that this "might have been interpreted to foreshadow a change in internal conditions." That is, it might have interfered with the effectiveness with which credit control was administered in England with the aid of a fixed or arbitrarily altered gold reserve used as a 'limiting fund.' But that would have followed also had the Bank been able to purchase gold at market prices and to carry it at cost in its accounts. In that case, indeed, the Bank's intervention in the exchange market would have left even greater traces on its return, and the psychological reaction of the public might have placed even greater difficulties in the Bank's way.

5) Since the Bank's operations in the exchange market would have had to be indicated, however obscurely, in its published statements, the size and general character of the

[20] Cf. Ch. 34, Gold Wears a Coat of Many Colors.

steps taken against speculators would have become public, and the secrecy necessary for their effectiveness would have been partly lost. Indeed, the interpretation of the Bank return might, under these circumstances, itself have given new fuel to speculative enterprise, though whether the encouragement to speculation would have been greater than that customarily induced by the Bank's traditional reserve is a matter of opinion.

6) If the Bank of England had been permitted to buy gold at market prices, certain questions would have arisen in calculating the distribution of profit as between the Issue Department, whose profits go to the Treasury, and the Banking Department, whose profits go to the proprietors of the Bank.[21] This difficulty, though real, was minor and was ignored when the Bank's gold holdings were actually revalued at market under the Currency and Bank Notes Act of 1939 under which profits and losses were charged to the Exchange Equalization Account and transferred in gold to or from the Issue Department. It was not on such minor grounds that revaluation of the Bank of England's gold was postponed, but because the Bank shared the view of Mr. Chamberlain that the suspension of the gold standard was merely temporary.

The essential meaning of these various difficulties may be compressed into a single sentence: the use of the Bank of England's gold reserves as part of the technical administration of a managed currency system was inconsistent with their use as part of the technical administration of a system of foreign exchange control. It was impossible to administer successfully through the same agency and at one and the same

[21] *Op. cit.*, p. 25. The list of difficulties encountered by the Bank of England in carrving out exchange control operations given by Mr. Hall contains four points. All have been incorporated in the text but with a different emphasis and in some cases with a different interpretation. The writer feels that Mr. Hall fails to go to the root of the matter when he takes it for granted that the Bank of England could have escaped all exchange risk if it could have bought gold at market prices. This would have been more straightforward bookkeeping but would not have changed the real value of the Bank's assets.

time a managed domestic gold standard and a form of international gold bullion standard with varying export and import points. An escape from this dilemma was found in the creation of an agency outside the Bank of England to carry out such interventions in the foreign exchange market as were determined upon, but not as the result of abstractions like those formulated above, or for the purpose of attaining any preconceived 'equilibrium rate' for sterling.

The Establishment of the Exchange Equalization Account

All through the late autumn of 1931 and early spring of 1932 the Bank of England had been accumulating dollars and francs and steadying sterling as an incident to fulfilling its obligations to those from whom it had borrowed. When it had obtained all the dollars and francs needed for this purpose its special interest in the exchange market was lost, but its general interest remained, as did the personnel assembled and the procedures developed for intervention in the market. When the gold standard was suspended an Exchange Committee had been formed at the Bank, which was in regular consultation with the Treasury representative who visited the Bank every Friday in connection with the weekly tenders of treasury bills. A committee from the market also came weekly to the Bank to consult about the exchanges. It was therefore a natural suggestion that when the Bank's own reasons for intervening were no longer present, the work that it had carried on in close association with the Treasury and the market should be continued. Since the funds in the old Dollar Exchange Account were inadequate, a new government account with larger resources was clearly desirable. The Exchange Equalization Account thus came into existence in much the same empirical way as other London money market institutions and practices in the past. Its establishment was announced by Mr. Chamberlain in his Budget speech of April 19, 1932. In this speech Mr. Chamberlain completed his evolution from a grim defender of sterling against those who

thought its depreciation might be "substantial and prolonged" to an advocate of keeping sterling down and keeping it steady. Accepting the thesis that world conditions ruled out the possibility of an immediate return to the gold standard, he pointed out that since Great Britain had succeeded in balancing her budget and repaying foreign credits the tide of liquid capital was setting strongly toward her shores. This, he said, was flattering to British vanity but seriously embarrassing to trade, and so far as it represented no permanent improvement in the balance of trade, it was dangerous. "Therefore," he concluded, "I have been driven by the force of events to this conclusion: that if we are to avoid violent and perilous fluctuations in our currency, especially those which are due to these speculative operations; if we are to enable this country to function effectively as the main international 'centre' of the world, then it is essential for us to hold adequate reserves of gold and foreign exchanges, in order that we may meet a sudden withdrawal of short-dated capital and that we may check and repel these speculative movements. I propose to wind up the old Exchange Account and to use the assets as the nucleus of a new account, to be called the Exchange Equalization Account. I propose to ask the Committee to give me powers to borrow up to £150,000,000 for this account. The details of assets in the account will not be published, but they may take various forms, either gold or sterling securities or foreign exchange."

The Exchange Equalization Account thus provided for did not come into existence officially until June 24, 1932. Unofficially it probably began to operate some time earlier. There was, consequently, from May to July a transition in the Bank's relation to the foreign exchange market from direct intervention to indirect intervention through the informal predecessor of the Equalization Account, and finally to a retirement from this form of activity and a transfer of its remaining foreign exchange holdings to the Account. During this transition the Bank took steps to give to its return

the appearance of normality and strength. These transactions can be traced with some assurance, but not of course with certainty, on its balance sheet.

Immediately after the government's decision to establish the Account was announced, sterling declined substantially against the gold currencies, reaching 3.63¾ on April 26. But in the following week the passage of the Goldsborough Bill by the American House of Representatives, instructing the Federal Reserve system to restore prices to the 1926 price level, caused sterling to rise sharply in New York. This rise was counteracted by 'official' selling of sterling,[22] and the next week, as shown in Chart 71, 'other securities' in the Issue Department rose sharply while 'government securities' fell correspondingly.[23] The Bank of England was evidently buying foreign exchange but at this time it also began to convert a part of its foreign exchange holdings into gold. For some weeks previously the gold in the open market had been taken for "an undisclosed destination," and it is probable that the Bank was carrying out these transactions with the Treasury rather than directly in the market. This operation continued for some weeks, being reflected in the Bank's return in an increase in gold, and a simultaneous decline in 'other securities' and rise in 'government securities' in the Issue Department. In the last week of May sterling was strong in New York because of continued failure of the United States to balance its budget, and the now familiar indications of sales of sterling by the Bank of England reappeared temporarily in the Bank return (Chart 71).[24] The conversion of foreign exchange into gold by the Bank was not interrupted, however,

[22] Samuel Montagu & Co., *Weekly Review*, May 5, 1932.

[23] Samuel Montagu & Co., commenting on the Bank return for May 11, said: "The heavy increase of £12,035,388 in Other Securities and decline of £12,035,143 in Other Government Securities in the Issue Department . . . is attributable to foreign exchange transactions." *Ibid.*, May 12, 1932.

[24] Samuel Montagu & Co., commenting on the Bank return of June 1, said: "Other Government Securities in the Issue Department have declined £8,894,195 and Other Securities have risen £8,896,857, presumably owing to foreign exchange transactions." *Ibid.*, June 2, 1932.

and was reflected during the next two weeks in a continued replacement of 'other securities' by 'government securities' in the Issue Department.[25] When these gold purchases had completely replaced the gold parted with in November 1931 to repay foreign credits they ceased, but the Bank continued to part with foreign exchange. The presumption is that this foreign exchange was transferred through the Treasury to the new Exchange Equalization Account. Apparently the Account took over the remaining foreign exchange held by the Bank in the first week of July, a transaction clearly indicated in Chart 71. The Bank of England statement of July 6 therefore marked a complete 'return to normal' in external appearance. The management of the domestic gold standard through the Bank of England was no longer complicated by efforts to prevent undesired fluctuations in the foreign exchange.

This duty was now completely entrusted to a new government account authorized to deal in the foreign exchanges so as to preserve an orderly market and to prevent undue day to day fluctuations, and managed for the Treasury by the Bank of England. The Bank's exchange committee was continued after the Account was put into operation. The Treasury was permanently represented on it, but only important changes in policy were referred to the Chancellor of the Exchequer who was visited by the Governor of the Bank about twice a week. The Account was empowered to hold as its chief assets gold, foreign exchange, sterling deposits, and treasury bills. At its inception £150 million in treasury bills were allocated to it, but some of these were exchanged for sterling deposits and foreign exchange almost at once. In addition, a certain

[25] Samuel Montagu & Co., commenting on the Bank of England return for June 8, said: "It would appear from the current Bank of England Return that the official holdings of foreign exchange declined by £4,964,175 this being the amount of the fall in Other Securities in the Issue Department, while Other Government Securities have increased by approximately the same amount. The reduction mentioned above is probably connected with the increased gold holding." *Ibid.*, June 9, 1932.

amount of foreign exchange held by the Treasury and remaining from the old Dollar Exchange Account was turned over to it. The Account actually began operations with about £120 million in treasury bills, about £30 million in deposits obtained as Ways and Means Advances from other government departments, and about £25 million in foreign exchange obtained from the Treasury. One of its first acts was to reduce its treasury bills and add to its foreign exchange by taking over about £32 million in foreign exchange held by the Bank of England (Chart 71).

The ability of the Exchange Equalization Account to alter the distribution of its assets by shifting from any one of the four forms in which its resources were chiefly invested into any of the others made it an extraordinarily flexible instrument of financial policy. It is very doubtful whether the full extent of this flexibility was realized at the time the Account was established, for the fundamental transactions of the Account were simple, and it was established for the particular purpose of keeping sterling from rising. When the Account was used for this purpose its basic procedures were as follows:

1) The first and most important step was to buy foreign exchange and to sell treasury bills in the market to get the necessary sterling. These operations were nearly simultaneous. Since the Account kept its deposits with the Bank of England this was a transaction without effect upon 'bankers balances' at the Bank. The Bank of England funds paid out in the purchase of the exchange were withdrawn by the sale of treasury bills. If the treasury bills were sold to banks, then the effect upon the credit superstructure was to increase bank deposits, and since bank reserves were unchanged, to reduce the cash ratio of the banks.[26] If the treasury bills were sold to the public, the effect upon the credit superstructure was to leave deposits unchanged. Since the reserves also were un-

[26] Cf. Barclays Bank Ltd., *Monthly Review,* July 1936: The Exchange Equalisation Account and the Demand for Sterling, p. 4, col. 2; p. 5, col. 1.

changed, the whole transaction was neutral in its influence on the credit base and on the credit superstructure.

As far as the English banking system outside the Bank of England was concerned, these were precisely the effects of a gold import carried out under gold standard conditions by private arbitrage and offset by Bank of England open market operations.[27]

2) Having purchased foreign exchange and sold treasury bills the Account was free to convert this foreign exchange into gold. This transaction was neutral as far as the British banking system was concerned. The sale of the foreign exchange reduced the purchasers' deposits and reduced 'bankers balances at the Bank of England,' while the purchase of the gold increased the deposits of the sellers of the gold[28] and replenished 'bankers balances.' The transaction was also neutral in the foreign exchange market. The sale of the foreign exchange constituted an increased demand for sterling, but the purchase of the gold deprived sterling of the support it would have had if the gold had been exported. The conversion, however, eliminated the exchange risk assumed by the Account whenever it increased its portfolio of particular foreign currencies, though not the *exchange risk* to which it was exposed by a fluctuating sterling price of gold. It gave the Account not a claim on particular currencies, but an option on that gold standard currency which at any moment hap-

[27] Cf. Ch. 4, The Support of the Foreign Exchanges during the War in its Relation to the Supply of and Demand for Bank Credit, where it is pointed out that gold imports, when made by banks and not by customers of banks, do not reduce deposits as other imports do. Therefore the deposits created by the banks when they buy the foreign exchange with which to pay for the gold stay in the system. If the central bank then carries out offsetting operations by selling securities, the credit superstructure either increases or remains unchanged. If the securities are sold to banks, then the new deposits continue in existence, for when banks buy securities from a central bank they charge no one's account, merely changing their own assets from one form to another. If, however, the central bank sells securities to the public, then the accounts of the purchasers are charged, and the deposits resulting indirectly from the gold import are canceled.

[28] In the case of South African gold there would be one intervening step.

pened to be most valuable in terms of sterling.[29] The conversion, moreover, constituted an actual import of gold into England, so that the sale of treasury bills, the purchase of foreign exchange, and the conversion of foreign exchange into gold together constituted the equivalent of an import of gold into England under gold standard conditions, offset in its influence on the domestic banking system by open market operations.

3) Having sold foreign exchange and purchased gold, the Exchange Equalization Account was free to sell all or any portion of this gold to the Bank of England. Such sales increased the reserves of the Bank; whether they affected 'bankers balances' or not depended on the administration of the Account's own balances, included in 'public deposits.'

4) Having increased its balances at the Bank of England by selling gold to the Bank, the Account had the option of either retaining them or investing them in treasury bills. If it retained them the sale of gold to the Bank did not affect 'bankers balances,' and as far as the credit superstructure was concerned, the transaction was without substance, for it did not influence the lending power of the commercial banks or affect their deposits. Its importance was psychological. It completed the various steps by which the outward appearance of a gold import carried out by private arbitrage but offset by open market operations was reproduced under conditions when the gold standard was abandoned. If, however, the Account followed the usual practice of other government departments, the Bank balances would not be retained, but would be invested in treasury bills. The treasury bills so purchased were not, however, taken from the market, but bought 'through the tap' (cf. pp. 1138–9), that is, from the Treasury. Such purchases left the amount of 'public deposits' at the Bank unchanged, but increased the available funds of the Treasury itself and therefore made possible a reduction in the amount of treasury bills offered to the market at the next

[29] Cf. Ch. 34, Gold Wears a Coat of Many Colors.

tender. An increase in Bank of England funds made available to the banks as a result of treasury bill purchases by the Account followed therefore indirectly and after a delay of a few days and came to them through government expenditures not offset by sales of treasury bills by tender which would have been necessary had the Account not bought bills 'through the tap.' This was the customary procedure when the Account sold gold to the Bank, and as long as it was followed such sales were no longer neutral so far as 'bankers balances' were concerned. The effect of the whole series of transactions, beginning with the purchase of foreign exchange, was to increase the Bank of England reserve, to increase 'bankers balances,' to leave the amount of treasury bills in the hands of the banks and the public unchanged, and to increase bank deposits. The effects of a simple gold import by private arbitrage under the gold standard were fully reproduced.

Purchases of gold by the Bank of England from the Account when the gold standard was suspended were a purely arbitrary increase in the reserve fund used to limit the amount of credit made available under a managed currency system. If the Bank's policy was to increase the credit base by liberal discounts or open market operations, then such purchases could make this possible without a reduction in its proportion or an increase in its Fiduciary Issue. If its policy was to offset other deflationary forces at work in the banking system, such purchases could accomplish this purpose also. For example, after 1935 the deflationary effect of an increasing circulation upon the reserves of the clearing banks was anticipated by transfers of gold from the Account to the Issue Department.

If the gold was sold to the Bank at its statutory buying price the Account absorbed an actual loss in sterling equal to the difference between the Bank's statutory buying price and the market price, and by so doing had a moral claim to be reimbursed at some future date either by buying back the

gold at the statutory price or by sharing in the profits of some future revaluation. It had a legal claim also under the Finance Act of 1932 which provided that upon the winding up of the Account all profits on gold made by the Issue Department should go to the Account or be used for debt extinction.

In this analysis it has been assumed that in selling treasury bills in order to obtain the means of purchasing foreign exchange or gold the Account would deal only with banks or with the public so that its operations in this respect would not influence the banking system except for a possible alteration in the cash ratio. These assumptions have been made in accordance with actual practice, for there is no centralization of the operations of the various government departments in respect of their dealings in treasury bills. When government departments have a surplus of Bank of England funds to invest in treasury bills they 'tap' for them; when they need to dispose of treasury bills for cash they either let them run off or sell to the market. They do not, furthermore, deal in treasury bills directly with one another or with the Bank of England as principal, although there is no theoretical or technical reason making such dealings impossible. British practice is flexible enough to take advantage of them if a situation that seems to call for such action arises. For the sake of completeness, therefore, the money market effect of sales of bills by the Account directly to the Bank or the departments in order to get funds with which to buy gold or exchange should be set down. In that case the efforts of the Account to keep sterling from rising would have the effect of increasing 'bankers balances at the Bank of England' and increasing bank deposits. They would affect the banking system outside the Bank of England in the same way as an ordinary import of gold under gold standard conditions by private arbitrage. It was also assumed in the foregoing analysis that when the Account sold gold to the Bank and invested the proceeds in treasury bills, it bought these treasury bills 'through the tap.' But this assumption also need not have been made. These bills might

have been purchased from the Bank as principal or from other government departments, in which case the effects of a gold import under gold standard conditions offset by open market operations would be obtained.

The above analysis applies only when the Account was being used to keep sterling from rising. The Account, however, had not long been established before it was called upon to support sterling. In this situation the operations described above were reversed. The same extraordinary flexibility was still possible, but there was one fundamental difference. The scope of the operations of the Account on this side of the market was limited by the amount of gold and foreign exchange previously accumulated rather than by its capacity to borrow in sterling. Its procedures when being used to support sterling may be described in a more condensed form, as they are merely the converse of those already described:

1) The first and most important step was for the Account to sell gold or foreign exchange or both and to buy treasury bills. This transaction did not affect the amount of 'bankers balances at the Bank of England.' If the treasury bills were bought 'through the tap,' that is, indirectly from the market as a result of a reduced offer of bills at the next tender, then the effect of the whole operation upon the credit superstructure would depend upon whether the reduced holdings of the market were in the holdings of banks or in those of customers of banks. If of banks, then there would be a decrease in bank deposits and, bank reserves remaining the same, an increase in the cash ratio of the banks, because the deposits of the buyers of gold or exchange would be reduced without any corresponding increase in the deposits of those whose treasury bills had been paid off. If of customers of banks, then the deposits of these customers would be increased and the net effect of the operation on the credit superstructure would be neutral.

As far as the English banking system outside the Bank of England was concerned, these were precisely the effects of a

gold export carried out by private arbitrage under the gold standard, and offset by open market operations.
2) In order to replenish or increase its stock of gold the Account might purchase gold from the Bank of England. This transaction would be without influence upon the commercial banking system, but would reduce Bank of England reserves and give the total transaction the same outward appearance as a gold export under gold standard conditions offset by open market operations. It would, from a psychological point of view, justify a contraction of Bank of England credit, if on other grounds such a contraction was part of the Bank's credit control policy. If the gold bought by the Account from the Bank were bought at the statutory price the Account would realize a profit in sterling. If it had previously sold the gold to the Bank, the position would be the same as if it had continued to hold it from the moment of its original purchase.
3) Having bought gold from the Bank the Account might be content to allow its balances to remain depleted by the amount of the puchase, or it might sell treasury bills to replenish its account. If it sold treasury bills, then the total effect of the transaction would be the same as an ordinary gold export under gold standard conditions carried out at the statutory price. Both the credit base and credit superstructure would be contracted.

As in the analysis of the operations of the Account in preventing sterling from rising, this analysis has made certain assumptions as to procedure in accordance with actual practice. Theoretical completeness requires, in this case also, that the money market effects that would follow if these assumptions were removed be stated. It has been assumed that the treasury bills bought by the Account with the proceeds of its sales of foreign exchange or gold were bought 'through the tap' and therefore at one remove from banks or customers of banks. They might, however, have been bought from the Bank of England or from other government departments. In

that case the whole transaction would have the effect of an ordinary gold export under gold standard conditions. It has further been assumed that if the Account bought gold from the Bank and replenished its balances by the sale of treasury bills, it would sell these bills to the market. But it might replenish its balances by selling bills to the Bank itself or to other government departments. In that case the effect of the whole transaction would be the same as a gold export under gold standard conditions offset by open market operations.

The above analysis indicates that the authorities could so use the Exchange Equalization Account as to harmonize its activity in the foreign exchange market with the administration of any desired domestic credit control policy. The positive economic functions fulfilled by the Account may now be examined. Within the limits imposed by the size and distribution of its resources the Account was an effective instrument for accomplishing certain things that had previously been accomplished by other techniques of the London money market. Its functions were a mixture of old and new. In part it was a new way of doing old things and in part it was a way of doing things that were new in themselves. This may be brought out as follows:

1) The Exchange Equalization Account provided a substitute for short term capital movements induced in the prewar gold standard system by inter-money market interest rate differentials. It fulfilled in a measure the functions of interest-arbitrage in equalizing interest rates internationally and smoothing out fluctuations in the exchanges. Before the war, and to some degree after the war also, when sterling was strong in the exchanges, interest rates in London were likely to be relatively low. Hence there was a motive for an outward movement of short term capital from London. It became profitable to borrow in London, remit the proceeds abroad, and employ them in other money markets. Such an outward movement of short term capital tended to make interest rates

rise in London and fall elsewhere, and also to weaken sterling. When sterling was weak the operation was reversed.

The intervention of the Exchange Equalization Account to check a rise in sterling or to prevent a decline was a planned and controlled short term international capital movement which had similar effects. When sterling was strong, the Account borrowed in London by selling treasury bills, used the proceeds to buy foreign exchange, and held them in foreign money markets in the form of gold and working balances. It was an equalizer of interest rates, though in this respect fully effective in only one market, and it smoothed out fluctuations in the exchange. When sterling was weak the Account reversed the operation. In doing so, however, it was limited by the amount of its foreign assets, whereas private capital movements from abroad to London could be swelled by borrowing abroad. The effectiveness of the Account in taking the place of short term capital movements in acting as an interest rate equalizer and steadying influence in the exchanges was therefore likely to be greater when sterling was strong than when sterling was weak.

There was, furthermore, one fundamental difference between pre-war conditions and those prevailing when the Account was established. The former regulating mechanism had to a large extent become the thing to be regulated, or at least an important part of it. Under the new conditions, international short term capital movements responded so largely to other motives, far more powerful than the desire to take advantage of interest rate differentials, that they no longer offset other items in the balance of payments which were responsible for substantial interest rate differentials and exchange fluctuations. They became themselves a *source* of such differentials and fluctuations. Instead of being the allies and instruments through which discount rate policy was made effective, they became the objects against which such policy was directed. Hence the Account assumed an economic

function which had not only been left unfulfilled by private short term international capital movements, but had also been rendered more difficult by such movements.

Mr. Hall points out that when sterling was strong because of an inward flow of capital, and the increased balances of foreigners were as a consequence seeking employment in London, then the sale of treasury bills and purchase of exchange by the Account constituted, in effect, a sale of treasury bills to foreigners 'through the tap,' without allowing the inward movement of capital to affect British interest rates or the sterling exchange. When sterling was weak because foreigners were withdrawing their investments in sterling the purchases of treasury bills by the Account and the sale of foreign exchange neutralized the effects of these withdrawals. Mr. Hall says: "The Account, in fact, is *simply* a device which puts Treasury Bills 'on tap' for foreigners, and permits them to increase or decrease their holdings without unduly influencing the sterling exchange." [30] It was undoubtedly this service of the Account that dominated the thought of the authorities at the time of its foundation, but once having the instrumentality in operation, they did not fail to explore its other possibilities when the situation changed. It seems to the writer a serious error to neglect the *general* capacity of the Account to fulfil the functions of a mobile international loan fund, whether the disturbances to be corrected arise from private capital movements or from other causes. The sales of treasury bills by the Account were by no means restricted to periods when foreigners were investing in them, nor were its purchases restricted to periods when foreigners were selling bills.

2) The Treasury, through the Account, was able, when sterling was strong, to acquire a fund of foreign exchange and gold which was, in effect, a reserve against the foreign liabilities of the London money market, additional to, and inde-

[30] *Op. cit.*, p. 24 (our italics).

pendent of, the 'reserve' [31] held by the Bank of England. By separating the reserve against foreign liabilities from the arbitrary limiting fund restricting the expansion of domestic bank credit, an important new technique of currency management was introduced. When sterling was weak the British authorities no longer relied on the reversal of interest arbitrage, gold arbitrage, and security arbitrage transactions, the use of the gold reserves accumulated by the Bank of England, and the general influence of a high Bank rate on the marginal elements in the British balance of payments to correct the situation. They now used foreign assets and gold held by the Treasury for this purpose.

3) Though the establishment of the Account did separate the function of holding a reserve against foreign liabilities from the function of holding a reserve against domestic obligations, the separation was not absolute. It was a separation that was subject to the will of the authorities, as shown in our account of the extraordinary flexibility of which the management of the Account was capable. The Exchange Equalization Account was in fact a direct descendent of the whole 'offsetting' policy of the Bank of England which had, in a large degree, insulated the British credit system from the direct impact of international influences, and which we have analyzed in our account of the Typical Year of the Bank of England, 1922–1931, in Chapter 19 and elsewhere. At no time was British credit administration divorced from international considerations. In the formulation of credit policy these were always important, often dominating. But in the execution of policy the pre-war so-called 'automatic' connections between the international movement of funds and the credit base and credit superstructure were broken. From 1922 to 1931 the technical device for accomplishing this was open market policy. After July 1932 the technical device was, again

[31] 'Reserve' is here placed in quotation marks because the old connotations of the term are not in harmony with its new uses.

subject to the limitations imposed by the size and character of its assets, the Exchange Equalization Account.

4) The acquisition by the Exchange Equalization Account of a stock of foreign exchange and the conversion of a part into gold at various market prices created a strong interest on the part of the Treasury in seeing to it that the price of gold in sterling should not go below the average cost at which the gold held by the Account was bought. It was in the highest degree unlikely that the government would ever go before Parliament and show a loss in sterling, that is, a loss to the taxpayer, arising from the operations of the Account. The sale of a part of the gold of the Account to the Bank of England created a vested interest by the Treasury in the potential profits of a future revaluation of the Bank's assets. The whole question of the terms and conditions under which England might in future return to the international gold standard was influenced by this very simple and often neglected fact.[32]

5) The announced purpose of the Exchange Equalization Account, reiterated upon many occasions, was to smooth out fluctuations in the exchanges, but not to impose any general level or to engage in competitive exchange depreciation. It must, nevertheless, be recalled that the inconveniences to trade caused by a rising sterling exchange were the primary reasons assigned by Mr. Chamberlain in the Budget speech quoted above for the establishment of the Account. In the spring of 1933 the operations of the Account made possible substantial increases in the Bank of England gold reserve, and were a major factor in determining the 'general level' of sterling, though other motives greatly influenced its policy at that time. Finally during the World Economic Conference the authorities sounded out the market to ascertain the amount of sterling that would have to be sold to bring the pound to a substantially lower level than then prevailed. The Exchange

[32] Cf. Ch. 34, Rationalizing the Behavior of Hoarders and Exchange Stabilization Funds with respect to Gold.

Equalization Account, in fact, became one of many tools used in the experimental and empirical development of Great Britain's general financial policy.

Refunding the 5 per cent War Loan, the Control of Foreign Lending, and the Support of Sterling

During the entire Experimentation period and even before, neither the Bank of England in carrying out its discount rate policy nor the Treasury in administering the public debt had been able to escape the horns of a serious dilemma. Being constrained, for reasons already set forth at length, to pursue a 'deposit-attracting' policy, and to offer her securities, particularly her short term government debt, at prices attractive to foreigners, Great Britain could not relieve her Budget by large scale refunding operations in her long term public debt on a basis profitable to the taxpayer. Nor could she fund any large part of her short term debt except by assuming the obligation to pay a high rate of interest for a long period in the future. On the other hand, the existence of a large floating debt was an obstacle to a policy of very high interest rates designed to force a deflation sufficiently severe to free Britain from dependence on short term foreign funds. Even if all other objections to such a policy had been overcome, the increased cost of service of the short term debt would have constituted an almost insuperable barrier. The exigencies of credit control and foreign exchange policy limited the freedom of the government in the field of fiscal policy in one way, and the exigencies of fiscal policy limited the freedom of the Bank in another. During the first quarter of 1932 this difficulty was overcome. Ever since 1930 discussion had been active concerning the possibilities of refunding the 5 per cent War Loan, and early in 1931 the judgment of the City had been that the best that could be hoped for was a 4¼ per cent conversion, or 4 per cent if business conditions improved. Therefore the opportunity of balancing the Budget by a 3½ per cent conversion after the suspension of the gold standard

was eagerly seized upon by the Bank and the Treasury. This, rather than the promotion of trade, was the dominant motive for the inauguration of an easy money policy. The economic advantages of such a policy, however, were increasingly stressed when it became clear that the strongly held view of the City, that a revival of the domestic market and economic recovery without a revival of foreign loans was impossible, was being contradicted by events.

On June 30, 1932, one week after the Exchange Equalization Account had officially come into being, Mr. Chamberlain announced that the £2,000 million 5 per cent War Loan would be repaid on December 1, 1932. Holders were offered a new security bearing 3½ per cent interest and not subject to redemption for 20 years. Those who signified their intention of converting, or more accurately, continuing in the new security, before July 31, were offered a bonus of £1 per cent, and those who did not signify their intention of converting before September 30 were deemed to have assented. The conditions of success for this gigantic operation were three: (1) to create easy money conditions and to convince the investing public that these conditions would continue for a long time; (2) to clear the way for the government in the capital market by eliminating as far as possible all other demands for long term funds; (3) to keep the foreign exchanges stable.

No steps taken to achieve any one of these objectives could be without influence upon the other two. In particular, to keep foreign exchange rates stable it was necessary to convince both British nationals and foreigners that the beginning of a period of easy money was not to be a prelude to inflation in England. The continued failure of the Bank of England to request any further increase in its Fiduciary Issue, the efforts of the authorities to prevent a rapid rise in prices, and the whole policy of imposing heavy taxes and maintaining a balanced budget all contributed to give the needed assurance on this head. With these safeguards against an adverse psychological interpretation of its policies, the Bank began to

promote easy money conditions as soon as the necessity of defending sterling had passed. As shown above, the reduction of Bank rate from its crisis level of 6 per cent was begun by two successive reductions of 1 per cent on February 18 and March 10, 1932. On March 17 the rate was reduced to 3½ per cent, on April 21 to 3 per cent, on May 12 to 2½ per cent, and finally on June 30, the day on which the refunding was announced, to 2 per cent. In May and June bankers balances increased substantially, and in order to prevent any appearance of stringency the Bank of England increased its gold holdings (Chart 73).

To supplement the effect of easy money and abundant credit every effort was made to prevent competing demands for capital from appearing in the market. It was, for example, at this time that the Bank of England first exercised its veto power over the transactions of the Bank for International Settlements in the London money market. The most important step taken in this respect, however, was the imposition of an informal but effective embargo on new capital issues. This embargo was publicly proclaimed in the typically British form of an inconspicuous and soft-spoken paragraph in Mr. Chamberlain's speech announcing the terms of the conversion to the House of Commons:

"I am sure that anyone who may be contemplating the issue of new capital in the market in the early future will forbear from coming forward for a few weeks while this great operation is proceeding and that the authorities in the city of London will cooperate in this necessary object."

This prohibition was faithfully adhered to until the end of September 1932, when the conversion lists were closed. It was then announced that no further restrictions on new issues were necessary except on foreign loans, and on all optional replacements of existing securities by new issues involving either underwriting or an invitation to the public to subscribe to new shares. In January 1933 a further relaxation was

announced, only foreign issues and optional conversions of trustee issues remaining under control.[33]

As far as foreign issues were concerned, therefore, the "few weeks" postponement of which Mr. Chamberlain spoke lengthened into years. The embargo on foreign lending at the time of the refunding operation was, from the domestic point of view, part of the government's determined effort to eliminate competing demands when the Treasury was in the capital market on a great scale. From the foreign exchange point of view it was a particular episode in an established policy of supporting sterling and correcting the British balance of payments. From the more general viewpoint of British financial and economic policy it was part of England's acceptance of a restricted, though still very extensive, field of international financial influence.

Foreign lending in the London market, already severely limited (Ap. Table 4), had practically ceased when the confidence crisis spread to England in July 1931. With the easing of money rates and the improvement in sterling in the first half of 1932 there was a slight revival, but this was exclusively in loans for the Empire. India was the chief borrower but, in addition, the Canadian provincial governments returned to the London market. No overseas issues outside the Empire were placed in London during the first six months of 1932. The money market sanctions that enforced this embargo were the same as those behind the restrictions in force at the time of the return to gold in 1925.[34] The economic sanctions were those imposed by the state of the British balance of international payments. The memorandum of the British delegation to the League of Nations Institute for Intellectual Cooperation, upon which we have already drawn in our discussion of the new position of London in world finance after the war, describes the position:

"[at the time of the confidence crisis] a suspicion, which had

[33] The New Capital Market, *Midland Bank Review,* Oct.–Nov. 1933, p. 5.
[34] Cf. Ch. 11, London and New York as Distributors of Capital.

arisen earlier in the year, that the international balance of payments of the United Kingdom was definitely adverse, hardened into a certainty. Thus it became imperative to discontinue the business of foreign lending, no longer simply on grounds of temporary financial expediency, but on consideration of serious financial maladjustment; it has now (March 1933) been proscribed for an indefinite period under authority of the Bank of England, whose embargo has, in fact, the full force of government action." [35]

With the imposition of the general embargo on new issues in June 1932 control of foreign lending became a recognized Treasury function. In January 1933 most of the restrictions on the placing of new capital issues, other than foreign, were removed, and the Treasury at that time formally defined 'foreign issues' as: "issues on behalf of borrowers domiciled outside the Empire, or issues the proceeds of which would be remitted directly or indirectly to countries outside the Empire." In May 1933 the Treasury announced that the Chancellor viewed with disfavor, as "not in the public interest," purchases from foreign holders of large blocs of securities, whether issued by British or foreign undertakings for resale in England by public issue or otherwise, and hinted that private investments abroad were not at that time desirable.[36]

The new capital embargo of June 1932, therefore, marked a stage in the development of a policy of Empire preference in the export of capital, and a rigid adherence to the principle that the proceeds of foreign loans should be spent in England. Under this policy even Empire borrowing was severely restricted when new capital was involved, though refunding was freely permitted. In the last six months of 1932 only one substantial Empire loan, other than refunding loans, was placed in London—a large South African government issue. Even this was not put on the market until after the War

[35] British Memorandum 2, Part II, *Recent British Measures affecting International Finance.*

[36] *Midland Bank Review, loc. cit.*

Loan conversion lists were closed. When, in August 1933, the Dominion of Canada returned to the London market as a borrower by placing a £15 million issue, the prospectus contained these all important words:
"No part of the proceeds of this issue will be remitted directly or indirectly to countries outside the British Empire."

One further stage in the development of this policy may be mentioned here, though it does not fall within the period being discussed. With the development of closer ties between England and non-Empire sterling countries, the policy became one of sterling area financial preference, rather than strictly Empire financial preference. This is illustrated by loans to Denmark and Argentina in 1933. Exceptions were also made when clearly in Britain's interest, such as the Austrian Loan in 1933, the proceeds of which were used chiefly to repay the Bank of England advance to Austria of June 1931.[87]

The complete stoppage of all new foreign lending in July, August, and September 1932 (Ap. Table 4) was only one of three special measures taken to prevent fluctuations in the exchanges during these three critical months. The other two were the inclusion in the terms of the conversion offer of a bonus of £1 per cent to those signifying their intent to convert before July 31, 1932, and the use of the Exchange Equalization Account.

N. F. Hall (*op. cit.*, pp. 39–40) has clearly described the connection between the bonus offered for early conversion and the anxiety of the government lest the conversion operation itself give rise to exchange fluctuations. Under the terms on which the War Loan was originally issued, three months' notice of the government's intention to convert had to be given.
"This meant that on September 1st, unless special steps were taken to prevent it, all this War Loan would become the equiv-

[87] R. B. Stewart, 'Instruments of British Policy in the Sterling Area,' *Political Science Quarterly*, June 1937, pp. 184–90.

alent of a three-months sterling bill bearing interest at a rate of 5 per cent per annum. It would have been a very attractive holding for foreigners on and after September 1st as they could cover the exchange risk involved by a purchase of three-months forward dollars. In the absence of other influences, this might have meant a big upward movement in the sterling exchange in the early autumn of 1932 followed by an equally rapid fall at the end of the year. Power to prevent this disturbance occurring by exchange control through the Exchange Equalisation Account must have greatly strengthened the authorities in preparing their plans. This factor in the situation also helps to explain why the much criticised bonus of £1 per hundred pounds of stock was paid to those who gave notice of their intentions to convert before the end of July 1932. The effect of this bonus was to give approximately the same profit to holders as that which they could obtain by selling their holdings as soon as they became a three-months maturity. The attractiveness of holding non-assented stock to conversion as a three-months bill practically disappeared. As much could be made by claiming the bonus as by holding non-assented stock to maturity as a bill. The bonus must, therefore, have played an important part in securing the success of the conversion operations. It reduced almost to nothing the supplies of non-assented stock which might have been useful material for exchange operations. It was, therefore, a powerful ally of the Exchange Account in reducing to a minimum the exchange disturbances which would otherwise have been associated with these operations."

The Decline of Sterling and the Depletion of the Foreign Assets of the Exchange Equalization Account

That the Exchange Equalization Account stood in need of allies in keeping sterling steady became apparent in August and September 1932. During June and July sterling exchange tended downward. The rate on New York, after holding steady at about 3.67 during May and the first part of June, fell to a level of about 3.54, at which it again remained stable for about a month. At the beginning of August it declined to about 3.47, and at this rate was once more kept

fairly stable until the middle of October, when a rapid fall occurred. A decline of this type in a series of steps is characteristic of an exchange with a weak underlying trend but artificially supported.[38]

Some indication of the activity of the Exchange Equalization Account during the early months of its operation may be derived from the behavior of the so-called 'tap bills outstanding.' British treasury bills are issued partly by public tender and partly to government departments 'through the tap.' A government department finding its balances increasing may 'invest' these in treasury bills issued for this purpose. A government department finding its balances drawn down may replenish them by selling treasury bills to the market or by letting them run off. Working balances of the various departments are thus kept from fluctuating very greatly and the government deposits at the Bank of England are largely mobilized in the Exchequer Accounts. The instrument for keeping these public deposits at the Bank within the limits desired by the Bank and the Treasury is the variation in the weekly amount of treasury bills offered by tender. This variation is continually influenced by changes in the amount of treasury bills held by government departments. When the Exchange Equalization Account was established it was assigned £150 million in treasury bills. This was not a transaction similar to the ordinary issues 'through the tap,' for these bills were not bought from the Treasury by the Account by tender of Bank of England funds, but once the operation of the Account began, the practice of other government departments with reference to treasury bills was followed. The Account had a stock of bills which it could sell, and when it wished to increase this stock for any reason it 'tapped' for more. When the Account or any other government department purchases bills from the Treasury through the 'tap'

[38] The behavior of the French franc in 1926 was of this type; cf. Ch. 15, Laying the Foundations for Future Power in the Gold Standard System, 1925–1926.

there is a change in the composition of 'public deposits' at the Bank that makes possible a reduction in the next issue of tender bills. When a government allows its holdings of treasury bills to run off, there is a change in the composition of the 'public deposits' that makes necessary an increase in the next offer of tender bills. When it sells treasury bills to the market, there is no change in the Exchequer Accounts and no immediate change is required in the amount of the next tender. Such sales, however, reduce the market's eagerness to buy at tender and may influence the terms on which the government can borrow, and as the market's increased holdings mature in due course, there is a change in the Exchequer Accounts that makes necessary an increase in the amount of later tenders. This is the same effect as if the bills had matured in the hands of the departments.

The method by which the amount of 'tap bills' outstanding at any one time is usually calculated is to subtract a 13-week moving total of successful weekly tenders for treasury bills from total treasury bills outstanding. Subject to certain time lags, this method seems to be fairly satisfactory. It allows for the effects both of the replenishment of departmental portfolios 'through the tap' and for their depletion by the conversion of 'tap bills' into market bills because, as shown above, both these operations influence the amount of tender bills offered. If it did not take account of the second factor it would merely measure the amount of treasury bills outstanding that had originally been issued through the tap, not the amount of 'tap bills outstanding.'

Using this method, H. J. Sarles has presented figures for tap bills outstanding, from which the values for July 1932 to April 1933 [89] in Table 81 are taken. These figures help to throw some statistical light upon the operations of the Ex-

[89] The English Equalization Account, unpublished ms. Since his study was concerned with general trends Mr. Sarles did not feel it necessary to make allowance for the time lag of from three to six days between the allotment of and payment for tender bills.

change Equalization Account, though subject to strict reservations. The effects of the operations of other departments are included in the figures, and the Issue Department of the Bank of England on occasion 'taps' for bills. When, for example, a large government long term issue is offered to the

TABLE 81

Tap Bills Outstanding, July 1932–April 1933, by weeks (millions of pounds)

	WEEK				
1932	FIRST	SECOND	THIRD	FOURTH	FIFTH
July	238	238	236	231	226
August	220	259	262	258	
September	281	288	285	282	
October	284	283	276	267	255
November	249	255	248	232	
December	246	275	277	266	268
1933					
January	265	246	238	227	
February	223	211	217	213	
March	208	199	206	220	227
April	234	234	224	219	

SOURCE: H. J. Sarles, The British Exchange Equalization Account, unpublished ms.

public and is not readily absorbed by the market, the Issue Department may take a portion of it. Gradually as the market becomes more receptive, the Issue Department may sell these long term bonds and replace them by 'tapping' for bills. The Exchequer Accounts are replenished from the market via the Issue Department, and the next offer of tender bills is reduced, reserve funds flowing back to the banks in this way. Tap bills outstanding are increased. Such transactions are probably the most serious drawback to the use of changes in 'tap bills outstanding' as indications of the operations of the Exchange Equalization Account, for the routine operations of other government departments are as a rule of moderate size. Since, however, from the outset, the payments made to and received from the public by the Exchange Equalization Account were very large, the changes in its holdings of treasury bills were very large also and were consequently the

dominant influence in the behavior of 'tap bills outstanding.'

The Exchange Equalization Account does not seem to have actively supported the exchange immediately after beginning its operations. Indeed, the decline in 'tap bills outstanding' during July and the first week in August of about £18 million is a statistical indication, though far from a statistical proof, that the Account was parting with treasury bills and adding to its foreign exchange holdings. An increase of £68 million in 'tap bills outstanding' from the first week in August to the second week in September indicates that the Account had reversed its position and was coming to the support of sterling.

At this time sterling was being kept stable at about a 30 per cent depreciation in terms of the gold currencies. This was a return to the position prevailing during January and February 1932 just before the rise in sterling that led to the establishment of the Account. At this level, however, sterling was under pressure, owing to the position of the current merchandise and current invisible items in the balance of payments, and to an outward movement of capital.

In November 1932 the *Midland Bank Review* reached the conclusion that ordinary current transactions in the balance of payments were still showing a deficit. Imports were indeed restricted by the decline in the exchange and by new tariffs but, for reasons given above, exports did not expand. The Review estimated that up to October 1932 the adverse merchandise balance was about £90 million less than in the preceding year, but that this was not sufficient to offset declines in other current items. Shipping income and interest and dividend receipts from overseas continued to fall. A special and important cause of loss of overseas revenue was the declining demand for sterling by insurance brokers. Before the war Lloyds and others wrote insurance policies in currencies other than sterling and remitted the premiums home regularly. Sterling policies were also written all over the world and the premiums remitted to London. Since Sep-

tember 1931, however, the practice of writing dollar and other foreign currency policies had greatly declined and at the same time the practice of accumulating the premiums abroad to build up reserve funds in the currencies in which they were written developed, while the trend of legislation in the American states made the carrying on of insurance business by British companies more and more difficult. By the summer of 1932 only a small amount was being remitted home. In addition, the amount of gold received from India, though it continued substantial, began to decline, and the special gold exports from domestic circulation became a mere trickle.

Upon this weak foundation was superimposed an outward movement of capital which was encouraged by the easy money policy rigorously pursued in London. Preoccupied by fiscal considerations the Bank and the Treasury underestimated the effect on the exchanges of the remittance abroad of the proceeds of cash redemptions of the 5 per cent War Loan. They relied upon the patriotism of British nationals and upon the self-interest of foreigners who might be afraid to remit at a low rate of exchange and thus lose all chance of future sterling appreciation. Foreign war loan holdings amounted to about £200 million, and many of these were converted into cash and remitted abroad. The fanfare of a patriotic campaign to vindicate the British government's judgment that British credit was now on a 3½ per cent basis did not appeal to foreigners and the Exchange Equalization Account had itself made sterling unattractive as a speculative medium. In its November–December 1932 issue the *Midland Bank Review* wrote:

"Another factor [in the decline of sterling] has been the tendency for foreigners to exchange into other currencies the sterling realized by sales of War Loan or due to them on the date of redemption. It is impossible to estimate the force of this influence, but probably tens of millions of pounds sterling have been added to the supply in the foreign exchange markets on this account.

The sales have been concentrated within a relatively few months and may therefore be presumed to have exercised considerable weight against sterling."

The easy money policy in London, moreover, carried London rates below those in New York. This was not the appropriate relation for a country with a weak and sinking exchange. It encouraged an outward flow of capital, and also influenced the forward exchange markets in a way unfavorable to sterling. The position in this market, as Mr. Hall shows, was completely reversed in May and June. The high discount on forward dollars disappeared, tending to bring the realizable earnings from forward purchases into line with interest rates in New York, thus indicating that the uncovered sterling balances of speculators for the rise were being liquidated.[40] Finally the declining trend of sterling was in itself an inducement to withdraw part of the very large amount of foreign capital still temporarily employed in London to avoid further exchange losses.

Hardly more than two months, or at most three, after its official beginning, the Equalization Account therefore found its role in the exchange market reversed. The limitations of its powers to support sterling became evident under these accumulated pressures. The Account had had little opportunity to acquire a very substantial volume of foreign assets and gold over and above those it had obtained at the outset. Even these had been depleted by sales of gold to the Bank of England in July and August. The size of the increase in 'tap bills outstanding' in August and September suggests that the drafts upon its foreign resources were very heavy. In the middle of October they were nearly exhausted according to the testimony given by O. M. W. Sprague before the Banking Committee of the United States Senate.[41] A difficult decision had to be made, for opinion was divided as to the probable duration of the pressure. The more pessimistic view prevailed and

[40] Cf. pp. 1107–8 supra; Hall, *op. cit.*, pp. 38, 45.

[41] *The Economist,* March 3, 1934, p. 46; Hall, *op. cit.*, pp. 48, 51.

support was withdrawn. Sterling fell from 3.44 on October 11 to 3.30 on October 25. In November the renewal of British war debt payments was under negotiation, and the uncertainty produced by this conflict was clearly reflected in the exchange. Sterling again dropped, from 3.32 on November 15 to 3.15 on November 30. A decline in the amount of 'tap bills outstanding' suggests that the Account was accumulating fresh foreign reserves as sterling fell. At the low point sterling was again supported and 'tap bills outstanding' rose sharply.

On December 15, 1932 the British Treasury paid £28.9 million in gold to the United States on account of the war debt. The Treasury purchased gold valued in the market at this amount from the Bank of England, paying for it, however, at the statutory price. The government paid for the gold in treasury bills, of which £19.6 million went to the Bank and £9.3 million to the Exchange Equalization Account which had previously borne the loss involved in sales to the Bank, and now reaped the profit of purchases from it at its statutory price. The gold was earmarked at the Bank of England for the Federal Reserve Bank of New York, which in turn turned over gold at the United States Treasury.[42] The Bank's gold reserve was as a result once more reduced to the amount held immediately following the payment of £15 million in gold on account of foreign credits in November 1931 (Chart 72). With the ending of uncertainty regarding this payment and the completion of the refunding operation, and with some official support, sterling had already begun to rise. At the turn of the year the New York rate was 3.33.

The Critical Decisions of January 1933

In January 1933 a profound change in the international position of sterling suddenly presented the management of the Exchange Equalization Account with an entirely new set of problems, and the line of action then adopted had consequences so far reaching that it may be regarded as a critical

[42] Sarles, *op. cit.*, pp. 8–9.

turning point in the history of the Disintegration period. The decisions made at this time however were not clear-cut, public, and formal like those of 1927 (cf. Ch. 18). They were made in the ordinary course of business without explicit consideration of long run consequences, and have often been misinterpreted in the light of later events to which they directly contributed, but which they were not intended to bring about.

The recovery of sterling, which began with the announcement that the American war debt installment would be paid in gold, became very strong after the payment was actually made. Toward the end of December and in January seasonal factors began to turn in favor of sterling. In view of the low level to which the pound had fallen business men all over the world were anxious to cover their sterling requirements well in advance. Foreign balances that had been withdrawn in 1932 were built up again.[43] At the same time sterling area countries were building up their sterling balances depleted in the early years of the depression.[44] Speculators, especially on the continent, assured of a rising trend in sterling, began to take substantial long positions in sterling.

The Exchange Equalization Account was, in consequence of this suddenly altered situation, in a position to increase its foreign assets very considerably. It was at the same time eager to increase its sterling assets, and in January suggested to the Chancellor of the Exchequer that its resources should

[43] Paul Einzig, *op. cit.*, pp. 65–6.

[44] "In the last nine months of 1929 Australian London funds were drawn down by over £30 million; Indian official sterling reserves fell by £40 million from the end of 1929 to 1931; New Zealand's sterling funds previously perhaps £10 million or more were practically exhausted; the National Bank of Egypt's sterling holding was reduced from £30 million early in 1929 to £15 million in 1931. . . . The reestablishment of sterling area balances started in the autumn of 1931, and by the spring of 1934 these sterling reserves had increased by over £200 million—some £50 million each for Australia and India, £20 million each for New Zealand and South Africa, and so on." B.I.S., *9th Annual Report, April 1, 1938–March 31, 1939* (Basle, May 8, 1939), pp. 81–2.

be increased. The Chancellor requested that this increase be postponed until after his Budget Speech. This was done, and in the Finance Act of 1933 the powers of the Account to borrow in sterling were enlarged by placing at its disposal a further £200 million in treasury bills. Meanwhile, the Account was able to increase its sterling resources by converting foreign exchange into gold, selling gold to the Bank of England, and investing the proceeds in treasury bills as described above. This coincided happily with the need felt by the Bank of England to build up its depleted reserve. Though the decision to increase the resources of the Account was made in January, the increase actually occurred in April immediately after the United States had left the gold standard. It therefore had the appearance of being a weapon specially provided to fight a battle of competitive exchange depreciation with the United States. This impression was accentuated by preceding active and regular intervention by the Account which had prevented the dollar from rising, as evidenced by the decline in 'tap bills' early in 1933, the course of the exchanges, and the unanimous opinion of the market. For several months the sterling-dollar rate was prevented from rising above 3.45, though many observers were of the opinion that in a free market it would have gone to 3.80 or even 4.00. There is no doubt that the speculative movement was encouraged and the pound made unusually attractive to potential buyers of every sort by the intervention. Competitors of British exporters can hardly be blamed for seeing in the situation a deliberate effort to foster British export trade. Yet the Account was not actuated by a desire to undervalue the pound as a stimulus to exports. The Bank had not received from its friends in the United States any intimations that a rise in the rate would be welcomed in America, and in its day to day operations in the market the Account found itself the counter-party of the purchases of sterling by speculators for the rise, and the source of many of the speculators' profits. Its managers were subject to the innate tendency of men

operating a trading fund not to let themselves be beaten by speculators. This human, if unstatesmanlike consideration, affected the judgment of the Account, and must be given due weight in interpreting the course of sterling. It affords a further example of the tendency of the British to follow market instincts rather than analytical judgments in the execution of financial policy. At this critical juncture these instincts proved an unsafe guide. Had they been given less weight, sterling would have risen further and the divisive and destructive debates of later months concerning competitive exchange depreciation would have been less bitter.

The English Credit Base and Credit Superstructure after September 1931

The transition traced in the preceding sections from a policy of defending to one of controlling sterling had its reflection and its parallel in the field of domestic credit control. Between September 1931 and April 1933 the long and steady opposition to any increase in the credit base came to an end and the credit base and credit superstructure were both raised to higher levels. The manner in which this was accomplished marks a further step in the development of the art of currency management in Great Britain. The provision of the new machinery of the Exchange Equalization Account gave the government and the Bank power to decide whether and to what degree the domestic credit structure was to be influenced by the international movement of capital and the behavior of the exchanges. At the same time, the external forms of the gold standard were retained as a convenient sanction for the enforcement of credit control policy. This was a change in technique of the first order, which differed from the methods of credit control of 1925–31 nearly as much as the latter differed from the pre-war techniques. Yet it is an error to draw these contrasts too sharply, for neither the techniques of 1925–31 nor those of 1932–33 broke wholly with established tradition.

Building up a New Gold Reserve

Chart 72, on which the forces playing upon the 'reserve of notes and coin' of the Banking Department from September 1931 to March 1935 are depicted, brings out clearly that the reserve was influenced, first, by a series of special gold transactions carried out at the initiative of the Bank rather than of

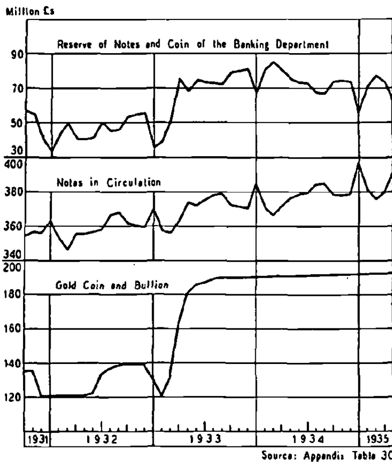


CHART 72

Bank of England, Factors affecting the Reserve of the Banking Department, September 1931–March 1935

the market, and, second, by a steadily rising trend in the note circulation modified by seasonal factors. This rising trend in circulation, attributable in large part to the growth of continental hoarding, was a major change in the problem confronting the Bank of England. For years the joint stock banks had been aided in their resistance to a credit restriction policy on the part of the Bank by a declining trend in circulation. Now, on the eve of a period when the Bank was initiating and promoting a policy of abundant credit and easy money, a rising trend in circulation appeared. The behavior of the circulation continued therefore to be an obstacle in the way of Bank of England policy.

During the last quarter of 1931 the combined effect of the use of Bank of England gold to repay foreign credits and a

seasonal increase in the note circulation depleted the Bank's reserve £24 million, or about 42 per cent. For the next four months gold holdings remained steady and the reserve fluctuated with the seasonal movements of the currency. In the summer of 1932 the Bank began to purchase gold, and the reserve began to rise, subject, of course, to the same seasonal influences. These masked somewhat the rising trend in the circulation, which, it is clear from Chart 72, was robbing gold purchases of a part of their effectiveness. When in December 1932 the Bank gave up gold to the Treasury in payment of the December installment of the American war debt,[45] and at the same time circulation increased to meet year end needs, the reserve was heavily drawn down. In January 1933 the effect of the gold transfers to America was largely offset by a return flow of currency. The Bank's reserve and proportion were still relatively low in February 1933 (Table 82) but full advantage was taken of the opportunity which then arose for building up a new gold reserve.

It had been one of the outstanding characteristics of the pre-war management of the international gold standard through London that the Bank of England did not pursue a policy of gold accumulation, but, on account of England's 'gold income,' was able to administer its responsibilities with a small gold reserve. In 1933, more than a year after the gold standard had been abandoned, the Bank broke completely with this ancient tradition and embarked purposefully upon a policy of gold accumulation. In three months, from February to April 1933, it purchased sufficient gold not only to make good the amount used for the war debt payment and to offset the effect of a continued rise in circulation, but also to lift the reserve of the Banking Department to the general level of from £70 to £80 million. The Bank's gold holdings jumped from just over £120 million to just over £180 million

[45] In this instance the use of monthly averages is unsatisfactory and the transaction appears as if it were spread over two months in Chart 72. The same observation applies to the discussion of 'bankers balances' on p. 1155.

but as they increased, the position of the Bank became a less important, and the position of the Exchange Equalization Account a more important factor in the Bank's purchases from the Account.

During the following year the reserve continued under pressure from the circulation (Chart 72), but this was partly offset by further moderate gold purchases, and the new level

TABLE 82

Bank of England, Proportion of the Banking Department, 1931-1933 monthly average

	1931	*1932*	*1933*
January		33	25
February		42	34
March		33	48
April		33	45
May		32	50
June		36	47
July		34	44
August		34	44
September	43	39	49
October	40	41	48
November	33	40	51
December	24	25	43

SOURCE: Bank of England, *Statistical Summary*

of reserves was on the whole well maintained. By its gold purchases the Bank was enabled to encourage an increase in 'bankers balances' and at the same time to increase its proportion, as shown in Table 82. It was able to reap all the psychological advantages that could be derived from a Bank statement strong and 'sound' according to the ancient tradition of the gold standard.

The Credit Base

In Chapter 19 we emphasize the fact that the effectiveness of Bank of England credit control policy was dependent not only upon changes in the total amount of Bank of England credit but also upon its distribution between 'public deposits,' 'other accounts,' and 'bankers balances,' and that the whole technique by which 'public deposits' and 'other accounts'

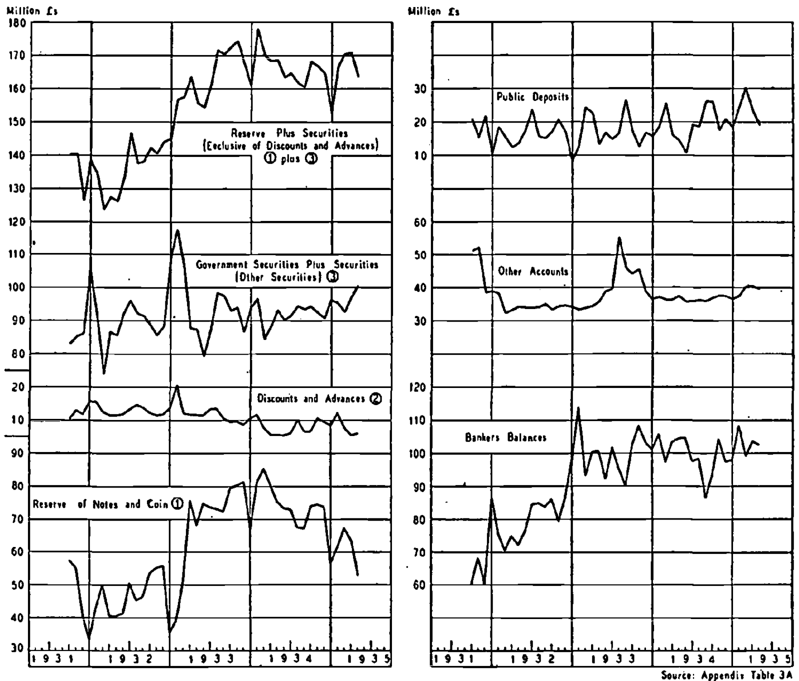
were kept stable from 1923 to 1931 was a major, if inconspicuous, element in credit policy during those years. With the additional complications introduced into the administration of 'public deposits' by the dealings between the Bank, the Treasury, and the Exchange Equalization Account, and the influence of large inter-central bank credits upon 'other accounts,' this aspect of British credit control policy became even more important. The task of tracing its evolution in the Bank's statements was also made more difficult. However, one conclusion can be drawn from the behavior of 'public deposits' during and after 1932 that somewhat simplifies the task of interpretation. Notwithstanding large sales of gold by the Treasury and later by the Equalization Account to the Bank of England, 'public deposits' showed no trend, and fluctuated within the range of £10 million to £25 million. It is, therefore, proper to conclude that Bank of England balances secured by the Treasury and the Account by the sale of gold were invested in treasury bills. This conclusion is in harmony with the general practice of government departments in the employment of their cash resources. Upon this assumption a general account of the forces playing upon bankers balances at the Bank may be given with the aid of charts of the type previously used for the same purpose (Charts 73 and 74).

In our account of the English credit base under emergency measures in Chapter 19 we indicate that about three fourths of the effect of the drain of gold from the Bank of England during the confidence crisis in the summer of 1931 was offset by Bank of England credit, leaving 'bankers balances' in September 1931 about £11 million less than in June 1931, and that the provision of foreign credits in defense of sterling during this period resulted in the first substantial increase in 'other accounts' since 1920. During the first five months following the abandonment of the gold standard the position existing prior to July 1931 in both these respects was restored. The export of gold to pay a portion of the Bank's foreign

credits in November 1931 was accompanied by a decline in 'other accounts' of an approximately equal amount, leaving 'bankers balances' and 'public deposits' unaffected.[46] This foreign payment in gold therefore had no deflationary effect upon the credit base in England. The Bank was at the same

CHART 73

Bank of England, Assets and Liabilities of the Banking Department, September 1931–April 1935



time beginning to increase its holdings of foreign exchange, as indicated by a growth in 'other securities,' but until December 1931 this small operation was apparently offset by

[46] During November a rise in 'public deposits' and a decline in 'bankers balances' of equal amount took place. Since there was no appreciable change in the circulation, or open market dealings by the Bank, these may be attributed to routine Treasury operations.

other security transactions. In any event it was quantitatively not very significant. In December 1931, however, the Bank provided so lavishly for year-end requirements by further increases in 'other securities' and by purchases of government securities that 'bankers balances' were built up seasonally

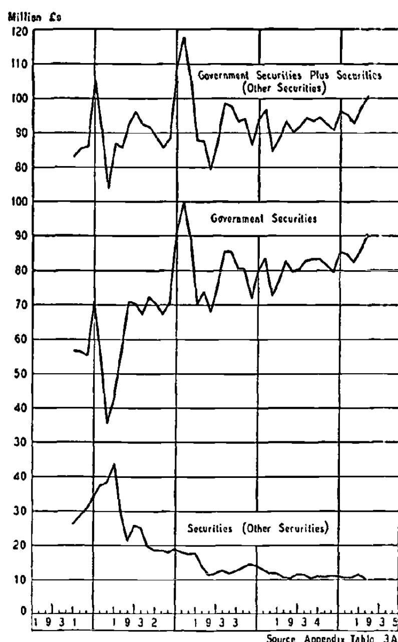


CHART 74
Bank of England, Securities in the Banking Department, September 1931–April 1935

without the usual seasonal expansion of 'discounts and advances' at the Bank (Charts 73 and 74) . After the turn of the year a continued increase in 'other securities' together with a fresh reduction in 'other accounts' indicated substantial purchases of foreign exchange by the Bank and the use of part of these purchases to repay foreign credits. Whether this interpretation is correct or not, the two operations together added to 'bankers balances,' 'public deposits' meanwhile showing no upward trend. 'Bankers balances' were further built up by the usual seasonal return flow of currency. Consequently, the Bank was able to make an exceptionally large reduction of

£36 million in its holdings of 'government securities' in January and February 1932, and still not fully offset the year-end increases in 'bankers balances.'

In the first quarter of 1932, therefore, bankers balances were restored to the level of June 1931 and, for the time being, 'other accounts' ceased to be an active influence upon the credit base. The portfolio of the Banking Department, however, was left in a very unusual condition. Of a total of £86.9 million in 'securities' held in March 1932, £43.9 million were in 'other securities,' probably largely foreign exchange, and only £43 million in government securities. This put the Bank in a rather inconvenient position for carrying on open market operations without influencing the exchanges, and in April, as shown in Charts 74 and 71, about £20 million of 'other securities' of the Banking Department were exchanged at the Issue Department for 'government securities.' This did not affect 'bankers balances,' but was another step in restoring the Bank's balance sheet to a more normal condition. The subsequent transfer of the foreign exchange of the Issue Department to the Exchange Equalization Account, though passing through the accounts of the Banking Department, did not affect the balance sheet of that Department and consequently is not indicated in any of the charts presented in this section.

With the transformation in the foreign exchange position during March 1932 the Bank took definite steps to promote easy money in order to prepare for the refunding of the War Loan. 'Government securities' in the Banking Department increased more than 'other securities' declined, indicating not only a change in the character of the portfolio but genuine open market purchases as well. In May on a small scale, and in June on a larger scale, the Bank also began to buy gold from the Exchange Equalization Account or its informal predecessor. Upon the general assumption made at the beginning of this analysis, the Bank of England balances thus created were invested in treasury bills. Therefore in May and

June the effect of an import of gold by the Bank of England under gold standard conditions supported by open market operations was achieved by the new techniques.

By these means a second step was taken in lifting 'bankers balances' at the Bank of England to higher levels. Over the year end they had been raised from £65 million to £75 million. They were now increased to a general level of about £85 million. In December 1932 the reserve of the Banking Department was reduced £20 million in connection with the payment on the American war debt, and the Bank purchased £20 million in government securities to offset the effect of this gold export. During December the only other important changes affecting 'bankers balances' were a decline in 'public deposits' and a seasonal increase in circulation of about equal size and therefore without net effect. In January 1933 'bankers balances' were temporarily increased by further security purchases, a return flow of currency and an increase in 'discounts and advances' reaching the high level of £113 million. In February they declined £20 million as a result of the repayment of the 'advances' and a sharp increase in 'government deposits.' Though they were substantial, the movements of 'government deposits,' 'note circulation,' and 'discounts and advances' were fluctuations about a constant level. The increase in 'government securities' was of a different character and was the factor responsible for raising the level of 'bankers balances' by approximately £10 million. This completed the series of three steps by which 'bankers balances' were increased from about £65 million to about £95 million or roughly 45 per cent. The balance sheet of the Banking Department, however, had again assumed an abnormal aspect. 'Government securities' were now exceptionally high, standing in January at nearly £100 million while the 'reserve of notes and coin' had fallen to just under £40 million and the proportion to 25 per cent.

At this juncture the weakness of the franc and the dollar in terms of sterling offered an opportunity of restoring the

Bank's return to a 'normal' condition without reducing the general level of 'bankers balances.' During February, March, and April 1933 the Bank of England bought from the Exchange Equalization Account over £60 million in gold at its statutory price. These great purchases are not reflected in the movement of 'public deposits.' The Account must therefore have purchased treasury bills with the proceeds, thus producing the effect of an ordinary gold import under gold standard conditions not offset by open market operations. The Bank of England, however, sold £26 million in government securities from its portfolio, thus completely reversing its purchases of December and January. Notes in circulation increased £17 million and 'public deposits' £10 million. The increase in 'bankers balances' was therefore offset to the extent of £53 million, leaving a net increase of £7 million and bringing them up to £100 million. At this level the rising trend in 'bankers balances' ceased (Chart 73). In the summer of 1933 'other accounts' at the Bank were built up by the accumulation of Bank of England deposits by the French government in preparation for repayment of a Bank of England credit of £30 million granted in April (cf. p. 1278), but the effect on 'bankers balances' was offset by open market purchases of securities. These were not reversed when 'other accounts' fell with the repayment of the French credits but remained in the hands of the Bank. Consequently, a continued rise in the note circulation was prevented from causing any pressure on 'bankers balances' that might have interfered with the fundamental easy money policy of the Bank.

Charts 71–4 disclose very clearly the main features of the reversal of credit policy which followed the abandonment of the gold standard. Before March 1932, when sterling was still being defended, 'bankers balances' were built up by drawing down 'other accounts,' that is, by the expenditure of part of the Bank's foreign exchange holdings. Thereafter the mechanism of the Exchange Equalization Account and its informal

predecessor, in combination with open market operations, was used to produce the effect of a steady import of gold. This is indicated graphically by the rise in the top line in Chart 73 and by the absence of any trend in the Bank's holding of securities. The connection established under the gold standard *by the market* between the domestic credit structure and the international movement of goods and gold was broken, but another type of connection completely subject to the will of the financial authorities had been substituted for it. By this new technique total Bank of England credit was increased sufficiently to take care of a rise in circulation of £30 million, to eliminate borrowing by the market from the Bank almost completely, to increase 'bankers balances' £40 million, and at the same time to raise the Bank's proportion to about 45 per cent.

The Credit Superstructure

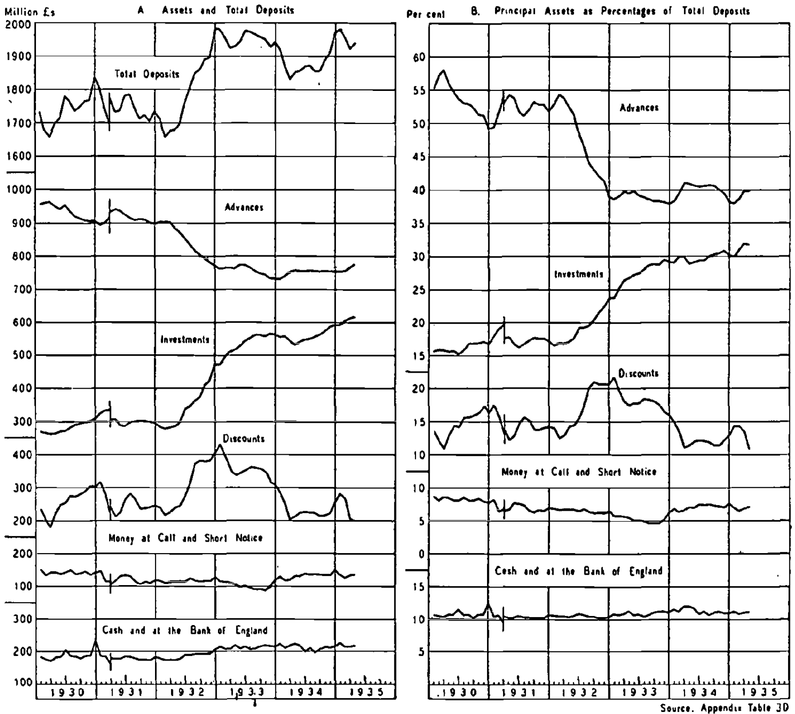
The change in credit control policy that followed the restoration of confidence in sterling in the spring of 1932 was reflected in the position of the London clearing banks by a resumption of the movement in their principal assets and in their total deposits that had begun in 1930 (Chart 75 A). As far as the credit superstructure was concerned 1931 was an interruption in the behavior pattern characteristic of the British banking system during periods of depression.[47] The movement of total deposits was downward from December 1930 to February 1932, though reflecting seasonal variations in 'discounts' of a type previously described fully. The cause of this decline was chiefly a gradual and prolonged fall in 'advances.' 'Investments,' 'discounts,' and 'money at call and short notice' changed very little, though these three items were all slightly lower in February 1932 than in February 1931. 'Cash and at the Bank of England' also declined slightly, though not enough to influence the general appearance of this line on

[47] Cf. Ch. 27, Part III, The Prolongation of Established Credit Control Techniques until June 1931.

Chart 75 A. Our analysis of the behavior of 'bankers balances,' however, has shown that during the last six months of 1931 the clearing banks were under pressure from loss of reserve at the Bank of England. The steadiness of all the important

CHART 75

London Clearing Banks, Selected Balance Sheet Items, 1930-1935



ratios of the clearing banks from the spring of 1930 to the spring of 1932 is a noteworthy feature of Chart 75 B in which the ratio system of the clearing banks is plotted for 1930–34.

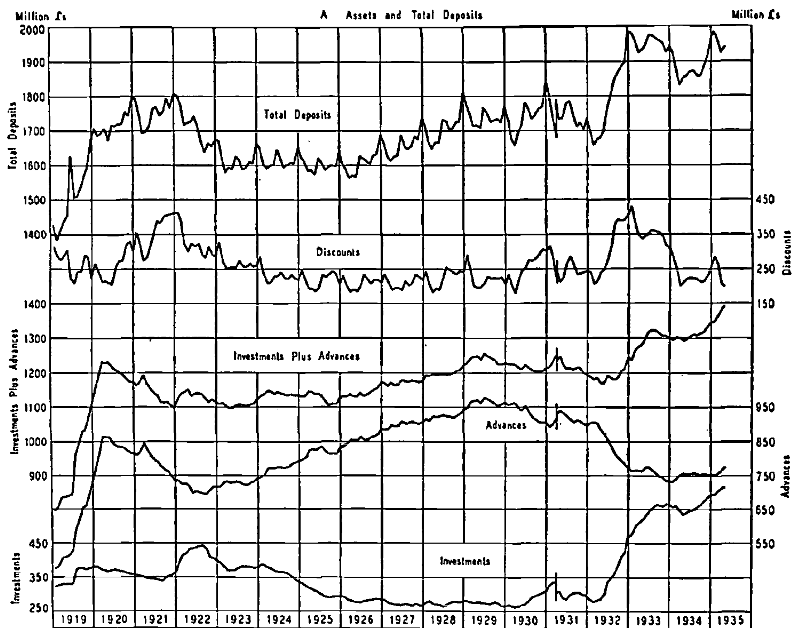
With the ending of the pressure on the English banking system incident to the loss and restoration of confidence in sterling all the characteristic movements of 1920–21 and 1930 were resumed. Between April and August discounts increased

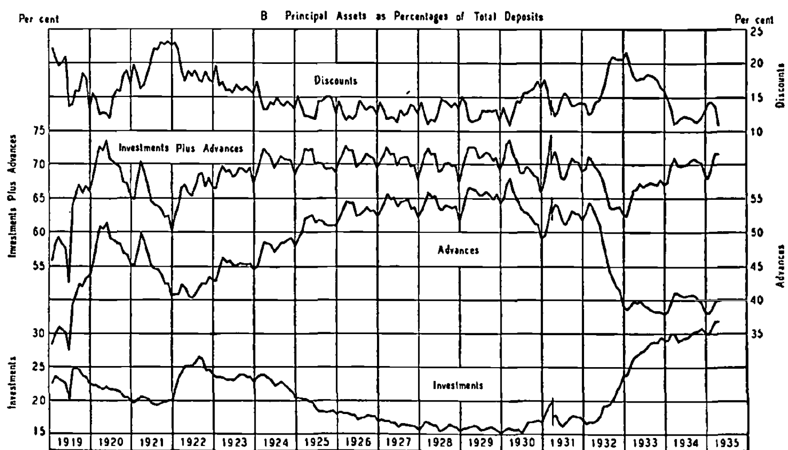
£140 million, the sharpest increases being in June, July, and August. At this time tender bills outstanding rose about £100 million, while a large spread appeared between Bank rate and market rate. The conditions under which an increase in the short term public debt held by the joint stock banks was to be expected were again present as in 1930. At almost the same time, with the deepening of the depression, advances began to fall off rapidly and were replaced by investments. Investments, however, increased faster than advances fell; consequently deposits were built up both by a net increase in advances and investments together and by an increase in discounts (Chart 75 A). The most important characteristic, therefore, of the behavior of the credit superstructure after March 1932 was an increase in total deposits in the last nine months of 1932 of about £300 million, from just under £1,700 million to just under £2,000 million. This was made possible by the increase in the credit base. The ratio of 'cash to total deposits' did not decline, but the ratio of 'money at call and short notice' to 'total deposits' declined slightly. Advances fell from 55 per cent to under 40 per cent of total deposits, and the relative importance of 'discounts' and 'investments' increased pari passu.

The chief difference between the behavior of the credit superstructure in England during 1932–33 and during 1921–22 and 1929–30 was the sharp increase in the total of 'advances plus investments' (Ap. Table 3 D) and the consequent building up of 'total deposits.' In both earlier periods advances were declining steadily and were replaced by investments without increasing total deposits. But in 1932, after the restrictions imposed by the defense of sterling were lifted, there was a genuine expansion of bank credit by an increase in investments greater than the decline in advances. In this respect March 1932 was a major turning point in English credit control policy. In order to show this contrast, and also to provide a bird's eye view of the behavior of the credit

CHART 76

London Clearing Banks, Selected Balance Sheet Items, 1919-1935





Source. Appendix Table 3D

superstructure during the entire post-war period Chart 76 is presented.

Cultivating England's Garden

The general financial and economic policy we have designated at the beginning of this chapter by the phrase Cultivating England's Garden was made clearly apparent prior to the abandonment of the gold standard by the United States. Only the beginnings of the new policy, however, fall within that period, and consequently any account of its main features must anticipate events that took place after the international gold standard had entered the second and even the third stage of its disintegration. In order, therefore, not to sacrifice a bird's eye view of the new lines of policy as a whole, reference will here be made to events falling outside the period to which this section of our analysis is primarily devoted.

The Home Market

The brief deflationary pressure necessary to complete the steps by which confidence in British fiscal policy and in the pound sterling was restored was followed by a long period of cheap and abundant credit. Together with a protective tariff policy, this was the major instrument relied on by the government for promoting a revival of the home market in England. Under this stimulus, and without large scale government expenditures for the direct increase of consumer purchasing power at the sacrifice of a balanced budget, such a revival did make its appearance in 1932 and 1933. By April 1934 it had gathered sufficient momentum to yield, at the high levels of taxation then in force, a budget surplus of over £30 million, and to make possible a reduction of 10 per cent in the British income tax. The chief influence underlying this revival was the widening margin between incomes and expenditure on food due to low food prices and the use of the purchasing power so released for other purposes such as installment payments on new houses. Low food prices were therefore not only

responsible for the development of production control in agriculture and the support of agricultural prices in the newly protected market, often by government subsidy, but also in part for a revival of building construction, particularly in dwellings,[48] and a continued shift from old to new industries.

A 'shift' in the employment of the man power and resources of a great nation from old to new employments is of course an extremely complex process and a term of this kind can be used only as a convenient label or caption to indicate a series of economic changes which in themselves are material for prolonged study and analysis. As indicated in preceding chapters, this process had been going on in Great Britain during the entire Experimentation period but had not started early enough or proceeded far enough to overcome the major difficulties of maintaining the gold standard. It was by no means a product of the new post-1931 economic and financial policies, but cheap money and protection were powerful agencies in accelerating and carrying it forward. This may be seen by grouping the official British figures for employment in various occupations under several main divisions, and noting the shift in the number employed in each division from 1924 to 1934. In Table 83 four groups are set out, containing the following occupations:

I Engineering, Coal Mining, Shipbuilding, Iron and Steel, Textiles, Transport

II Chemicals, Clothing, Food, Drink, and Tobacco, Laundries, etc., Printing and Paper, Sawmilling, etc., Public Works Contracting, etc.

III Entertainment and Sport, Hotels, etc., Distributive Trades, Building, Motors, etc., Metal Trades

IV Other Industries

From 1924 to 1929 the number employed in Group I, the old staple trades of England, decreased 339,000, and the num-

[48] The estimated cost of buildings for which plans were approved was for 1931, £63 million; for 1932, £66 million; and for 1933, £83 million (*Statistical Summary*, Bank of England, Nov. 1934, p. 140).

ber employed in Group III increased 524,000. From 1929 to 1931 the number employed in Group I decreased 699,000 while Group III lost only 5,000. With the beginning of economic recovery, from 1932 to 1934, Group I recovered only 135,000 of its losses while Group III increased 411,000, and

TABLE 83

United Kingdom, Changes in Employment by Groups of Occupations, 1924-1934

THOUSANDS EMPLOYED

	1924	*1929*	*1931*	*1932*	*1933*	*1934*
I	4,150	3,811	3,112	3,024	3,082	3,247
II	1,923	2,035	2,034	2,027	2,069	2,094
III	2,838	3,362	3,357	3,361	3,556	3,768
IV	1,551	1,597	1,561	1,539	1,599	1,677
Total	10,462	10,805	10,064	9,951	10,306	10,786

NET CHANGES

	1924-29	*1929-31*	*1931-34*	*1929-34*	*1924-34*
I	−339	−699	+135	−564	−903
II	+112	−1	+60	+59	+171
III	+524	−5	+411	+406	+930
IV	+46	−36	+116	+80	+126

Compiled from *Statistical Summary* (Bank of England, December 1934), p. 154

Group IV 116,000. For the whole decade 1924–34 the shift in occupations was remarkable: Group I declined 903,000, Group II increased 171,000, and Group III and IV together increased 1,056,000. The older industries upon which British prosperity in the nineteenth century was based, coal, steel, textiles and shipping, had declined, but new industries such as the automobile industry, radio, and rayon arose in their place. The industrial North of England was chronically depressed, but the South was becoming industrialized. The industrial changes looked forward to by the Balfour Report were in progress, and the home market was taking a larger share of British output. The export trade had not recovered its losses, but vigorous efforts were being made to promote it, especially by the cultivation of closer financial and economic ties be-

tween Great Britain and the countries in which British economic and financial influence was dominant.

The Sterling Area

In our analysis of the behavior of the exchanges from September 1931 to February 1932 the extent of the sterling area, using the term in this broad economic sense, was understated in several important particulars. First, since only 36 countries were studied, several countries whose exchanges did from the outset move with sterling were omitted. Second, the Crown Colonies whose exchanges remained stable in sterling were excluded, and these comprise a very substantial part of the Empire. Third, countries attracted into the sterling area had not, by February 1933, reached the full number afterwards attained, and finally some countries whose exchanges did not at any time closely follow sterling were still, from a broad economic and financial point of view, within the dominant sphere of British influence. The boundaries of England's garden were in fact not marked with absolute precision, and it cannot be said that the gardener never cast his eyes upon neighboring plots.

The instruments used by Great Britain in binding the diverse portions of the sterling area closer to herself have been summarized by R. B. Stewart as follows:

"The particular instruments which Britain used in forging . . . closer links within the Sterling Area are the system of imperial preference embodied in the Ottawa Agreements, the reciprocal trade pacts with non-Empire countries, the establishment of stable exchange rates with these countries, the securing of favourable treatment under the Argentine system of exchange control, the development of central banking in the dominions, and the preferential treatment, in the matter of international loans, extended to the Dominions and to other countries within the Sterling area." [49]

This summary is in many respects admirable but its suggestion that the United Kingdom *established* stable exchange

[49] 'Instruments of British Policy in the Sterling Area,' *Political Science Quarterly*, June 1937, pp. 174–207.

rates with sterling area countries cannot be accepted for two reasons, one old and one new. In our discussion of the reasons for the stability of the exchanges of many countries on London before the war in Chapter 19 the *passive* role of the London market was stressed. It was to the interest of other countries before the war to have stable rates on London, and we have suggested that this was a major factor in making the prewar international gold standard a sterling exchange standard. The sterling exchange standard after September 1931 was not essentially different. The sterling area was formed by other countries pegging their exchanges on sterling. Yet the fact that they *were* pegged made the sterling area a reality and provided a stable basis for trading within it. This was the old reason. The new one was that the Exchange Equalization Account was concerned with the relations of sterling to the gold currencies and would not buy and hold Swedish kronor, Australian pounds, or other sterling area currencies. Therefore the pegging was carried out at rates satisfactory to the sterling area countries. Except for the rupee, the Egyptian pound, and the South African pound all the sterling area currencies were pegged at a discount from the old parity.

The general policy of imperial preference embodied in eleven treaties negotiated between different portions of the British Empire at the Ottawa conference in the summer of 1932 cannot be described with greater condensation than in Mr. Stewart's summary in the article from which the above quotation is taken (pp. 181–2), except at the sacrifice of all pretense to accurate statement:

"In return for concessions on the part of the dominions, Great Britain undertook to give definite advantages in the English market: (1) to continue (with certain reservations to protect the United Kingdom producer) free entry for all Empire products already admitted free under the Import Duties Act of 1932; (2) to impose fresh duties—by putting on new duties, increasing existing ones, and consolidating *ad valorem* into specific duties—on certain foreign imports, including wheat, maize, butter, cheese,

raw and canned or dried fruits, eggs, condensed milk, etc; (3) to continue certain existing preferences, by not reducing the general *ad valorem* duty of 10 per cent imposed by the 1932 Act on certain foreign goods, as timber and leather, without consent of the dominion government concerned; (4) to establish an import quota, restricting quantitatively imports of frozen mutton and lamb and frozen and chilled beef from foreign countries, with a view to raising meat prices in the British market to the point required for efficient production at home and in the dominions and to give the dominions a greater share of the British market; (5) to prohibit the imports of any foreign country which appeared likely to frustrate the preferences granted or guaranteed at Ottawa.

There were, however, some very definite limitations upon the preferences granted. The United Kingdom reserved the right, if at any time in consequence of restrictions upon foreign imports of meat and wheat the supplies became inadequate, to remove any such restriction until supplies were again adequate. The duties on foreign wheat, copper, lead and zinc imported into the United Kingdom were made conditional in each case on Empire producers continuing to offer those commodities on first sale in the United Kingdom 'at prices not exceeding the world price.'

The concessions granted by the dominions differed in each case. New Zealand was to reduce the British preferential duty on specified items; clothing, confectionary, hosiery, silk and rayon piece goods. South Africa agreed: (1) to grant new or increased preferences on a list of manufactures; (2) to leave the existing British preferential tariff on cotton and rayon piece goods unchanged; (3) and to maintain existing margins of preference on a long list of British manufactures. India, Newfoundland and Southern Rhodesia made similar promises of preference.

Canada, Australia and New Zealand entered into a common undertaking, first, that tariff protection should be offered 'only to those industries which are reasonably assured of sound opportunities for success,' and, second, to keep or reduce duties to a level which would give United Kingdom producers 'full opportunity of reasonable competition on the basis of the relative cost of economical and efficient production,' with special consideration, however, to 'industries not fully established.' . . . As

soon as practicable the Dominion Tariff Boards were to review existing rates and, after permitting United Kingdom producers to appear before the Boards, to vary the tariffs in accordance with this compensatory principle.

Canada agreed that all existing surcharges on imports from the United Kingdom should be completely abolished as soon as the finances of Canada would allow, and further undertook 'to give sympathetic consideration to the possibility of reducing and ultimately abolishing the exchange dumping duty in so far as it applies to imports from the United Kingdom.' "

These concessions from the Dominions were far from substantial, and many of them were not lasting, nor were the principles of the Ottawa Agreements new in tariff history. The Agreements, however, when they went into effect on October 12, were sufficient, combined with Great Britain's general tariff of February 1932, to raise serious problems in connection with British trade relations with other sterling area countries. In April and May 1933 four reciprocal trade agreements were entered into—with Norway, Sweden, Denmark, and Argentina. Mr. Stewart describes the treaties with the three Scandinavian countries (pp. 181–2):

"The treaty which Denmark finally concluded with Great Britain guaranteed to Denmark 62 per cent—compared with her 67 per cent in 1932—of the total permitted imports into the United Kingdom of bacon and hams from foreign countries. Yet, as was pointed out by *The Economist,* in view of the reservations which Great Britain made in favor of the marketing of her own domestic supplies, it was altogether possible that Denmark might find herself 'guaranteed 62 per cent. of nothing.' Denmark also secured an export quota of butter slightly under 1932 exports to Great Britain, and a quota of egg exports, also slightly less than 1932 exports. Reservation was made, however, as to action necessary to maintain a remunerative price level in Great Britain.

In return, Denmark agreed to redress the balance of trade which was heavily in her favor as follows: (1) a wide range of British goods—including machinery, coal, coke, iron and steel, galvanized plates—was to be admitted duty free; (2) other

classes of British goods, such as cotton piece goods, were to enjoy a reduction of duties; (3) another very wide range of goods, including woolen and cotton piece goods, other than those in the second class, were to be free from any increase of duties. Denmark agreed, further, to buy from Great Britain 80 per cent of her total coal imports and all the jute, salt, saltpeter and wrapping paper required for the export of bacon, hams and butter to Great Britain. The treaties with Norway and Sweden followed much the same line as the Danish agreement."

The conclusion of these treaties was followed by the admission of these three countries to the list of preferred borrowers in London, to which the Dominions had already been admitted. It was also followed early in 1934 by a definite stabilization of the exchanges of two of these countries in terms of sterling: the Swedish krona was pegged at 19.40 and the Danish krone at 22.40 to the pound in January 1934. Norway continued as before to be a faithful sterling country.

The negotiations with Argentina were more difficult and more important. Argentine competition in the British market was a serious concern of some of the chief members of the Empire and also of certain sections of British agriculture. Furthermore Argentina, since the imposition of her exchange restrictions in September 1931, had maintained a stable exchange relationship to gold, first as represented by the American dollar and then as represented by the French franc. The solutions of the problems arising from these facts are described by Mr. Stewart (pp. 182–3):

"Argentina agreed (1) to reduce to the 1930 level existing duties on certain goods, a large proportion of which, particularly cotton goods, come from the United Kingdom, (2) to levy no new or increased duties, thus continuing to admit coal free. Great Britain similarly agreed to impose no new or increased duties or quantitative restrictions on certain goods and to take as much Argentine chilled beef as she had imported during the corresponding quarter of the year ending June 30, 1932, subject to a 10 per cent reduction, if necessary, to keep the price at a remunerative level. No restrictions were to be imposed on frozen meat except those

agreed to at Ottawa. The underlying principle of this agreement is 'the home supply first, next the Dominions, then the Argentine.'

The Argentine agreement, however, was 'cast in a different mould' from the Scandinavian agreements. In the first place, the restrictions on frozen beef embodied in the Ottawa agreements were not to be tightened unless further limitations were applied equally to the dominions. Britain, in return, secured preferential treatment in the matter of blocked remittances: Argentina was to make available sterling remittances equal to the exchange arising from Argentine sales in the United Kingdom, after retaining 'a reasonable sum' to service other foreign obligations.

The Argentine agreement was also supplemented by a financial arrangement under which a long-term loan was raised in the United Kingdom for the liquidation of frozen short-term debts due to British nationals. Under this financial arrangement Great Britain has received, in return for her trade concessions and a sterling loan, first, the conversion of a large sum of blocked peso balances into direct obligations of the Argentine government. These balances had been 'frozen' in Argentina during the period October 1931 to May 1, 1933, that is, from the date of the institution of Argentine exchange control until the conclusion of the Anglo-Argentine agreement. Secondly, Great Britain has enjoyed exceptionally favorable treatment in the allotment of Argentina's available supply of foreign exchange. Moreover, this supply of exchange has been provided to Great Britain at a substantially lower rate—as much as 20 per cent lower—than that available to other countries. Finally, Argentina has been induced to abandon her formal adherence to the French franc and to peg her peso to the British pound, a change of policy initiated in February 1934."

The effort of Great Britain to cultivate the more distant portions of her garden encountered serious difficulties, of which perhaps the most important was the strong protectionist feeling in both the Dominions and the United Kingdom. Yet the boundaries of the sterling area were gradually extended, and in spite of all obstacles and contradictions of policy, there was a degree of cohesion within the world of sterling that exercised a continued and powerful influence over the world of gold.

CHAPTER 32

The World of Gold, a Patchwork Quilt

One of the first and most conspicuous results of the rapid decline of sterling in terms of the dollar, the franc, and of all gold standard currencies that remained at their old gold parities after September 1931 was a series of large and wholly unprecedented foreign exchange losses for the central banks of many gold standard countries. The contingency that these losses might be suffered was present in the minds of many central bankers before they were actually realized, but it was on the whole felt to be rather remote. The credits of the Bank of France and the Federal Reserve Bank of New York to the Bank of England were extended in the confident expectation that they would be adequate to tide over the British crisis, and informal assurance was given other central banks on the continent concerning the safety of their sterling balances. Some of these were surprised to learn that any part of the Bank of England's gold reserve was considered as pledged to its American and French creditors. The most illuminating account of their relations to the Bank of England on the eve of sterling's departure from gold is given in the following passages in the Annual Report of the Netherlands Bank for 1931–32. The Bank refers to its losses on its sterling balances and comments (official English translation, pp. 44–6):

"And as to the loss itself, the decisive factor here lies in the question whether the Bank, in exercising a careful management, should not have discarded its holding of sterling in time. The Management were of opinion that they should not do this because they were convinced that the British Government and the Bank of England firmly intended to maintain the gold standard

and to make the gold stock of the said Bank entirely available for this purpose. This conviction was based on the conversations which Dr. Vissering and Dr. Tetrode had with the Management of the Bank of England on August 26th. 1931, when anxiety concerning the financial position of England began to prevail. Immediately after this interview the said gentlemen put down in writing a summary of the discussions which had taken place. The statements which had been made to them, according to that summary . . . placed beyond doubt that it was intended that the proceeds of the loan of £80,000,000 which the British Government had obtained from abroad to support sterling, should be employed in order to maintain the gold standard together with the entire gold stock of the Bank of England then available. This intention also appears from the telegram received on August 29th, 1931, from the Deputy Governor of the Bank of England, which reads as follows: 'With reference to our conversation on Wednesday last you will no doubt have seen the official announcement to-day of the conclusion by our Government of large credits in New York and Paris. I trust this announcement will serve to abolish all doubts as to the safety of foreign funds in London.'

On the grounds of these facts, the Management considered that they were entitled to continue their efforts towards international co-operation and to refrain from liquidating the Bank's sterling assets, a liquidation which would inevitably become known and give rise to a most alarming increase in distrust. They considered that they were bound, in view of their public function, to maintain the relationship as it had grown entirely in accordance with the views and the desire of the Bank of England, as long as they might expect, from the discussions held and the assurances received, that England would maintain the gold standard. This expectation received strong support from the fact that the gold stock of the Bank of England between the dates of the conversations referred to and that of the last weekly return before the suspension of the gold standard, not only exhibited no diminution, but even showed an increase. On these two dates the gold stock stood at £133.300.000 and £135.600.000 respectively.

In the light of the developments described above, the Management was so convinced that the Bank of England would consider themselves in equity bound by the exigencies of international co-

operation to safeguard The Netherlands Bank against all losses on its sterling assets, that they drew up and published on September 27th. 1931, their *communique* of that date.

The Management of The Netherlands Bank has, however, been disappointed in this conviction, as it has since become clear that the Bank of England takes the view that the responsibility for the suspension of the gold standard rests exclusively with the British Government and that there existed a connection between the gold stock which, according to the weekly returns published, was at the disposal of the Bank at the time when the gold standard was abandoned, and the loans which had been taken up abroad by the British Government and the Bank of England in order to support sterling. It is obviously unnecessary to state here that such a connection could by no means be surmised by third parties."

Since even for central banks in closest touch with the London market the losses incurred came as an unexpected shock, this was even more true of many central banks in smaller countries; for example, the newly established central bank in Peru, whose sterling assets were the basis for newly won membership in the world of stable money. These losses were not only largely unexpected, but also for the most part unavoidable. Important central banks felt a strong moral obligation to refrain from adding to the difficulties of the moment by themselves taking the lead in runs on one another's markets. No such considerations restrained the actions of private banks whose object, in fact, whose duty it was, to avoid loss. Consequently, when the sterling exchange did depreciate, many central banks held substantial gold exchange balances [1] abroad and were at once faced by the double problem of how to deal with their losses in sterling and how to safeguard themselves against similar losses in other currencies in the future. The first part of this problem was met in many countries by calling in the aid of government to shoulder part of the

[1] This term is used in the broad meaning assigned to it in Ch. 20, The Definition of the Gold Exchange Standard. In order to avoid needlessly cumbersome forms of expression 'balances' used in this connection includes short term assets in general, and not bank deposits alone.

central banks' losses, legislation to this effect being passed, for example, in France, the Netherlands, Belgium, Austria, Poland, and Czechoslovakia. The second part gave rise to earnest discussion among central bankers concerning various forms of mutual guarantee against such losses, but was in practice met by the liquidation of foreign exchange by central banks. This liquidation was sufficiently large and sufficiently general to leave its impress upon the movement of central banking reserves the world over, not only in the last quarter but also in the last half of 1931 (Table 67).

In analyzing the consequences of the breakup of the nucleus on the behavior of reserves the use of figures for the half year has obvious disadvantages, but it also has one great advantage. The last six months of 1931 have strong claims to be considered a unit in one important respect. They cover nearly the whole period from the outbreak of the confidence crisis to the restoration of confidence in sterling, and within them occurred nearly all the events that brought to an end the Experiment of the Gold Exchange Standard without a Focal Point.

The Fate of the Gold Exchange Standard

The Gold and Foreign Exchange Reserves of Central Banks and Governments, July–December 1931

In Table 84 the 32 countries included in Table 67 are grouped according to the changes in their reserves after June 1931. The salient features of the redistribution of reserves shown by this table are:

1) heavy losses of gold by the two active partners in the nucleus of center countries—Great Britain and the United States—and large gains by the inactive partner in the central nucleus—France, and by the smaller European creditor countries, the Netherlands, Belgium, and Switzerland

2) losses of gold by two periphery countries—Argentina and Japan

3) loss of gold and of foreign exchange by Germany

4) general reduction by European central banks of foreign exchange reserves, partly by recording their losses on sterling balances, partly by genuine liquidation, and partly by conversion into gold
5) the presence of a psychological gold export embargo throughout the group of countries pegged to gold, as evidenced by the concentration of their entire losses in reserves in the form of losses in foreign exchange while gold holdings were little changed
6) an increase in foreign exchange reserves by Australia, characteristic of the general building up of London balances by sterling standard countries
7) the influence of hoarding, indicated by a net loss in gold reserves by the 32 countries at a time when additions were being made to the gold supplies of the West, not only by the whole amount of new production but also by shipments from the East
8) the elimination from the world's central banking systems of a total of 3,742 million Swiss francs ($722 million) in reserve funds either through a depreciation in the valuation of foreign exchange in the currency of the holding central bank or through the sale of foreign exchange to purchasers other than central banks (when such sales were made, not in order to purchase gold, but to support the exchanges of countries whose currencies were under pressure, this meant that balances previously accumulated abroad were being used, as in 1919–20, to settle international indebtedness).[2]

The general movement of central banking reserves from July to December 1931 may be divided with reasonable accuracy into two periods, that immediately preceding and that immediately following England's abandonment of the gold standard, by referring to our discussion of the position of individual countries. Except for the shipments made to repay foreign credits in November 1931, the British gold losses are accounted for by the withdrawals during the crisis of July 1931. Germany's entire foreign exchange reserve losses during the six months, and about one-third of her gold losses, took place before England left the gold standard, as did the

[2] Cf. Ch. 9, The Pull of the Dollar over the Exchanges.

TABLE 84: *Gold and Foreign Exchange Reserves of Central Banks and Governments, Net Changes, July–December 1931*

	GOLD	FOREIGN EXCHANGE	TOTAL
		(millions of Swiss francs)	
COUNTRIES LOSING GOLD RESERVES ONLY			
United States	−2,571		−2,571
United Kingdom	−1,063		−1,063
Japan	−986		−986
Argentina	−503		−503
Canada	−47		−47
COUNTRIES LOSING BOTH GOLD AND FOREIGN EXCHANGE RESERVES			
Germany	−539	−157	−696
Sweden	−45	−341	−386
Austria	−18	−231	−249
Denmark	−39	−56	−95
COUNTRY LOSING GOLD AND GAINING FOREIGN EXCHANGE RESERVES, BUT LOSING RESERVES ON BALANCE			
Spain	−179	175	−4
COUNTRIES LOSING GOLD AND GAINING FOREIGN EXCHANGE RESERVES, BUT GAINING RESERVES ON BALANCE			
Portugal	−2	71	69
Australia	−120	137	17
Hungary	−9	12	3
COUNTRIES GAINING GOLD AND LOSING FOREIGN EXCHANGE RESERVES, BUT LOSING RESERVES ON BALANCE			
Italy	70	−478	−408
Czechoslovakia	17	−132	−115
Poland	19	−79	−60
Finland	1	−59	−58
Chile	3	−39	−36
Greece	25	−61	−36
Roumania	26	−61	−35
Yugoslavia	20	−46	−26
Lithuania	6	−18	−12
Bulgaria	1	−9	−8
Latvia	8	−9	−1
Norway	12	−13	−1
COUNTRIES GAINING GOLD AND LOSING FOREIGN EXCHANGE RESERVES, BUT GAINING RESERVES ON BALANCE			
France	2,448	−1,134	1,314
Switzerland	1,507	−316	1,191
Netherlands	812	−306	506
Belgium	803	−630	173
Danzig	22	−8	14
COUNTRY GAINING FOREIGN EXCHANGE RESERVES ONLY			
Brazil		46	46
COUNTRY GAINING GOLD RESERVES ONLY			
India	57		57
Grand Total	−264	−3,742	−4,006

SOURCE: Table 67

bulk of Argentine gold losses. During the confidence crisis, also, substantial additions were being made to the gold reserves of France, the Netherlands, Belgium, and Switzerland, either through purchases in the London market or by earmarkings in New York. The chief characteristics of the movement of reserves during the first three months after England left the gold standard were the large gold losses of the United States to France and to the smaller European creditor countries, renewed gold losses by Germany, heavy gold exports from Japan to the United States, the growth of continental hoarding, and the general liquidation of foreign exchange reserves on the continent of Europe. It was during these three months also that the Bank of France determined upon a method of meeting her sterling losses and reached the decision to liquidate her position as a country using the gold exchange standard as a half-way house.

France Leaves her Half-Way House

On account of the magnitude of the foreign assets of the Bank of France the domestic problem occasioned by the depreciation of sterling was very serious and the international problems presented by the Bank's determination to escape further losses of the same kind were exceptionally acute.

THE TREATMENT OF THE STERLING LOSSES OF THE BANK OF FRANCE

When England left the gold standard the Bank of France still held sterling assets of over £60 million,[3] amounting at par to about 7,750 million francs, or about 30 per cent of her total foreign exchange holdings of 25,194 million francs. For several months the Bank continued to carry this sterling on its books at the old par value, but it was clear that the actual loss involved would have to be revealed when the Bank presented its annual balance sheet to the stockholders in

[3] Bank of France, Annual Report for 1931 (*Federal Reserve Bulletin,* March 1932, p. 163).

December. Since this loss far exceeded the Bank's total capital and surplus [4] it was also clear that the government must intervene. Accordingly three conventions were entered into on December 7 between the Bank, the Treasury, and the Caisse d'Amortissement, and approved by the Law of December 23, 1931, that is, the day before the annual report had to be submitted. The content of these conventions is summarized by Miss Myers:

"The Bank was to revalue the items 'Sight deposits abroad' and 'Negotiable bills and other short-term assets abroad,' according to the value of sterling on the day before the gold standard was suspended in England. A special account was to be opened on the books of the Bank for these items, and all operations made after that date were to be entered at the rate of exchange then prevailing. On December 24th, 1931, the Bank was again to evaluate these two assets at the rate of exchange on that date. The difference between these two figures, which represented the amount of the Bank's loss on December 24th, 1931, was to be covered by a Treasury note for that sum, without interest, maturing on December 31st, 1945. A similar evaluation was to be made by the Bank at the end of June and of December each year, and the amount of the Treasury note was to be adjusted to cover the actual loss at each date. If sterling were again made convertible into gold, the Bank was to make a final evaluation and the account closed; but if sterling did not return to a gold basis before 1945, the Treasury was at that time to pay the note and thus finally settle the matter." [5]

The conventions provided also that the Treasury note to the Bank should take the form of bills issued by the Caisse d'Amortissement similar to those issued to the Bank in 1928 in connection with its losses on Russian bonds. These bills were to be amortized partly by a contribution of 200 million francs by the Bank on December 24, 1931 and partly by addi-

[4] Cf. M. G. Myers, *Paris as a Financial Center* (Columbia University Press, 1936), p. 94.

[5] *Ibid.*, p. 96–7. The writer has taken the liberty of altering the sequence of tenses in this passage because of the context in which it is here used.

tional taxes on the circulation and profits of the Bank. In addition, the Bank made a further contribution of 50 million francs toward reducing these bills on December 24, 1931. The Bank therefore made a total contribution of 250 million toward meeting a total loss, estimated at the end of the year at 2,343 million francs ($91,806,000).[6] The balance, 2,092 million francs, was taken care of by the government's notes. The changes in the balance sheet brought about by these arrangements are shown in the accompanying table.[7]

Selected Items from the Balance Sheet of the Bank of France showing the Loss on Sterling Exchange in 1931 (millions of francs)

ASSETS	DECEMBER 18	DECEMBER 24	CHANGE
Gold Reserve	68,064	68,481	+417
Sight funds abroad	15,335	13,040	−2,295
Negotiable bills, etc., abroad	8,288	7,560	−728
Commercial portfolio	7,287	7,969	+682
Notes of Caisse d'Amortissement	5,065	7,157	+2,092
LIABILITIES			
Capital	182	182	
Surplus	273	273	
Notes in circulation	82,527	83,547	+1,019
Treasury deposits	295	340	+45
Deposits of Caisse d'Amortissement	5,542	5,533	−9
Other deposits	24,695	23,639	−1,056
Miscellaneous	2,107	1,778	−329

Between September 25, 1931 and December 24, 1931 total foreign exchange holdings of the Bank of France fell from 25,194 to 20,600 million francs, or 4,594 million. Deducting from this the write-down on sterling assets of 2,343 million francs a genuine liquidation in these holdings of 2,251 million francs ($88 million) is indicated. At the same time the Bank's gold holdings increased 9,135 million francs ($296 million). These figures reflect the development of the Bank's policy with respect to the second half of its foreign exchange problem.

[6] Bank of France, Annual Report for 1931 (*Federal Reserve Bulletin*, March 1932, p. 163).
[7] This table is presented by Miss Myers, *op. cit.*, p. 97.

LIQUIDATION OF FRENCH DOLLAR BALANCES AND THE DEFENSE OF THE DOLLAR

Ever since the de jure stabilization of the franc in 1928 it had been the policy and aim of the Bank of France, as clearly stated in its annual reports, to liquidate its foreign exchange holdings. As indicated in Chapters 20 and 27, it had been restrained from doing so only because such action would have had serious repercussions in London and New York, and would have endangered the stability of the international exchanges. It is not surprising, therefore, that the losses sustained on sterling balances produced in France an uncompromising hostility to the gold exchange standard, well illustrated by M. Flandin's bitter attack on it during the debate in the French Chamber over the ratification of the December conventions. More than ever the question to be decided was not whether to dispose of the Bank's foreign exchange, but when and how to do so. The decision to liquidate in good earnest was not made until December 1931, but by June 1932 the bulk of the Bank's holdings of exchange had been converted into gold.

This major change in the assets of the Bank is brought out in Chart 58. This chart, however, gives a misleading impression in one respect, for it suggests a larger conversion of foreign exchange into gold in the last quarter of 1931 than actually took place, because half of the reduction in foreign exchange during these months was a bookkeeping transaction. For the first six months of 1932, however, it portrays faithfully the departure of France from her half-way house.

The considerations that led the Bank of France to postpone the liquidation of its dollar balances immediately after September 21, 1931 derive from the peculiar difficulties of the New York market at that time. Because of the depreciation of the pound in terms of gold currencies, confidence in the dollar on the part of continental holders of dollar assets was seriously undermined. At the same time, foreign central

banks and commercial banks were eager to strengthen their own positions quite independently of any question of distrust in New York. Consequently, immediately after September 21, 1931 large sales of dollars took place and large transfers were made to Europe. The demand for francs in particular was overwhelming. During October gold exports from New York to Paris were $324 million, and $63 million in gold was shipped to Belgium, the Netherlands, and Switzerland, but New York was still drawing gold in substantial amounts from Argentina, Japan, and several other countries, so that the net exports for October were $337 million, only slightly larger than the gold movement to France. The export figures, however, tell less than half the story of American gold losses at this time,[8] as is evident from the accompanying statement of the changes of the monetary gold stock for September and October. Under these circumstances international considera-

Changes in the Monetary Gold Stock of the United States, September–October 1931

Imports +, Exports— (millions of dollars)

	SEPTEMBER	OCTOBER
Net gold import	+20.6	−334.7
Net release from earmark	−279.1	−107.6
Excess of domestic production over non-monetary consumption	+4.2	−8.2
Net change in gold stock	−254.3	−450.3

tions of the type that had prevented the wholesale conversion of sterling balances by the Bank of France just before September 21 weighed heavily against wholesale conversions of Bank of France dollar balances immediately after. The conditions under which these balances, which were probably not far from $600 million, would be retained in New York became a matter of negotiation between New York and Paris, and it soon became very clear that, in view of her recent experience with sterling, France would have to be offered substantial inducements to refrain from carrying out her long cherished program of conversion of Bank of France

[8] Cf. Ch. 27, The United States, Preparing for Trouble.

devisen into gold. Those which the United States was able to offer were two—first, assurances or guarantees that no policy would be pursued that would endanger the maintenance of the gold standard in the United States; second, an increase in the interest rate that would make the employment of French funds in New York more profitable. The attitude of the American banks immediately after Great Britain's suspension of the gold standard was favorable to an agreement or understanding on these lines. Withdrawal of Bank of France balances on a large scale would have been seriously inconvenient to the New York money market as a whole and to the particular banks holding French balances. These banks made their views felt in Washington where apprehension for the preservation of the gold standard had already created a receptive state of mind.

For the first time, in fact, since 1914 the United States found itself earnestly defending the gold standard. Between September 19 and October 31 money in circulation increased $404 million, the monetary gold stock declined $725 million, and in spite of an extraordinary increase in Federal Reserve credit of $947 million, member bank reserve accounts declined $169 million. Fear gripped the American market as these changes began to disclose themselves, and it became necessary to give official assurance that the American gold standard was not in danger. For this purpose Randolph Burgess went to Basle at the time of the October meeting of the Board of the Bank for International Settlements. In October also two emissaries of the Bank of France were sent to America to discuss with the Federal Reserve officials and with the Treasury the conditions on which Bank of France balances would be left in New York. Meanwhile, the discount rate of the Federal Reserve Bank of New York had been raised from 1½ to 2½ per cent on October 9 and to 3½ per cent on October 15. A general understanding seems to have been reached by the bankers which was reflected in the following passage in the Joint Communique issued by

M. Laval and President Hoover as a result of M. Laval's brief visit to Washington at the end of the month:

"Our especial emphasis has been upon the more important means through which the efforts of our governments could be exerted toward the restoration of economic stability and confidence. Particularly we are convinced of the importance of monetary stability as an essential factor in the restoration of normal economic life in the world, in which the maintenance of the gold standard in France and the United States will serve as a major influence.

It is our interest to continue to study methods for the maintenance of stability in the international exchanges."

Behind these financial and currency considerations was the question of the American attitude toward the renewal of the Hoover Moratorium upon its expiry in July 1932. Mr. Wheeler-Bennett, in fact, states unequivocally that the object of French withdrawals and threats of withdrawals of funds from New York was to regain for France the initiative in reparation matters.[9]

As a result of these negotiations gold exports from the United States to France temporarily ceased in November 1931,[10] but the whole episode had important psychological repercussions in the international financial world. The apparent yielding of the United States to French views on certain aspects of American financial policy came as a shock to the views of many people in Europe concerning the relative financial strength of the two countries. This together with the American policy of huge open market purchases to offset the effects of the gold exports and gold hoarding combined to produce a genuine lack of confidence in the American dollar on the European continent.

The cooperation of France with the United States during the crisis of September and October, moreover, did not mean

[9] *The Wreck of Reparations,* p. 121.

[10] In this respect also Chart 58 is somewhat misleading. It does not show this break in the gold movement, for a large proportion of the gold shipped to France, and included in the American figures for October, appears in the French figures for November.

a change in the settled policy of the Bank of France toward its foreign exchange holdings, and in December gold withdrawals were resumed and were continued without interruption until June 1932, when the New York balances were exhausted. During this period the gold holdings of the Bank of France rose to 82 milliard francs, an increase of 14 milliard between December 30, 1931 and June 24, 1932. This increase by no means represented a simple conversion of Bank of France dollar balances, though that was undoubtedly the major element contributing to it. From December 1931 to June 1932 France was a steady importer of gold from England as well as from the United States and also drew gold on balance from the Netherlands, Germany, and Switzerland. Total French gold imports exceeded considerably the increases in Bank of France holdings, and imports from the United States and England were not distributed in the exact proportion in which Bank of France dollar and sterling balances were drawn down. The movement probably combined in some proportion the following elements: first, the Bank of France purchased gold with its sterling and dollar balances wherever it was cheapest, that is, alternately in New York and London in accordance with the fluctuations of the triangular system of rates that joined Paris, London, and New York; second, a considerable volume of imports from the United States represented the satisfaction of a hoarding demand for gold coins in Europe. Since the United States was the sole remaining gold standard country that continued to coin gold and maintain a gold circulation, and gold coins were desired for hoarding, this was almost inevitable. In a sense the United States was the source from which the world's hoarding demand was satisfied, and there was a steady movement of American gold eagles through the Paris bullion market, some of them bearing the date 1932.

During April, May, and June the amount of gold taken by France from the United States became very large, and once more produced a substantial net export movement and a

repetition on a smaller scale of all the American credit phenomena of October 1931. It also caused a repetition of one special aspect of the defense of the dollar: the need for banking support in Paris on account of the inadequacy of transport to move gold to France in the volume demanded. To prevent the dollar from going below gold export point from New York to Paris the Guaranty Trust Company, which had special facilities at the Bank of France, bought, at the height of the two major gold movements, all dollars offered at 25.32½, just above gold export point from New York to Paris, and sold dollars at 25.35, i.e., at the Bank of France buying price for gold. The gold movement was thus spread over time and the bad psychological effect of extreme weakness in the dollar quotation avoided. Even at the height of the French liquidation of her dollar balances international financial cooperation was thus brought into play to carry out the operation technically with a minimum of disturbance to the market.

The Babel of Tongues

The losses incurred by central banks on their sterling balances placed the whole question of the future serviceableness of the gold exchange standard in the forefront of central banking discussion. Notwithstanding these losses strong hopes were entertained in many central banking quarters that some way could be found to preserve its advantages and guard against its risks.

At the time the gold exchange standard received the severe shock of sterling depreciation the general idea of an actual or at least a potential gold shortage had gained a strong hold over many minds. Many central bankers in the smaller debtor countries felt that in the international competition for gold produced by such a shortage their banks would be unsuccessful bidders and would be unable to add to their holdings. Such bankers therefore wished to find some means for rehabilitating the gold exchange standard

since they foresaw that in any event they would have to continue to use foreign exchange reserves. The reasons that had led to the development of the gold exchange standard in pre-war days as a technical convenience in maintaining exchange stability between the smaller countries and the center countries were not obliterated by the depreciation of sterling, and a return to it at some future date was considered both probable and desirable by some central banks on that account. In addition, the central banks of smaller countries wished to hold foreign exchange reserves rather than gold because these were earning assets. Behind this was the deeper, and often unacknowledged motive several times stressed in these studies—the psychological gold export embargo imposed by public opinion. The fact that a gold inflow was considered almost universally as a sign that 'all is well,' while a gold outflow was, irrespective of its causes, considered a sign of the reverse, was a serious impediment to the operation of the gold standard. Though central bankers of the debtor countries were not wholly immune from this feeling themselves, they were in general prepared to admit that from the point of view of the central bank the question of whether they had gold or gold exchange was of no consequence technically. They were, however, faced with the fact that gold exports from their countries were practically impossible because of the public alarm they occasioned. This was not true of the drawing down of foreign exchange balances. Therefore the only way by which any genuine two-way connection between the movement of central banking reserves and the changing international position of the country could be established was by the gold exchange standard. In addition, even after September 1931, the gold exchange standard received considerable support as a general measure of gold economy and efficient gold standard administration among central bankers in the smaller European creditor countries—an attitude that was a direct inheritance from the time of the Genoa conference (cf. Ch. 11).

Accordingly, the utmost ingenuity was devoted to devising schemes whereby the dangers to which the operation of the gold exchange standard without a focal point was exposed could be overcome. Four possible methods at least were at this time suggested in various discussions to eliminate the exchange risk involved in the holding of foreign exchange reserves by central banks:

1) some form of insurance against losses from foreign exchange depreciation
2) a pool contributed by all central banks to be used to make good the losses due to depository banks going off the gold standard—a form of self-insurance by central banks
3) the continued covering of the exchange risk by a regularly maintained volume of forward exchange contracts
4) some form of gold guarantee given by the depository bank.

Of these, the last two were seriously considered, and the fourth was in part put into practice.

The terms and conditions under which a 'gold clause' by central banks could be given and received were the subject of earnest debate by central bankers, and the utilization of the B.I.S. in connection with it was proposed in different ways. It was stated to the writer, for example, by a Dutch authority that the gold exchange standard could be restored under the following conditions:

1) centralization of all gold exchange deposits with central banks
2) conference among central banks through the B.I.S. concerning the size of these deposits
3) a guarantee by the respective governments acting through the B.I.S. of repayment of central bank foreign exchange deposits up to an amount deemed by the central bankers in conference to be not too large.

Finally, the B.I.S. itself was an active advocate of the development of a system of inter-central bank gold guarantees, and the centralization of inter-central bank deposits in its hands. Such a plan was in harmony with the general purposes of the B.I.S. and it also had a special reason of a more practical

kind. With the breakdown of the reparation and war debt system a large reduction in its working funds was at least a possibility. If, then, the B.I.S. was to continue to function as an agency of inter-central bank cooperation it would need to develop other sources of funds. The proposed centralization of gold exchange balances with the B.I.S. seemed desirable and appropriate from this viewpoint.

These various suggestions, however, foundered upon the rock of central banking opposition in France and the United States. The officials of the Bank of France were during 1932 so convinced of the shortcomings of the gold exchange standard that they could not imagine ever considering it again, and invited its advocates to glance at the balance sheet of the Bank of France after England left the gold standard, if reasons were sought for their attitude. The suggestion of government guarantees did not appeal to the realistic French mind, since governments cannot be obliged to keep their promises, and, when responsible to parliaments which are not bound by the promises of their predecessors, often *cannot* keep them. In the view of the Bank of France the only solid basis for international financial obligations was gold and a domestic portfolio of bills. The Federal Reserve Bank of New York had also consistently taken a stand against the gold exchange standard under the leadership of Governor Strong and continued to do so after his death. This opposition was rooted in a conviction that its use exposed the Federal Reserve banks to the repercussions of financial disturbances originating far from the United States and with which the United States had no concern, and in the general view that the gold exchange standard was a fundamentally inflationary device. The Federal Reserve Bank of New York was also opposed to the inter-central bank gold clause on the following grounds:

1) If the Federal Reserve banks gave other central banks a gold guarantee on their deposits they would have to keep larger reserves, as they would be assuming a special type of liability calling for special treatment.

2) If the Federal Reserve banks gave such a special guarantee to other central banks and not to their own American banking depositors, they might, by inference, be casting a doubt upon the safety of their domestic deposits which were in the general form of promises to pay in gold.

In general it was the attitude of the Federal Reserve banks that gold exchange standard countries were asking too much —all the safety of gold and all the flexibility and earning power of exchange.

In actual practice a very small beginning was made toward a realization of the inter-central bank gold clause. Italy, which, together with some other countries, had raised special objections to the proposals for safeguarding other central bank deposits in Italy by forward exchange operations on the ground that this was bad for the Italian exchange, consented to give a gold clause for the deposits of the B.I.S., as did Belgium. But other central banks refused, and the general movement was still-born.

The fundamental bar to the survival of the gold exchange standard as a major form of the gold standard was the absence of confidence. In a world in which the international financial structure was divided and decentralized this was a fatal obstacle. In the post-war world the gold exchange standard was, like Janus, two-faced—the British blamed their troubles on French withdrawals, but the French raised their eyebrows when speaking of their losses on sterling balances.[11] The inter-central bank gold clause had two faces also. Its advocates pointed out that if these mutual guarantees had been in effect before the confidence crisis the panicky withdrawals that led to the breakdown of the gold standard would not have taken place. Its opponents pointed out that if such mutual guarantees had been in effect the B.I.S. would have been ruined. If the B.I.S. had given a gold guarantee to its own depositors and received similar guarantees for its own funds deposited

[11] For these expressions the writer is indebted to his colleague C. J. Smit.

with central banks, they said, the result would have been that, despite the gold clause, the B.I.S. would have found its assets frozen, but would have had to meet the demands of its depositors in gold.

Gold Standard Countries and Countries Pegged to Gold

The general retreat from the gold exchange standard was a milestone marking a definite stage in the journey the world had traveled since the gold exchange standard and the sterling exchange standard were for practical purposes indistinguishable terms, and sterling deposits could be described by the expression 'gold plus interest.' Considered in this light it was a sign of the disintegration of the international gold standard system. Another such milestone was the division of the world of gold into a small group of gold standard countries and a large group of countries pegged to gold.

The Basis for the Distinction

The basis for this distinction was not to be found, after September 1931, by dividing the gold countries into those which strictly adhered to the legal forms of the gold standard and those which did not, for the movement of gold to the central banks of some of the European creditors was resisted by various forms of gold repulsion policy, and gold was not made available by all such countries to all comers. In the middle of 1932, for example, the National Bank of Belgium was not always willing to purchase gold. Bullion dealers on the continent had to call up the Bank in advance to ascertain whether it was a buyer. For long periods the belga was pegged at just above gold export point by the central bank and there was no private arbitrage in gold between Paris and Brussels. At the same time the Swiss National Bank would not buy gold upon demand. It was, in fact, not obliged to do so, but from time to time three large Swiss banks, the Crédit Suisse, Société de Banque Suisse, and Union de Banques Suisse came

into the bullion market as buyers of gold, from which it could be inferred that the Swiss National Bank was a buyer and that these banks would pass the gold on to it. Nor could gold be bought at all times in Switzerland. A rigid and literal interpretation of the statutes of the Bank for International Settlements, in fact, would have excluded the Swiss National Bank from representation on its Board, whose membership was to be drawn from gold standard countries. The raising of such a point may, especially in view of the continued representation of the Bank of England and the Reichsbank on the Board, smack of ridiculous pedantry, but it is made here to reinforce our contention that it is not by looking to the legal maxims governing the gold standard that a distinction is to be drawn between gold standard countries and countries pegged to gold. Nor is such a distinction to be founded on the ground that in the gold standard countries the gold standard continued to fulfil its ancient *economic* role and that in the countries pegged to gold it no longer did so.

All the gold countries except those adhering to gold at levels below the parities in force at the beginning of the depression experienced in common the full impact of sterling depreciation, and many members of the central group of gold standard countries traveled a long distance in adopting 'the new protection' to counteract its effects. France, for example, not only raised her tariff rates continuously but used most of the new devices for checking imports. In September 1931 certain import prohibitions were imposed, and these were followed by the development of an elaborate and ever growing system of import quotas. The driving force behind this was the special and organized interest of groups of French producers,[12] to which the general interests of French consumers and of France as a creditor nation were sacrificed. By the early months of 1933 the quota system covered over 1200 tariff items, about one-sixth of the whole tariff schedule,

[12] An extreme example is the demand for a special quota on the import of fountain pens.

including many of the chief import groups. It was strengthened by milling regulations imposed on behalf of French agriculture. In February 1932, for example, it was decreed that 90 per cent of the wheat used for flour in France must be of French growth. Such developments in the gold standard countries were by no means confined to France. In Belgium, also, tariff increases were supplemented by a quota system which was extended from month to month. The same thing was true of Switzerland which added to its protective devices the use of import monopolies in 1932, while in the Netherlands also the quota and licensing system was developed steadily during the first six months of 1932. Furthermore these countries were parties to clearing or compensation agreements with countries in Central and Eastern Europe and in one or two cases even outside Europe.[13] If direct regulation of items entering into the balance of payments may be considered a form of exchange control, using the term in a broad sense, then it may be said that the gold standard as a device for facilitating trade and correcting one-sided movements in the balance of payments had broken down even in these countries. The United States alone among the gold standard countries did not practice exchange control in this sense, and on this basis the United States alone could be called a true gold standard country. This conclusion, also, like the one based upon strict observance of the gold standard obligation to buy and sell gold at fixed prices to all comers, is extreme and open to the charge of pedantry, but is drawn here for the same reason.

It is clear from the movement of central banking reserves that the European creditor countries did not adopt the new protection primarily, or even mainly, as a means of maintaining their exchanges. The motive of protection and the necessity for arriving at some basis of carrying on trade with, and securing repayment of debts due from, countries that did

[13] The spread of 'the new protection' and of exchange control is presented in tabular form in the *World Economic Survey, 1931/2*, Ap. I, pp. 319–22.

find themselves driven along this road by the weakness of their exchanges were dominant. They did not interfere directly in the exchange market, except as an incident of such clearing and compensation agreements, and the necessity of supporting the exchange was not, in the gold standard countries proper, *the initiating force* in the spread through their internal economy of ever increasing waves of economic regulation. Our distinction therefore rests upon the view that a country in which direct interference with foreign exchange operations was considered necessary to force the balance of payments adjustments, formerly accomplished through the mechanism of the gold standard, as they have been described in these studies was a country pegged to gold.[14] Yet the line is not easy to draw. Poland, for example, was a borderline case. In France early in 1933 over one-third, in Switzerland one-fourth, and in the Netherlands one-tenth of total imports were subject to quotas, and in Poland about one-fourth of total imports were subject to prohibitions mitigated by licensing systems. Whether any distinction should be drawn between quotas and prohibitions mitigated by licensing systems, as forms of exchange control, is a question to be decided more by the way the regulation was administered than by its form. Poland, moreover, of all the countries in the world of gold, was the most rigorous in its application of long continued deflation [15] in harmony with the strictest canons of the gold standard as applied to periphery countries in time of crisis. Nevertheless the fact that the *purpose* of Polish restrictions on imports was to maintain the exchange and that a form of exchange control was instituted in July 1932 has caused us

[14] Cf. Ch. 3, Pegging and Exchange Control. The same distinction, of course, could be drawn between sterling standard countries and countries pegged to sterling.

[15] Cf. Charles Rist, 'Memorandum on the Depression Experiences of Gold Bloc Countries,' *The Problem of Monetary Stabilization* (International Chamber of Commerce, Paris, 1936), pp. 252–3. Professor Rist includes Poland in the gold bloc, and after 1933, indeed, Poland was one of the major members of the group of countries to which that term was technically applied.

to include Poland in the group of countries pegged to gold (Chart 65).

A bare recapitulation of the spread of foreign exchange control in the narrower sense includes all the countries in each of the classifications: countries pegged to gold; countries adhering to gold at different levels; and countries attempting to stabilize in both gold and sterling. Spain, Hungary, and Germany entered the Disintegration period with exchange control already in force officially. In September 1931 exchange control was instituted in Greece and in October in Argentina, Austria, Brazil, Belgium, Czechoslovakia, Estonia, Latvia, Turkey, and Yugoslavia. In December Italy and Chile imposed restrictions, followed by Roumania in February 1932 and Poland in July 1932. In most of these countries the system was elaborated and extended almost from month to month and became the central mechanism of the new protection. It is clearly impossible here to go into any extended analysis of this process. Its relation to the gold standard as an international institution may be brought out adequately by stressing certain aspects of the experience of Austria, Hungary, and Czechoslovakia.

Countries pegged to Gold, Illustrative Cases

AUSTRIA

One of the consequences of the dramatic events in Austria associated with the confidence crisis [16] was internal inflation due to the discounting by the National Bank of hundreds of millions of Credit Anstalt notes. Great difficulty was consequently encountered in maintaining exchange stability and this led to three important financial and economic steps in the control of Austria's international relations:

1) Exchange restrictions were enforced to correct the balance of payments.

2) Clearing agreements were negotiated with Switzerland and other countries to finance trade at the official parity.

[16] Cf. Ch. 24, Austria, and Ch. 28, The Austro-German Crisis.

3) Private clearing agreements were entered into, which were clearing in name only, and gave rise to a dual system of exchange rates.

In the interrelation of these three may be found the measure of Austria's contribution to the disintegration of the international gold standard.

In its annual report for 1931 the Austrian National Bank tersely described the imposition of exchange restrictions in Austria (*Federal Reserve Bulletin,* May 1932, p. 306):

". . . in accordance with the advice of the National Bank, the government issued regulations on October 9 similar to those already in force in other countries, providing for the control of the foreign exchange. Following the suspension of the gold standard in Great Britain on September 20 the Bank had delivered foreign exchange only after examining each application and approving only such as represented legitimate requirements. The decree, since amplified by three amendments, confined dealings in foreign currencies to the National Bank and persons whom it appointed; placed international clearing and credit operations under the control of the Bank; and made it obligatory to declare existing stocks and future receipts of foreign exchange, and to surrender them to the National Bank on demand."

Allotments of foreign exchange under this system were at first extremely small. In the first week of November, for example, they were only 3 or 4 per cent of the amount demanded. This led to retaliatory measures abroad and throttled trade with surrounding countries to such a degree that it seemed likely to cease entirely, unless this could be prevented by special arrangements for direct settlement with each country individually. Consequently early in December a clearing agreement with Switzerland was put into effect, followed by agreements with other countries. The Swiss treaty provided that payments for merchandise would be effected only through the Austrian and Swiss National Banks, and that an export surplus amounting to 33 per cent should be guaranteed to Austria and should go to liquidate Swiss finan-

cial claims in Austria. Under this agreement the Swiss importers paid the Swiss National Bank in Swiss francs, and the Austrian importers paid the Austrian National Bank in schillings. The two National Banks then made the required offset at par. This meant that Austrian importers would get a good price in schillings provided they could get exchange at all. It meant, further, that the Austrian government could get a good rate of exchange and pay off its external debt which was expressed in gold with fewer schillings as long as the National Bank had exchange to deliver to it. As long as there was inflation in Austria relative to gold standard countries the importers and the government undoubtedly benefited, but only at the expense of exporters. For the arrangements also meant that under these conditions the exporters had a difficult time. Their costs were rising, and the proceeds of their shipments were not rising correspondingly, because the exchange rate was pegged at par. Hence the clearing arrangement that required that the exporter must sell his foreign exchange to the National Bank was in fact *a check to exports,* and since it was a check to exports it reduced the amount of foreign exchange available. Therefore the National Bank had to ration the available credit between the government for its foreign debt service, the banks for their foreign payments, and the importers. Hence the clearing arrangement became also *a check to imports.*

This situation was of general significance, for it showed that the condition of a successful working out of clearing agreements is that the currencies of the participating countries must not be either under- or overvalued substantially at the rate at which the clearing is made. Otherwise there is a tendency for imports and exports to balance, not at some point representing a genuine international division of labor and determined by the general principles governing international trade in a free economy, but at zero.

The results of the clearing agreements first negotiated by Austria soon became intolerable and led to illegal trading in

schillings. The National Bank was obliged to authorize what were called private clearing agreements under which exporters were allowed to sell foreign exchange to importers. Importers began to advertise in the newspapers for exporters who wanted to sell foreign exchange, and the two went hand in hand to the National Bank for a license to make their barter of foreign exchange. The rate was fixed by mutual bargaining and registered the real depreciation of the Austrian crown. Exporters, however, were not allowed to sell all their foreign exchange to importers. The producers of some articles were allowed to sell all, the producers of other articles, half, and of still others, a quarter, and other percentages, and some producers, i.e., producers of luxury goods, none. The balance was bought by the National Bank at the official rate. In the summer of 1932 the National Bank's proportion was on the average about a quarter.

These distinctions were made according to rules laid down by employees of the National Bank not in close touch with the businesses involved, who in this way came to fix in part the price in schillings of exported articles and the cost of imported articles. The business community soon complained about the inconvenience of bringing together particular pairs of exporters and importers (i.e., finding counter-parties) in order to barter their foreign exchange, and the task of matching these orders was then turned over to the Giro und Kassenverein, the clearing house of the Austrian Banken Verband. A free market thus came into existence, which could be used legally only for offsetting the export and import of goods. There were, however, ways of effecting disguised capital exports and disguised payment of foreign creditors. This was particularly true in connection with 'compensation' arrangements in which exporters of manufactures who were at the same time importers of raw materials could get permission for the disposal of their own devisen for import purposes. Moreover, since the National Bank continued to demand a certain, though varying, percentage of all

devisen the market rate varied in every individual case. The fact that 25 per cent had to be tendered at the gold par in one case and only 5 per cent in another influenced directly the market rate for the balance.

The free market thus created, with all its limitations, served to finance a large share of Austrian trade and furnished a rate, the recognition of which would have made an Austrian devaluation easy. It was theoretically entirely outside the banks, but the banks were able to save their foreign exchange business by offering to carry out the transactions of their customers at the Giro und Kassenverein. Furthermore, the restrictions in force could be avoided in many ways. For example, at one time an immense amount of quinine was imported, giving the impression in Switzerland that Austria was suffering from a sudden plague of malaria. This was happily not so—the quinine being later exported to Germany for foreign exchange. The concentration of offsetting foreign exchange transactions at the Giro und Kassenverein also made possible the conclusion of triangular transactions in the exchanges without physical imports and exports. In spite of all bonds, the essentially multilateral character of international trade found some slight avenues of expression.

Finally, most of the tourist traffic was financed outside Austria. Tourists purchased schillings from Austria's creditors, buying from them smuggled notes or schilling drafts. This produced another free market, but between the two free markets there was no arbitrage, so that the rates might differ by as much as 8 per cent.

Notwithstanding this struggle of her commercial life to find appropriate expression Austria continued officially to be a country pegged to gold. In the official view the quotations daily published for schillings at below the old par were held to be of no significance.[17]

[17] In the preparation of these paragraphs on Austria the writer was greatly assisted by interviews with Gottfried von Haberler, Fritz Machlup-Wolf, and Frau Leiser, Director of the Giro und Kassenverein when he visited Vienna with Mr. Smit in 1932.

HUNGARY

In Hungary there was no counterpart of the Austrian toleration of a regulated free market to meet the exchange needs of trade. The governing authorities, the League of Nations Commissioner and the National Bank, were fearful that such a practice would lead in Hungary only to the appearance of a second illegal market with quotations at a much lower level. They were not sure that any rate could be named that would lead to the development of a sufficiently large favorable balance of trade to enable the country to meet its annual obligations abroad. They were disillusioned by the unfavorable results of clearing agreements. For example, the first Hungarian clearing agreement with Switzerland provided for the sale of cattle in Switzerland, but almost as soon as it was signed the agricultural interest in Switzerland got the ear of the government and veterinary regulations were made which effectually excluded the Hungarian cattle. In general Hungary found that while financial reasons led to the conclusion of clearing agreements, special industrial and agricultural reasons nullified them, or if not, fiscal reasons did so, for the growth of imports interfered with the revenues of the government by reducing the business of the domestic producer. Finally, the financial authorities were convinced, for psychological reasons, that any abandonment of the gold par of exchange would lead to uncontrolled inflation in Hungary.

Hungarian policy, therefore, was to hang on to the exchange restrictions like grim death in spite of all difficulties, to stop the leaks, and to bring the balance of payments into equilibrium by restricting imports. The leaks were, nevertheless, substantial, for during the first ten months of the life of the restrictions, August 1931 to May 1932, Hungarian exports were 395 million pengö and only 252 million pengö were notified to the National Bank. There were two main causes for this deficiency: permission granted during part of the period to export goods in packages of not over 300 pengö in

value and differences between the values declared at the custom house and at the National Bank. Of the 252 million pengö notified, 135 million pengö, that is only 34 per cent of the value of exports, were actually delivered. About half of this difference was due to items not yet matured, but it indicates the constant vigilance demanded of the authorities in countries pegged to gold. In Hungary adherence to the gold standard meant holding the fort until economic self-sufficiency could be attained, or an outlet for Hungarian products found by negotiation with or between the great powers. Under these circumstances it became the function of the private foreign exchange banker to find ways of doing illegally what it was formerly his duty to do legally.

CZECHOSLOVAKIA

In Czechoslovakia neither the extreme position of Hungary nor the intermediate ground taken up by Austria prevailed after the confidence crisis. Exchange restrictions were imposed on October 2, 1931, following the exchange restrictions in Germany, Austria, Hungary, and England. These countries were the principal customers of Czechoslovakia, and when Czechoslovakian exporters could not get payment for their exports action was taken.

Under the Czechoslovakian system as it was developed by the summer of 1932 all exporters were obliged to notify the National Bank that they were exporting certain commodities and the amount of foreign exchange expected in payment. Permission to deal in the foreign exchanges was restricted to a few large banks, which had to have all their exchange transactions, subject to certain minor exemptions, passed on by the National Bank. Great precautions were taken to prevent capital exports, but exchange was freely made available for interest and for merchandise imports. Imports were controlled directly. Certain commodities could be imported only by permission of a committee on which various ministries, such as agriculture, commerce and finance, and various inter-

ests, such as the Chamber of Manufacturers and the National Bank, were represented. The list of these commodities was continually increasing and gradually the bulk of Czechoslovak import trade came under control. Hence the same sort of intricate questions of priority arose in Czechoslovakia as in Hungary where direct exchange control was much more severe.

These examples could be elaborated almost indefinitely, but without adding much to the general picture already given of the position of the countries pegged to gold. Something, however, should be said of the interactions of systems of exchange control in countries closely connected by trade. The Austrian-Czechoslovak trade will be used as our example.

The major difficulties in clearing between Austria and Czechoslovakia arose because there were more exports from Czechoslovakia to Austria than the reverse. Since blocked schilling accounts were released in Austria only when counter parties were found, blocked schillings owned by Czechs accumulated. But an active trade balance with Austria was a regular feature of Czechoslovakian trade, and in the absence of exchange control and of a regulated trade it had been settled by remittance of schillings to Czechoslovakia through other countries where Austria was a creditor. This was not done consciously but by means of free arbitrage dealings in the foreign exchange market. Under the system of exchange control the Czechs were credited in payment of their surplus of exports to Austria with schillings which they could not sell in their natural markets. These 'blocked' schillings therefore depreciated, and this depreciation, being due not to a general decline in the purchasing power of the schilling or the state of Austrian trade as a whole but to the state of the balance of bargains between the two countries, might easily have led to uneconomic exports from Austria to Czechoslovakia. It would not have been a cause for wonder under such condi-

tions to see shoes moving from Austria into the country of Bata. Unless something of this sort did happen, Czechoslovakia could not be paid for its export surplus, and in the end there could be no such surplus. That portion of the trade between the two countries which was a part of multilateral trade would be cut off.

Countries pegged to Gold, the General Case

The system of exchange control described in the illustrative cases of Austria, Hungary, and Czechoslovakia, when put into effect simultaneously in many countries was self-perpetuating and progressively destructive of international trade. It was part of the process described in Chapter 29 as Forcing a Balance on the World's Books. In the paper upon which our discussion of the Boundaries of the World of Sterling and of the World of Gold was based Charles Wilson admirably states the dynamic nature of the forces at work. The countries that chose to remain on the gold standard by the use of exchange controls did so:

"because they feared that the suspension of the gold standard would lead to panic among the population after the inflation already experienced, and so to a collapse of the domestic credit system, and because suspension would have made the burden of their foreign debts expressed in gold heavier rather than lighter. They accordingly endeavored to check both the further withdrawal of foreign credits and the flight of capital by the introduction of foreign exchange restrictions and the conclusion of standstill agreements for certain categories of credit, while at the same time maintaining a more or less artificial gold parity.

The foreign exchange restrictions thus served the two-fold purpose of restraining the further outflow of foreign credits and checking the flight of capital. A new feature was very shortly added, when foreign exchange restrictions came to be employed as a means of cutting down imports. In their efforts to maintain the interest and amortisation service on their long-term foreign debts and the service of interest on the short-term foreign credits

protected by means of standstill agreements and exchange restrictions, and in their endeavor to make the repayments required by standstill agreements or other contracts, the debtor countries were driven to a policy designed to obtain a corresponding surplus of exports over imports in the balance of trade. They accordingly made desperate attempts to force the pace of exports and to cut down imports. Dearer and scarcer credit, price and wage reductions enforced by the Government, curtailment of foreign exchange supplied for import purposes and (in certain cases) refusal to surrender exchange for other than vital imports, these are the stages of the path followed by some countries with success so far and by others with no success at all. These efforts were however increasingly obstructed by the fact that almost every country, in order to protect its own social life, likewise introduced higher customs duties, import quotas, import prohibitions and foreign exchange restrictions while in some countries the gold standard was suspended. The measures introduced with the object of obtaining an export surplus had accordingly to be tightened over and over again, with the result that the measures taken abroad were likewise rendered more severe. The greater, therefore, the difficulties encountered by the individual debtor country in the fulfillment of its foreign obligations, the greater the compulsion on that country to restrict its imports or—as ultimately happened in the case of Hungary, Greece and Austria —to suspend the fulfillment of its foreign obligations in whole or in part."

In this whole development, particularly as it applied to Central and Eastern Europe, the position of Germany was crucial. Her effort to attain self-sufficiency in agriculture under the pressure of reparation payments was one of the major causes of the shutting off of outlets for the exports of Eastern European countries, and the continual pressure to increase German exports was one of the earliest causes of clearing and compensation agreements. In fact, such agreements had been concluded secretly between Germany and Yugoslavia, Hungary, and Roumania before England had left the gold standard. Germany had become a country pegged to gold in the

sense in which that term has been here defined even before September 21, 1931, and the depreciation of sterling led to a development of, rather than a change in, German policy.

The Place of Germany in the World of Gold

The Annual Report of the Reichsbank for 1931, presented to the shareholders on March 6, 1932, contains the following passage (our italics):

"An important contribution to the restoration of confidence within the country was the fact that the Reichsbank, in complete accord with the Government of the Reich refrained strictly from *experimenting with the currency.* In the future as in the past the bank will consider it its highest duty to insure the stability of the reichsmark by all available means."

The determination of Germany to stay 'on' the gold standard recorded in this passage was steadfastly adhered to in spite of an invitation to join the world of sterling conveyed by a high British Treasury official on a visit to Berlin shortly after Great Britain left the gold standard. It was based on strong and compelling considerations which may be formulated as follows:

1) The whole German middle class was still painfully attempting to establish a new backlog of savings, and, in common with all other elements in German society, retained a well founded and ineradicable fear of currency inflation. With the national experience of hyper-inflation only six years in the background, the psychological effects of a depreciation of the reichsmark in terms of gold standard currencies would have been disastrous.

2) The statutes of the Reichsbank bound Germany to the gold standard, and the statutes of the Reichsbank were still an integral part of the Young Plan.[18] When sterling began to depreciate in terms of gold standard currencies Germany was on the eve of initiating new negotiations for a final settle-

[18] Cf. Ch. 25, The Gold and Foreign Exchange Reserves of the Reichsbank during the Period of Chronic Emergency, March 1930 to May 1931.

ment of reparations through a drastic revision of that plan. German abandonment of the gold standard would have made a successful outcome of these negotiations impossible, and the reparation problem would have had to be solved by unilateral German action in an atmosphere of extreme international recrimination and distrust.

3) On the eve of sterling depreciation Germany had concluded the first Standstill Agreement with her banking creditors. This agreement had a duration of only six months at most and did not include municipal and other German public indebtedness to private foreign creditors. Depreciation of the reichsmark would have made it extremely difficult to arrange for a new Standstill Agreement governing 'municipal' foreign debt and for an extension of the first Agreement when it expired, and would have threatened seriously the protection secured by these agreements against further sudden and indiscriminate international runs on Germany.

4) Just before the depreciation of sterling the Reichsbank and the Gold Discount Bank had received very substantial, but very short term credits. The renewal of these credits was vital to the Reichsbank in its efforts to provide for domestic credit needs, but was subject at least in part to political considerations. Moreover the very existence of the Standstill Agreement was, by its explicit terms, 'dependent' upon their continuation.

5) Sterling depreciation was a substantial benefit to Germany in the repayment of that part of her foreign debt expressed in sterling. Depreciation of the reichsmark in terms of francs and dollars and other gold currencies would have eliminated this advantage and produced an added burden in the repayment of that very substantial proportion of German foreign debt payable in dollars and other gold standard currencies. Since the Standstill Agreements provided for substantial initial repayments and gradual liquidation this was a serious consideration affecting their execution as well as the payment of obligations not included in them.

6) Germany was dependent for the maintenance of her economic life upon the uninterrupted inflow from abroad of certain important commodities, notably cotton, copper, iron, and wool. A sudden increase in the cost of these imports, which would have followed from a depreciation of the reichsmark, would have been disastrous to the German economy. Furthermore, this dependence gave to the powers largely controlling the production of these commodities a strategic position in negotiations with Germany which could not be overlooked.

On psychological, financial, economic, and political grounds, therefore, devaluation of the reichsmark or pegging it to the pound sterling were not practical politics in Germany after September 20, 1931. Strictly speaking, Germany did not decide to remain on the gold standard any more than, strictly speaking, England after the war decided to return to gold.[19] Germany was simply confronted with the problem of how, in the face of sterling depreciation, to free herself from her excessive dependence on foreign capital, reach a final reparation settlement, maintain her essential imports and preserve her international credit standing without permitting the reichsmark to depreciate in New York and Paris. The solution of this many sided problem was closely bound up with her success or failure in building up her export trade, or at least securing an export surplus against the new competition of sterling and the sterling area.

The German Reply to Sterling Depreciation

From 1928 to 1930 German exports increased steadily in value relative to imports. Including reparation payments and

[19] Cf. Ch. 9, The Recognition and Measurement of the Problem by Great Britain; cf. also a speech of Dr. Luther, President of the Reichsbank, in which he said that the decision of the Reichsbank and the Reich not to let the reichsmark slip after September 20, 1931 was not a decision, but simply the expression of a conclusion rendered inevitable by Germany's state of indebtedness and the German people's past experience of inflation. Samuel Montagu & Co., *Weekly Review,* Nov. 26, 1931.

deliveries in kind the trade balance for the last quarter of 1930 showed an export surplus of over 600 million reichsmarks. The surplus declined early in 1931 but in the third quarter reached a new peak of nearly a milliard. Immediately after the onset of the depression this trend had been due to the favorable terms of trade, the decline in Germany's capacity to buy imports owing to a reduced domestic purchasing power, and steady pressure by the government to direct German energies toward production for export. But the 1931 peak was entirely due to other and special causes. Before the conclusion of the first Standstill Agreement, raw material imports fell heavily and exports of manufactured goods rose as a direct reflection of a state of financial panic, and early in the fourth quarter exports of manufactured goods continued on a high level owing to purchases by the United Kingdom in anticipation of higher tariffs.

After October 1931, however, these special causes ceased to operate and were replaced by new tariffs, trade barriers, and exchange depreciation. The German export surplus consequently began a rapid decline which did not taper off until the middle of 1932.[20] The support given the reichsmark by German exports was, moreover, less than the trade figures suggest. In spite of the foreign exchange restrictions imposed after July 1931, a substantial proportion of the proceeds of German exports was not remitted home, but was retained abroad. In addition, a further large part of German exports was to Russia and was financed by 54 month (4½ year) credits, which did not begin to be repaid until after October 1932. These exports to Russia were of fundamental importance for German internal economic life, particularly in providing work for her heavy industry. Without them, for example, the German steel industry could not have operated, in the opinion of qualified observers, at over 17 per cent of capacity. The bills drawn under the long credits that financed the Russian orders were essentially work-creation bills, and through them

[20] Cf. *Review of World Trade, 1932,* charts and tables, p. 39.

the Bruening government was building up a foreign exchange reserve for the future payment of Germany's private foreign debt. At the time of the first depreciation of sterling, however, this part of German export trade did not support the reichsmark.

At the same time, the first Standstill Agreement, though it had stopped the unregulated foreign run on Germany, gave rise to special drafts on the diminishing supplies of foreign exchange accruing from trade. This agreement provided that forward exchange contracts were to be settled when they matured and that the necessary reichsmark balances should be released for this purpose. It provided also that the reichsmark balances of the banking creditors were to be placed at their free disposal as follows: 25 per cent of each creditor's balance was to be set free upon the adherence of the creditor to the agreement, and 15 per cent monthly thereafter, subject to certain safeguards if the Reichsbank represented to the B.I.S. that these withdrawals were endangering its position. The importance of these provisions is illustrated by the statement of the *Frankfurter Zeitung,* quoted by Samuel Montagu and Company in their *Weekly Review,* October 22, 1931, that of the foreign currency withdrawals from the Reichsbank during the first half of October only one-third was needed for imports, the other two-thirds going for the repayment of seasonal credits, the settlement of forward transactions, payment of interest, and the release of bank balances under the Standstill Agreement. The Agreement, moreover, was based on the principle that foreign banks should keep open credit lines for German borrowers of not less than the amounts outstanding at the time it was signed, so that in case repayments were made, and the new requirements of German borrowers were not sufficient to utilize the full amount of the original credits, an actual withdrawal of capital from Germany would take place, and an unutilized credit line would be established. This actually happened in many cases. Finally, the Standstill Agreement covered only banking credits, and capital repay-

ments continued to be made in the autumn of 1931 on debts not included under it.

For these various reasons the reichsmark was under severe pressure during the last quarter of 1931, and the Reichsbank gold reserve continued to be drawn down as shown in Chart 56. Since this contraction of reserves was not accompanied by any contraction of Reichsbank credit, but on the contrary was more than offset by increases in the portfolio of domestic bills, the reserve position became continuously weaker. Under these circumstances a renewal of the central banking credits of $100 million falling due on November 4 became of urgent necessity. On October 12 the Council of the Bank for International Settlements decided to renew its $25 million share in these credits for another three months, and undertook to negotiate with the Bank of England, the Federal Reserve Bank of New York, and the Bank of France for similar extensions of their shares. This was arranged and the whole amount was renewed for three months.[21]

Meanwhile, as stated in the passage from the Reichsbank Annual Report quoted above, the stability of the reichsmark was being promoted by the use of "all available means." Among the first of these means was the issue on September 26 of a decree preventing German nationals from making use of the proceeds of securities sold abroad. On October 2 a new series of foreign exchange regulations was published, requiring all holders of foreign exchange, of German securities issued in foreign currencies, and of gold to declare their holdings if in excess of 200 marks and offer them to the Reichsbank. All newly accruing foreign exchange, especially that derived from exports, was to be declared as it accrued and sold to the Reichsbank. A monthly maximum amount of foreign exchange which an importer might acquire was also to be fixed, and the foreign exchange control was obliged to consult the Reichsbank before granting general import permits

[21] Cf. Ch. 28, the Austro-German Crisis, for the political implications of such periodic renewals for *short periods.*

of over 250,000 reichsmarks a month or individual import permits of over 20,000 reichsmarks.

The essential principles of German exchange control as a means of forcing an adjustment in the balance of payments were thus established: (1) centralization of the nation's foreign exchange resources in official hands; (2) restriction of imports by withholding the means of payment. In order to prevent the evasion of the first principle, a decree was issued on November 17, 1931 providing that whenever goods were exported from Germany a declaration containing the full details of their value had to be made to the Reichsbank and that in order to retain any part of the foreign exchange proceeds the exporter had to obtain special authorization from the Reichsbank.

By the beginning of November Germany was already in possession of an elaborate code of foreign exchange regulation. On November 4 the *Frankfurter Zeitung* performed the arduous task of summarizing this code:

"*Devisen (foreign exchanges) are:* Foreign notes, coins, claims, bills of exchange, cheques, as well as gold in any shape or form (excluding manufactured articles, as for instance jewelry).

Foreign exchanges have to be delivered: Within three days after acquisition by sale to the Reichsbank, or to the customary bank (a devisen bank).

Foreign exchanges may be retained: On permission received from the Reichsbank, which it gives under certain exceptions and on documentary evidence.

Foreign exchanges may be utilised, as well as sent abroad or to the Saar District or taken over there: After permission has been obtained from the Reichsbank and only with the consent of the local finance office acting as substitute for the Central Exchange office.

Foreign exchanges may be purchased: From the Reichsbank or the usual bank (devisen bank) as follows:

Up to R.M. 200: Within any one month without special permission, but against presentation of an official passport. This does not concern gold.

Over R.M. 200: With special or general permission of the local finance office acting as substitute for the Central Exchange Office.
Foreign exchanges may be dealt in on forward terms: Only with the permission of the local finance office, acting as substitute for the Central Exchange Office and with the consent of the Reichsbank.
Cash credits may be granted abroad or in the Saar District: Only with the permission of the local finance office, etc.
Cash debts abroad or in the Saar District may be paid: When the creditors are *banks,* only with permission of the Reichsbank Directorium, Berlin, (still-holding agreement) in every particular case; when the creditor is *not a bank,* only with the permission of the local finance office, etc. in every particular case.
Debts in foreign currencies owing to banks in Germany when the latter act as guarantors towards foreign banks may be paid: Only with the permission of the Reichsbank Directorium in Berlin.
Credits in account in Reichsmarks which are kept abroad or in the Saar District, Cession of claims in Reichsmarks to persons domiciled abroad or in the Saar District,
Disposals of persons residing abroad or in the Saar District over credit balances in Reichsmarks in Germany which existed before the 16th July, 1931, and which belong to other persons than banks,
Payments on deposit or transfers in Reichsmarks in accounts kept in Germany belonging to persons abroad or in the Saar District,
Handing over of Reichsmark media of payment in Germany to a person residing abroad, and
Transmission or bringing over of Reichsmark media of payment abroad or to the Saar District
May be effected only with the permission of the local finance office acting as substitute for the Central Exchange Office (free maximum limit R.M. 200).
Balances in Reichsmarks belonging to foreign banks which joined the still-holding agreement . . . are free in the meaning of the rules set down in the still-holding agreement."[22]

Two of the above provisions go to the heart of the new position of Germany as a gold standard country. First, that

[22] Quoted in Samuel Montagu & Co., *Weekly Review,* Nov. 12, 1931, p. 693.

purchases of foreign exchange of over 200 marks could be made only with special or general permission of the local finance office acting as a substitute for the Central Exchange Office. This regulation raised the whole thorny question of priority of imports, and its influence extended potentially into every nook and cranny of the German economy. Second, that payments on deposit or transfers in reichsmarks in accounts kept in Germany belonging to persons abroad could be effected only with the permission of the local finance office acting as substitute for the Central Exchange Office. This made possible numerous distinctions between marks owned by foreigners but available only in Germany and only for certain purposes. Marks with these different characteristics, blocked in various degrees, soon became the subjects of trading, and this regulation became the basis for the multiple currency system employed by Germany in her international relations.

The administrative machinery for closing the gaps in the balance of payments having thus been set up, Germany entered into negotiations, late in 1931, for the renewal of the Standstill Agreement with the bankers, the expiry date of which had become definitely fixed as February 1932 by the extension of the central bank credits to the Reichsbank. One of the major obstacles to an extension was the fear of the banking creditors that, while their claims were postponed, the transfer capacity of Germany might be exhausted to their prejudice by capital repayments outside the Standstill. To meet this difficulty official control was imposed over the repayment of all German foreign indebtedness, a proceeding that was practicable within the framework of the foreign exchange control system. The solution of this problem is described in the *Report of the Foreign Creditors' Standstill Committee* of January 23, 1932 (p. 7):

"The schedule of future repayments is to depend upon the transfer capacity of the Reichsbank, which in turn must be largely dependent upon the developments in the German export situa-

tion. Instead of a fixed schedule of repayments at fixed dates, it has seemed best to leave the future determination of what can be repaid to an Advisory Committee representative of the Creditors, who will from time to time consult with the German authorities. Arrangements are being made by which continuous information will be available, both as to incoming and outgoing foreign exchange, and as to payments which have been made or are contemplated, both within the Standstill and outside the Standstill. The future schedule of repayments, determined in the light of this information, will be one which will safeguard both the Reichsbank and the Standstill creditors.

But this forbearance on the part of the Standstill creditors for the purpose of strengthening the German situation renders it necessary that German resources should not be dissipated to meet other claims outside of the Standstill Agreement.

The Reichsbank has by letter informed the Foreign Creditors Committee of the intention of the German Government, with the concurrence of the Reichsbank, to create a Committee for Foreign Debts (*Ausschuss fuer Auslandsschulden*), to exercise under the authority of the Government and the Reichsbank a general control over all payments in respect of all German external indebtedness, whether within or without the Standstill Agreement. The Foreign Creditors Committee are satisfied that this will safeguard the interests of the Standstill creditors, and ensure that, so long as they do not receive further repayments of capital, no such payments will be made to creditors outside the Standstill, except when they are deemed essential for the maintenance of German credit."

In addition to these radical measures in support of the reichsmark, Germany met the new situation created by sterling depreciation by pressing forward the negotiation of clearing and compensation agreements and bilateral trade treaties to encourage or force German exports, and imposed retaliatory tariffs, some equipped with sliding scales moving with the depreciation of the exchanges, against countries whose exchanges moved with sterling. Finally, after long diplomatic negotiation, Germany also took the initiative required by the

terms of the Young Plan to bring forward the whole question of a new reparation settlement. On November 19 the German government requested the B.I.S. to appoint a special Advisory Committee as provided for by the Plan, but concluded its application in the following language:

"In accordance with the New Plan the application requires a declaration by the German Government to the effect that 'they have come to the conclusion in good faith that Germany's exchange and economic life may be seriously endangered by the transfer in part or in full of the postponable portion of the annuities.' In making this declaration, the German Government must expressly state that such a declaration does not do justice to the present situation. Since the New Plan was framed, the economic and financial situation in the world, and particularly in Germany, has been fundamentally altered by a crisis without parallel. As the New Plan requires the Committee to examine the situation from all points of view, the Special Advisory Committee must investigate the problem in its entirety by taking into consideration all its factors, with special reference to the circumstance that the question of Germany's private indebtedness must duly form the subject of a new settlement before the end of the month of February next, by means of an agreement to be reached between foreign creditors and German debtors." [23]

The Special Advisory Committee was duly formed; it met and deliberated from December 9 to December 23, 1931, and reached the conclusion that the German government was fully justified in asserting its inability to resume in the following July the transfer of the conditional annuities under the Young Plan, that the character of the crisis was far graver than any contemplated when the Young Plan was drawn up, and that the governments concerned should take a very broad view of the whole matter and arrive at a general solution of the whole question of intergovernmental debts in the light of economic realities. Among these economic realities were the claims of private creditors upon German resources and the consequences for the whole structure of international trade

[23] *The Economist*, Reparation and War Debts Supplement, Jan. 23, 1932, p. 8.

of placing German production for export under an ever increasing forced draft. This was brought home to the creditor powers, and to Great Britain in particular, by the fact that the heart of the German reply to sterling depreciation did not lie in any of the measures described above but in a rigorous deflationary policy, which, in the words of the Basle Committee, was "unparalleled in modern history."

As early as the end of September comprehensive decrees embodying this policy were prepared by the German government. Early in October official pensions were further cut, the wages of miners in the Ruhr were reduced, and steps were taken to reduce high salaries in trade and industry even where these were of a contractual character. The major decrees embodying heroic measures of deflation were withheld, however, for some time, until it should be clearer what the course of the sterling exchange would be. By late November, however, the principles to be applied were fully presented to, and approved by, an Economic Advisory Council formed by the government to assist it in working out its economic program. The conclusion reached by the Council was that prices, wages, and rents must be reduced simultaneously, that the price cartel system and wage agreement system must be rendered more elastic, that prices that had been proportionately too high must be reduced, and that interest rates must be lowered. The major decree embodying this program was the Fourth Emergency Decree for the Safeguarding of Economy and Finance and for the Protection of Internal Peace, issued on December 8, 1931. This decree provided for a reduction of wages to the level of January 10, 1927—in most cases a 10 and in many cases a 15 per cent reduction. To make it possible to relieve the wage earner's budget by a reduction in rents, interest rates on all mortgages and private mortgage bonds were reduced so as not to exceed 6 per cent. The interest relief thus obtained was in the case of houses built after the war distributed among tenants, and rents were reduced on pre-war houses by 10 per cent of the pre-war rent. All cartels

and price associations were put on notice to reduce prices to 10 per cent below those of June 30, 1931, and the prices of coal and potash, which were subject to government control, were forthwith reduced 10 per cent. Such a sweeping horizontal reduction in wages, rents, and long term interest had of course many repercussions in German life. Among these were the necessity of agreeing upon a reduction of short term interest rates,[24] the further drastic reduction in government expenditures required by the loss of government revenue from income and land taxes, and the provision of new agencies to provide a market for the mortgages whose interest had been reduced. Into a discussion of these measures, and of the influence of such deflation upon the political life of Germany, these studies cannot enter. That they were, in their main purpose and effect, a reply to sterling depreciation, and that they were therefore a direct consequence of the disintegration of the international gold standard system was explicitly stated on many occasions by Dr. Bruening. They contained a message that could not be misunderstood concerning German competition in the export markets, and they had a direct

[24] *The Economist* correspondent in Berlin wrote on Jan. 12 (*The Economist,* Jan. 16, 1932, p. 118):
"After much toil, the agreement of the bankers' associations relating to interest on short-term debts, which was foreshadowed by the emergency Decree of December 8th, has been completed. Subject to the following exceptions, a maximum rate of 4 per cent. has been established for bank and savings bank deposits; for sums not exceeding Rm. 25,000, subject to notice of at least a month, the rate is 5 per cent.; for sums over Rm. 25,000 the rate is to vary with the Reichsbank discount rate, but must be at least ½ per cent. below it. On sums exceeding Rm. 50,000, even of 15–30 days' maturity, the rate may vary with the Reichsbank rate, but must be at least 2 per cent. below it. An exception is made for end-of-month money. Local credit committees may further reduce the amounts for which it is permissible to vary the charges according to discount rate. Extensive departures from the regulations are permitted in the dealings of banks with each other, but they are not likely to be very frequent in practice. Small and medium-sized banks and private firms are allowed to exceed the maximum rate by ¼–½ per cent. The regulations do not apply to stock exchange credits against securities, except in so far as the Banking Commissioner may decree."

bearing upon the attitude of Great Britain at least in the final negotiations concerning reparation.

The End of Reparation

During the first six months of 1932 the policies initiated immediately after Great Britain left the gold standard were in some respects consolidated and completed. In February the bankers' Standstill Agreement was renewed for one year, from March 1, 1932 to February 28, 1933, on the terms already described, and at the same time the $100 million Reichsbank foreign credit was renewed, though only after difficult negotiations and only for one month. In March, however, a three month extension was agreed to with a 10 per cent reduction in the principal; and thereafter, in common with other foreign credits of the Reich and of the Gold Discount Bank and private short term debt, it began gradually to be amortized and reduced.[25] In April 1932 the principle of the Standstill was extended to public and municipal loans by a Municipal Standstill Agreement. With these preliminary matters arranged, and with the German deflationary measures an accomplished fact, the Powers assembled at Lausanne on June 16, 1932 to deal finally with reparation. Their first act was to postpone, for the duration of the Conference, the payment of the reparation obligations falling due on July 1. Their last act was to continue this postponement until a new agreement between Germany and the creditor powers made at the Conference should come into force or until the government of any one of the signatory powers, Germany, Belgium, the United Kingdom, France, Italy, or Japan should signify its intention not to ratify. This new agreement recognized that, once the continuity of payments had been broken by the Hoover Moratorium and the course of the world depression had completely undermined all the calculations upon which the Young Plan was based, any revival of the old sys-

[25] Reichsbank, Annual Report for 1932 (*Federal Reserve Bulletin,* May 1933, p. 296).

tem was impossible. It therefore put an end to the Young Plan and provided that "the obligations resulting from the present agreement will completely replace the former obligations of Germany comprised under the annuities of the new Plan." [26] These new obligations consisted in the delivery by the German government to the B.I.S. of three milliard marks of 5 per cent bonds to be sold by the B.I.S. at 90 or better, but not until three years had elapsed. Such bonds as could not be sold at this price within 15 years were to be canceled. The Lausanne Agreement was negotiated for Germany by the Von Papen government, for on the eve of the Conference the Bruening government fell. For lack of ratification, it never came into effect and German reparation was left, legally, in a state of suspended animation from which it never recovered.

Hesitant Revival, 1932

While the last chapter in the reparation controversy was being written, the measures taken in reply to sterling depreciation were contributing to some relaxation in the internal strains in the German economy. As a result of the Bruening decrees Germany was the only country in which the gap between raw material prices and the prices of manufactured goods was to some degree closed.[27] Industrial production, which during the confidence crisis had been insufficient to meet current needs, revived somewhat. The downward pressure on prices lessened. The prolonged fall in savings deposits was checked. Commercial bills drawn and the demands of the commercial banks on the Reichsbank both declined and the money market became more liquid. Germany, in fact, seemed in the spring of 1932 to be entering a period of hesitant revival. This was checked by seasonal factors in the winter of 1932–33 but was resumed again in the spring of 1933 under the stimulus of German rearmament. Before the fall of the Bruening government tentative agreements had been reached

[26] *B.I.S., Third Annual Report,* p. 28.
[27] *World Economic Survey, 1932/3,* pp. 61, 129.

for a disarmament program based on the then existing German armament, but these were subsequently rejected largely at the insistence of German heavy industry which strongly emphasized the work-creation aspect of rearmament.

The forces of recovery, however, were far from strong enough to alter the basic system of exchange control or to relieve the reichsmark from pressure. In *German Business Cycles* Carl Schmidt describes the underlying position (pp. 59–60):

"But difficulties that had become increasingly apparent during the course of the depression hindered the progress of revival. Despite the easing of the money markets, the supplies of long-term credits for industrial expansion remained meager. Domestic banks and business enterprises and foreign lenders were primarily interested in the continuing liquidation of debts. The presence of a large reserve of domestic consumer purchasing power might have acted as a support and stimulus for industrial activity, once prices were steady. However, the long depression had greatly reduced both the incomes and the savings of individuals and business enterprises. The downward pressure on wages continued into 1933, and such business profits as accrued were applied to a considerable extent to the reduction of liabilities. Also, the growing resistance of world markets to German goods made improbable a stimulus from export trade. Although construction costs were at a low point, the meager purchasing power in domestic and foreign markets, together with the large surplus productive capacity of many industries, threatened that returns on new investments would be inadequate. There was, then, little incentive to make extensive additions to the existing plant."

The Multiplicity of Marks

In spite of slightly better economic conditions Germany continued in 1932 to have difficulty in repaying her private foreign debt. Though the export surplus for the first half of 1932 was 540 million reichsmarks, foreign debt payments made drafts on the reserves of the Reichsbank. In the first week of July, for example, the Reichsbank lost 17 million

reichsmarks in gold and foreign exchange in connection with the service of the Dawes and Kreuger loans, and in the second week of July another 53 million reichsmarks through the partial repayment of the $125 million Lee Higginson credit of 1930.[28] Although Russia began in the autumn of 1932 to repay her 54 month credits, which had previously been considered by the German government as a reserve to meet just such a contingency, these transfer difficulties persisted into 1933. Consequently, on June 9 Germany entered a new phase in her relations with her foreign creditors. A transfer moratorium was decreed on all foreign liabilities incurred before July 1931, except those covered by the Standstill Agreements. German debtors were to continue to pay in reichsmarks, but foreign exchange was no longer to be made available pending an increase in the Reichsbank foreign exchange and gold reserves.

The imposition of this transfer moratorium was justified on two major grounds: (1) the difficulties met by Germany in developing her export trade; (2) the depletion of the Reichsbank reserves. To demonstrate the real state of these reserves, the $45 million rediscount credit of the Gold Discount Bank was repaid.[29] In an official statement by the German cabinet announcing the moratorium, the following words were used:

". . . the representatives of the short and long term foreign creditors have in full agreement with the Reichsbank unanimously recognized that a further decline in the gold and foreign exchange reserves will jeopardize the plain function of the Reichsbank as a central note issuing institution. . . ."

Thus in the name of preserving the gold reserves of the Reichsbank still another form of blocked marks was created.

[28] Figures published by Deutsche Bank and Discontogesellschaft and quoted in Samuel Montagu & Co., *Weekly Review*, Aug. 25, 1932.

[29] This repayment being made in dollars after the United States had left the gold standard, a profit of 30 million reichsmarks accrued to the Reichsbank.

Germany still remained legally a gold standard country, but the landmarks in her journey away from that standard as a code of practice were clearly revealed in the state of her currency. The reichsmark, as far as its international uses were concerned, was broken up into fragments described by the *World Economic Survey, 1932/3* (pp. 223–4) as follows:

". . . in Germany, the following classes of blocked accounts are recognized: foreign mark claims accumulated before July 16th, 1931, but not subject to the standstill agreements (Altguthaben), foreign property claims acquired after August 3rd, 1931 (Kreditsperrmark), bank-notes brought into Germany after February 19th, 1933 (Notensperrmark), claims created by the sale or redemption of stocks and bonds (Effectensperrmark). Scrip issued in even amounts, with a minimum of Rm. 40, may be issued to the owners of Konversionssperrmark and marketed on German and foreign stock exchanges. All of these blocked marks can be used, with the consent of the Exchange Control Office (Devisenbewirtschaftungsstelle), to buy mortgages or fixed property, or to give credit to Germans in Germany, or to share in a German enterprise, provided always that the investment is for five years at least. Under certain conditions, also, they may (except in the case of Effectensperrmark) be used to pay for purchases of German commodities destined for 'supplementary exports.' The price paid for such blocked marks varies with the uses for which permission is given. At the end of July the current values ranged from about 28 per cent to 37 per cent (Effectensperrmark) below the gold parity. In the same way, tourists may buy blocked marks below the official rate. The credits subject to the standstill agreement of February 1933 (Registermark) may also be used extensively for certain purposes within Germany at about the same parity. Finally, the blocked marks now being accumulated as the result of the transfer moratorium on interest and amortisation payments on long-term loans which began on July 1st, 1933 (Konversionssperrmark), will provide another large amount of currency valued below gold parity. On the other hand, German exporters who have acquired the right to make 'supplementary exports' may use part of the proceeds to buy German bonds abroad

and re-sell them in Germany. This right is marketable and its value depends mainly upon the relative prices of German bonds at home and abroad. In July 1933, the value was about 20 per cent of the foreign price of such bonds."

The Juridical Concept of Gold as Standard

Though still preserving a traditional attitude toward the gold reserves of her central bank, Germany had long since abandoned all but the external symbols and the juridical concepts of the gold standard. Her position was that of a country that could no longer employ any of the traditional means of financial adjustment associated in the past with the international gold standard, but was nevertheless determined to maintain its psychological advantages. For the international solidarity of money markets which in the past had prevented wholesale withdrawals of foreign capital, she had substituted elaborate agreements with her creditors. For the long run influences of the international investment cycle upon her merchandise balance she had substituted direct control of imports and government promotion of exports. For the competitive price mechanism she had substituted price fixing by decree. For one system of commercial treaties she had substituted a series of special bargains. For one exchange rate she had substituted many. Yet her central bank was able to say that it had "refrained strictly from experimenting with the currency." Such a statement could have only a legal significance in a country connected by a multiplicity of marks with a world of gold whose boundaries were steadily shrinking, and which exemplified in the highest degree the atrophy of the international banking and credit functions called in these studies the substance of the international gold standard. Against such a background the juridical concepts of gold as reserve and gold as standard in Germany stood out like the weatherbeaten ribs of some old sailing vessel long since cast ashore by a tropical hurricane.

The Defense of the Gold Standard in the United States, September 1931 to April 1933

The position of the United States in the world of gold after September 1931 appears upon the surface much simpler and susceptible to much more concise description than that of Germany. Yet fundamentally the forces at work were just as complex. There is hardly a thread in our whole historical analysis of the post-war period that is not woven into the pattern of events in the United States during this period. In particular, the latent conflict between the responsibilities of New York as an international money market and its responsibilities as the domestic money market for a continent (cf. Ch. 18) was brought sharply to the surface by the interplay of three major influences: (1) a foreign drain of gold incident to the liquidation of the gold exchange standard in Europe at a time when the United States was endeavoring to mitigate the rigors of a domestic deflation; (2) the accentuation of deflationary pressure in the United States by the depreciation of sterling in terms of the dollar; (3) the ripening of the harvest sown during the long inflationary development of the One-Way American Banking System. Behind all this, and coloring the interaction of these forces at every turn was the necessity of finding some solution to the problem of the basic disharmony existing in the structure of American prices, which in turn was a reflection of structural maladjustment of the world economy inherited from the war.

Meeting the Foreign Drain

The first factor, the foreign drain of gold, has already been partly described. It lasted from September 1931 to June 1932. Within this time there were two periods of intense foreign gold demand, amounting to 'runs' on the United States and sometimes described, in our judgment incorrectly, as attacks upon the dollar. The first was in September and October 1931, the second in May and June 1932.

In analyzing the position of the American economy on the eve of the European confidence crisis we said that within her own borders the United States exemplified in the highest degree the fundamental economic deadlock of the world depression, the maintenance of agricultural production in the face of declining prices, and the maintenance of industrial prices by means of restricted production. During the entire period of the foreign drain of gold this deadlock continued and was even accentuated. The high production levels in the major crops were preserved. In 1932 the crops of corn and oats were 13.5 and 10.3 per cent, respectively, larger than the 1929 crops, while the cotton, wheat, and hay crops were only 12.2, 10.7, and 6.5 per cent, respectively, less than those of 1929. Prices at the farm were 61.5 per cent lower in June 1932 than in June 1929. In contrast, prices of non-agricultural products were, in June 1932, still only 28 per cent less than in June 1929, while the composite index of industrial production for 1932 was 56.5 per cent less than in 1929. No sign of genuine economic recovery appeared before June 1932. Security prices continued to fall, unemployment increased, there was a scarcity of good borrowers, and the liquidity of the whole banking system was even more seriously impaired. Bank failures continued, and there was persistent pressure for further credit and monetary expansion, running counter to the fundamental objectives of banking reform measures proposed in the United States immediately after the Stock Exchange crisis of 1929 and also to the policy of raising interest rates which, as already shown, was one of the conditions imposed upon the United States for the maintenance of Bank of France balances in New York during September and October 1931, and which was appropriate, in general, to the defense of the dollar against a foreign drain.

From October 16, 1931 to February 26, 1932 a 3½ per cent rate was in force at the Federal Reserve Bank of New York. The downward trend of short term interest rates in the New York money market, in progress since the end of 1929,

was sharply interrupted. In addition, rates charged to customers by New York banks, which had fallen from a 6 to a 4 per cent level, were increased about 3/4 per cent. The defense of the dollar against the foreign gold drain was a distinct check to the Federal Reserve policy of easy money to promote recovery. It also brought into the foreground certain peculiarities of American central banking legislation, and consequently altered in a significant way the techniques employed when, in March 1932, this easy money policy was resumed.

Between September 19 and October 31, 1931 Federal Reserve credit was increased $947 million to offset the effect of gold exports. Just over one-half of this increase was provided by purchases of bills by the Federal Reserve banks, whose 'bills bought' increased $514 million. Slightly under one-half was provided by member bank borrowing. 'Bills discounted' rose $444 million. The gold drain was not fully met by these means, however, and member bank reserve accounts fell $169 million. The technical conditions necessary to make the higher discount rates at the Reserve banks effective were thus fulfilled.

In November and December 1931 the gold drain temporarily ceased, but was resumed at the end of the year. The pressure on the member banks, however, was uninterrupted. Until February 1932 the joint influence of currency and gold movements on their reserves was about neutral, chiefly because the resumption of gold exports coincided with a seasonal return flow of currency, but the Federal Reserve banks allowed their portfolio of 'bills bought' to run off to the extent of $547 million. Against this deflationary pressure there were three offsetting factors: declines in foreign central bank balances, in required reserves, and in excess reserves. The deposits of foreign central banks with the Federal Reserve banks, which had been increased just before England left the gold standard,[30] were now drawn down $134 million,

[30] Cf. Ch. 27, The United States, Preparing for Trouble.

partly to buy gold, a transaction without effect on member bank reserves, but also partly to acquire earning assets in the New York market. Required reserves were reduced by a steady fall in time and demand deposits from $30,500 in September 1931 to $25,715 in February 1932 (Chart 37) almost wholly due to repayment of commercial loans. Consequently the effectiveness of previously accumulated excess reserves as a cushion against deflationary pressure was increased, but this did not prevent their falling to a very low level. In October 1931 they were $129 million and in February 1932 only $43 million. In spite of these 'cushions,' the decline in the bill portfolio of the Federal Reserve banks was great enough to force the member banks to go $129 million further into debt. On February 26, 1932 'bills discounted' at the Federal Reserve banks reached $842 million.

The growth of this indebtedness at a time when the Federal Reserve system and the government were fundamentally committed to an easy money policy was directly connected with the resumption of the foreign drain of gold. Foreign central bank balances, particularly those of the Bank of France, were still very large and it was clear that further withdrawals were to be expected. Under these circumstances the peculiar legislative provisions governing the issue of Federal Reserve Notes imposed an effective bar against simultaneously meeting a new foreign drain and resuming an easy money policy by means of open market purchases of securities. They even threatened the ability of the United States to maintain the gold standard. In technical language the question of 'free gold' at the Federal Reserve banks suddenly came to the forefront of America's central banking problem.

Under the provisions of the Federal Reserve Act as they then stood, the Federal Reserve banks were required to hold a reserve of 35 per cent in gold or lawful money against their deposits, a reserve of 40 per cent in gold plus 60 per cent in either gold or commercial paper against Federal Reserve Notes *in circulation,* a reserve of 100 per cent in either gold

or commercial paper against Federal Reserve Notes *issued* but not in circulation, and a redemption fund in gold of not less than 5 per cent of Notes outstanding not covered by gold. Three points are to be noted concerning these requirements. First, that lawful money as well as gold could form part of the reserve against deposits, and that the Federal Reserve banks on February 24 held $202 million in reserves other than gold. Second, that notes printed and held in stock but not in circulation had to be secured by a 100 per cent reserve which might be entirely in the form of commercial paper, and that on February 24, 1932 such notes amounted to $266 million. Third, that commercial paper eligible as collateral against Federal Reserve Notes included member bank promissory notes secured by government bonds. Member banks held at the end of 1931 over $5 billion of government bonds, but belief was widespread that many individual banks had exhausted their supplies of eligible paper and therefore could not bring to the Federal Reserve banks the type of asset required for pledge against the issue of notes.

On February 24 the deposit liability of the Federal Reserve banks was $1,973 million and their notes in actual circulation were $2,643 million. Had they been in possession of enough commercial paper to provide 60 per cent of the 100 per cent collateral required against notes in actual circulation and the 100 per cent collateral required against notes issued but not in circulation, they could have met their legal reserve requirements as shown in the accompanying tabulation.

Required reserve against deposits	
in lawful money	$ 202,000,000
in gold	489,000,000
Total	691,000,000
Required collateral against 'notes issued'	
in gold	1,057,000,000
in commercial paper	1,951,000,000
Total	2,908,000,000
5 per cent Redemption Fund against notes in circulation, but not secured by gold, in gold	79,000,000

That is, if the Federal Reserve banks had possessed $1,951 million in commercial paper, they would have had to set aside only $1,625 million in gold to meet their reserve requirements. Since they actually held $2,938 million in gold, they would, under these circumstances, have had an excess over requirements of $1,313 million in gold. Gold held in this way was technically called 'free gold,' because it could be exported without impairing the legal reserve requirements of the banks, but it was 'free' even in this sense only upon the assumption that it could be exported without causing any changes in the note and deposit liabilities and the holdings of commercial paper of the Reserve banks.

Instead, however, of $1,951 million in commercial paper, the Federal Reserve banks on February 24, 1932 held only $921 million. Their actual reserve requirements, therefore, were as follows:

Required reserves against deposits	
in lawful money	$ 202,000,000
in gold	489,000,000
Total	691,000,000
Required collateral against 'notes issued'	
in gold	1,987,000,000
in commercial paper	921,000,000
Total	2,908,000,000
5 per cent Redemption Fund against notes in circulation, but not secured by gold, in gold	46,000,000

This tabulation shows that, instead of $1,625 million, gold required for reserve was $2,522 million. Deducting this amount from the total gold holdings of $2,938 million only $461 million was left in 'free gold.' [31] This was the amount actually available to meet a foreign drain provided the deposit and note liabilities of the Reserve banks and their holdings of eligible paper remained constant. It was less than the amount of foreign central bank balances remaining in New York.

[31] Cf. *Federal Reserve Bulletin,* March 1932, and Federal Reserve Board, *Annual Report, 1932,* p. 17, chart.

The Federal Reserve banks were therefore in a dilemma. If they offset the deflationary effects of actual gold exports their 'free gold' would be diminished by exactly the amount of the exports. If they more than offset the gold exports and built up member bank reserves by such purchases they would put the member banks in a position to pay off a portion of their bills discounted. This would reduce their holdings of eligible collateral for pledge with the Federal Reserve Agent against notes, and still further reduce their 'free gold.' If the Federal Reserve system desired to bring about easy money conditions this is what they had to do, for there could be no really 'easy money' with the member banks indebted to the Federal Reserve banks by over $800 million. But such a policy might easily lead, in view of the probable magnitude of impending withdrawals by foreign central banks, to the exhaustion of the 'free gold' and the suspension of the gold standard. If, on the other hand, the Federal Reserve banks permitted gold exports to exert their full effect on member bank reserve accounts and thereby forced the member banks to borrow from them, and thus provide them with eligible paper with which they could obtain gold from the Federal Reserve Agent for export, then they would have to abandon all thought of a really easy money policy. They had to choose one of three alternatives—to continue an easy money policy at the sacrifice of the gold standard, to defend the gold standard at the sacrifice of an easy money policy, or to change the reserve requirements laid down in the Federal Reserve Act.

The third choice was made by the passage of the Glass-Steagall Act on February 24, 1932, which provided that government bonds purchased by the Federal Reserve banks in the open market might be pledged with the Federal Reserve Agent as part of the 60 per cent collateral other than gold required against Federal Reserve Notes. As applied to the statement of February 24 this meant that the 'free gold' of the system could be increased $897 million, i.e., from $416 to $1,313 million provided the Reserve banks purchased enough

government bonds to bring their holdings up to $897 million. On February 24 their actual holdings were $741 million. Thus by the purchase of $156 million of government bonds the Federal Reserve banks could put themselves in a position to lose $1,313 million of gold without violating their own reserve requirements. By the purchase of $1,313 million of government securities they could lose an equal amount of gold without imposing any deflationary pressure upon the member banks.

Certain parallels could be drawn between the Glass-Steagall Act and the British Currency and Bank Notes Act of 1928, based upon the similarity of function between the Federal Reserve Agent and the Issue Department of the Bank of England. Both acts were measures of gold economy, and both introduced greater flexibility into a system of note issue based upon the principle of the segregation of assets against notes. Both increased the proportion of such assets that could take the form of government bonds. The differences are obvious, but the similarities have perhaps been too often overlooked.

With the great addition to its 'free gold' given by the Glass-Steagall Act the Federal Reserve system was able to face with confidence further large outward movements of gold, and at the same time to renew its easy money policy. On February 26 the Federal Reserve Bank of New York reduced its rate to 3 per cent and other short term rates resumed their downward trend. A policy of providing and maintaining 'excess' reserves in the commercial banking system and enabling the member banks to free themselves from debt was decided upon, and large purchases of government bonds were begun. The first result was to encourage the repayment by the member banks of their indebtedness to the Federal Reserve banks and the second was to build up excess reserves. During March and April 'bills discounted' fell $299 million and the average of excess reserves increased from $59 million in March to $152 million in April. The Federal Reserve system seemed to have escaped from the dilemma caused by

the collapse of the gold exchange standard and the breakup of the central foreign exchange nucleus.

Other obstacles, however, had to be overcome before an easy money policy could be really effective. The first was the generally weakened position of the American banking system. During 1931 the closing of banks throughout the country had immobilized approximately $1,700 million in deposits, and many banks were finding their assets increasingly frozen. The government therefore turned its attention toward a general strengthening of the banking system. The first step was the formation of the National Credit Corporation on October 13, 1931. The principle on which this corporation was organized was cooperative lending by the banks. In each Federal Reserve District associations of banks were to be formed, the members of which were to subscribe to the notes of the National Credit Corporation up to a maximum of 2 per cent of their time and demand deposits. The Corporation was then to lend to individual banks against security collateral and the joint guarantee of the banks forming the Association of which the borrowing bank was a member. Under the conditions prevailing this plan of having the strong banks help the weak was foredoomed to failure. Of the one billion dollars of National Credit Corporation notes authorized only $135 million were ever issued. In January 1932 more effective action was taken by the establishment of the Reconstruction Finance Corporation, which was given a capital of $500 million entirely subscribed by the government, and was authorized to sell its own bonds, at first up to $1,500 million, and later, under the Emergency Relief and Construction Act of July 21, 1932, up to $3 billion. In practice these bonds, when issued, were subscribed by the Treasury and not offered in the market. The Corporation was, by the original act, authorized to lend to banks and other financial institutions and to the railroads under certain conditions, and its powers were many times broadened and extended. An institution thus came into existence which functioned as a channel for dis-

tributing part of the existing bank credit, secured by the government through increasing the public debt, to those points in the national economy where the need seemed most urgent. During the first two months of its life the Corporation lent $192 million, of which $125 million was to banks. By June 30 it had lent $805 million, of which $497 million was to banks. By December 31, 1932 loans had been made to 5,600 banks, including over 500 institutions in receivership, and $600 million of such loans were outstanding on that date. In eleven months the Corporation had advanced $1,525 million to borrowers of all kinds, of which $300 million had been repaid.[82]

The establishment of the Reconstruction Finance Corporation to strengthen the banks directly was followed by further action to meet popular pressure for credit expansion. The conviction was widespread that the banks were adding to the existing deflationary pressure by refusing to lend, owing to an inordinate desire for liquidity, and it was also widely believed that many banks could not expand their operations for lack of eligible paper with which to replenish their reserves at the Reserve banks. Consequently certain segments of the proposed general banking legislation were acted upon separately. In the Glass-Steagall Act provision was made permitting member banks to borrow from the Federal Reserve banks on non-eligible assets under certain conditions, and also permitting the Federal Reserve banks to make direct loans to industry where ordinary banking accommodation was not obtainable. In the event, these facilities were little used, for the banks already had ample supplies of government bonds on which to borrow, and no amount of additional borrowing facilities for industry could produce a great increase in the number of eager and solvent borrowers in a basically unbalanced economy.

These measures were the domestic side of a battle against

[82] Quarterly Reports of the R.F.C.; Federal Reserve Board, *Annual Report, 1932*, p. 22.

deflationary pressure, of which the steps taken to deal with the foreign drain of gold were the international side. With the passage of the Glass-Steagall Act, the resumption of open market purchases by the Reserve banks, and the reduction in interest rates, the American government felt that this battle had been won. In April 1932 President Hoover celebrated this victory in a remarkable speech in Des Moines in which he said:

"I wish to describe one of the battles we have fought to save this nation from a defeat that would have dragged farmers and city dwellers alike down to a common ruin. This battle was fought parallel with other battles on other fronts. Much of what I will tell you has been hitherto undisclosed. It had to be fought in silence, for it will be evident to you that had the whole of the forces in motion been made public at the time there would have been no hope of victory because of the panic through fear and destruction of confidence that the very disclosure would have brought.

Happily we have won this battle. There is no longer any danger from disclosure.

Our own speculative boom had weakened our own economic structure, but the critical assaults and dangers swept upon us from foreign countries. We were therefore plunged into a battle against invading forces of destruction from abroad to preserve the financial integrity of our Government; to counteract the terrific forces of deflation aligned against us; to protect the debtor class who were being strangled by the contraction of credit and the demands for payment of debt; to prevent our being pushed off the gold standard, which in our country would have meant disaster to every person who owned money; and finally to preserve the savings of the American people.

We were fighting to hold the Gibraltar of world stability, because only by holding this last fortress could we be saved from a crashing world, with a decade of misery and the very destruction of our form of Government and our ideals of National life."

At the time these exultant words were spoken, however, a complicated interaction between the withdrawal in gold of

foreign central bank balances from New York and the development of the American policy of creating and distributing 'excess' reserves still remained to be worked out.

The Creation and Distribution of Excess Reserves

The uninterrupted large scale purchases of government securities by the Federal Reserve banks seemed in the eyes of foreigners to be evidence of approaching inflation in the United States. The gold outflow to the continental creditor countries was consequently sharply accelerated as this policy was vigorously pressed forward. The heavy exports in May and June, in which the smaller continental creditor countries participated heavily as shown by the accompanying table, were sometimes referred to as a second attack upon the dollar, and were sufficiently great to call into play again the technical measures of defense first employed in October 1931 (cf.

GOLD EXPORT FROM THE UNITED STATES TO

	France	Belgium	Holland	Switzerland	Four Countries
	(thousands of dollars)				
1932					
Jan.–April	244,145	37,432	34,036	2,134	317,637
May–June	174,627	46,180	81,641	116,157	518,605

p. 1184). During this period the New York Federal Reserve Bank was aided in meeting the situation by receiving advance notice of intended withdrawals through the B.I.S.[33]

The preparations for this contingency proved amply sufficient, and late in June the New York market was intensely relieved by the final repayment of the New York balances of the Bank of France. Immediately thereafter, on June 24, the Federal Reserve Bank of New York reduced its rate from 3 to 2½ per cent. This was, however, not quite the end of the matter. The concentration of such heavy gold losses in a few months had an unfortunate psychological effect upon a public already shaken by past events, alarmed by recurrent banking troubles, and newly made aware, on the authority of the

[33] E. L. Dulles, *The Bank for International Settlements at Work*, p. 486.

President himself, that the suspension of the gold standard had only a few months before been a distinct possibility, if not a probability. From June 18 to July 9 there was a wholly non-seasonal increase in money in circulation. The dehoarding movement of the first quarter of 1932 was more than reversed, and on July 9 money in circulation was at a record —$925 million greater than in July of the preceding year.

The Reserve bank policy of relieving member banks from debt and creating excess reserves by the purchase of government securities thus encountered obstacles partly of its own creating. To be effective, therefore, the open market operations had to be carried out on a grand scale. From February 27, when the purchases began, to August 13, when they ceased, government securities held by the Federal Reserve banks increased $1,106 million. Half of the new Federal Reserve credit created was absorbed by a net gold export of $375 million and an increase of money in circulation of $133 million. The other half was divided between a decrease of $384 million in 'bills discounted' and an increase in member bank reserve accounts of $119 million. Since member bank deposits continued to fall (Chart 77) the rise in excess reserves was somewhat greater. In May excess reserves reached $277 million, but by July gold exports and hoarding had reduced them to $204 million.

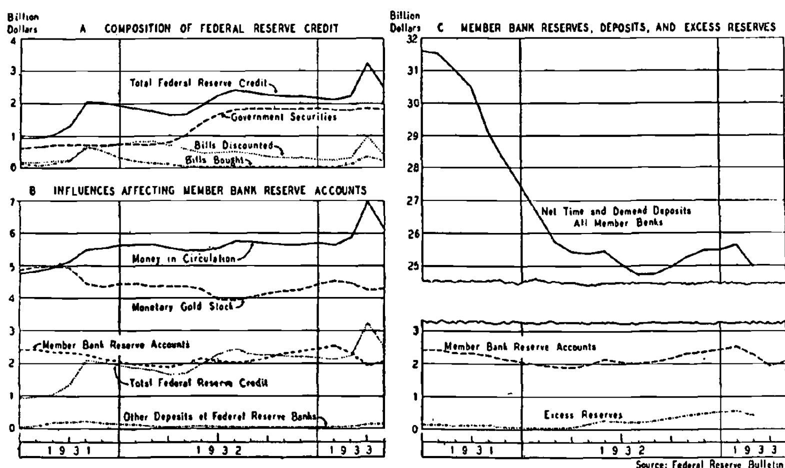
The ending of government security purchases by the Federal Reserve banks in August 1932 did not mean a change in the basic credit policy of excess reserves. During the whole period of gold loss to the continental creditor countries gold imports from Canada, South America, and the Far East continued. They were widely distributed and regular, and when once the European pressure was lifted, added substantially to the American gold stock. In December these imports were swelled by large gold receipts from England on War Debt account.[34] This, together with a return flow of currency from hoarding during the late summer, made possible a still fur-

[34] For the full year 1932, including earmarking, there was a small net import.

ther reduction in member bank indebtedness and a further building up of member bank reserves. Though deposits of the member banks increased $748 million from the low point of July, excess reserves also increased rapidly.

CHART 77

The American Credit Base and Credit Superstructure June 1931–April 1933



The force of the stimulus to credit expansion resulting from the Federal Reserve banks' credit policy from February to December 1932 is recorded in the accompanying figures.

	1932 FEBRUARY	1932 DECEMBER	CHANGE
	(millions of dollars)		
Bills discounted	848	282	−566
Member Bank reserve accounts	1,907	2,435	+528
Excess reserves	59	525	+466

The influences bringing about these results, and in particular the shift from open market operations to gold imports as the principal initiating force in July, are brought out in Chart 77.

By these means a large volume of new potential lending power was introduced into the American banking system in spite of the liquidation of the gold exchange standard in

Europe and the retirement of the New York money market from its international role as a holder of foreign balances. There were surface indications that in the late spring and summer of 1932 the problem of finding outlets for this lending power was on the road to solution, even though the New York market had almost completely retired from its international role as a long term international lender. From July to September the Federal Reserve Board index of industrial production rose from 58 to 66; factory employment and carloadings increased, security prices rose and bank suspensions declined. The position of the banking system appeared to be favorable for financing a business revival. Interest rates were falling and member bank 'loans and investments' were increasing.

During these months, however, the underlying difficulties of American banking were not really solved. Commercial loans continued to decline, and the increase in member bank deposits was wholly due to an increase in government bond holdings. Interest rates to borrowers throughout the country were not substantially reduced, and the gap between short term money market rates and other rates of interest, which was one of the most persistent phenomena of the depression, continued to be wide. A substantial part of the new excess reserves continued to be concentrated in New York where, in large measure, they were first introduced into the banking system. The balance of payments of the western parts of the country, and to a less degree of the southern districts, with the eastern seaboard, was unfavorable during the last six months of 1932. As surplus reserves were piled up in New York, they were in large part transferred to the West by the government through the R.F.C., but there was a strong tendency for funds to flow back again to the East since banks in distress continued to lose cash and since agricultural purchasing power continued at a low ebb. New York banks, having freed themselves from the dangers involved in holding large mobile balances for foreign accounts subject to sudden withdrawals, became increasingly

holders of mobile balances for the rest of the country. In the first quarter of 1933 these balances were suddenly withdrawn. From February 1 to March 8 the excess of 'due to' over 'due from' banks of banks in New York City declined $834 million. For the Federal Reserve District of New York the decline was $878 million. During the months immediately preceding the American banking crisis of March 1933 reserves in the East declined, while those in the West increased.

Closing the Banks

The events leading up to, and taking place during, the American banking crisis of March 1933, like those of the confidence crisis of 1931 in Europe, are so familiar that they will not be described in detail here except as they bear directly on America's relation to the gold standard. After September 1931 an almost uninterrupted series of events tended to undermine confidence in the American banking system and in particular banks. In September a Democratic victory in Maine foreshadowed a change in the political leadership in the country, and a four month political interregnum followed the election of President Roosevelt during which no effective action could be taken. The decline in sterling which followed the War Loan refunding operations [35] was very disturbing to American opinion and constituted a threat to American export trade. This was followed by the receipt of notes from America's foreign debtors clearly indicating that the end of reparation meant also the end of war debt repayments. The negotiations over the British payment of December 15 were carried on in an atmosphere of unfriendly political discussion. Meanwhile, American bankers as a class were being subjected to persistent and long continued attack in connection with the hearings on the Glass Bill, and the evidence presented at these hearings was reducing public confidence in banks in general to a low ebb.

These general psychological influences were early trans-

[35] Cf. Ch. 31, The Control of Sterling, March–December 1932.

lated into distrust of particular banks. The R.F.C. was obliged by Congress to make public the names of banks to which it was lending, a procedure that immediately disclosed the identity of banks in difficulties and contributed to the uneasiness of depositors. Bank failures increased, and when runs on particular banks began to involve other banks, series of state 'bank holidays' were proclaimed. The first was in Nevada on October 31, 1932, followed by Iowa on January 20, 1933, Louisiana on February 3, and Michigan on February 14. The subsequent spread of the movement is described in the Annual Report of the Federal Reserve Board for 1933 (pp. 9–10):

"While the Michigan holiday arrested withdrawals of deposits from banks in that State, outside Michigan there was an increase in the movement of funds from weaker to stronger banks and in currency withdrawals. Funds were withdrawn from banks in other States to send to Michigan or to meet payments that would otherwise have been met from deposits in Michigan banks. Developments of this nature were partly responsible for the rapid spread of the bank-holiday movement among other States. On February 25, the Governor of Maryland declared a bank holiday, chiefly on account of conditions in Baltimore, and at about the same time restrictions were authorized on withdrawals of bank deposits in Indiana, Arkansas, and Ohio. In a number of States new laws were passed to provide for safeguarding bank depositors or for readjusting the liabilities of banks without establishing receiverships. With a view to enabling the banking situation in any particular State to be better handled as a whole, a joint resolution was adopted on February 25 by the Congress of the United States authorizing the Comptroller of the Currency to exercise with respect to national banks such powers as State officials might have with respect to State banks.

On March 1 Alabama, Kentucky, Tennessee, and Nevada declared bank holidays, and similar action was taken by 6 other States on March 2 and 7 others on March 3. On the morning of March 4, the Governor of the State of New York issued a proclamation declaring that day, which was a Saturday, and the fol-

lowing Monday to be bank holidays. Similar action was taken in Illinois, Massachusetts, New Jersey, Pennsylvania, and elsewhere."

During February and the first days of March, as the rapid collapse of the American banking system spread throughout the country, a hoarding movement of unprecedented proportions developed, accompanied by a foreign drain of gold largely through earmarking. Its effects are brought out in Chart 78 in which the changes in the principal items making

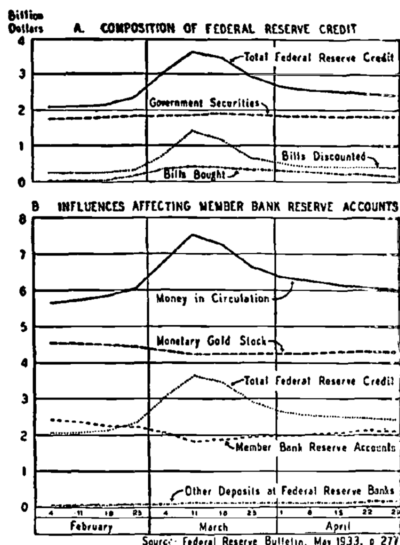


CHART 78

Composition of Federal Reserve Credit and the Factors influencing Member Bank Reserve Accounts, February 4–April 29, 1933, weekly

up total Federal Reserve credit and the factors influencing member bank reserve accounts are plotted weekly, from February 4 to April 29. Since these figures are weekly averages of daily figures, the full effect of the changes from early February to March 4 is shown by comparing the figures for the week ending February 4 with those for the week ending March 11 during which the Reserve banks were partly closed. During this period money in circulation increased $1,868 million and monetary gold stock declined $305 million. To

meet this immense draft of $2,173 million on member bank reserve accounts the Federal Reserve banks increased their portfolio of bills bought $386 million, their government securities $113 million, and their bills discounted $1,152 million. But though Federal Reserve credit rose $1,587 million member bank reserve accounts were drawn down $623 million. Of the increase in money in circulation about $320 million was in gold withdrawn for domestic hoarding so that the gold loss of the Federal Reserve banks was over $600 million. Together with the net increase in their liabilities of over $800 million this reduced the reserve ratio of the Reserve banks to a point not far from the legal minimum. On March 3 the ratio of the reserves of the Federal Reserve banks to their note and deposit liabilities combined was 45.3 per cent. Their lending power was not quite exhausted, for on March 4 they still had excess reserves, as Rufener points out, of $416 million on which they could legally have extended an additional one billion dollars in Reserve credit.[36] Moreover, on March 3 the Federal Reserve Board suspended the reserve requirements of the Federal Reserve banks for thirty days subject to a tax on deficiencies as provided by law. In a legal sense the utmost limits of the power of the system to expand its credit had not been reached but they had been reached in practice. The gold drain was proceeding at an accelerated pace and would have continued through the stronger member banks, while the weaker member banks, being unable any longer to find the means of borrowing at the Reserve banks, could not be helped by further Federal Reserve credit. In addition, the Federal Reserve Bank of New York, upon which the major burdens of meeting the general run on the Federal Reserve system were concentrated, had completely exhausted its own lending power and was being carried by the other Federal Reserve banks, a circumstance distinctly adverse to any further large credit extensions by the system as a whole.

[36] *Op. cit.*, p. 689.

The Position of the Federal Reserve Bank of New York

Some of the most important aspects of the central banking crisis in America are obscured by considering the figures of the twelve Federal Reserve banks as a whole. During the six weeks preceding the closing of the banks the Federal Reserve Bank of New York was subject, in extreme degree, to the special difficulties, often referred to in these studies, that had their origin in the fact that New York was an international money market and at the same time the domestic money market for a continent. The system as a whole was subject to a double drain, but the New York bank was subject to a triple drain, a foreign drain of gold, a domestic gold hoarding demand from within the New York district, and an outflow of gold to the interior through the Gold Settlement Fund. During the three weeks from February 1 to February 21 the New York Bank met these demands almost entirely from its own resources, and the entire gold loss for the system was borne by it. During the next two weeks it was able to meet the situation only by exploiting to the uttermost every device for the mobilization of reserves of which the Federal Reserve system was capable. Almost the entire gold loss of the system was then borne by the eleven interior banks. This is brought out clearly by examining the behavior of the principal assets and liabilities of the Federal Reserve Bank of New York and comparing it with the behavior of the principal assets and liabilities of the other eleven banks as a group. In Table 85 the relevant figures are given weekly from February 1 to April 26, and on Chart 79 the cumulated changes are plotted.

Between February 1 and 21 the note circulation of the eleven interior Federal Reserve banks increased $218 million, and in addition, these banks paid out a substantial amount of gold to meet a domestic hoarding demand. Far from showing a corresponding decline, however, their member bank reserve accounts increased $26 million. They must therefore have been replenished from some source by at least $244

TABLE 85

Federal Reserve Bank of New York and the other Eleven Reserve Banks, Certain Assets and Liabilities, February–April 1933, weekly (millions of dollars)

A ASSETS AND LIABILITIES

	FEBRUARY				MARCH					APRIL			
	1	*8*	*15*	*21*	*1*	*8*	*15*	*22*	*29*	*5*	*12*	*19*	*26*
Bills Bought													
F.R. Bank of N.Y.	9	9	9	66	89	79	86	64	51	59	39	29	27
Other 11 banks	22	22	21	108	294	338	317	288	259	226	207	179	150
Bills Discounted													
F.R. Bank of N.Y.	57	54	58	63	280	772	614	248	170	115	121	110	87
Other 11 banks	211	198	228	264	432	641	618	422	375	321	307	304	297
Bills Rediscounted by F.R. Bank of N.Y. with other F.R. banks						210	143						
Bills Bought & Bills Discounted													
F.R. Bank of N.Y.[1]	66	63	67	129	369	641	557	312	221	174	160	139	114
Other 11 banks[2]	233	220	249	372	726	1,189	1,078	710	634	547	514	483	447
Government Securities													
F.R. Bank of N.Y.	698	704	718	725	620	515	555	625	700	725	725	725	725
Other 11 banks	1,065	1,079	1,091	1,109	1,215	1,365	1,344	1,239	1,138	1,112	1,112	1,112	1,112
Total Gold Reserves													
F.R. Bank of N.Y.	965	917	791	744	710	697	761	818	865	914	933	1,004	1,016
Other 11 banks	2,290	2,330	2,409	2,374	2,182	1,986	2,249	2,374	2,371	2,364	2,382	2,361	2,380
Federal Reserve Notes													
F.R. Bank of N.Y.	557	561	592	610	798	969	994	897	848	824	794	773	745
Other 11 banks	2,172	2,212	2,299	2,390	2,781	3,246	3,298	3,019	2,899	2,820	2,753	2,704	2,679
Member Bank Reserve Accounts													
F.R. Bank of N.Y.	1,130	1,082	929	938	837	758	834	764	890	897	985	1,047	1,036
Other 11 banks	1,307	1,337	1,307	1,333	1,201	1,041	1,129	1,153	1,097	1,078	1,111	1,111	1,086

Total Gold Reserves as percentage of note and deposit liabilities													
F.R. Bank of N.Y.	56	55	51	47	43	40	41	49	49	53	52	54	55
Other 11 banks	65	65	66	63	54	46	50	56	58	59	60	59	61
12 F.R. banks	62	62	61	58	50	44	47	53	54	56	57	57	59

B CUMULATED CHANGES

		BILLS BOUGHT PLUS BILLS DISCOUNTED		GOVERNMENT SECURITIES		TOTAL GOLD RESERVES		FEDERAL RESERVE NOTES		MEMBER BANK RESERVE ACCOUNTS	
WEEK	Feb.	F.R. Bank of N.Y.	Other 11 banks	F.R. Bank of N.Y.	Other 11 banks	F.R. Bank of N.Y.	Other 11 banks	F.R. Bank of N.Y.	Other 11 banks	F.R. Bank of N.Y.	Other 11 banks
1	8	−3	−13	6	14	−48	40	4	40	−48	30
2	15	1	16	20	26	−174	119	35	127	−201	0
3	21	63	149	27	44	−221	84	53	218	−192	26
	March										
4	1	303	493	−78	150	−255	−108	241	609	−293	−106
5	8	575 [1]	956 [2]	−183	300	−268	−304	412	1,073	−372	−266
6	15	491 [1]	745 [2]	−143	279	−204	−41	437	1,125	−296	−178
7	22	246	477	−73	174	−147	84	340	847	−366	−154
8	29	155	401	2	73	−100	81	291	727	−240	−210
	April										
9	5	109	314	27	47	−49	74	267	648	−233	−229
10	12	94	281	27	47	−32	92	237	581	−145	−196
11	19	73	250	27	47	39	71	216	532	−83	−196
12	26	48	214	27	47	51	90	188	507	−94	−218

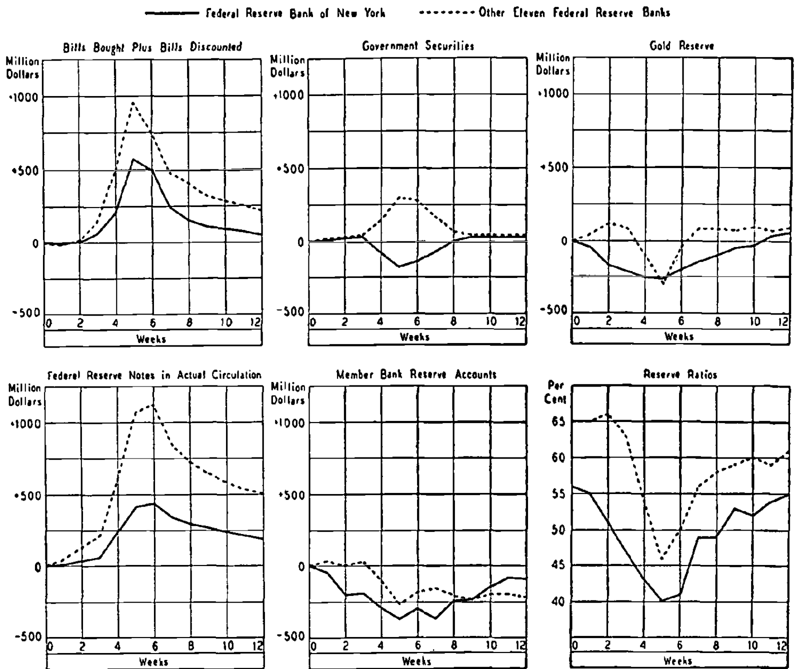
[1] Bills rediscounted with other Federal Reserve banks deducted.

[2] Bills rediscounted for the Federal Reserve Bank of New York added.

million. Of this, \$53 million was provided by an increase in bills discounted at these banks and at least \$84 million by transfers from New York, for the eleven interior banks gained gold in that amount. This leaves at least \$107 million to be accounted for. During the three weeks the eleven banks in-

CHART 79

Federal Reserve Bank of New York and the other Eleven Reserve Banks, Certain Assets and Liabilities, February–April 1933, weekly



creased their bills bought \$86 million and their government securities \$44 million, a total of \$130 million. The difference is accounted for by changes in the float and other minor balance sheet items.

This is not, however, an accurate picture of what actually happened. The principal means by which the member bank reserve accounts of the interior banks were built up was by

transfers from New York.[37] The bulk of the bills and securities purchased by the interior Reserve banks were not bought in their own districts but from the Federal Reserve Bank of New York, to offset the effects of such transfers. Had these purchases not been made, the interior Reserve banks would have gained not $84 million in gold but $214 million at the expense of the New York Bank. The bills and securities were bought in the first instance in their principal market, New York City, by the New York Reserve Bank. Member bank reserve accounts in New York were therefore increased by nearly this amount. They were then drawn down by transfers to the interior, and these transfers were prevented from causing a corresponding drain of gold from New York by the sale of the bills and securities to the interior Reserve banks. By this means the gain in gold by the interior Reserve banks was kept down to $84 million. This was less than their total gain in gold from the New York Bank through the Gold Settlement Fund, for they gained sufficient additional gold in this way to meet the interior hoarding demand.

At the Federal Reserve Bank of New York note circulation increased only $53 million during the three weeks, but member bank reserve accounts were reduced $192 million. This is accounted for in the main by the following operations:

Federal Reserve Bank of New York (millions of dollars)

TRANSACTIONS INCREASING MEMBER BANK RESERVE ACCOUNTS		TRANSACTIONS REDUCING MEMBER BANK RESERVE ACCOUNTS	
Increase in portfolio of Bills and Securities	+84	Increase in Notes in Circulation	−53
Increase in Bills Discounted	+6	Gold supplied for Export and for Domestic Hoarding (partly through transfers to the interior)	−137
Bills and Securities bought for interior Reserve Banks	+130	Other transfers to the interior	−214
	+220		−404

Effect of these transactions on Member Bank Reserve Accounts	−184
Actual decline in Member Bank Reserve Accounts	−192

[37] From February 1 to 21 the excess of 'due to' over 'due from' banks for banks in New York City fell $329 million.

Though both interior Reserve banks and the Federal Reserve Bank of New York had to meet a hoarding demand, the gold losses of the system were distributed as follows: the system as a whole lost $137 million, the New York Bank lost $221 million, the interior Reserve banks gained $84 million. Consequently, the decline in the gold reserve ratio of the whole system from 61.7 to 57.7 per cent was due largely to a decline in the ratio of the New York Bank. In spite of an increase in their note and deposit liability of $244 million, the gold reserve ratio of the eleven interior banks fell only from 65 to 63 per cent, while in spite of a decline in its note and deposit liability of $139 million, the gold reserve ratio of the Federal Reserve Bank of New York fell from 56 to 47 per cent.

Between February 21 and March 8 [38] this situation was reversed. In less than two weeks the twelve Federal Reserve banks lost $425 million in gold and $86 million in cash other than gold. Their note circulation increased $1,215 million, and in addition, the Federal Reserve float was contracted $79 million. In order to meet this extraordinary draft of $1,805 million on member bank reserve accounts, bills bought, bills discounted, and government securities together rose $1,375 million, leaving a net reduction in reserve accounts of $430 million as a result of these items. The actual reduction was $472 million. The position of the New York Bank within the system was remarkable. The triple drain to which it was exposed was accentuated in all its components. Its calls, therefore, upon the interior banks for assistance were carried to the point where it became dependent upon that assistance for *its entire gold reserve,* and had shifted to the interior banks virtually the whole burden of meeting the gold losses of the system.

During the two weeks from February 21 to March 8 the bills bought of the twelve banks increased $243 million, but

[38] More accurately March 4, for the March 8 statement was issued while the Federal Reserve banks were still partly closed.

of this increase only $13 million was at the New York Bank and $230 million at the interior banks. As indicated above, this undoubtedly meant a substantial addition to member bank reserve accounts in New York with which to meet transfers to the interior, and also prevented corresponding losses of gold by the New York Bank through the Gold Settlement Fund. At the same time, bills discounted by the Federal Reserve Bank of New York increased $709 million, representing a further replenishment of member bank reserve accounts by that amount. Of these bills discounted, $210 million were rediscounted with other Federal Reserve banks, Chicago in particular, thus further replenishing the gold reserves of the New York Bank. Finally the government securities of the system were increased $46 million. To the extent that these purchases, like those of bills, were made in New York, this also represented an increase in member bank balances in New York. The main feature of the government security holdings, however, was the transfer by the Federal Reserve Bank of New York not only of its small net purchases, but also of a large part of its existing holdings to the interior banks. Government securities held by the New York Bank declined $210 million, while those of the interior banks increased $256 million. A further large amount of gold was thus provided for the New York Bank.

An approximate statement of the size of the foreign gold drain, the domestic hoarding demand in the New York district, and the interior drain combined can be gleaned from these figures. If it is assumed that the increase in bills bought and government securities held by the system as a whole represented in the first instance increases in member bank balances in New York, then the additions to these balances during the two weeks were $998 million, as shown on page 1248. This great increase was offset in part by an increase in the note issue of the New York Bank of $359 million and by the operation of the Federal Reserve clearing system. Checks throughout the system were being collected faster than they

were being credited and the Federal Reserve float became a negative quantity, changing from +$2 to −$77 million. The consequent reduction in member bank reserve balances was, for the system, $79 million. If the New York member banks'

Factors increasing Member Bank Reserve Balances in New York, February 21 to March 8, 1933

	MILLIONS OF DOLLARS
Bills bought by the whole system	+243
Bills discounted by the Federal Reserve Bank of New York	+709
Government securities bought by the whole system	+46
Total	+998

share in this contraction was approximately a third, the proportion of New York clearings to the whole, member bank balances in New York were reduced about $26 million. In addition, there was a reduction of $37 million in 'cash other than gold' at the Federal Reserve Bank of New York, indicating a further reduction in member bank reserve balances. When these three items, amounting together to $422 million, are taken into account, the indicated increase is still $576 million. There was, however, an actual reduction of $180 million, indicating a total gold drain from the New York Bank of $756 million.

The actual gold loss of the Federal Reserve Bank of New York was $47 million, so that the help obtained from the interior banks was about $700 million. The way in which this help was secured is shown in the accompanying state-

Replenishment of Gold Reserves of the Federal Reserve Bank of New York by the Other Reserve Banks, February 21 to March 8, 1933

	MILLIONS OF DOLLARS
Increase in bills bought by the interior Reserve banks	+230
Increase in government securities held by the interior Reserve banks	+256
Bills rediscounted by the interior Reserve banks for the Federal Reserve Bank of New York	+210
Total	+696

ment. On March 8 the total gold reserves of the Federal Reserve Bank of New York were $697 million. Had no help been given to the New York Bank by the interior banks they would have been reduced to zero and the reserves of the interior banks, instead of declining $388 million, would actually have increased $308 million. Even if it were assumed that none of the bills bought by the interior banks were bought in the first instance in New York, it would still be true that the gold obtained by the New York Bank from the interior banks was greater than the entire net loss of gold by the system as a whole.

Under these circumstances the interior banks were obliged to meet an increase in their note circulation of $856 million with declining gold reserves. Though their bills and securities increased $899 million, their member bank reserve accounts declined $292 million, leaving a net increase in their liabilities of $564 million. But with the loss of $388 million in gold this reduced their gold reserve ratio from 63 to 46 per cent. At the same time, the ratio of the New York Bank, notwithstanding the assistance rendered it, fell to 40 per cent.

Interregnum, March 4–April 20, 1933

On the eve of the inauguration of the new President of the United States it was clearly recognized that the Federal Reserve banks could not long remain open. On March 3 the Federal Reserve Board and others endeavored to induce the outgoing President, Mr. Hoover, to sign a proclamation for a National Bank Holiday on the ground that if he did not there would be an immediate and total collapse of the whole banking system. Mr. Hoover agreed to take action only if the incoming President would share the responsibility. This Mr. Roosevelt refused. On March 4 the Federal Reserve banks closed, all the leading exchanges ceased operations, and in the words of the Federal Reserve Board Annual Report for 1933, "business in general was practically at a standstill."

March 4 was a Saturday, and on the following Monday

President Roosevelt issued a proclamation declaring a nation wide bank holiday to continue until March 9, a period later extended. Under this proclamation banks were forbidden to pay out any coin, bullion, or currency, or to transact any other banking business except as permitted by the Secretary of the Treasury. The gold standard in the United States was thus suspended temporarily, but no final decisions concerning it were made. An interregnum was begun, during which the legal forms of the gold standard as they had existed since the lifting of the war-time gold export embargo in June 1919 were profoundly changed by a series of steps. As a result of decisions made during this interregnum the United States not only ushered in an entirely new phase in the exchange relationships of the center countries, but, *by indirection,* broke down the overwhelming obstacles that, under any other circumstances, would still have stood in the way of her acceptance in the future of some form of the gold bullion standard.

At the time of England's abandonment of the gold standard, the opinion had been seriously expressed in the United States that the export of gold should be prohibited in order to make possible continued domestic inter-convertibility between currency and gold, and thus to 'preserve the gold standard' in America. American opposition to proposals for an inter-central bank gold clause had been largely on the ground that foreign banks should not be given a favored position with respect to the conversion of dollars into gold as compared to American banks. Even in March 1933 American opinion was not prepared to accept the view that the essential economic function of gold reserves was to meet foreign demands, and that the gold standard was essentially an international institution. It was unalterably opposed to the idea that gold should be made available for export while denied at home. For this reason the measures taken concerning the domestic gold circulation immediately after the clos-

ing of the banks have a peculiar technical interest for these studies. The argument for the gold bullion standard was vigorously advanced within the Federal Reserve Board. It was pointed out that since domestic hoarding was overwhelmingly the most important single factor in bringing the Federal Reserve banks to the position in which they found themselves on March 4, 1933, the time had come to deprive domestic convertibility of all real meaning and to continue on the gold standard internationally. An order was drafted that legally continued the right of convertibility of the dollar, but provided that gold could not be held within the country, thus in effect, if not in form, suspending domestic convertibility. This proposal, however, was rejected by the Board and by the government. Steps were nevertheless taken to eliminate gold from circulation, but on quite other grounds. The President's original Bank Holiday proclamation was issued under section 5 (b) of the Trading with the Enemy Act of October 6, 1917, which empowered him to "investigate, regulate, or prohibit . . . any transactions in foreign exchange and the export, *hoarding*, melting or earmarkings of gold . . ." The Proclamation itself declared that, except as authorized by the Secretary of the Treasury with the approval of the President, no bank could, during the holiday, "pay out export, earmark or permit the withdrawal or transfer in any manner or by any device whatsoever, of any gold or silver coin or bullion or currency or take any action which might facilitate the hoarding thereof." In Treasury regulations issued on March 7 providing for the extension of Federal Reserve credit and the issue of currency to banks during the holiday for specified purposes, the giving of such help was made conditional on the delivery by the bank seeking assistance of all gold and gold certificates held by it to the Reserve banks. On March 8 the Federal Reserve banks prepared a list of large holders of gold, and in the President's Proclamation of March 9 extending the Bank Holiday the purpose of preventing hoarding was again

stressed. On March 10 in an Executive Order permitting banks to reopen under license from the Treasury, the following language was used:

"Until further order, no individual, partnership, association, or corporation, including any banking institution, shall export or otherwise remove or permit to be withdrawn from the United States or any place subject to the jurisdiction thereof any gold coin, gold bullion, or gold certificates, except in accordance with regulations prescribed by or under license issued by the Secretary of the Treasury.

No permission to any banking institution to perform any banking functions shall authorize such institution to pay out any gold coin, gold bullion or gold certificates except as authorized by the Secretary of the Treasury, nor to allow foreign exchange except such as may be undertaken for legitimate and normal business requirements, for reasonable traveling and other personal requirements, and for the fulfillment of contracts entered into prior to March 6, 1933."

Notwithstanding all this emphasis upon hoarding none of these regulations and orders contained any provision that made it illegal for private individuals to hold gold. There was in fact no 'gold hoarding' order up to this time, but only a prohibition of the export of gold and a suspension of the convertibility of the currency. Not unnaturally, however, the public gained the impression that gold hoarding was now illegal and small holders began to turn in their gold. Large holders, on the other hand, taking advice of counsel, were told that no such order had been issued and kept their gold. This seemed unfair and unjust to the Federal Reserve Board, and resulted in the issue of a genuine gold hoarding order on April 5, which explicitly prohibited "the hoarding of gold coin, gold bullion and gold certificates within the continental United States."

On April 5, 1933 the United States had by a curious route arrived at the following position: gold could be exported under license from the Secretary of the Treasury, but the dollar

was not convertible into gold, and gold could not be held legally by the citizens. A simple restoration of convertibility would have been sufficient to put America on the gold bullion standard.

Meanwhile, the banking crisis had been successfully met. On March 9 at a special session of Congress an Emergency Bank Act had been passed giving the President the emergency powers under which the two gold orders were issued, providing for the appointment of conservators for closed or illiquid banks, for the issue of preferred stock by banks and its sale to the Reconstruction Finance Corporation, for the issue of Federal Reserve Bank Notes, and for further relaxation of eligibility requirements. On March 11 the Federal Reserve banks were reopened, and the process of reopening the banks under Treasury license was begun. In the main it was completed within the next four days. Banks, with approximately $4 billion in deposits, however, remained closed pending liquidation or reconstruction. As shown in Chart 78 gold and currency immediately returned from hoarding. Between March 11 and April 19 Federal Reserve Notes fell $838 million, the gold holdings of the Federal Reserve banks rose $672 million, and the member banks repaid $1 billion of their indebtedness to the Reserve banks. The Federal Reserve Bank of New York, as funds flowed back to New York, paid off its rediscounted bills at the other Federal Reserve banks, took back the government securities it had placed with them, and secured the lion's share of the increasing gold reserves. The system's portfolio of bills was allowed gradually to run off, and by the end of April, as Chart 79 clearly shows, the positions of both the system as a whole and the Federal Reserve Bank of New York were not far different from those existing just before the crisis.

While the American banking system was thus returning to what might be described as 'normal,' the dollar remained relatively stable in the foreign exchanges. Trading in the exchange markets had been suspended from March 4 to March

12 but quotations were resumed on March 13. After a pent-up commercial demand for dollars had been satisfied the underlying trend of the dollar was weak in London, but the intervention of the British Exchange Equalization Account prevented sterling from rising. From March 14 to April 15 sterling kept within the range of 3.46 to 3.41, most of the time closer to the bottom of this range than to the top (Table 79). It will be recalled that it was during March and April that the Bank of England was accumulating the bulk of its new gold reserve.[39] The dollar-franc rate remained within the gold points and the whole period of the acute banking crisis in America passed without serious disturbances in the world's exchange markets, owing to the apparently temporary nature of the suspension of the international gold standard in America. During the Bank Holiday itself the Secretary of the Treasury was granted the power to permit the export of gold earmarked at the Federal Reserve Bank by foreign central banks and governments prior to March 6, and the Secretary granted such licenses freely. Under the gold order of March 10 the Secretary was authorized to issue licenses for export. On April 13 licenses were granted to a New York bank to export $600,000 in gold bars to the Netherlands, and on April 15 to 17 licenses were granted for the export of $9 million in gold bars to France. When these licenses were issued the dollar stood at gold export point against gold standard currencies and these exports steadied the market.[40] They constituted the last acts in defense of the gold standard in the United States. On April 18 licenses applied for were refused though the exchanges were weak, and on April 19 it was officially announced that no further licenses would be granted. On April 20 an Executive Order was issued prohibiting gold exports, except for gold already earmarked. The power of the Secretary of the Treasury to issue licenses was restricted to such transactions

[39] Cf. Ch. 31, Building up a New Gold Reserve; cf. also Chart 72.

[40] Federal Reserve Bank of New York, *Annual Report, 1933*, p. 28.