Session 5: A Reassessment of Sterling 1945-2005

'Sterling and the End of Bretton Woods'

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The final phase of the Bretton Woods international monetary system was marked by a series of crises from November 1967 to March 1973. The four principal episodes, out of at least a dozen such events, were:

- November 1967 – devaluation of sterling
- August 1971 – suspension of the convertibility of the dollar into gold
- June 1972 – floating of sterling
- February/March 1973 – second devaluation of the dollar and generalised floating

Thus sterling held centre stage twice, in November 1967 and June 1972. On both occasions, the sterling crisis was followed by bouts of instability in other major currencies and ultimately by the breakdown of the system: the Bretton Woods system in August 1971; and the modified Smithsonian Agreement parities, in February/March 1973.

There were two dimensions to these episodes: a political dimension and a market dimension. The involvement of senior politicians, sometimes in dramatic conflict with counterparts, and the attendant press attention, generated a public perception of a 'crisis' that was assigned to a particular country or currency. The market dimension was not so publicly visible and tensions in the foreign exchange markets are less straightforwardly attributable to a particular currency. The foreign exchange market is a zero-sum game: downward pressure on one currency means upward pressure on others, and vice-versa. In this sense, each of the international monetary crises was a crisis of the whole system, rather than a component currency.

Nevertheless, the term 'sterling crisis' was applied at the time to two of the key crises and the instability of sterling was plainly central to both episodes. Certainly policy-makers in the 1960s were convinced that the defence of sterling was essential for the stability of the dollar and hence the Bretton Woods system. ‘Whenever sterling might be devalued’, recalled Milton Gilbert of the Bank for International Settlements, ‘confidence in the dollar price of gold could be expected to evaporate and a large rise in the market for gold, as well as central bank conversions of dollars for gold, could be anticipated.’

But how well founded were these convictions of contemporaries? How significant were the sterling crises and the instability of the pound – the repeated emergencies and need for support operations - in destabilising the system as a whole or fostering its breakdown?

As politicians and officials struggled to manage the increasingly unstable and dysfunctional international monetary system in the late 1960s and early 1970s, a countervailing development was taking place: moves towards the creation of a European monetary bloc and ultimately a European single currency. This endeavour was not successful, at least on the time-scale originally envisaged. Thus another question arises: Did sterling instability significantly impede the progress towards EEC monetary union?

With these questions in mind, this paper looks in turn at: (1) the role of sterling in the Bretton Woods system; (2) the November 1967 devaluation of sterling and post-devaluation instability; and (3) the June 1972 floatation of sterling. It then offers some conclusions.

The role of sterling in the Bretton Woods system

Sterling and the dollar were often referred to as the Bretton Woods system’s ‘key currencies.’ The dollar’s pivotal position derived from being: the only currency to be convertible into gold on demand; the currency that served as a reference point for all other currencies; and the world’s leading transaction, intervention and reserve currency. But sterling had no special position in the postwar international monetary arrangements. Sterling’s status as a key currency was a legacy of its historic gold standard glory days and from being the currency of one to the Bretton Woods system’s twin architects, as well as reflecting the continuing close relationship between the UK and US international monetary authorities, a dimension of the wider ‘special relationship’ between the two countries.

In the immediate post-war years sterling was also important as a transaction, intervention and reserve currency, though each of these roles waned during the 1950s and 1960s. In the late 1940s around half of world trade was sterling financed, but its use as a *transaction* currency dwindled over the next two decades and by 1965 sterling's share was perhaps a quarter. Sterling's role as an *intervention* currency diminished as countries that before the war had pegged their exchange rate to the pound tied their currencies to the dollar. At the end of the war sterling was still the world's foremost *reserve* currency: official holdings in 1945 were equivalent to $15 billion, compared to $7 billion dollars. But thereafter holdings of dollars as a reserve asset increased rapidly, overtaking sterling in 1952: IMF statistics show that in 1960 sterling comprised 36 per cent of official holdings of foreign exchange; in 1965, 26 per cent; in 1970, 13 per cent; and in 1974, 7 per cent. While gradually waning in significance in the international monetary system, gross overseas sterling holdings remained nominally roughly stable from 1945 to 1970 at around £3.4 - £3.8 billion.

While all countries held dollars as a reserve asset, only members of the 'sterling area' held a significant proportion of their reserves in sterling. The sterling area was not a geographical region but a set of countries that traditionally had commercial ties to the UK, many, though not all, being members of the British Commonwealth: in 1968 the sterling area numbered 32 independent countries and six dependent countries. Current and capital account movements among members of the sterling area were unrestricted, but payments outside were subject to stringent exchange controls.

Overseas holdings of sterling arose originally from the use of sterling in international trade and the holding of reserves in sterling to take advantage of the banking and investment services provided by the City. They increased substantially during the Second World War through the crediting of governments that supplied war materials to the UK with sterling in London. After the war the volume of external sterling liabilities exceeded Britain's reserves of gold and dollars by around eight-times. The gradual accumulation of reserves by the UK reduced the ratio of external liabilities to reserves, but in the 1960s the so-called 'sterling balances' were around four times UK reserves. The scale of the sterling balances overhang made sterling inherently unstable. Confidence in the pound was thus crucial, making it vulnerable to perceptions of poor economic management, weak economic performance or irresolute international support.

There were several potential solutions to the sterling balances 'embarrassment.' In theory, the UK might have attempted to 'pay off' the sterling balances, but in reality this would have been, as a Treasury assessment put it: 'quite impracticable and harmful to the world monetary system.' Also out of the question was the hard-nosed suggestion in 1956 by Sir Robert Hall, the government's Economic Adviser, that the vexing problem might be disposed of by a default. Blocking the sterling balances of sterling area holders was an option, but it was regarded as a last resort by the UK authorities because of the breach of faith with sterling holders and because of the damage that would be done to London as an international financial centre. 'The Treasury seemed to have looked on the balances as one of the facts of life,' stated a confidential internal assessment in 1971, 'inseparable from the continued existence of the sterling system which we had no means of liquidating; and pinned their hopes of relief on the strengthening of the UK's external position… and on the development of an international monetary system which would provide adequate support for sterling as a reserve currency essential to the system.'

The stability of the sterling balances and their potential destabilising impact became a matter of concern in the 1960s due to two factors: diversification and volatility. The diversification of the reserve assets of sterling area countries proceeded from the early 1960s due to widening trade and political contacts: initially this took the form of the accumulation of non-sterling assets as total reserves rose, but from mid-decade some countries actively reduced their absolute exposure to sterling. The mid-1960s also saw an increase in the volatility of holdings of sterling by non-sterling area holders. These movements were mostly triggered by developments in the UK's balance of payments position, but in exaggerated magnitudes that could heavily deplete UK reserves affecting confidence in sterling and potentially its ability to hold to its par value. These short-term fluctuations in the sterling balances became widely recognised as a potential source of instability for sterling, and hence the international monetary system as a whole.

The outcome was the Sterling Group Agreement that came into effect in June 1966. In contrast to previous ad hoc emergency assistance, it was a painstakingly negotiated renewable credit facility of up to $1 billion provided by other leading central banks (not including France, which refused to participate in sterling support packages from 1965) and the BIS. Its specific purpose was to relieve operational stresses arising from the international use of sterling and hence reduce instability in the international monetary system - not to reduce the volume of the sterling balances, nor to finance UK balance of payments deficits.

Members of the sterling area were ‘badly bitten’ by the devaluation of the pound in November 1967. Diversification of official reserves turned into a ‘scramble’ in the first half of 1968, imposing a strain on UK reserves. The UK Treasury believed that after the ‘severe shock’ of devaluation many sterling area countries decided to diversify their reserves as a matter of policy, but if diversification continued at the current rate it would be necessary to block the sterling balances or float the pound. This necessitated further support for the pound from the other major central banks and the BIS not only to offset fluctuations in the sterling balances, as agreed in 1966, but also to fund potentially large-scale run downs.

The result was the Second Sterling Group Arrangement of September 1968, by which the BIS and a dozen industrial countries provided a new $2 billion facility – double the previous amount - for three years (renewable for anther two). The funds enabled the UK to provide official holders of sterling balances with a dollar value guarantee for holdings of sterling in excess of 10 per cent of a country’s total reserves. The torrent of diversification not only stopped but reversed – the sterling balances rose from £3.4 billion in September 1968 to £4.2 billion at the end of 1970. As a result, it was unnecessary for the UK to draw on them. However, what a Treasury official in August 1969 called the ‘ghastly problem’ remained.

‘These arrangements have given sterling a new stability,’ the Chancellor of the Exchequer, Roy Jenkins, told the IMF Annual Meeting in Washington in early October 1968. ‘I believe that we need not again fear a flight from our currency and the contingent threat to the international system… The world as a whole benefits from a strengthening of the system through a less extended and exposed position for sterling.'

Treasury officials maintained that the sterling agreement of 1966 proved 'very helpful' for the management of the sterling balances and the 1968 arrangement helped to bolster sterling. Moreover, as an exercise in central bank cooperation they were a notable success. However, their existence did not prevent devaluation in 1967 nor several sterling panics in 1968 and 1969. In fact, by the end of the 1960s the sterling balances had become just one part of the broader problem of the growth of short-term capital movements, which was a mounting source of instability for all currencies not sterling alone. The IMF drew attention to the phenomenon for the first time in its *Annual Report* for 1969: 'The liberalization of capital transactions in the last ten years has been a major factor tending toward an integrated world economy. But it has brought with it the greatly increased possibility of sudden pressures on exchange rates, notably when underlying economic developments give reason to suppose that an adjustment may occur.'

Devaluation of Sterling November 1967, and post-devaluation instability

The first sterling crisis of the 1960s occurred in March 1961, sparked by a revaluation of the Deutsche mark. It was met by bilateral pledges of support for sterling on the part of European central banks, working with the BIS, totalling $900 million (known as the Basle Agreement). Further ad hoc temporary facilities were provided by the other major central banks through the BIS in 1963, 1964 and 1965 to boost confidence in sterling and provide the UK with ammunition for intervention in the foreign exchange market. These were important steps in the development of central bank co-operation: the necessity for repeat operations reflected the magnitude of the sterling overhang and the lack of progress on the enhancement of British economic performance.

Support for the second key currency was regarded by the Kennedy and Johnson administrations as a 'major foreign policy concern.' In June 1965, during yet another sterling crisis, President Johnson instructed Treasury Secretary Henry Fowler to: 'consider what steps the United States could take to arrange for a relief of pressure on sterling, so as to give the United Kingdom the four- or five-year breathing space it needs to get its economy into shape, and thereby sharply reduce the danger of sterling devaluation or exchange controls or British military disengagement East of Suez or on the Rhine.' Moreover, with the emergence of US external payments deficits from 1959 and the growing problem of a dollar overhang, the defence of sterling was regarded as a vital 'outer perimeter defence' for the dollar.

The Federal Reserve Bank of New York played a very active role in the struggle to 'save the pound' in the 1960s. In practical terms, support took the forms of currency swap lines between the New York Fed and the Bank of and England, support for the provision of multilateral facilities for the UK in international bodies, and occasional pugnacious co-ordinated intervention in the foreign exchange market, for instance the highly effective 'bear squeeze' of September 1965.

The UK's anaemic economic performance in the mid-1960s – small current account surpluses at best, with relatively slow growth and relatively high inflation – undermined confidence in sterling and increased the likelihood of a devaluation to restore competitiveness. As the chance of devaluation increased, so did the prospect of sterling balance holders heading for the exit *en masse*. The Labour victory in the October 1964 election appeared to some to increase the chance of a devaluation of the pound, the party being associated with the devaluations of 1931 and 1949. Wilson, Brown and Callaghan, the leading figures in the new administration, were determined that Labour should not be branded the party of devaluation and resolved to defend the pound. This was not made easier by the British balance of payments lurching deeply into the red in the second half of 1964. From then recalled Alec Cairncross, Treasury chief economist, such was the delicacy of the situation that the word 'devaluation' disappeared from the vocabulary of politicians and officials – it was 'unmentionable.'

A speculative attack on the pound in the autumn of 1964 was followed by further bouts in summer 1965 and summer 1966: 'Sterling crises have become a bore,' quipped *The Economist* during the third crisis. The government responded on 20 July 1966 with an austerity package that was intended as a decisive move – a once and for all demonstration of the administration's determination not to devalue. But by then the Wilson government's credibility had worn thin and as Cairncross later put it: 'there was no full-blooded return of confidence in the market: the durability of the parity continued to be regarded with suspicion.' This was despite the conclusion of the First Sterling Group Arrangement the month before. It took another substantial package of central bank short-term support in September 1966 to convince the market that the authorities really meant business before speculative pressure subsided – for a while.

The Wilson government's fourth sterling crisis over the summer and autumn of 1967 was driven by a conjunction of economic and political factors, notably: a clouded balance of payments outlook, shadows being cast by the closure of the Suez Canal and stagnation in Germany; equivocal UK government monetary moves and reflationary measures to confront rising unemployment that called into question the administration's real resolve to confront the country's economic malaise and the defence of the currency; an upsurge of labour militancy; and the UK's second application to join the EEC, which was announced on 3 May 1967.

It was not a co-incidence that pressure on sterling in the foreign exchange market paralleled the EEC accession negotiations from May to November. It was widely accepted in the market, particularly on the Continental bourses, that devaluation of the pound and the end of its role as a key currency were conditions of EEC entry, a perception that UK officials attributed to French government rumour-mongering. 'Although sterling was ripe for devaluation in any case,' protested an outraged British commentator after devaluation, 'the rumours, snide remarks and cold comfort that came out of Paris left a bad taste, at a time when the bankers' co-operative was visibly failing to cope.'

By the autumn of 1967 the principal European central banks had become sceptical about arranging yet another support package for sterling and had come to the conclusion that devaluation was in everyone's best interest. Wilson and Callaghan had become weary of the struggle: weary of defending the pound not only against Swiss gnomes but also against many in their own party and beyond who advocated devaluation rather than deflation - the 'soft alternative', Leslie O'Brien, governor of the Bank of England, called it – to resolve the long running sterling saga.

Nevertheless, the US authorities were keen to try to arrange a further and long-term support package, being fearful of the impact of sterling devaluation on confidence in the dollar. 'I wont go into the pros and cons of letting the pound go,' Walt Rostow, Johnson's special presidential assistant told the president on 13 November 1967. 'The main point is the risks are just too great to be worth the gamble.' However, this time the European central banks refused to go along.

On 18 November 1967, an hour after notifying the IMF, sterling's par value was devalued by 14.3 percent, from $2.80 to $2.40, a magnitude that was known to be acceptable to the other members of the G10. No major currency devalued along with the UK, so the competitive impact of devaluation was not substantially dissipated. However, fourteen countries that were heavily dependent on the UK market, including Denmark, Eire, and New Zealand and some colonial territories, notably Hong Kong, followed the pound. To help the UK to hold the new parity, massive short-term facilities were made available by the G10 central banks and the IMF, totalling $2.9 billion.

US monetary officials felt let down by the British decision to devalue. 'Oh I was disappointed all right,' said Alfred Hayes, president of the New York Fed. 'After all, we worked like the devil to prevent it. And we nearly did. In my opinion, Britain could have got enough assistance from abroad to hold the rate.' The day after the devaluation, Thomas Waage, the New York Fed's vice-president in charge of public information, answered journalists' questions at a press conference. Quizzed about the dangers of the situation, he replied that it was still too early to tell whether the devaluation of sterling would lead to 'another 1931.' Then a reporter asked whether the crisis had kept him up all night? 'No, last evening I went to "The Birthday Party",' Waage replied, 'and I must say Pinter's world makes more sense than mine does, these days.'

At the European Commission and for some European ministers and officials, particularly in Germany, the devaluation of the pound held a clear message: the need for regional monetary integration to protect Europe from the instability of the international monetary system. Pursuing this outlook to a logical conclusion, on 27 November 1967, just nine days after devaluation, General de Gaulle vetoed UK membership of the EEC for a second time, citing the debilitated condition of sterling, as demonstrated by the recent devaluation, as one of the main justifications. He stated that the pound's weakness: 'would not allow the country to be part of the solid, interdependent and assured society in which the Franc, the Mark, the Lira, the Belgian Franc and the Florin are brought together.'

A UK Treasury analysis of the impact of the November 1967 devaluation of sterling, concluded that it had 'shaken the system to its foundations… with far-reaching repercussions.' Having toppled one of the key currencies, speculative attention focused on the other – the dollar, whose value was now questioned as never before. It was susceptible to challenge because of repeated US external deficits and the relentless growth of dollar balances.

A 'tidal wave' of speculation immediately swept through the London gold market in anticipation of devaluation of the dollar against gold. At the UK Treasury it was believed that, as during the sterling devaluation struggle, speculators were being egged-on by the French authorities because they favoured an increase in the gold price, partly because French reserves were overwhelmingly in gold and partly because of hostility to the reserve currencies, favouring the re-establishment of the gold standard. Heavy intervention was required to maintain the official gold price of $35 an ounce by the members of the international Gold Pool, an arrangement created in 1961 to stabilise the gold price in which the biggest participant was the US. In the six weeks between sterling devaluation and the end of the year the US sold almost a billion dollars' worth of gold, pushing its gold stock below $12 billion for the first time since 1937. The Johnson administration's response was a 'draconian' programme of measures to improve the US balance-of-payments announced by on New Year's Day 1968. It secured a brief a respite.

Heavy speculative pressure on the dollar resumed in early March and by the end of the second week, with the Gold Pool losing $1 million of gold every 1 minute 53 seconds, the continued convertibility of the dollar into gold was being questioned. Initially the US authorities were determined to soldier on, assisted by moves in the US Congress to repeal the legal provision for the note issue, thereby freeing the whole of the US gold stock for balance of payments purposes. The Bank of England was on board too, the governor telling his Federal Reserve counter-part, chairman William McChesney Martin: ‘we will hold on.’ At the UK Treasury, however, officials were forming the view that UK gold reserves were being depleted at such a rate that the country was on the verge of having either to block the sterling balances or float the pound – or both – unless additional US credits up to the ‘highest conceivable level’ were immediately made available. It seemed inevitable that either blocking or floating would put further pressure on the dollar, a prospect that it was hoped ‘might induce the US to provide the credits which were needed.’

This piece of monetary arm twisting was overtaken by the realisation in Washington that, as special assistant Walt Rostow put it to President Johnson on Thursday 14 March: ‘we can’t go on as is, hoping something will turn up.’ At the request of the US authorities, the London gold market was shut on Friday 15 March while the governors of the central banks of the seven active members of the Gold Pool were airlifted by a US presidential jet to a hastily convened conference in Washington that weekend. The gathering endorsed a proposal advanced by Guido Carli, governor of the central bank of Italy, for a new dual price structure for gold with segregated official and free market prices. The creation of the two-tier gold market resolved the crisis by diverting speculative exuberance into the free market while preserving an official gold price of $35 an ounce.

Pressure on sterling was relieved by the establishment of the two-tier gold market and by the continued closure of the London gold market for a further two weeks to allow the new arrangements to settle down. In addition, there was a new support package for sterling totalling $4 billion, though it took the threat by the US of an immediate suspension of dollar convertibility to persuade some European central banks to support the facilities.

The introduction of the two-tier gold market compromised a key feature of the Bretton Woods system – the undertaking by the US Treasury to buy or sell gold to all parties.

Henceforth only monetary authorities were eligible, and more in theory than in practice - applications were treated almost as ‘unfriendly acts.’ ‘With the introduction of the dual price system and partial dollar inconvertibility, a long step had been taken in the direction of total inconvertibility,’ concluded a later UK Treasury analysis. ‘The gold crisis of March 1968 was the writing on the wall foreshadowing the dollar crisis of August 1971.’

Confidence in sterling remained fragile for the rest of 1968 and through to the summer of 1969 as the UK balance of payments deteriorated before improving in the usual J-curve pattern. Despite the Chancellor’s bullish words (quoted above) to the IMF Annual Meeting in October 1968, the following month the UK authorities again became convinced that sterling was about to be forced off the $2.40 parity. The context was the crisis of November 1968 that revolved around market expectations of a revaluation of the mark and a devaluation of the French franc. But by drawing heavily on the Federal Reserve swap line the $2.40 parity was held and the emergency passed.

In May 1969 the UK balance of payments figures turned the corner and went into surplus. Nevertheless, following the devaluation of the French franc by 11.1 per cent on Friday 8 August 1969 speculative pressures focused on sterling, taking as a cue the ‘mildly disappointing’ monthly trade figures for July. On Thursday 14 August 1969 the sterling rate fell to $2.3812 - the lowest since devaluation - and intervention cost $247 million. Among officials at the UK Treasury, the unexpected and unwarranted onslaught led to talk of floating the pound, rather than incurring further heavy reserve losses. The Chancellor, Roy Jenkins, was horrified by this defeatism: ‘to float (and float down) in the autumn of 1969, when we had at last got our surplus as a result of vast efforts, and thus to throw away victory just when we were achieving it, seemed to me the height of perversity. I was resolved to defend a rate which had shown itself to be defensible by its results.’

After August 1969, with the emergence of a substantial UK current account surplus, sterling ceased to be a substantial source of instability for the international monetary system. The crises of the years 1969 to 1971 focused on the parities of the mark, the franc, the Canadian dollar and the US dollar. During this interlude of sterling stability, the attention of the UK international monetary authorities shifted from the struggle to save the pound to reform of the international monetary system and negotiation of membership of the EEC.

Flotation of sterling June 1972

The Smithsonian Agreement of 18 December 1971, which brought to an end four months of uncertainty following the 15 August suspension of the convertibility of the dollar into gold, was greeted with 'euphoria' in the markets. It established a new set of realigned exchange rates. The Smithsonian parities had a permitted fluctuation range of 2 ¼ per cent either side of a 'central rate' (par value) – 4 ½ per cent in total. The new central rate for sterling was $2.6057, an 8.57 per cent revaluation against the dollar, with announced selling and buying rates for dollars of $2.5471 and $2.6643. At the same time the UK authorities revoked the stiff exchange control regulations they had imposed in summer 1971 to discourage inflows of non-resident funds.

Doubts about the durability of the Smithsonian parities surfaced early in the new year. 'A devalued dollar might be devalued again,' observed Charles Coombs, vice-president in charge of the Foreign Department of the Federal Reserve Bank of New York and a doyen of the foreign exchange market, 'the unthinkable had now become possible, even plausible. Moreover, the dollar remained inconvertible, with no undertaking by the US to defend its new, reduced value by exchange market or other support operations.' The situation was aggravated by the lack of measures of monetary or fiscal restraint to tackle the US deficits because of the need to reflate the economy in an election year. The lack of confidence in the dollar was reflected in strong advances of the mark, yen, guilder and Belgian franc. Sterling, which entered the new era on the floor of its Smithsonian parity trading range, was lifted by the advance of the Continental currencies and from early February was quoted at its middle rate of $2.6057.

On 7 March 1972, as a first move towards fulfilment of the Werner Plan's schedule for the achievement of a European single currency by 1980, the EEC countries announced their intention to launch the 'narrow margins' scheme – the so-called 'snake' - which restricted fluctuations among EEC currencies to a maximum of 2 ¼ per cent (though the Smithsonian 'broad margin' against the dollar remained 4 ½ per cent – the 'tunnel'). The foreign exchange market perceived the move as greatly increasing the likelihood of a concerted European response to further inflows of dollars, either through new capital controls to manage the system or through a joint float against the dollar. This led to a rush to stockpile Continental currencies, pushing them to their Smithsonian parity ceilings and sterling up to $2.65. But resolute intervention by the European central banks, new administrative measures to ward off capital inflows, a narrowing of the differentials between US and European interest rates and public statements supporting the Smithsonian parities restored order to the market.

The sterling spot rate fell back sharply later in late March to $2.61. One reason was the announcement that the UK trade balance had moved back into deficit in February 1972. The other was the budget, presented on 21 March by Chancellor of the Exchequer, Anthony Barber, which, with an emphasis on growth and combating unemployment, was even more expansionary than the market had expected. In addition, there was a modest relaxation of exchange controls.

Barber's budget speech included a passage on the balance of payments in which he stated that:

> the lesson of the international balance of payments upsets of the last few years is that it is neither necessary nor desirable to distort domestic economies to an unacceptable extent in order to retain unrealistic exchange rates, whether they are too high or too low. Certainly in the modern world I do not believe that there is any need for this country or any other, to be frustrated on this score in its determination to sustain economic growth and to reduce unemployment

In his review of the budget the following day, Peter Jay, economics editor of *The Times* and an advocate of floating rates, drew attention to this passage, which he called: 'the most important words to be spoken by any Chancellor for a decade.' Federal Reserve economist Robert Solomon was astonished: 'Although an economist could not quarrel with one word in this statement, it was not the sort of thing that foreign exchange market operators expected to hear from a finance minister. It was interpreted to signify that, should sterling come under pressure, Barber would not wait long before changing its value.'

The EEC's narrow margins scheme was activated on 24 April 1972. The UK was scheduled for EEC membership in January 1973 and the prime minister was eager to demonstrate the UK's commitment to its new partners, and enhance his relationship with President Pompidou, by joining the snake ahead of schedule. Treasury officials were opposed on the grounds that it would restrict the management of the reserves and interest rates, and constrain moves to reduce unemployment. But Heath's European priorities prevailed and the UK joined the snake on 1 May 1972, as soon as the necessary hotline telephone links had been installed. In the meantime, on 28 April, with considerable fanfare, the remainder of the short- and medium-term official borrowings from the IMF and the central banks - which at peak in late 1968 amounted to over $8 billion - were paid-off. For the first time since May 1964, the UK was completely unencumbered by official debts.

Nevertheless, during May an 'increasingly pessimistic atmosphere' developed in the market regarding sterling because of the threats to Britain's competitiveness posed by relatively high price and wage inflation and the continuing series of labour disputes. Moreover, the trade figures for March and April showed further deficits and there was growing concern that the healthy surplus of the previous three years was over. The pessimism first showed through in a widening of discounts on forward sterling late in May, then in early June spot sterling began to soften as well and the pound moved towards the bottom of the snake band. The first quarter balance of payments figures released on 8 June showed a sharp drop in the UK's current account surplus confirming market fears about the pound's prospects: sterling began to come on offer in the market in substantial volumes, with traders beginning to switch into marks, guilders and Swiss francs.

For the first half of 1972, sterling stayed within both its broad and narrow margins without intervention. But in mid-June a wave of speculation developed focused on the pound that, recalled Charles Coombs: 'brought the Smithsonian Agreement to the verge of collapse.' Confidence in sterling simply evaporated. The immediate trigger was the eruption of a confrontation between the government and militant dockers and the threat of a national dock strike. In the background was the UK's adoption of EEC narrow margins, seven weeks earlier. There was a widespread view, especially on the Continent, that a devaluation of the pound was necessary to restore British competitiveness; a poll published in the European business magazine *Vision* revealed that 56 per cent of leading European bankers, finance directors, economists and journalists surveyed believed that the pound would be devalued before UK entry into the EEC - but time was running out if this was to happen. Moreover, market operators had not forgotten the Chancellor's budget speech remarks about retaining unrealistic exchange rates.

On Thursday 15 June a huge selling wave of both forward and spot sterling drove the pound to the floor of the EEC band against several other snake currencies. This triggered obligatory intervention in support of the pound by the Bank of England and other EEC central banks. In fact, the other central banks found themselves having to provide much larger scale support than they had anticipated since the UK's substantial accumulated reserves were mainly in the form of dollars and thus 'useless' for intervention to keep sterling in the snake. The large-scale intervention in EEC currencies had the effect of pulling the whole EEC band down vis-à-vis the dollar, making the EEC currencies appear cheap. This 'major technical deficiency' provided market operators with a heaven-sent two-way speculative opportunity to go short of sterling and long of the EEC currencies in the expectation of profiting from both positions. 'The "snake in the tunnel" arrangement', foreign exchange expert Charles Coombs explained, 'became a shooting gallery for speculators.'

The sterling crisis moved from the financial pages to the front page on Tuesday 20 June as politicians became involved. The previous day, the Shadow Chancellor, Dennis Healey, told the Commons Standing Committee on the Finance Bill that: 'The fact that the Chancellor of the Exchequer has given warning that he will devalue rather than deflate when he thinks he's getting into trouble means that foreigners will want to pre-empt the devaluation… I do not see devaluation being delayed beyond July or August. The prospect of entry into the Common Market on January 1 is likely to force the Chancellor's hand.'

That evening the Chancellor appeared on the television current affairs programme *Panorama* and contested Healey's prediction. Barber said: 'The only case for changing the exchange rate of any currency is if in fact it is at an unrealistic rate. The pound is not. We have paid off all the debts left to us by the Labour government. Last year our reserves doubled. We are in a very good situation.' In the Commons, the Prime Minister, Edward Heath, angrily denounced Healey and accused the Labour party of doing its best to 'destroy sterling.' That brought Harold Wilson, the leader of the opposition and prime minister during the 1967 devaluation crisis, 'storming to the defence of his Shadow Cabinet colleague. He said he would take those strictures on Mr Healey from anyone except Mr Heath, who had consistently sold sterling short both at home and abroad during the time of the Labour Government.'

While the politicians catcalled, sterling was 'dumped on the exchanges.' Forward sterling was driven to deep discounts and despite massive intervention spot sterling went through its narrow margin floor to $2.5675. The authorities countered at noon on Thursday 22 June by hiking Bank rate by 1 per cent, from 5 per cent to 6 per cent, the first increase since February 1969. Unconvincingly, it was 'stoutly maintained' that the rise was not to succour the pound but for purely for domestic technical reasons. Whatever the reason, the move failed markedly to relieve pressure on the pound in the foreign exchange market.

As the speculators piled in, the cost to the central banks soared: over the six trading days 15-22 June, the cumulative cost of support to UK reserves was $2.6 billion, which should be seen in the context of total UK reserves at the start of June 1972 of $8.25 billion. On Thursday, 22 June, the cost to the reserves was $1.2 billion, the biggest-ever outflow of short-term capital in a single day for the UK. The Bank of England warned that the cost the following day might be $1.5 billion, and that the pressure was likely to continue the following week. Nonetheless, Barber was keen to go on fighting, apparently, according to a UK Treasury account, because he felt personally embarrassed to have stated in public that sterling's Smithsonian parity was 'fair and realistic' and did not want to be proved wrong so quickly. But he bowed to his advisers who told him that there was a widespread view, not only in the markets but also among the EEC partners, that sterling was overvalued, and that further depletion of UK reserves would not be in the national interest.

Having decided to let the rate go, the issue for determination at the meeting between the Chancellor and senior officials on the afternoon of Thursday 22 June was whether to float or adopt a new lower parity. The choice of floating was publicly explained as being less disruptive to the international monetary system. This was probably so, but the real reason was that the turmoil in the UK's industrial relations and the lack of an effective incomes policy made it uncertain that a new fixed rate, whatever might be chosen, could be held. On Friday 23 June, the 8 am BBC news carried the announcement of a temporary float of sterling and its withdrawal from the snake. Free to find its own level the pound promptly plummeted by 6 per cent, and by the end of the year was 10 per cent below its Smithsonian parity.

UK ministers stressed that the sterling float was a provisional measure in response to extreme speculative pressure. The move had been forced on the government by what prime minister Edward Heath described as: 'the vast masses of highly mobile funds which can be switched out of one currency into another at very short notice and in enormous volume.' The UK authorities remained opposed in principle to floating rates as a means of achieving and sustaining balance of payments equilibrium and continued to support the Bretton Woods system of fixed exchange rates. Nevertheless, there was no attempt to adopt a new par value in the nine months between the floating of the pound in June 1972 the end of Bretton Woods in March 1973.

Eighteen countries with close commercial and historical ties to the UK floated their currencies along with sterling or independently. To prevent disgruntled twice bitten holders of sterling balances from dumping their pounds, UK exchange controls were intensified by their extension to sterling area holders. This brought sterling area holders into line with non-sterling area holders, effectively abolishing the sterling area after four decades. Some questioned whether this was necessary given the resources provided for this purpose by the Sterling Agreements. However, the elimination of the distinction was required prior to UK entry into the EEC in January 1973 and the urgency of the June 1972 crisis provided a pretext for an otherwise potentially controversial step.

The government's decision to float was well received in Britain. A roundup of public reaction to the float compiled by the American Embassy in London, reported a consensus in the quality British press that 'postponing the date at the cost of the reserves or deflation was just not worth it.' *The Times* was 'fulsome' in its praise of the prompt action, *The Guardian* welcomed the correction to the 'unrealism' of the UK's Smithsonian parity and the country's adoption EEC narrow margins, and the *Daily Telegraph* concluded glumly that the successive British devaluations were 'a symptom of continuous relative economic failure over a prolonged period.' The Confederation of British Industry and the Trades Union Congress both hailed the move, though the latter expressed concern about its impact on food prices. The ordinary share index jumped 15 points, while the government securities index staged its biggest ever one-day rise.

The UK move was welcomed as a breakthrough by proponents of floating exchange rates. *The Economist* magazine congratulated the Heath government for acting: 'more promptly and decisively than nearly anyone had expected. This was in sharp contrast with the Wilson government's way of dithering during exchange rate crises, and borrowing lots of foreign money on terms that put all its internal economic policies in pawn.' It hailed the float of sterling as marking the beginning of the end of the 'Smithsonian absurdities': 'We doubted if it would last for six months. In the event, it lasted for six months and one week. It ought to be an advantage for the long-term that it was Britain that brought it down.'

'Welcome to a Floating Pound', ran the headline above Milton Friedman's *Newsweek* column. First he commended the British for being 'sensible.' As regards the impact of the floating pound on the Smithsonian agreement: 'the answer is… the sooner the Smithsonian agreement is undermined the better.' Then he asked whether the British floating rate constituted a 'danger' to the dollar?

> The international crisis has no doubt induced some holders of dollars to sell them for marks or Swiss francs or French francs or yen. That is a problem for Germany, Switzerland, France and Japan… It is no direct problem for the US, since fortunately we are not committed to pegging the price of the dollar. It could be an indirect problem if other countries react, as unfortunately some of them are reacting, by imposing additional restrictions on the international movement of money, capital and

> goods. This is in neither their interest nor ours. The best way to eliminate this indirect problem is for other countries to follow Britain and float their currencies too.

Following the floating of the pound, speculative pressures pushed in several directions: the Danish krone, the Italian lira, and the dollar were candidates for devaluation, the mark and Swiss franc for revaluation. Denmark dropped out of the narrow margins scheme, though it retained its Smithsonian parity. The Italian authorities were minded to do likewise but were persuaded not to by their EEC partners, being allowed a special dispensation to repay intervention debts in dollars thus allowing them to maintain their gold and non-dollar currency reserves. The British floating of the pound and the concern of Federal Reserve Board chairman Arthur Burns about its contagion effect on Italy were reported to President Nixon by his chief of staff, H R Haldeman on 23 June 1972. Nixon had other things on his mind that day: the bungled burglary at the Watergate building a few days previously had just blown up in his face and about ten minutes earlier he had given an instruction for the CIA to lean on the FBI to halt their investigations – the move that ultimately led to his resignation. The Oval Office tape captured both conversations, including the president's comment on the flotation of the pound: ''I don't care. Nothing we can do about it'; and the plight of the Italian currency: 'I don't give a shit about the lira.'

With the floating of sterling traders immediately began to shift funds out of dollars into the stronger Continental European currencies and the yen, fearing a general abandonment of the Smithsonian parities. In the opening hour of trading on Friday 23 June, the German and French central banks together took in over $1 billion. At that point the European and Japanese foreign exchange markets were closed by official order and they remained shut until Wednesday 28 June. The following day, Saturday 24 June, the EEC Monetary Committee and the EEC Committee of Central Bank Governors held emergency meetings in Paris, while Community officials in Brussels were reported as calling the British action: 'a grave setback to the EEC's new moves to economic and monetary union.' The devaluation of the pound pushed the pre-scheduled items off the agenda at the meeting of EEC finance ministers in Luxembourg on Monday 26 June. The outcome of the meeting, which ran till midnight, was a joint declaration of their resolution to adhere to both the broad and narrow margins arrangements.

Having decided to soldier on, it was necessary to take steps to forestall the anticipated resumption of heavy selling of the dollar when the European markets reopened by the introduction of new capital controls or other expedients. After the floating of the pound the Swiss National Bank temporarily suspended intervention in the foreign exchange market: from Friday 23 June to Monday 3 July the Swiss franc floated along with sterling and the Canadian dollar. In following days, the Swiss authorities introduced a 'barrage' of new measures to discourage the inflow of funds.

In Germany on Thursday 29 June the cabinet followed the recommendation of the president of the Bundesbank, Dr Karl Klasen, and introduced exchange controls for the first time. 'The decisions,' stated Klasen, 'reflect the iron determination of the government to maintain the present parity of the Deutsche mark in terms of the United States dollar.' However, Dr Karl Schiller, the Minister of Economics and Finance and the second most powerful figure in the government, an economic liberal, was opposed to exchange controls as a matter of principle and argued against their adoption in cabinet. Finding himself at the end of a long and acrimonious meeting in a minority of one, he resigned. 'Thus, indirectly', observed *The Times*, 'the floating of the pound sank the "defender of the mark."'

The sterling crisis of June 1972 caused surprise at the IMF, whose staff had only a few weeks before completed a 'moderately optimistic' appraisal of the UK economy. Concern at the floating one of the reserve currencies was tempered by the expectation that the float would be temporary: it was generally believed that the UK would have to return to a par value prior to joining the EEC on 1 January 1973. The Executive Board approved the UK decision to float and several executive directors even commended the authorities' prompt response to the crisis.

But the mood among the IMF staff was distinctly downbeat. 'While we spend much of our time on reform of the system, that system itself is crumbling away', wrote Jacques Polak in a memorandum of 5 July 1972 entitled 'Some Urgent Questions' addressed to the managing director: ‘Two main currencies, the Canadian dollar and the pound sterling are floating; a third one, the Swiss franc has just finished a 10-day float; and it is clear that resistance to the course of floating on the part of members in general is much reduced… The spread between the private and the official gold price is now so large as to seriously undermine the latter… The US rejection of (or at least unwillingness to accept) the principle of balance of payments discipline raises the issue as to whether there is still a working adjustment process.’ Above all what the situation required was a reengagement by the US in the direction of the international monetary system.

Despite the heightened capital controls, heavy selling of the dollar resumed when the European and Japanese foreign exchange markets reopened on Wednesday 28 June: by Friday 14 July, the flight of funds from the dollar into EEC currencies, the Swiss franc and the yen totalled over $6 billion. The dollar’s weakness was ascribed to a combination of factors: poor US trade figures; the prospect of a joint EEC float against the dollar; and the utter passivity of the US in the face of huge speculative flows, which led some observers to ask whether the US actually still supported the Smithsonian parities?

US intervention in the foreign exchange market and participation in the inter-central bank swap network had ceased on 15 August 1971, with the suspension of dollar convertibility into gold, and had not been resumed with the 18 December 1971Smithsonian Agreement. ‘Benign neglect’ was a negotiating posture on the part of rumbustious Texan, John Connally, the US Treasury Secretary, to put pressure on the surplus countries ahead of the forthcoming negotiations on fundamental reform of the international monetary system. The US stance generated complaints from the IMF and other countries: the US embassy in Bonn reported that during the summit between Pompidou and Brandt on 3-4 July 1972 the French President had protested: ‘that the Europeans were now “defending the dollar” while the US sat by and did nothing.’ There were also critics at home, most outspokenly Arthur Burns, chairman of the Federal Reserve. And then on 16 May, 1972, out of the blue, Connally resigned.

The new Treasury Secretary, George Shultz, was a professional economist – the first to occupy the post – who had been a member of the Nixon administration since the outset. As a former colleague and 'disciple' of Milton Friedman at the University of Chicago he was believed to be favour floating exchange rates, which posed a question as to his support for the Smithsonian parities. However, he was a more conciliatory figure than Connally and had a more international outlook. Sworn in on 12 June 1972, he had been in office for three days before he was caught up in the sterling crisis and its hectic aftermath.

Working with Paul Volcker, since 1969 the under secretary at the Treasury for monetary affairs and the leading figure on the international side, Shultz undertook a review of US international monetary policy at this important juncture. The outcome was the paper *Responses to Monetary Disturbances Set Off by British Float*. After revision, it went forward to President Nixon as a policy paper on 18 July 1972. The principal recommendation was the reactivation of the swap network to calm the markets and to counter 'the already widespread beliefs that "we don't care."' With presidential approval, intervention by the Federal Reserve resumed on 19 July 1972. Confirming the change in policy, Burns said: 'we are moving to play our part in restoring order in the foreign exchange markets and to do our part in upholding the Smithsonian agreement.' The US move was widely welcomed. 'What mattered, as one delighted banker put it,' reported the *New York Times*, 'was the demonstration that the United States was "back in the ball game". He added, with un-banker-like hyperbole, "back in the human race."'

The Fed's intervention was highly effective and speculative flows, which had been discouraged by the proliferation of capital controls, were quickly tamed. The release of a set of very favourable economic figures at the end of July provided a powerful boost for the dollar, and for Nixon's prospects of re-election. A jubilant Herbert Stein, chairman of the president's Council of Economic Advisers, hailed the data as: 'the best combination of economic news, to be released on one day this decade,' adding, reported *Newsweek*, in a 'wry allusion' to Nixon's predilection for hyperbole, 'I will not say in the Christian era.' This marked a turning point: over subsequent months through to the presidential election in

November the dollar stayed strong and the foreign exchange markets were stable. But then, just after the beginning of Nixon's second term, the final crisis erupted…

Conclusions

The sterling crises of 1967 and 1972 were sensational events and prominent milestones in the breakdown of Bretton Woods. The devaluations of the world's second reserve currency were major shocks, particularly to holders of sterling, and undermined confidence in the dollar and the international monetary system. Both sterling crises were followed by instability in other currencies that were attributable secondary effects.

However, eventually speculative pressure subsided and each episode was followed by a period of calm in the international monetary system: post November 1967, from October 1969 to May 1971; and post June 1972, from August 1972 to February 1973. But the relative tranquillity of these interludes masked deterioration in the US balance of payments. Revelation of the true picture was followed by the breakdowns of the system in August 1971 and February/March 1973. But neither stoppage was attributable directly to sterling.

Suppose, counterfactually, that sterling had not been plagued by balance of payments problems and that there had not been sterling crises in 1967 and 1972. Would it have made a difference to the survival or longevity of the Bretton Woods system? Probably not, because the fundamental factors that undermined Bretton Woods were the problems of the dollar and the rapid expansion of short-term capital mobility. Because of the latter, the successful sterling arrangements of 1966 and 1968 made only a marginal difference.

A stronger pound might possibly have made a difference to the outcome of the UK's second application to join the EEC in 1967, though General de Gaulle would probably have found another reason to exercise the veto. But suppose the application had been successful. Would UK membership in, say, 1969, have promoted or hindered progress towards EEC monetary union? A case could be made for either answer.

The third and successful round negotiations for EEC membership in 1970 and 1971 took place against the most favourable sterling backdrop for a generation. In 1970 the UK achieved an overall payments surplus of $3.1 billion, which mushroomed in 1971 to $6.5 billion – the largest of any country save Japan. Between March 1969 and December 1971, the official net reserves of the UK swung from a deficit of SDR 5 billion to a surplus of SDR 5 billion. Although the role of sterling was an issue in the negotiations, the ostensibly healthy condition of the pound helped to ensure that monetary matters were not allowed to hold up enlargement. In reality, however, 1970 and 1971 were utterly exceptional years in the story of sterling from the 1950s until the end of the 1970s when it was transformed into a petro-currency.

The sterling crisis of June 1972 erupted just seven weeks after the launch of the EEC narrow margins scheme, the first step towards monetary union by 1980. The crisis drove two currencies, the pound and the Danish krone, out of the snake and special arrangements had to be made for the lira. It led to a cabinet crisis in Germany and every EEC country had to adopt more stringent capital controls, which was the opposite of the direction in which they were trying to travel. Without the strengthening of capital controls, and a timely reversal of policy by the US, it is likely that the strains that followed the sterling crisis would have brought down the narrow margins scheme. However, failure to adhere to the Werner Report timetable for monetary union was due to factors such as the collapse of Bretton Woods, the oil price shock and the onset of global stagflation – it could not be blamed on the pound.

Each of the crises that beset the international monetary system in the late 1960s and early 1970s undermined confidence in the international monetary system. The sterling crises of 1967 and 1972 assuredly contributed to that process and the tribulations of the junior reserve currency certainly complicated the management of the Bretton Woods system. However, the links between these sensational episodes and both the breakdowns of the fixed exchange rate system in August 1971 and February/March 1973 and the postponement of the achievement of monetary union by the EEC for two decades were indirect and not decisive. The Bretton Woods system had more fundamental problems than the pound.