Monetary cooperation and exchange rate management in the 1950s: Britain, Germany and France in the return to currency convertibility

Sylvia Maria Schwaag
Economic History

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London School of Economics and Political Science
University of London

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ABSTRACT

The architects of the post-World War II international economic order considered the free convertibility of currencies for current account purposes one of the fundamental prerequisites of multilateral trade and thus of economic growth. While the Bretton Woods system started operating in 1946, the Western European countries only formally established currency convertibility in December 1958.

So far, analytical studies of the return to convertibility are scarce. The few studies that exist generally treat convertibility as a technical, monetary issue, even a simple formality. The prevailing view is that, because of its trade-facilitating characteristic, convertibility was a widely accepted and uncontroversial economic policy objective shared by the Western European countries. This assumption follows from the belief that the Bretton Woods period was characterized by an international consensus on the benefits and desirability of international trade and long-term economic growth. The collective move to convertibility is regarded as proof of this consensus and of the willingness to cooperate to achieve common goals. Therefore, most accounts consist of historical narratives of Western Europe's path to convertibility rather than analyses of the development within the context of national policy aims.

The comparison of Britain, France and the Federal Republic of Germany shows that convertibility was a far more complex, even controversial issue than has so far been argued in the literature. This thesis analyzes the national policy on convertibility in each country, respectively, by comparing the importance of convertibility for trade, macroeconomic policy, foreign policy and economic adjustment. Economic and political considerations played a crucial role in each country's policy on convertibility.

The comparative analysis of the three leading countries' national economic policy on convertibility reveals a fundamental divergence in general long-term policy orientations in the three countries, challenging the widely accepted idea of a post-war consensus among Western European countries on the long-term policy objectives. The collective return to convertibility represented a very versatile tool, which the key countries employed to fulfill different, often incompatible, objectives. The national economic and political circumstances, which determined French, British and German policy on convertibility explain why the return to convertibility occurred in December 1958 and why the key countries coordinated their efforts. In particular, the establishment of convertibility was intricately linked to national policies on European integration. As a vehicle for national economic policy the return to convertibility provides important new insights into the formation of national exchange rate policy and international monetary cooperation in the 1950s.

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LIST OF ABBREVIATIONS

BdL	Bank deutscher Länder
BIS	Bank for International Settlements
BoE	Bank of England
ECSC	European Coal and Steel Community
EEA	Exchange Equalization Account
EEC	European Economic Community
EFTA	European Free Trade Association
EMA	European Monetary Agreement
EPU	European Payments Union
GATT	General Agreement on Trade and Tariffs
GDP	Gross Domestic Product
GNP	Gross National Product
HMSO	Her Majesty's Stationery Office
IMF	International Monetary Fund
OEEC	Organization for European Economic Cooperation
OECD	Organization for European Cooperation and Development

Key to Archival References

AEF	Archives Économiques et Financières, Paris
BA	Bundesarchiv, Koblenz
BBA	Historisches Archiv der Deutschen Bundesbank, Frankfurt am Main
BoE	Archives of the Bank of England, London
MAE	Ministère des Affaires Etrangères, Paris
PRO	Public Record Office, Kew

INTRODUCTION

On December 29, 1958, fourteen Western European countries - Austria, Belgium, Denmark, Finland, France, the Federal Republic of Germany, Ireland, Italy, Luxembourg, the Netherlands, Norway, Sweden, Portugal and the United Kingdom - made their currencies convertible for nonresidents for current account transactions.[1] The move meant that these countries,

> freely permitted nonresident current earnings of their currencies in general to be exchanged into any foreign (nonresident) currency at rates within the official margins, whereas formerly there had been limitations on such transactions.[2]

In addition, fifteen other members of the International Monetary Fund (IMF), most of whom were members of a monetary area with one of the European countries, undertook to adjust their exchange control regulations in concordance with establishing nonresident current account convertibility.[3]

Currency convertibility was one of the pillars upon which the system of free and multilateral trade and payments envisaged by John Maynard Keynes and Harry White at Bretton Woods in 1944 was to be built.[4] It constituted a vital prerequisite for the unhindered flow and the flourishing of multilateral trade. Yet until 1958, the European currencies were not officially convertible.[5] The European Payments Union (EPU) had made European currencies transferable for trade purposes within the OEEC. However,

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[1] Greece followed the move five months later.

[2] IMF, *Tenth Annual Report on Exchange Restrictions*, 1959, p.4.

[3] J. K. Horsefield, *The International Monetary Fund 1945-1965, Twenty Years of Cooperation, Volume I: Chronicle*, IMF, 1969, p.466.

[4] For an in-depth account and analysis of the Bretton Woods negotiations, see R. Gardner *Sterling-Dollar Diplomacy: Anglo-American Collaboration in the Reconstruction of Multilateral Trade*, Clarendon Press, 1956; for a brief summary of the Keynes and White plan see M. D. Bordo, "The Bretton Woods International Monetary System: A Historical Overview", in M. D. Bordo and B. Eichengreen (eds.), *A Retrospective on the Bretton Woods System: Lessons for International Monetary Reform*, University of Chicago Press, 1993, pp.30-37.

[5] For the remainder of this thesis 'Europe' will refer to Western Europe unless stated otherwise.

until 1958, non-residents of the dollar area could not officially convert European currencies into the dollar and vice versa, thus presenting an obstacle to the growth of trade between Europe and countries outside the EPU. In this sense, the Bretton Woods system only began in 1958, when the establishment of official convertibility for European currencies for current account purposes, which was followed by many other countries in the world, finally completed the formal foundation upon which the liberal trade order was to be erected. Convertibility of Western European currencies had been a declared goal of European and US administrations since the Bretton Woods conference in 1944. The time necessary for the transition to currency convertibility was intended to be a brief interim phase.[6] This transitional period was certainly not expected to last as long as it did, namely 13 years.[7] Even when countries established non-resident current account convertibility in December 1958 they refused to renounce the privileges of Article XIV and accept the obligations of Article VIII, which was one of the requirements of the IMF for convertibility.[8] The latter step took place in February 1961 and is referred to as the establishment of IMF convertibility whereas henceforth the terms official or formal convertibility will be used to refer to the move that took place in December 1958.

If convertibility was vital for the functioning of the Bretton Woods system,[9] or,

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[6] The United Kingdom made an unsuccessful attempt at convertibility in 1947; it declared its currency convertible into dollars, which led to a run on sterling that within six weeks had drained the United Kingdom's foreign reserves to the extent that it could no maintain the par value of currency and was forced to suspend convertibility.

[7] According to Michael Bordo, the transitional pre-convertibility phase was only supposed to last three years after the establishment of the International Monetary Fund. M. D. Bordo, *The Gold Standard, Bretton Woods and other Monetary Regimes: An Historical Appraisal*, Working Paper No.4310, National Bureau of Economic Research, April 1993, p.26. See also M. Obstfeld, "The Adjustment Mechanism", in Bordo and Eichengreen (eds.), *A Retrospective*, p.204.

[8] Among other things, under Article VIII countries renounced the use of restrictions on payments and transfers for current account transactions.

[9] according to Howson, convertibility "ushered in the operation of the Bretton Woods system", S. Howson, "Money and monetary policy in Britain 1945-1990", in R. Floud and D. McCloskey (eds.), *The*

in other words, if inconvertibility presented "one of the main barriers to the full introduction of the peacetime international monetary order set out in the Bretton Woods Agreements"[10], then why did the European signatories of the Bretton Woods Agreements wait one and a half decades to make Bretton Woods formally operable? This thesis examines the return to currency convertibility in 1958 with the aim of understanding why it took Europe longer than expected to return to currency convertibility, why the key actors in the move chose December 1958, and why - or whether - the European countries cooperated in the move to convertibility. Considering the delay in the return to convertibility, and the importance of convertibility for multilateral trade and thus for the Bretton Woods system, the choice of the timing of the move requires particular attention. What made December 1958 the 'right' moment to move to convertibility after so many years of waiting? Finally, the return to convertibility was a joint move undertaken simultaneously by nearly all Western European countries. Such a large scale collective move necessarily raises questions about how and why countries cooperated to make the joint move possible. The thesis examines what circumstances and national policy considerations coincided to make it possible for Western Europe to agree on one date for a joint move.

While the literature abounds with accounts of the creation of the Bretton Woods system, with comparative assessments of its performance and with explanations of why the Bretton Woods system collapsed when it did, very few authors have examined the national economic policy considerations and the international negotiations that led to

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Economic History of Britain since 1700, second edition, Volume 3: 1939-1992, Cambridge University Press, 1994, p.221.

[10] J. Fforde, *The Bank of England and Public Policy - 1941-1958*, Cambridge University Press, 1992, p.31.

the joint establishment of currency convertibility, which was one the building blocks of the Bretton Woods system.[11]

Observers have expressed widely diverging opinions on the relevance of the move for the international economic system. The German central bank (Bundesbank) hailed the events of December 1958 as a "milestone in postwar monetary history"[12], and Per Jacobsson, the Managing Director of the IMF at the time, called it "the most spectacular move that has occurred in the monetary sphere since the end of the war"[13]. More recently, Paul de Grauwe stated that,

> It is no exaggeration to state that this step, together with the institution of the European Economic Community in the same year, contributed towards the explosion of growth in trade in Europe, and to the historically unique growth of the European economies....Together with the steps taken in Europe at about the same time towards liberalizing trade flows, the system of convertible currencies facilitated international trade and can be said to be responsible for the surge in trade, output, and investment experienced by the industrialized countries during the decade.[14]

Christoph Buchheim called the move a watershed ("Epochenwende") for international payments in Western Europe, while stating at the same time that the event played no significant role for German payments.[15] The British Treasury, on the other hand,

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[11] For an account of the Bretton Woods negotiations see Gardner, *Sterling Dollar Diplomacy*; for a discussion of the Bretton Woods system in the context of international economic relations since World War II see W. M. Scammell *The International Economy since 1945*, second edition, Macmillan, 1983, and B. Tew, *The Evolution of the International Monetary System 1945-88*, fourth edition, Hutchinson, 1988; for an extensive account and assessment of the Bretton Woods era see Bordo and Eichengreen (eds.), *A Retrospective*. For an a analysis of the determinants of international monetary cooperation and and assessment of the Bretton Woods system in comparison with other historical periods, see M. Panic, *National Management of the International Economy*, Macmillan, 1988, M. Panic, "The Bretton Woods System: Concept and Practice, in J. Michie and J. Grieve Smith (eds.), *Managing the Global Economy*, Oxford University Press, 1995, pp.37-54, and M. Panic, "International Economic Integration and the Changing Role of National Governments", in H. J. Chang and R. E. Rowthorn (eds.), *The Role of the State in Economic Change*, Clarendon Press, 1995, pp.51-78.

[12] *Geschäftsbericht der Deutschen Bundesbank 1958*, p.45.

[13] P. Jacobsson, "Toward More Stable Money", in *Foreign Affairs*, Vol.37, April 1959, p.378.

[14] P. de Grauwe, *International Money - Post-war Trends and Theories*, Oxford University Press, 1989, pp.20-1.

[15] C. Buchheim, *Die Wiedereingliederung Westdeutschlands in die Weltwirtschaft 1945-1958*, Oldenbourg Verlag, 1990, p.170.

presented the move to the public as the mere technicality of unifying the transferable and the official rate for sterling.[16] Consequently, J.C.R. Dow claimed five years after the event that "[i]t [convertibility] was certainly a more significant step than the Chancellor made out".[17] In its Economic Review from January 1959, the National Institute of Economic and Social Research stated that the move "will not have much effect on the current balance of payments".[18] Similarly, economics textbooks make only brief or no mention of the collective move to nonresident current account convertibility in 1958, and, by implication, attribute little importance to its effect on the international monetary system.[19] Books on the history of international monetary relations only briefly discuss the event or explain the technical changes it involved for the currencies in question.[20]

In spite of the widely diverging views on the importance of the event, very few attempts have been made so far to analyze, firstly, why European countries chose December 1958 to establish convertibility and, secondly, why they chose to move jointly to convertibility. Since the opening of the archival documents in January 1989, some accounts of the event have been published which make use of this evidence. Most of these accounts, however, limit themselves to narrating the story of the negotiations

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[16] J. J. Kaplan & G. Schleiminger, *The European Payments Union - Financial Diplomacy in the 1950s*, Clarendon Press, 1989, p.320.

[17] J. C. R. Dow, *The Management of the British Economy, 1945-60*, Cambridge University Press, 1964, p.107.

[18] National Institute of Economic and Social Research, *National Institute Economic Review*, Number 1, January 1959, p.30.

[19] The widely used economics textbook by Begg, Fischer and Dornbusch, for example, contains a section on the international monetary system in which the Bretton Woods system is discussed, but which makes no mention of the return to convertibility. D. Begg, S. Fischer and R. Dornbusch, *Economics*, third edition, McGraw-Hill, 1991, pp.602-618.

[20] see, for example, Scammell, *The International Economy*, pp.94-124, Horsefield, *The International Monetary Fund*, pp.466-470, Tew, *The Evolution*, pp.47-51. R. Hinshaw provided a good account of the path towards convertibility, albeit only up until mid-1958; due to the time of his writing, however, he lacked access to archival documents. R. Hinshaw, *Toward European Convertibility*, Essays in International Finance, No.31, November 1958. In 1961, W. M. Scammell analyzed the importance of the return to convertibility in 1958 and suggested possible consequences of the move for international monetary stability. W. M. Scammell, *International Monetary Policy*, second edition, Macmillan, 1961, pp.397-406.

leading to the return to convertibility without providing a critical analysis of why countries behaved the way they did, or attempting to draw conclusions about the importance of the event for international monetary relations, for European integration and for the stability of the Bretton Woods system. In their detailed history of the EPU, Jacob J. Kaplan and Günther Schleiminger, both former members of the EPU Managing Board, give a detailed account of the events leading up to the return to convertibility. In their eagerness to convince the reader of the determining role of the EPU in monetary relations in the 1950s, however, their analysis of the key countries' economic policy considerations, and their reasons for cooperating in the move remain superficial.[21] The over 600-page long assessment of the Bretton Woods system edited by Michael Bordo and Barry Eichengreen contains no analysis of the achievement of convertibility. This is surprising, especially when considering that Michael Bordo attributed considerable importance to the event stating that

> most analysts would agree that, until the Western European industrial countries made their currencies convertible on 27 December 1958, the system did not operate as intended. On this calculation, the regime lasted only twelve years.[22]

In spite of thus classifying the move as a watershed, none of the authors in the book examine how the event came about and why it happened in 1958. Both questions are, however, crucial to understanding the rise and fall of the Bretton Woods system and allowing one to learn "lessons for international monetary reform".[23]

The three key countries in the return to convertibility were the United Kingdom, the Federal Republic of Germany and France. The United Kingdom was the first country after World War II in Western Europe to put convertibility on the political

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[21] Kaplan and Schleiminger, *The European Payments Union.*
[22] Bordo, "The Bretton Woods International Monetary System", p.4.
[23] subtitle of Bordo and Eichengreen (eds.), *A Retrospective.*

agenda. It could be argued that initially convertibility was forced upon Britain by the United States, leading to the failed attempt at currency convertibility in 1947. The traumatic experience with convertibility, unique to Britain, makes it all the more remarkable that by 1952, convertibility was back on the economic and political agenda. Britain undeniably presented one of the driving forces in the European move to convertibility, even though it will be argued later that, contrary to British assertions at the time, the British did not lead Europe into convertibility in December 1958.

The Federal Republic of Germany emerged out of a severe balance of payments crisis in 1950/1 to assume rapidly the role of the strongest economy and currency in Europe. Germany's unofficial but large strides towards convertibility equaled, if not exceeded, British progress towards convertibility, putting great pressure on the latter to keep up the pace. The economic and political goals that stimulated Germany's desire for a rapid return to convertibility differed significantly from those of the British government and monetary authorities. For reasons explained later, Germany therefore never even considered leading Europe into convertibility, even though its favorable economic conditions would have easily allowed it do so.

Unlike Germany and Britain, who communicated frequently on the issue of convertibility, France hardly participated in any convertibility negotiations throughout the 1950s. France's position was, however, always present in the minds of both German and British policymakers when considering convertibility. Part of France's importance must be attributed to the fact that, because of its reticence, it constituted the big uncertainty factor in the preparations for European convertibility. Nobody knew for sure, when it would act and whether it would act in cooperation with the rest of Europe or unilaterally. In the course of 1958, France emerged from the shadow of Britain and

Germany and overtook them both, providing the final decisive impetus that propelled Europe into official currency convertibility. All three countries were key actors in the European return to currency convertibility.

Several of the publications which draw on archival evidence tell the convertibility story only from the perspective of Britain or Germany, respectively.[24] Moreover, most authors conteneted themselves with briefly referring or simply narrating the event. Some authors have provided thorough analyses of one of the countries in question[25] The French position on, and involvement in, the return to convertibility has hardly been examined at all, largely because of the difficulty of access to French archival sources.[26] Any attempt to understand and evaluate the events of 1958 must,

[24] For Britain, see Fforde, *The Bank of England*, and C. Schenk, *Britain and the Sterling Area: From Devaluation to Convertibility in the 1950s*, Routledge, 1994. J.C.R. Dow should be mentioned in this category even though he wrote as early as 1964. He provided an excellent analysis of British economic policy in the 1950s, including a very insightful discussion of Britain's policy on convertibility; Dow, *The Management*, pp.77-110. For Germany, see Buchheim, *Die Wiedereingliederung*, M. Dickhaus, *Zwischen Europa und der Welt: die internationale Währungspolitik der deutschen Zentralbank 1948-1958*, Ph.D. Dissertation, European University Institute, Florence, 1995, and H. Giersch, K.-H. Paqué and H. Schmieding, *The Fading Miracle: Four Decades of Market Economy in Germany*, Cambridge University Press, 1992, pp.88-123.

[25] Catherine Schenk provides an excellent analysis of some important aspects of the convertibility issue for Britain. Her discussion on British policy on convertibility is generally very useful since she examined in depth the determinants of the formation of British external monetary policy in particular with regard to the sterling area. Schenk, *Britain and the Sterling Area.* John Fforde's book also offers valuable insights into British policymaking in the 1950s, including on the convertibility issue; however, he concentrated mainly on the actions and attitudes of the Bank of England in the return to convertibility. Fforde, *The Bank of England.* Giersch, Paqué and Schmieding presented an interesting and insightful analysis of the German economic policy in the 1950s, including monetary objectives and policies; however, they fail to apply their analysis to understanding the return to convertibility, merely stating that "[u]nfortunately, the short way to currency convertibility, i.e. the option of genuinely flexible or at least readily adjustable exchange rats, was hardly considered at all by policy-makers in the late 1940s and early 1950s". Giersch, Paqué and Schmieding, *The Fading Miracle*, p.114. Christoph Buchheim's book provides a good analysis of Germany's economic reconstruction and its external economic relations after World War II, but stops short of the return to convertibility, offering only a very brief and superficial account of the event. Monika Dickhaus, whose work focused on the history of the German central bank's external monetary policy between 1948 and 1958, confined her discussion of the convertibility debate mainly to relating the discussions within the German central bank and between the central bank and the Economics Ministry. Thus her book lacks a clear conclusion on the central bank's, or Germany's, policy on convertibility and there is no close examination of the motivations determining the policies pursued. C. Buchheim, *Die Wiedereingliederung*, and Dickhaus, *Zwischen Europa und der Welt.*

[26] F. M. B. Lynch. "Restoring France: The Road to Integration", in A. S. Milward, F. M. B. Lynch, F. Romero, R. Ranieri and V. Sørensen, *The Frontier of National Sovereignty: History and Theory, 1945-1992*, Routledge, 1993, and F. M. B. Lynch "Le franc français 1952-1956: Le débat sur la convertibilité", in Comité pour l'histoire économique et financière de la France (ed.), *Du franc Poincaré à l'écu*,

however, look at the three countries who were decisive in the move to convertibility, namely, Britain, France and Germany together. While many authors have examined the UK's external monetary policy and the problem of sterling[27], few have analyzed sterling's return to currency convertibility in the European context. The literature on Britain tends to underestimate the extent to which the return to convertibility was determined by France and Germany. Thus, most authors treat the establishment of convertibility either as the natural outcome of Britain's policy aims in the 1950s, or as an exogenous event, comparable to a freak occurrence, the advent of which cannot and need not be explained since it simply happened.[28] In addition, the literature has not so far attempted to place the return to convertibility in the context of European integration. The chronological concurrence of the return to convertibility, the coming into force of the tariff and quota provisions of the Rome Treaty and the failure of the free trade area negotiations is not coincidental. The beginning of the customs union of the European Economic Community (EEC) affected France's, Britain's and Germany's policy on, and timing of, the move to convertibility, and their decision to cooperate. So far, no examination of the link between European integration and the move to convertibility has

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Colloque tenu à Bercy les 3 et 4 décembre 1992. Presses de l'imprimerie nationale, 1993, pp.385-395.

[27] See, for example, A. Cairncross and B. Eichengreen, *Sterling in Decline: The Devaluations of 1931, 1949 and 1967*, Basic Blackwell Publishers Ltd., 1983, A.C.L. Day, *The Future of Sterling*, second edition, Clarendon Press, 1956, Fforde, *The Bank of England*, R. Hawtrey, *The Pound at Home and Abroad*, Longmans, 1961, F. Hirsch, *The Pound Sterling: A Polemic*, Victor Gollancz Ltd., 1965, P. B. Kenen, *British Monetary Policy and the Balance of Payments 1951-1957*, Harvard University Press, 1960, J. Polk, *Sterling: Its Meaning in World Finance*, Harper and Brothers, 1956, S. Strange, *Sterling and British Policy: A Political Study of an International Currency in Decline*, Oxford University Press, 1971.

[28] Strange, *Sterling*. Sidney Pollard merely stated that "[s]terling was made fully convertible at what looked to be an auspicious time". S. Pollard, *The Development of the British Economy 1914 - 1990*, fourth edition, Edward Arnold, 1992, pp.319 & 357.

The lack of interest in the move to convertibility in 1958 is all the more striking in the British case when considering researchers' interest in the failed attempt at sterling convertibility in 1947. See, for example, L. S. Pressnell, *External Economic Policy since the War, Vol. I: The Post-War Financial Settlement*, HMSO, 1986 and comment in G. J. Ikenberry, "The Political Origins of Bretton Woods", in Bordo and Eichengreen (eds.), *A Retrospective*, pp.191-4.

been undertaken.

Alan Milward analyzed the path towards convertibility in the 1950s by examining the interaction betwee France, Britain and Germany on this issue.[29] However, due to the archival constraint at the time he conducted his research, Milward only analyzed the path to convertibility up until 1955. Moreover, he put strong emphasis on trade objectives as the force which affected the three countries' respective stance on convertibility. Aside from trade considerations, however, exchange rate management, and foreign policy considerations also constituted key parts in the convertibility puzzle. None of the authors mentioned so far has examined the connection between national policies on convertibility on the one hand, and exchange rate stability and national policy autonomy on the other.

Most authors have argued, then as well as today, that while economic policymakers in Europe considered the rapid return to convertibility desirable and necessary per se, economic conditions, such as a shortage of gold and foreign exchange reserves, prevented them from acting as quickly as they would have liked.[30] Kaplan and Schleiminger claimed that "Europeans' interest in convertibility was genuine", and that

[29] A. S. Milward, "Motives for Currency Convertibility: The Pound and the Deutschmark, 1950-5", in C.-L. Holtfrerich (ed.), *Interactions in the World Economy: Perspectives from International Economic History*, Harvester Wheatsheaf, 1989, pp.260-284, A. S. Milward, *The European Rescue of the Nation-State*, Routledge, 1992, pp. 201, 345-395, and A. S. Milward, "La Livre Sterling, le Franc et le Deutsche Mark 1950 - 1955", in Comité pour l'histoire économique et financière de la France (ed.), *Du Franc Poincaré*, pp.405-418,

[30] The general argument is that the poor reserve levels of European central banks after World War II - caused by a dollar shortage and, in the British case, large outstanding sterling liabilities - impeded a speedy return to convertibility. Foreman-Peck argued that in light of the dollar shortage the UK had no alternative but to rely on quantitative restrictions throughout the 1950s, since the British economy needed the time and protection to recover from war and adjust to the changed postwar conditions. See A. Cairncross and N. Watts, *The Economic Section, 1939-1961, a Study in Economic Advising*, Routledge, 1989, p.350 and J. Foreman-Peck, "Trade and the Balance of Payments" in N.F.R. Crafts and N.W.C. Woodward (eds.), *The British Economy since 1945*, Clarendon Press, 1991, p.159.

reservations and differences among Europeans "did not involve whether they wanted convertibility, but only how and when to achieve it".[31] Similarly, contemporary observers of British economic policy in the 1950s identified a widespread acceptance of the objective of convertibility:

> With the exception of the autarkists and imperialists of the extreme left and extreme right, the principle that we should move towards convertibility is remarkably generally accepted.[32]

This thesis rejects the seemingly well-established view that convertibility was a widely-accepted policy aim the achievement of which was only postponed by exogenous economic or monetary constraints. It shows instead that policymakers in the key countries, in particular the UK, seriously questioned the desirability of convertibility throughout the 1950s. Among other things, policymakers questioned the desirability of multilateral and non-discriminatory trade which was the principal argument for convertibility in the Bretton Woods creed. Thus, as will be shown, multilateral trade was not the general motivation for establishing convertibility that it has been portrayed to be. Moreover, there was a fundamental conflict between domestic policy aims and the maintenance or establishment of the economic conditions necessary for the stability of a system of free of trade and payments at fixed, though adjustable, exchange rates.

Just as the desirability of convertibility was not generally accepted, so it was by no means a foregone conclusion that the move to convertibility would be undertaken jointly by all of Western Europe. In the announcements to press and parliament, the UK government took deliberate care to emphasize both British leadership but also the

[31] Kaplan and Schleiminger, *The European Payments Union*, p.160.
[32] Day, *The Future*, pp.119-120.

cooperative nature of the move. Upon the British Prime Minister's intervention, the original press announcement was changed to state that the establishment of sterling convertibility was "part of a co-ordinated European move", the date of which had been "chosen after consultation in the first instance between H.M.G. and the French and German Governments".[33] On the surface, the collective return to currency convertibility in December 1958 might be considered a showpiece of international cooperation. A closer inspection of the move reveals, however, that up until 1958 it was by no means certain that Western Europe would move to convertibility collectively. Particularly the UK showed little interest, throughout most of the 1950s, in cooperating with the rest of Europe to ensure a joint move to convertibility. Moreover, the collaboration on the move to convertibility did not promote the longer-term stability of the international monetary system. This thesis argues that the collective return to currency convertibility in Western Europe is not an example of countries' willingness to cooperate and to renounce part of their autonomy over their domestic policymaking for the benefit of the collective interest and the stability of the international monetary order.

The key countries in the move to convertibility, France, Britain and Germany pursued very different, even conflicting, political and economic objectives with the return to convertibility. The contrasts in the agendas that determined national policy on convertibility reveal the incompatibility of the membership of these three countries in a joint fixed exchange rate regime. For national policymakers, the weakness of sterling and the French franc, on the one hand, and the strength of the DM, on the other hand, played an important role in the choice of the timing of convertibility. This thesis

[33] PRO PREM11-2671, draft press announcement, December 27, 1958.

analyzes the national policies on convertibility of Britain, France and Germany by linking them to the economic dilemma between national policy autonomy and fixed exchange rates. It assesses the importance of the move by establishing important links between the return to convertibility in December 1958 and exchange rate management for each of the three countries and for the Bretton Woods regime. National policy on convertibility both affected and was influenced by exchange rate credibility and expectations. By affecting expectations convertibility also had an impact on the stability of the Bretton Woods regime which is examined in the last two chapters of this thesis.

In addition to exchange rate considerations, national policies on European integration played a determining role in the return to currency convertibility. Particularly in Britain, policy towards Europe was still evolving in the 1950s, and, in the second half of the decade a significant shift in policy took place. This policy shift played a decisive role in British decisionmaking on convertibility in 1958, leading to a rather dramatic change of course. In the case of Germany, cooperation with Britain on convertibility was an important component of the Economics Ministry's European policy. The importance of national policy towards Europe for the timing and the collective nature of the return to convertibility, a connection that has so far been neglected in the literature, will be discussed in this thesis.

The implications of the return to currency convertibility in December 1958 for exchange rate stability and for system stability have not yet been analyzed. As long as convertibility was not achieved, the Bretton Woods system could not function as intended.[34] The reluctance with which European countries approached convertibility reflects a more general rejection of the principles upon which the Bretton Woods system was built. It is shown that economic policymakers in key European countries questioned the desirability of an international system of multilateral trade and payments with convertible currencies at fixed exchange rates. Dislike of fixed exchange rates, the reluctance to work towards establishing the economic conditions necessary for the speedy return to convertibility, the delay in accepting the irreversibility of the removal of exchange control set out in Article VIII of the IMF articles of agreement, and the readiness to resort to quantitative restrictions, all reveal a hesitancy to implement, or maintain, the tenets agreed upon by the individual countries by becoming a member of the International Monetary Fund (IMF).[35] The examination of national policy formation on convertibility provides valuable insights into countries' behavior in, and commitment to, an international monetary system. The policies of France, Britain and Germany are particularly interesting since all three countries were large enough for their economic and monetary policies to affect both international trade and the stability of the international monetary system.[36]

This thesis shows that the establishment of non-resident current account convertibility by the Western European currencies on December 28, 1958, in itself a

[34] Bordo, "The Bretton Woods International Monetary System" , p.4.
[35] The IMF was established on December 27, 1945 when thirty countries attended a signing ceremony in Washington. Scammell, *The International Economy*, p.18. According to Bordo, the Bretton Woods system began on December 18, 1946, when 32 countries established par values for their currencies. Bordo, "The Bretton Woods International Monetary System", p.4.
[36] For an analysis of the effect of national policies of principal members of an international monetary regime on the regime see D. Calleo and S. Strange, "Money and World Politics", in S. Strange, (ed.), *Paths to International Political Economy*, Allen and Unwin, Inc., 1984, p.99. and P. Guerrieri and P. C. Padoan, "Integration, Co-operation and Adjustments Policies", in P. Guerrieri and P. C. Padoan, (eds.), *The Political Economy of European Integration*, Harvester Wheatsheaf, 1989, p.1-30.

very technical step, was used by each of the three key country actors in the move - Britain, France and the Federal Republic of Germany - as a policy instrument to serve very different important political and economic goals. The three countries associated very different benefits with the establishment of convertibility in general, with cooperation in the move and with the timing of the move. The thesis analyzes the national policy considerations that enabled a joint return to convertibility in December 1958.

The interaction between France, Britain and Germany in the progress towards convertibility, provides particularly interesting insights into the national policy goals which determined international cooperation in the 1950s. The analysis of past monetary policy with the help of access to archival documents is invaluable for the understanding of the formation of monetary policy and international monetary cooperation in the present. The breakdown of the Exchange Rate Mechanism (ERM) and the recurrent currency crises in the 1990s illustrate the topical need to comprehend the conflict between the autonomy of national economic policies and currency stability in a fixed exchange rate regime. Increased international capital mobility might have magnified the friction between national monetary policy choices and international financial markets today compared to the 1950s, in the sense that nearly perfect market information enables an almost instantaneous response to changes in economic policies or conditions, but the problem is a familiar one. As the British example shows, foreign exchange market responses to economic news in the 1950s were already significant enough to trigger serious, and sometimes devastating, currency crises, which in turn put pressure on national policymakers to act in order to stop speculation. Thus, policymakers in the 1950s faced the same basic conflict between pursuing an independent monetary policy and maintaining a stable exchange rate as they do today. One of the aims of this thesis is to shed new light on the always topical discussion over the choice of exchange rate regime, by looking at the choices faced and made by policymakers in the past.

Since one of the aims of this thesis is to understand the process of national policy formulation and the dynamics of international monetary cooperation by looking at the return to convertibility, this thesis relies heavily on primary sources from the archives of the Bank of England, the Public Record Office, the German federal archives in Koblenz and the archives of the Ministry of Economics and Finance and of the Ministry of Foreign Affairs in France.

The first chapter defines the term convertibility and examines previously rendered explanations of national policy on convertibility. The chapter discusses the shortcomings of the hypotheses presented in the existing literature most of which concerns itself solely with monetary and economic conditions as determinants of national policy on convertibility. It also examines critically previous analyses of exchange rate instability, in particular of the weakness of the pound, in the 1950s. Finally, the first chapter also provides a background overview over the development of currency convertibility in the three countries. The second, third and fourth chapters analyze in detail the economic and political considerations that determined the national policies on convertibility of the UK, Germany, and France, respectively. The country chapters reveal the importance of political factors in the three countries' national policy on convertibility. The different objectives and motivations for pursuing the return to convertibility according to country are analyzed to show that convertibility was used as a policy instrument for a wide range of problems. The fifth chapter examines the cooperative element of the return to convertibility in December 1958. The negotiations leading up to the move to convertibility between the three countries and the circumstances surrounding the final move to convertibility are discussed. While the UK chapter explained the motivations for pursuing convertibility, this chapter analyzes the considerations behind its decision to move collectively. The link between British policy on Europe and the cooperation in a joint move is established. Chapter five also assesses the implications for monetary stability of the decision to cooperate in convertibility. The conclusion looks among other things at the general inferences that might be drawn from the analysis of national policy on convertibility and draws parallels to topical economic and monetary problems in Europe.

I: BACKGROUND AND PRECONDITIONS

INTRODUCTION

This chapter places the topic in a theoretical and historical context. It looks at the creation of the European Payments Union (EPU) and at previous attempts to explain the return to convertibility. The chapter closes with a brief account of the path towards convertibility in France, Britain and Germany, respectively.

According to a widely used economics textbook, " [a] currency is *convertible* [sic] if the government acting through the central bank, agrees to buy or sell as much of the currency as people wish to trade at the fixed exchange rate".[1] The two principal components of this definition are the guarantee of exchangeability and the guarantee of exchange value of a currency.[2] Brian Tew divided these two characteristics into "market" and "official" convertibility, with the former denoting a condition in which individuals have access to any foreign exchange market without being seriously impeded by exchange controls, while the latter implies that the government or the central bank stand ready to supply the market with domestic currency, primarily in exchange for dollars, and with dollars - in exchange for its domestic currency - to maintain the fixed parity (within a one per cent margin).

Raymond Mikesell organized different notions of the concept into degrees of

[1] Begg, Fischer and Dornbusch, *Economics*, p.526.
[2] From December 1958 to August 1971, so Tew, these two forms of convertibility coexisted with yet another kind of convertibility which was the official convertibility of the US dollar into gold - the commitment of the United States to convert dollars into gold at a fixed price. Together, these different forms of convertibility constituted what Tew called "Bretton Woods convertibility". Regarding the period after Bretton Woods, Tew took into account the changes in the international monetary regime that followed the breakdown of Bretton Woods. He described the floating exchange rate regime that started in 1974 as retaining convertibility "in the market" while abandoning "official" convertibility. Tew, *The Evolution*, pp.50-1. For another definition of Bretton Woods convertibility, see Bordo, "The Bretton Woods International Monetary System", pp.36-37.

convertibility, all of which satisfy the general condition of "the availability of a currency or means of international payment for making payments in international transactions with any country or currency area".[3] The degrees range from "general convertibility into gold" to "convertibility of balances owned by foreign central banks through a multilateral clearing union". According to Polk, no currency can be completely inconvertible, in the sense that "given enough indirection, ingenuity, or infraction of law, every currency in the world is convertible into every other currency on some terms".[4] Thus Polk argued that convertibility and inconvertibility were matters of degree. While this is true, currencies can nonetheless be officially inconvertible, with inconvertibility defined in H. E. Evitt's terms as a state in which "any holder of that currency ... has no statutory right to demand the conversion of that currency into any other currency or gold".[5]

Based on Evitt's definition, the era of currency inconvertibility in Europe can be dated back to 1931 when exchange control was introduced on a large scale in response to the financial crisis which ravaged Europe's currencies in the same year.[6] The financial crisis was the culmination of currency speculation and financial instability which had been plaguing European currencies throughout the 1920s.[7] In September 1931, Britain, - which Aldcroft identified as "the weak link in the system" -, abandoned the gold standard and

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[3] According to Mikesell's eight-tier definition, convertibility may be restricted to residents or non-residents, respectively, as well as to current transactions or capital transactions. R. Mikesell, *Foreign Exchange in the Postwar World*, Lord Baltimore Press, 1954, p.479.

[4] Polk, *Sterling*, p.239.

[5] H. E. Evitt, *Manual of Foreign Exchange*, sixth edition, Pitman, 1966, pp.3-5 & 257-163.
Contrary to Tew's use of the term, in this thesis, official convertibility will denote the statutory right to exchange currencies.

[6] B. Eichengreen, *Elusive Stability: Essays in the History of International Finance, 1919-1939*, Cambridge University Press, Cambridge, 1990, p.239.

[7] For an analysis of the international economic and monetary conditions of the interwar period and the financial crisis of 1931, see, for example, D. H. Aldcroft, *The European Economy 1914-1990*, third edition, Routledge, 1993, pp.4-97, Eichengreen, *Elusive Stability* and R. Nurkse, *International Currency Experience*, League of Nations, 1944.

imposed exchange control and import restrictions.[8] Most European countries followed the British example, letting their currencies depreciate with sterling while at the same time imposing drastic restrictions on the exchange of currencies and on trade and capital flows. By severely restricting currency convertibility, countries sought to isolate their domestic economy from the ongoing international depression and to prevent further deterioration of the balance of payments, but also to arrest the drain of gold reserves caused by adverse currency speculation and gold hoarding. As a result, "by the end of 1932, thirty-five countries were already off gold and twenty-seven, including nine still nominally on the gold standard, were officially exercising exchange control, while yet others were exercising unofficial controls or import prohibitions tantamount to exchange control".[9]

Inconvertibility continued after World War II with foreign exchange markets straitjacketed by stringent exchange controls. Exchange control varied slightly from country to country but in most countries residents were obliged to surrender all foreign exchange earnings to the central bank, and the exchange of currencies was strictly regulated. In addition, tight controls on imports further restricted the exchange of currencies. Importers could only obtain the foreign exchange necessary for payment of imported goods for which whey had been granted a license to import, enabling the government to regulate and limit currency convertibility through quotas. Currency convertibility for capital transactions was even more restricted than for current transactions.

The creators of the post-war international economic order, in particular the United

[8] Aldcroft spoke about Britain's "persistent tendency to lose gold". Aldcroft, *The European Economy*, pp. 56-57. For a discussion of sterling's interwar experience, see Cairncross and Eichengreen, *Sterling in Decline*, ch.3, Strange, *Sterling*.
[9] Aldcroft, *The European Economy*, p.76.

States, wanted to revive the flourishing international trading system of pre-World War I and for this goal they considered convertibility a vital prerequisite.[10] Looking back on the interwar period, the Bretton Woods architects blamed the breakdown of international monetary and financial stability, and, in particular, inconvertibility, for the collapse of international trade in the 1930s, and, ultimately, for the disintegration of economic and political stability.[11] More recently Aldcroft argued that in the interwar period, "both the volume and value of trade, already seriously diminished before the financial crisis, declined even more as countries resorted to restrictive measures to insulate their domestic economies from the impact of depression".[12]

The belief that convertibility is a vital prerequisite for multilateral trade is in line with basic economic theory. A convertible currency facilitates the multilateral flow of trade, as a country can use the income it earns from its surplus with one country or region to pay for a deficit it might be earning with another country or region. If a currency cannot be converted into other currencies then the multilateral clearing of deficits and surpluses becomes very difficult, if not impossible. In the Bretton Woods negotiations, particularly the United States lobbied for a system which would prohibit exchange control, - at least for current transactions -, after a transitional phase, and which would instead be based on a

[10] Thus, "multilateral trade and convertible currencies" were believed to have "facilitated general world trading" in the late nineteenth century and those interwar years, the 1920s, when economies had prospered. Scammell, *International Monetary Policy*, p.5.
For an account and analysis of the creation of the Bretton Woods system, see, for example, Gardner, *Sterling-Dollar Diplomacy*, A. Giovannini, "Bretton Woods and Its Precursors: Rules versus Discretion in the History of International Monetary Regimes", in Bordo and Eichengreen (eds.), *A Retrospective*, pp.109-153, Ikenberry, "The Political Origins", pp.155-198, H. James, "The IMF and the Creation of the Bretton Woods System, 1944-1958", in B. Eichengreen (ed.), *Europe's Post-War Recovery*, pp.93-126, Cambridge University Press, 1995, and Scammell, *International Monetary Policy*, pp.117-170.
[11] G. Patterson, *Discrimination in International Trade Policy Issues, 1945-1966*, Princeton University Press, 1966, pp.3-4 & 9-13. For a discussion of the importance of historical experience in shaping economic policy, see Eichengreen, *Elusive Stability*, pp.1-14.
[12] Aldcroft, *The European Economy*, p.74

system of multilateral currency convertibility.[13]

> Just as the general acceptability of national currency eliminates the costs of barter within a single economy, the use of national currencies in international trade makes the world economy function more efficiently. To promote efficient multilateral trade, the IMF Articles of Agreement urged IMF members to make their national currencies convertible as soon as possible. ... General *in*convertibility [sic] would make international trade extremely difficult.[14]

Similarly, the Bank for International Settlements (BIS) stated in 1953 that "[o]ne of the main reasons for the establishment of an effective foreign exchange market [through convertibility] is, of course, that it facilitates the interchange of goods and services between nations and thus leads to greater efficiency and a fuller satisfaction of human needs".[15]

The Articles of Agreement drafted at the Bretton Woods conference in 1944 were intended to provide a regulatory framework for the post-war monetary system. Among other things, these Articles defined the type of convertibility, which their authors thought should be achieved.

> Convertible currencies in the central sense in which this term is used in the Articles are the currencies of members that have undertaken to perform the obligations of Sections 2, 3, and 4 of Article VIII. These obligations involve the avoidance in general of restrictions on payments and transfers for current transactions, multiple currency practices, and discriminatory currency arrangements, and, in order to facilitate payments and transfers for current transactions, a readiness of the members concerned to convert balances of their own currencies held by other members into gold or the currencies of the members requesting conversion.[16]

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[13] Patterson, *Discrimination*, p.17.
For a discussion of the lessons from the interwar period and how they affected the design of the Bretton Woods system, see, for example, Paniç, "The Bretton Woods system", pp.37-54, Giovannini, "Bretton Woods", Ikenberry, "The Political Origins" and James, "The IMF".

[14] P. Krugman and M. Obstfeld, *International Economics: Theory and Policy*, second edition, Harper Collins, 1991, p.527.
The International Monetary Fund was created at the Bretton Woods conference in 1944 as the institution responsible for monetary and financial matters.

[15] BIS, *23rd Annual Report, April 1, 1952 to March 31, 1953*, p.137.

[16] International Monetary Fund, *Reform of the International Monetary System: A Report by the Executive Directors to the Board of Governors*, IMF, 1972, p.22.

The provisions of Article VIII and Article IV set out the three fundamental criteria of convertibility, which are the assurances of the use, exchangeability and exchange value of a currency.[17] A fixed exchange rate is thus an integral part of the International Monetary Fund's (IMF's) concept of convertibility.[18] The IMF applied the three convertibility criteria only to payments and transfers for current international transactions. The official Fund interpretation of its Articles is that Article VIII, Section 3 does not "derogate from the right of members to control capital movements: It is therefore, not part of the obligations of convertibility that members must refrain from discriminatory capital controls".[19] Thus, the IMF left it up to member governments to decide what to do about capital flows (Article VI, Section 3). Under Article VI, Section 1, "a member may not make net use of the Fund's resources to meet a large or sustained outflow of capital", and the IMF may even "request a member to exercise controls to prevent such use of the resources of the Fund". The IMF's constitution is rooted in the belief that destabilizing capital movements led to the problems of the interwar period.[20] Thus, Bretton Woods convertibility was non-resident convertibility for current account purposes at a fixed exchange rate.

THE EPU

Europe in the 1940s and 1950s was a prime example of the problems for trade

[17] ibid., p.1.

[18] The choice of a fixed exchange rate, with the theoretical possibility of occasional exchange rate adjustment in cases of 'fundamental disequilibrium', at which currency convertibility would be guaranteed was also based on previous experiences with fixed and floating exchange rate regimes. The Bretton Woods system grew out of the belief, particularly on the American side, that fixed exchange rates were desirable because they were conducive to trade, stability and confidence. Eichengreen, *Elusive Stability*, p.284.

[19] IMF, *Reform of the International Monetary System*, p.7.

[20] see James, "The IMF". Michael Bordo defined Bretton Woods convertibility as "the freedom for individuals to engage in current account transactions without being subject to exchange controls". Bordo, "The Bretton Woods International Monetary System", pp.37-38, footnote 30.

created by inconvertible currencies. In the words of Kaplan and Schleiminger, "the European market in the late 1940s was neither Common [sic], nor free, nor unsegmented".[21] Instead, European trade was organized in some 200 bilateral trading agreements.[22] In the agreements, two countries agreed on the volume of trade that was to flow between them in the coming year, with the idea that the value of each country's exports to the partner country should match the value of its imports from that country. The central banks then exchanged their domestic currency at a fixed exchange rate up until the prearranged limit. There was only minor room for discrepancies between the value of one country's imports from and its exports to the trading partner, which was called a "swing". Beyond the swing, payments, for the most part, had to be made in gold or convertible currency, - generally US dollars -, both of which were scarce in Europe.[23]

Countries regulated their trade volume largely through their control over the granting of import licenses and by exchange controls, with the value of trade being determined on the basis of fixed exchange rates. There was some small leeway in the form of bilateral credits, should one country's imports temporarily exceed its exports to the trading partner. Thus, if one country ran a deficit in its trade with its trading partner, it could be granted a credit, albeit only for a very limited period. Countries generally did not run persistent or large bilateral deficits with their trading partners because ultimately any deficit would have to be paid in US dollars or gold, both of which the European countries lacked. The problem was that dollars and gold were the only convertible means of exchange at the time - convertible meaning that any government accepted payments in dollars or gold - which implied that a country could not use the foreign exchange it earned

[21] Kaplan and Schleiminger offer the most in-depth account of the European Payments Union so far. Kaplan and Schleiminger, *The European Payments Union*, p.7.
[22] ibid.
[23] Tew, *The Evolution*, pp.15-16.

from a bilateral surplus with a non-dollar area country to pay for a bilateral deficit it might run with another country. Important exceptions to the system of bilateral trading arrangements were the sterling area, the franc area and the dollar area, where the pound sterling, the franc and the US dollar, respectively, "circulated without restriction as multilateral means of settlement".[24] These were essentially imperial arrangements run by the three metropolitan central banks. The crucial difference between the dollar area on the one hand and the sterling and franc area on the other - making the former a "hard" settlement and the latter two "soft" settlement areas - was that sterling and francs were only allowed to circulate freely within and were not convertible into currencies of countries outside their respective areas. Specifically, members could not use sterling, which they had accumulated as a result of intra-sterling area trade, to make payments in convertible sterling to the dollar area.[25]

The trade-impeding effects of limited convertibility and bilateral trading arrangements are obvious. One country's exports to another country were limited by the latter's imports from the former. Even if one country ran a surplus in its trade with another country, it could not use the proceeds of that surplus to offset a deficit it might be running with a third country, since European currencies could not be converted into one another. Instead it would have to pay the deficit to the third country in either dollars or gold, both of which it couldn't afford to lose, precisely because they were the only convertible currencies. In the longer run, a country could thus only export to another country as much as it was importing from that country.

[24] ibid.
[25] ibid., pp.16-17.

The EPU was created in 1950 to overcome the limitations that currency inconvertibility placed on the development of intra-European trade.[26] It provided a mechanism by which countries could offset surpluses with one country with deficits with another country. It was essentially a clearing union for trade payments made in any member currency.[27] In the course of the existence of the EPU from 1950 until 1958, Western Europe made the transition from a system of bilateral trading arrangements to a multilateral system of trade and payments within Western Europe.[28] In monthly settlements a country's overall receipts from its trade with all other EPU members were added up and then subtracted from its overall payment obligations to all EPU members. This mechanism stood in stark contrast to the previous strictly bilateral trade, where a country's receipts from one country could only be offset by its payments to the same country. The EPU monthly settlements left a country either in overall balance, or in an overall debtor or creditor position with respect to the whole of the EPU. Countries that were overall debtors in the EPU had a limited automatic credit facility - a debtor quota - upon which they could draw for the financing of their overall balance of payments deficit towards the EPU. As they drew more and more credit, however, the ratio of the credit that they had to pay back in gold increased in steps or tranches. Once a debtor country had exhausted its quota it had to settle its debt with the EPU entirely in gold, unless it was able

[26] In the late 1940s, gradual steps had been taken to multilateralize intra-European trade and payments, in the form of the Agreement on Multilateral Monetary Compensation of November 1947 and the first Intra-European Payments Agreement (IEPA) in October 1948. These pre-EPU agreements are discussed in W. Diebold Jr., *Trade and Payments in Western Europe: A Study in Economic Cooperation 1947-1951*, Council on Foreign Relations, 1952. For literature on the EPU see, B. Eichengreen, *Reconstructing Europe's Trade and Payments: The European Payments Union*, Manchester University, 1993, Kaplan and Schleiminger, *The European Payments Union*, A. S. Milward, *The Reconstruction of Western Europe 1945-1951*, Methuen & Co., 1984, pp.320-334, Tew, *The Evolution*, pp.38-43, and R. Triffin, *Europe and the Money Muddle: From Bilateralism to Near-Convertibility, 1947-1956*, Yale University Press, 1957.

[27] It was administered by a Managing Board whose task was "to supervise the operations and recommend improvements in the system". For a brief summary of the EPU, see Kaplan and Schleiminger, *The European Payments Union*, chapter 5, "EPU System in a Nutshell".

[28] Brian Tew called the EPU system a "binary system", since there were parallel arrangements for hard and

to convince the Managing Board of its need for a special credit.[29] Similarly, there were creditor quotas for countries that had overall surpluses with the EPU. Within the first 20 per cent tranche of their quota, creditors' surpluses were settled by giving a credit to the EPU. But for all the later tranches, that is, as surpluses grew from 20 per cent of their quota to 100 per cent, they received 50 per cent in gold or dollars and 50 per cent in credit for these surpluses. In addition to this tranche system, the ratio of gold to credit at which EPU settlements were made if a country used its entire quota, was also gradually increased over time.[30] Initially, the gold/credit ratio had been 40:60 for a country that had used its entire quota. In July 1954 the proportion of gold to credit was raised to 50:50 for all settlements, creditors and debtors alike. In August 1955, the gold/credit ratio was again increased to 75:25.[31] Increasing the gold element in the settlements mechanism performed two functions. Firstly, EPU debtors had to pay back their credits increasingly in hard currency that was still scarce. A growing gold element in EPU settlements was thus a way of imposing greater disciplinary constraint on deficit countries by deterring them from pursing expansionary policies which increased domestic demand, and thus imports, at a faster pace than in the rest of the EPU. Secondly, an increasing gold element correspondingly raised the degree of gold convertibility of European currencies, and, consequently, their convertibility into dollars. The EPU thus made European currencies transferable throughout the EPU area, while the 'hardening' of the EPU made them partially and increasingly convertible into dollars.

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soft settlements, with the EPU being the soft settlement area and the dollar area the hard settlement area. Tew, *The Evolution*, p.15.

[29] These special credits had strings attached to them, which deterred some debtors from seeking them even in situations of extreme debt.

[30] Each country had its own quota which was the same for the debit and the credit side with the size being determined by a percentage of its trade volume in 1949 (15 per cent).

[31] Kaplan and Schleiminger, *The European Payments Union*, p.94.

Lately, questions have been raised as to whether the EPU actually paved the road to convertibility or whether it in fact delayed or obstructed quicker progress toward currency convertibility.[32] The EPU made Western European currencies de facto convertible for trade purposes within the EPU. Thus, the EPU arguably facilitated intra-European trade, at the expense of trade between Europe and the rest of the world, in particular trade between Europe and hard currency countries. In addition, as long as the surpluses were not settled 100 per cent in gold or hard currencies, the agreement guaranteed overall debtors within the EPU an automatic credit. Since especially deficits with the dollar area had to be paid for in gold or hard currency, it was argued that a partially soft EPU might have induced countries to maintain discrimination against dollar goods and thus ensure that they ran a deficit with the EPU rather than with the dollar area. Eichengreen examined the trade-diverting effects of the EPU and found that

> [t]he discriminatory features of the EPU emphasized by contemporaries do appear to have significantly affected the direction of international trade. Participants traded significantly more with one another than would be predicted on the basis of their economic characteristics and the behavior typical of other countries. They traded significantly more with one another than they did with the rest of the world.[33]

Trade distribution is important for understanding these countries' stand on the EPU, and, consequently, for understanding their policy on convertibility. The country chapters will examine to what extent the discriminatory features affected each country's policy stance on the EPU and thus on a move to convertibility.

Another criticism leveled against the EPU was that structural deficit countries within the EPU, such as France, might have resisted not only a hardening of the EPU but

[32] see, for example, Eichengreen, *Reconstructing*.

[33] Eichengreen, *Reconstructing*, pp.116-117. For the econometric analysis see pp.101-117.

also a move to currency convertibility, since, for reasons explained later, the latter would have spelt the end of the EPU and thus of automatic credits. Rather than promote global convertibility, the EPU might have led to members preferring to keep trade within the EPU and associated monetary areas, instead of exposing their economies to global competition, in particular from the United States. Another principal problem of the EPU was that, while its progressive 'hardening' arguably imposed greater discipline on deficit countries, by forcing them to pay back an increasing portion of their debts in gold or dollars, the 'hardening' made it increasingly attractive for surplus countries to accumulate surpluses in the EPU since they received hard currency payment for a growing share of their surpluses. Thus, while the 'hardening' of the EPU put greater pressure on deficit countries to adjust their economies to balance their external balances, it did not increase pressure on surplus countries to adjust economies to reduce their surpluses. The lack of pressure within the EPU to correct structural payments surpluses was particularly apparent in the case of Germany. In their attempts to obtain a change in German economic policy that would lead to a reduction in German surpluses, EPU members were restricted to appealing to German good will.

The EPU was created to facilitate intra-European trade in the absence of currency convertibility while at the same time preparing European economies for convertibility. Once European currencies had become convertible established, the EPU lost its primary purpose of existence.[34] According to James, the EPU "had a specific task to perform and was redundant after the completion of that mission".[35] Depending on their trade patterns and national trade policies, countries are likely to have had very different views on the

[34] As will be shown in the country chapters, proponents of the EPU argued that in the course of its existence the EPU acquired a role as a forum for intergovernmental consultation and cooperation that justified its continued existence even after convertibility.
[35] H. James, "The IMF", p.96.

establishment of convertibility, not only of their own currencies, but also of other European currencies, particularly when convertibility implied the end of the EPU. Moreover, aside from the trade, countries might have attributed other economic or political costs or benefits to the EPU, for example as a forum for European economic cooperation or consultation. To understand countries' national policy on convertibility, one must therefore examine their attitude towards the EPU, and in particular towards a termination of the EPU. The analysis of the return to convertibility must therefore explain why convertibility replaced the EPU when it did and why countries might have hesitated to end the EPU. Barry Eichengreen's *Reconstructing Europe's Trade and Payments* from 1993 is one of the few attempts that have been made so far to analyze Europe's return to convertibility. His analysis will be discussed in the following section.

PRECONDITIONS FOR CONVERTIBILITY

The Eichengreen Hypothesis

In examining the problems of the economies of Eastern Europe in 1990, Janos Kornai identified several necessary preconditions for the establishment of viable convertibility.[36] These preconditions were, "a realistic exchange rate consistent with balance of payments equilibrium", "sufficient foreign exchange reserves", "elimination of monetary overhangs to prevent domestic absorption from crowding out exports and spilling over into unsustainable balance of payments deficits", and "adequate wage discipline".[37] Barry Eichengreen applied Kornai's preconditions to Western Europe after World War II to examine whether the EPU was necessary or whether countries could have

[36] J. Kornai, *The Road to a Free Economy*, Norton, 1990.

moved directly to currency convertibility.[38] He found that, "[m]ost of the obvious preconditions for the viability of current account convertibility appear to have been met when European countries opted instead for the European Payments Union in 1950".[39] Eichengreen claimed that a slightly larger devaluation than the one undertaken in 1949 in the UK and the Scandinavian countries would have been sufficient to eliminate current account deficits. He argued further that "[r]elative to the trade that had to be financed, it is not obvious, ... that the EPU countries possessed inadequate reserves".[40] Moreover, he contended that the monetary overhangs, - the result of price controls and pent-up demand - , had been eliminated in most economies by the early 1950s and in the UK by 1955. Regarding wage discipline, Eichengreen acknowledged that wage costs in Europe continued to undermine the competitiveness of European goods vis-à-vis the US throughout the 1950s. Nonetheless he estimated that, with the exception of the UK and France, from the early 1950s onwards, labor costs would not have threatened the viability of convertibility at pegged exchange rates. Overall, Eichengreen concluded that convertibility could have been established and maintained as early as 1952 or even 1950. Therefore, he claimed, the choice to delay convertibility can be explained by a consensus among European countries on the advantages offered by the EPU which convertibility could not provide. [41]

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[37] Eichengreen, *Reconstructing*, pp.44-5.
[38] ibid., pp.39-69.
[39] ibid., p.62.
[40] ibid., p.55.
[41] In particular, he argues that "[a] critical function of the EPU, ..., was to help seal the domestic and international bargains upon which the post-World War II generation of European economic growth was based". Domestically, the EPU was "one of the web of institutional arrangements that 'locked in' the domestic distributional compact". "Internationally, the postwar settlement involved a commitment to trade and European integration. For countries to restructure their economies along export-oriented lines, they had to be convinced that their neighbors embraced the same commitment. Here the EPU acted as an institutional exit barrier lending credibility to the commitment to trade and integration." Eichengreen, *Reconstructing*, pp.4-5.

Eichengreen's analysis suffers from some shortcomings and oversimplifications. First, his analysis of the adequacy of foreign exchange reserves only looked at the development of the reserves of the EPU countries as a whole, ignoring the growing unevenness in the distribution of reserves among the EPU countries. Thus, Germany's reserves grew at a rate that was disproportionately high, contributing significantly to the increase in overall reserves of the EPU countries, while UK and French reserves stagnated or even declined. Germany's holdings of gold and dollar reserves as a portion of the world's gold and dollar reserves increased from one per cent in 1948 to 11 per cent in 1957. Whereas France's gold and dollar reserves accounted for 20 per cent of the world total in 1928 its share had dwindled to one per cent of world holdings in 1948 and was still one per cent in 1957. Britain's gold and dollar reserves similarly remained stagnant at four per cent between 1948 and 1957 after having accounted for six per cent in 1928 and ten per cent in 1938.[42]

Second, and more importantly, in examining the preconditions, Eichengreen implicitly assumed that the EPU countries worked like a democracy when it came to deciding when to return to convertibility. His assessment is based on the assumption that since the necessary preconditions were fulfilled for the large majority of countries in the early 1950s, EPU countries' decisions to delay convertibility must be attributable to a consensus shared by all EPU countries to prefer the EPU over convertibility. This assumption allows him to brush aside his finding that in the UK, and to a lesser extent in France, the Kornai preconditions for viable convertibility were either not fulfilled or only later than in the other EPU countries.[43] In assigning equal decision weight to all EPU

[42] Figures from H. Kasten, *Internationale Währungsreserven und die nationale Reservepolitik*, Fritz Knapp Verlag, 1959, p.19. Total world holdings exclude the reserves of international organizations.
[43] In the case of France, Eichengreen argued that the monetary overhang had been removed by inflation, implying that inflation was higher than average in France. Thus France replaced one problem, monetary

countries, Eichengreen ignored that, of the EPU countries, only three, namely, France, Britain and Germany, had the political and/or economic power to affect, individually, the timing of the move to convertibility.[44] Eichengreen's analysis, while very valuable in proving that, according to Kornai's four preconditions, most EPU countries could have established and maintained convertibility in 1950, failed to recognize the disproportionately greater importance of the economic conditions in the three key countries in determining the move to convertibility. Moreover, the assessment that Western Europe delayed convertibility because countries preferred the advantages offered by the EPU neglects the fact that Britain continuously worked against the EPU from its inception, trying at several stages in the 1950s to end it.[45]

A third criticism of Eichengreen's analysis relates to his argument that convertibility was delayed because of a 'coordination problem'. According to Eichengreen, the establishment of convertibility in the early 1950s would have had to be undertaken jointly with a devaluation of at least some of the EPU countries in order to assure a "realistic exchange rate consistent with balance of payments equilibrium". However, the effectiveness of a devaluation in restoring balance of payments equilibrium, that is, the price elasticity of exports, "depended on the number of other countries offering market access". Eichengreen argued that

> it was not feasible for any one country to devalue and adopt convertibility on its own, but if all the relevant countries devalued, restored convertibility and opened their markets simultaneously, the strategy might prove viable. Devaluation was difficult to coordinate internationally, as both 1931 and 1949 had shown. Unable to solve this problem cooperatively, it is said, cautious governments retreated to inconvertibility.[46]

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overhang, with another, namely inflation. The latter, however, undermines exchange rate stability, making the prospect of viable convertibility questionable.

[44] In 1955, many believed that "if the U.K. moves they will all move, none being willing to be left behind". BoE G1/99, George Bolton reporting to the Governor on US views, April 4, 1955.

[45] Milward, *The European Rescue*, pp.350-66.

[46] Eichengreen, *Reconstructing*, p.42.

This analysis applies to Belgium and the Netherlands. Both countries signaled their interest in establishing convertibility at several times between 1954 and 1956.[47] Eichengreen is correct that these countries most likely refrained from acting because for them a successful move had to involve as many other countries, and, in particular, as many of their big trading partners, as possible. They only considered acting in concert with the rest of Western Europe. However, the British plans for convertibility in 1952 and 1953 show that UK policymakers worried little about other countries not following it into convertibility.[48] In general, as the UK chapter will show, trade, and, particularly, access to European markets played a minor role in determining British policy on convertibility.

In Eichengreen's study, Britain emerges as the country with the least satisfactory overall record of fulfilling the preconditions for viable convertibility. According to the preconditions hypothesis, Britain should therefore have been the least likely to advocate a return to convertibility. However, Britain was one of the first countries in the 1950s publicly to contemplate the establishment of convertibility. Eichengreen, while very useful in offering an explanation for the ensemble of smaller countries' policy on convertibility, cannot explain Britain's policy on convertibility in the 1950s.

Finally, Eichengreen's analysis does not explain why convertibility was established, jointly by all Western European countries, when it was, namely in December 1958. Up until 1958, France's competitiveness was deteriorating due to inflation that was growing more rapidly than anywhere else in Western Europe, with the possible exception

[47] See, for example, *The Banker*, "Sterling Now", June 1956, pp.333-4.

[48] The early UK plans for convertibility, particularly Robot, envisaged very little if any consultation, not to mention coordination, with EPU members preceding a British move to convertibility. Similarly, the failure of these plans is not linked to the fear of detrimental effects on UK trade. For a discussion of the early and unilateral plans for convertibility, see Fforde, *The Bank of England*, Milward, *The European Rescue*, and Kaplan and Schleiminger, *The European Payments Union.*

of Italy. Judging by free market exchange rates, France's currency was one of the weakest. Moreover, France trailed way behind the European average in trade liberalization. Up until 1958, nothing indicated that France was ready, or was preparing itself for the establishment of convertibility. Between 1952 and 1958, France was one of the strongest opponents to the establishment of convertibility. However, in December 1958, France took the biggest leap forward by combining a massive domestic economic reform with trade liberalization, devaluation and the establishment of convertibility. Eichengreen's analysis fails to explain the drastic turnaround in economic policy that took place in France in 1958.

FOREIGN EXCHANGE RESERVES AND CONVERTIBILITY

Corresponding to one of Kornai's preconditions for convertibility, one of the principal concerns of British policymakers regarding the establishment of convertibility in the 1950s was whether foreign exchange reserves were sufficient to support a move.[49] In early 1955, the President of Barclays Bank claimed that the level of UK foreign exchange reserves were still too low to be able to defend the convertibility of sterling.[50] How can reserve sufficiency be measured? What level of reserves can be considered sufficient to allow the establishment of convertibility? Many opponents of convertibility in the 1950s argued that international liquidity was insufficient to meet the needs of rapidly growing world trade.[51] The inadequacy of international liquidity allegedly made it impossible for

[49] In her examination of the external monetary policy of the Bundesbank in the 1950s, Monika Dickhaus similarly listed sufficient currency reserves as a necessary prerequisite for convertibility. She claimed that currency reserves were viewed as confidence-building and considered necessary to prevent a run on the reserves. Dickhaus, *Zwischen Europa und der Welt*, pp.33-4.

[50] L. Camu, "La convertibilité et les Banques", in *Revue des Sciences économiques*, March 1955, p.22.

[51] For contemporary views on the international liquidity problem, see Kasten, *Internationale Währungsreserven*, R. Harrod, *The Pound Sterling 1951-1958*, Essays in International Finance, No.30,

countries to earn sufficient foreign exchange reserves to allow the establishment of convertibility.[52] Examining the reserve requirement in the context of the Bretton Woods system of pegged convertible currencies, Obstfeld argued that

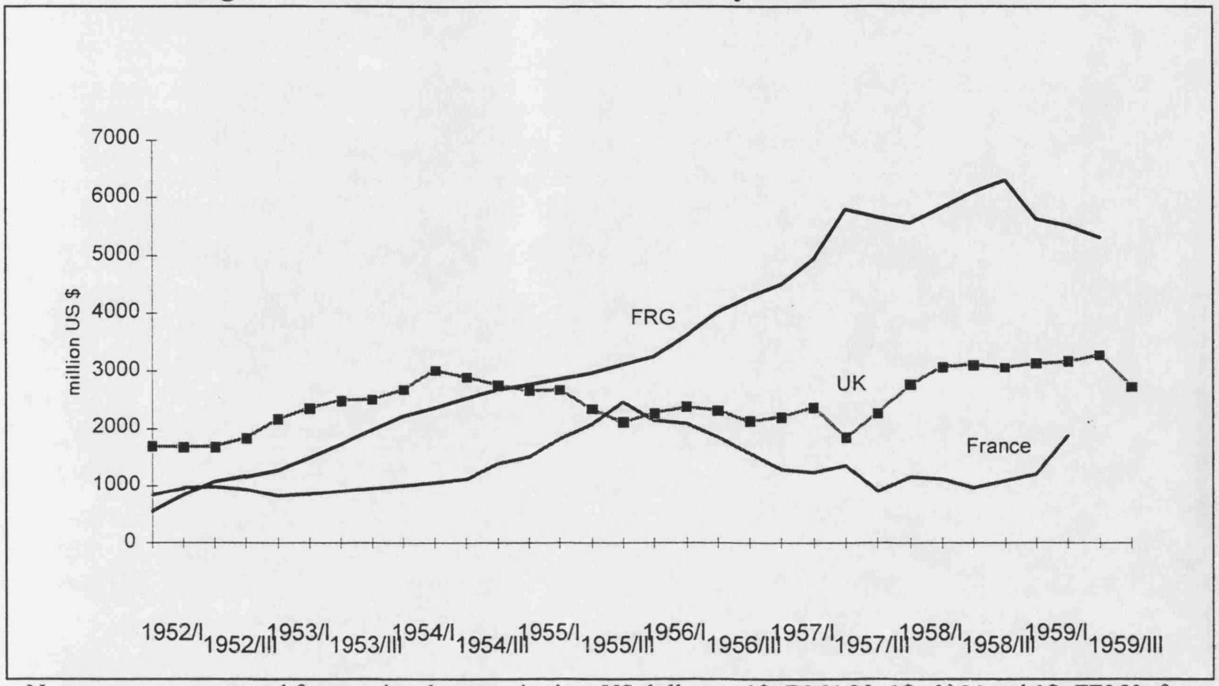
> ... countries need to have on hand a buffer stock of internationally liquid assets - essentially gold or dollars -available to smooth consumption or stabilize investment in the face of unexpected income shortfalls or deteriorations in trading opportunities.
> ... The individual country's need for an adequate stock of international liquidity, both as a buffer and to peg exchange rates, motivates the definition of *external equilibrium* that is probably most relevant for the Bretton Woods period: a target on change in net government holdings of a widely accepted international means of payment or of foreign assets quickly convertible into such at low cost.[53]

The ability of reserves to cover short-term deteriorations in the trade balance is one indicator of reserve sufficiency. Reserve sufficiency with regard to the trade balance can be measured by the ratio of foreign exchange reserves to average monthly imports. The second test applied to reserve sufficiency in the 1950s centered around the ratio of a country's foreign exchange reserves to its foreign liabilities. Third, according to one prominent Belgian banker in the 1950s, the level of reserves that is considered sufficient depends on the level of confidence the currency inspires.[54]

A look at the development of the foreign exchange reserves in Britain, France and Germany in the 1950s shows consistently growing reserves for Germany, which contrast with relatively stagnant reserves in both France and Britain. Figure I.1 shows British, French and German quarterly gold and convertible currency reserves converted into US dollars between 1952 and 1959.

Princeton University Press, 1958, and R. V. Roosa, "Reforming the International Monetary System", in *Foreign Affairs*, Vol.42, No.1, October 1963, pp.107-122.
[52]James, "The IMF", pp.118-121.
[53] Obstfeld, "The Adjustment Mechanism", pp.205-6.
[54] Camu, "La convertibilité", p.22.

Figure I.1: Gold and convertible currency reserves: 1952-1959



Note: reserves converted from national currencies into US dollars at 1\$=DM4.20, 1\$=£0.36, and 1\$=FF350; from 1958/II 1\$=FF420, from 1959/I 1\$=FF493.7

Source: OEEC, *Statistical Bulletins, General Statistics.*

Germany's foreign exchange holdings rose consistently throughout the 1950s with the exception of the winter of 1957/8 and 1959. The exclusion of the net bilateral claims on other European countries arising from the liquidation of the EPU starting in 1959 probably accounts for this apparent fall in Bundesbank assets. In contrast, Britain's gold and foreign exchange assets fluctuated in the same period between, roughly, two and three billion US dollars, without ever showing consistent signs of improvement. French reserves were similarly stagnant with the exception of a significant increase in 1955 and an improvement in reserves starting in 1959.[55] German reserves started out as the smallest of the three

[55] Any attempt to interpret French reserve statistics must be prefaced with the cautionary note that French reserve data differ considerably according to source and their reliability in the 1950s was in general questionable according to the IMF; see IMF *International Financial Statistics*, foot- and endnotes in French sections on gold and foreign exchange.
In addition, the devaluations of 1957 and 1958 further complicate cross-country comparisons.

countries. But by early 1955 reserves had overtaken both British and French reserves and continued to grow strongly.

Table I.1: Gold and foreign exchange holdings (convertible currency) (million US dollars at end of period)[a]

	Assets			Liabilities			Net (assets minus liabilities)		
	FRG	UK	France	FRG	UK	France	FRG	UK	France
1952	710	1845		86	9013		624	-7168	
1953	1281	2518	829	13	9780	717	1268	-7262	112
1954	1997	2762	1261	34	10368	495	1963	-7606	766
1955	2404	2120	1912	33	10013	212	2371	-7893	1700
1956	3402	2237	1180	37	9582	300	3365	-7345	880
1957	4105	2273	645	170	9164	1121	3935	-6891	-476
1958	4604	3069	1050	89	9377	1681	4515	-6308	-631
1959	4532	2736	1720	98	9820	744	4434	-7084	976
1960	6737	3231	2070	102	10878		6635	-7647	

a: gold and foreign exchange holdings of Bundesbank for FRG and of Exchange Equalization Account for UK
Source: calculated from IMF International Financial Statistics.
For France: Banque de France annual reports.

A superficial glance at the relationship between gold and foreign exchange assets and liabilities, as displayed in table I.1, produces again a much more favorable picture for Germany than for France or Britain. The overall absence of a clear upward trend in the UK's reserves, especially when compared with Germany's performance, certainly did not increase confidence in the ability of Britain to maintain the exchange rate of the pound, especially if the pound became convertible. Matters were made worse by the large sterling liabilities which exceeded by far the gold and foreign exchange assets of the Exchange Equalization Account (EEA) and which failed to drop significantly throughout the 1950s.[56] Germany's foreign liabilities, on the other hand, were reduced to insignificance

[56] These liabilities were thought to be easily liquifiable and therefore volatile. However, as will be discussed later in this chapter, the majority of sterling liabilities were not very volatile and, therefore, not the threat to the reserves that they were made out to be.

by the its gold and foreign exchange assets, serving further to bolster confidence in the DM especially when compared to the pound.

Table I.2: Convertible gold and foreign exchange holdings divided by average monthly commodity imports

	FRG	UK	France
1952	2.4	2.6	n.a.
1953	4.3	3.7	3.8
1954	5.6	4.0	5.6
1955	5.4	2.7	6.9
1956	6.8	2.9	3.6
1957	7.3	2.8	1.8
1958	7.9	3.9	3.5
1959	6.9	3.2	5.9
1960	8.6	3.4	5.4

Source: calculated from OECD *Balance of Payments Statistics 1950-61* and IMF *International Financial Statistics.*

The comparison of the growth in gold and foreign exchange reserves to the development of imports, as shown in table I.2, relates a country's reserves to its potential foreign exchange needs to pay for imports.[57] For Germany, this indicator shows again a steady increase, as the ratio of reserves to average monthly imports rises from 2.4 in 1952 to 8.6 in 1960, while in the British case, the ratio actually dropped between 1953 and 1960. Germany's reserve holdings thus grew quicker than its already rapid import growth, even after the removal of most import controls after 1954, while Britain's reserves failed to keep pace even with the sluggish growth of its imports in the same period. Just as the dynamic upward trend in Germany's foreign reserves made convertibility look easy for Germany, the stagnant, and therefore continued precarious, situation of Britain's foreign

[57] The central bank assessed the level of gold and foreign exchange holdings in relation to the country's needs for foreign reserves by dividing them by the average monthly import value. See, for example, Bank deutscher Länder *Geschäftsbericht für das Jahr 1954*, 1955, p.30.

exchange reserves ensured that convertibility remained a daunting task for the British government and financial institutions. France's ratio statistic is characterized by the most extreme vacillations of all three countries, indicating, if anything, the absence of a stable upward trend in the development of foreign exchange reserves with regard to imports. Moreover, a closer inspection of French reserves will show later that the levels indicated in the above table were frequently only maintained through massive foreign credits. In general, it is difficult to obtain reliable statistics on French reserves in the 1950s.[58]

The above measures of reserve performance, - reserve growth, reserve-liability comparison, and reserve-import ratios -, indicate a significantly more favorable development for Germany than for Britain or France. From this brief overview of reserve sufficiency one would therefore conclude that Germany should have been more predisposed to convertibility than Britain or France. However, for several reasons reserve sufficiency is a misleading or unreliable indication of a country's ability or willingness to move to convertibility. A country's reserves statistics, as they are generally published, are made up of many different components, the weight and development of which are often very difficult to distill. The trade balance, - with a trade surplus earning a country reserves, and a trade deficit costing reserves -, is only one of the economic variables affecting a country's level of reserves. Government intervention in the foreign exchange market, - that is, the sale, or purchase, of domestic currency for, or with, foreign currency with the purpose of affecting the exchange rate -, can also significantly increase or decrease a country's reserves. However, data on the magnitude of foreign exchange market intervention are very difficult to obtain. In addition, reserve levels differ significantly

[58] See IMF *International Financial Statistics*, footnotes and endnotes in French section on gold and foreign exchange reserves.

according to whether the data include actual credits and available credit lines, such as IMF drawing facilities. Also, after World War II European reserves were generally 'subsidized', although to varying degrees, by US aid or military expenditure. The different components that combine to determine a country's foreign exchange reserves make it very difficult not only to assess its actual reserve-earning potential but also to identify and assign changes in reserves to a specific factor.[59] A decrease in reserves need not indicate a deterioration in the current account or a period of speculation against a currency if the decline is caused, for example, by the repayment of a foreign loan. The repayment might actually be an indication of an otherwise strengthening reserve earning capacity, as a result of which the government sees itself able to repay a loan or debt ahead of time, assuming that the government can choose the timing of the repayment. In 1957, Germany, in light of the strength of its trade balance and its reserves offered to repay in advance £60 million pounds, purchased with US dollars, of its debt for post-war economic assistance. The repayment increased British gold and dollar reserves and reduced Britain's EPU debt while at the same time reducing German gold and dollar reserves and its EPU credit, both of which, according to Rootham from the Bank of England, was "one of the objects of the exercise".[60] Finally, leads and lags in the payment of trade can significantly affect reserves. An importer's decision to accelerate payment of goods or an exporter's decision to delay payment are determined by the trader's confidence in the stability of the exchange rate. For example, if an importer expects a devaluation of his or her currency in the near future, he or she will want to accelerate payments.[61] Thus, a country's reserve level is the

[59] See also B. Eichengreen, A. K. Rose, and C. Wyplosz, *Speculative Attacks on Pegged Exchange Rates: An Empirical Exploration with Special Reference to the European Monetary System*, NBER working paper No.4898, 1994, p.18.
[60] BoE OV34/42, Memo by Rootham, January 30, 1957 and P. Vinter to Copleston, "Germany: Accelerated Debt Repayment", January 23, 1957.
[61] It is very difficult to estimate the size of leads and lags in times of speculation for or against the pound.

outcome of a host of factors that combine to determine a country's reserve level. When all factors pull in the same direction to indicate a strong general trend, then the complexity of reserve data does not prevent the observer from being able to draw fairly clear, and correct, conclusions. This was the case in Germany in the 1950s. Reserves ceased to be an issue early in the 1950s. Their rapid and continued growth ensured that reserve sufficiency was no obstacle to convertibility. However, for France and Britain, there is no such general trend. As a result, the ability to assess the strength or weakness of a country's currency according to its foreign exchange reserves, can be misleading. Like British reserves, French reserves refused to grow in the 1950s. However, the sterling overhang, - the accumulation of sizable sterling liabilities in excess of reserves -, made UK reserves a more popular topic of discussion in Europe than French reserves, particularly in connection with convertibility. As opposed to Britain, in France, convertibility was not a controversial and topical issue in the 1950s, mostly because the return to convertibility was not the government's pet issue that it was in the UK. The following sections examine reserves in relation to, first, trade and competitiveness, second, liabilities, and, third, confidence. They concentrate on the link between reserves and convertibility in the UK, with France and Germany mainly serving as standards of comparison.

Reserves and the current account

A country's ability to run current account surpluses is one determinant of the size

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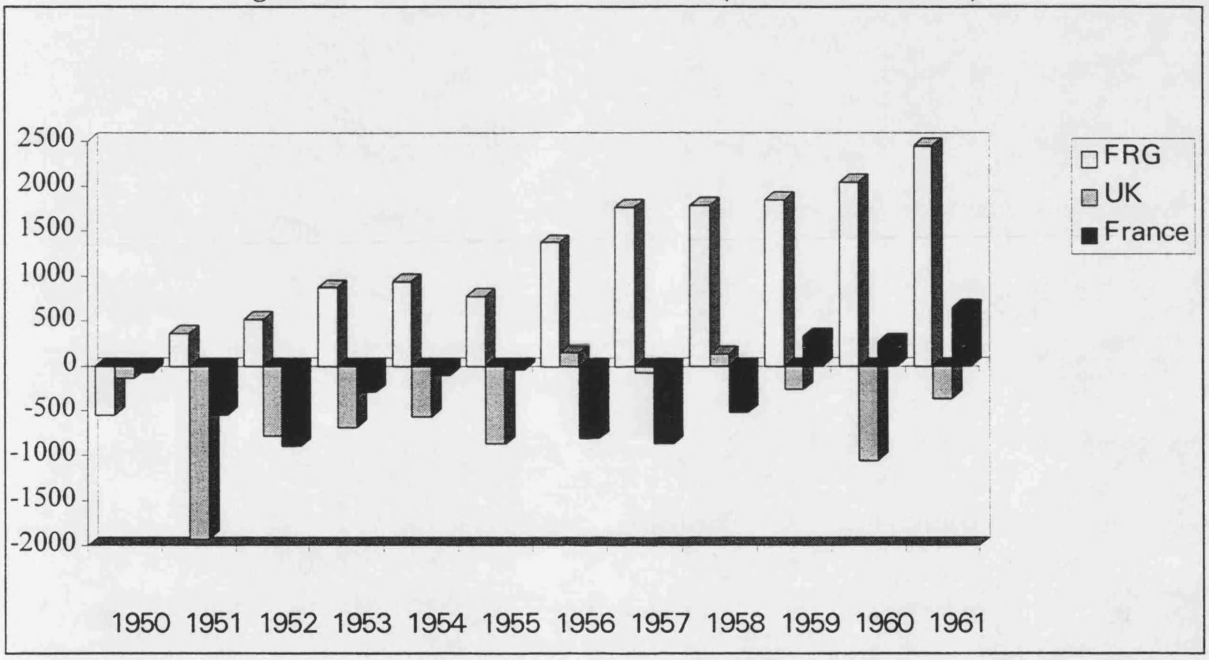
Similar to other short term capital flows they are often grouped under "errors and omissions" in balance of payments statements, making their movements difficult to trace. *The Economist* claimed in late 1956 that "[i]t has been authoritatively estimated that the total swing of the pendulum of 'leads and lags' in sterling payments throughout the world can affect the gold and dollar reserve by no less than £400 million". The Radcliffe report estimated that they could amount to hundreds of millions of pounds and that in the third quarter of 1957 they might have cost the UK reserves as much as £90 to 100 million, which would have amounted to nearly half of the fall in reserves during the crisis. The important point here is that leads and lags of payments are nearly impossible to control, yet they can have a significant impact on the trade balance and foreign exchange earnings. *The Economist*, "How vulnerable is sterling?", November 17, 1956, p.5., *The Banker*, "The Report analysed", September 1959, pp.523-4, J. Spraos, "Speculation, arbitrage and sterling", in *The Economic Journal*, March 1959, pp.7-8.

of its foreign exchange reserves. The balance for visible trade offers a better indication of a country's reserve-earning capacity as linked to trade movements than the current account balance. The latter includes official transfers, which, especially in the case of West Germany, were quite significant in this period, thus distorting the picture of market trends since official transfers did not respond to comparative advantage or other market forces. The trade balance, and the ability of a country to earn reserves through trade surpluses, however, is one indication of a country's competitiveness.

Figure I.2: Trade balance 1950-1961 (million US dollars)



Source: OECD *Statistics of Balance of Payments 1950-61.*

Figure I.2 compares the trade balances of the FRG, Britain and France between 1950 and 1961. Germany's trade balance record clearly separates it from Britain and France. After 1950, the trade balance never went back into deficit, and instead showed a continuous upward trend, with the exceptions of 1955, when the trade surplus fell, and 1958, when it remained the same as the previous year. Britain's trade balance reveals almost the opposite trend. The trade balance displayed a deficit throughout the period with the exceptions of 1955 and 1958, when Britain registered small surpluses. The French trade surplus showed consistent deficits until 1959 after which the trade balance became and stayed positive. The German trade balance thus provided a solid footing for a continuous and growing inflow of foreign exchange earnings. The prospects of continuous rising foreign exchange reserves in turn contributed significantly to confidence in the DM, whereas in Britain the trade balance certainly did not increase confidence in the pound and it probably even hurt the pound since it offered no prospects of growing foreign exchange earnings and thus did nothing to alleviate fears of insufficient foreign reserves to back the pound in case of a move to convertibility.

Britain's inability to accumulate foreign exchange reserves was a symptom of what can be identified as a structural balance of payments problem. Up until 1929, Britain's invisible earnings kept its current account in healthy surplus.[62] Thus, dividend, interest and profit earnings from UK investment abroad combined with a surplus in the balance for services and transfers to more than offset Britain's traditional trade deficits. The resulting net surplus on current account allowed Britain to accumulate gold and foreign exchange reserves and to create its overseas capital investments. After World War II, Britain's earnings from investments abroad and from the provision of financial services fell, the former being partially due to the significant liquidation of capital investments outside the UK in the course of the war.[63] In general, the surplus on the current account was considered unsatisfactory, particularly since a large section of the surplus was due to US defense aid to the UK. In 1952, Chancellor of the Exchequer Richard Butler stated that

[62] See, for example, C. Feinstein, "Success and Failure: British Economic Growth since 1948", in Floud and McCloskey (eds.), *The Economic History*, pp.103-4, and Scammell, *The International Economy*, pp.111-3.

[63] See also, *The Banker*, "Britain's Invisible Earnings", May 1958, pp.327-331.

Britain needed an annual current account surplus of £300 to £350 million, to be achieved through an increase in exports, to ensure the necessary stability in the external balances and allow Britain to increase its reserves.[64] This goal still held in 1957.[65] Since the UK was a net exporter of capital and consistently ran a deficit in its visible trade balance, the surplus had to come from invisible earnings.[66] However, invisible earnings failed to meet these demands.

All sterling area countries pooled their reserves in London. Thus, if sterling area countries outside Britain earned gold and dollars from their balance of payments they sold them to the UK. Alternatively, when they needed gold and dollars they were entitled to purchase them from the UK gold and dollar reserves. The rest of the sterling area (RSA) was a "net contributor to the central gold and dollar reserves throughout the 1950s, even including the deterioration of the RSA balance of payments with the EPU after 1955".[67] This can also be seen in table I.3 below. According to Schenk, between 1950 and 1958, the overseas sterling area contributed on average £7.4 million per quarter to the central reserves.[68] The UK inability to accumulate gold and foreign exchange reserves can therefore not be attributed to the rest of the sterling area, on the contrary, their consistent reserve earnings provided an element of stability for the UK's otherwise troubled reserves. The table shows the make up of the UK's gold and dollar reserves between 1952 and 1957. The net increase in gold and dollar reserves from UK transactions with the dollar area in the second half of 1957 is largely explained by a credit of £90 million from the US

[64] Federal Reserve Bank of New York, *Monthly Review*, January 1954, p.8.
[65] PRO T236-3945, "The Sterling Area", T.L. Rowan to Makins and Chancellor of Exchequer, November 4, 1957. See also F. W. Paish, *The Position of the United Kingdom as an Exporter of Capital*, University of Queensland Press, 1958 pp.4-6.
[66] Harrod, *The Pound Sterling 1951-1958*, p.15 and Scammell, *The International Economy*, p.112.
[67] C. R. Schenk, *British Management of the Sterling Area 1950-1958*, Ph.D. Dissertation, LSE, University of London, 1991, p.292.
[68] Schenk, *Britain*, p.29.

Export-Import bank granted to the UK. In addition, US defense aid, which is included in the current balance, increased UK gold and dollar reserves by £120 million in 1952, £102 million in 1953, £50 million in 1954, £46 million in 1955, £26 million in 1956, and £21 million in 1957. The table shows that without the sales of gold and dollars from the surpluses earned by the RSA with the non-sterling world, and without US defense aid, the UK balance of payments lacked a reliable source for accumulating gold and dollar reserves. This analysis would thus indicate a structural inability of the UK to earn gold and dollar reserves.[69]

[69] France's trade performance indicated even greater difficulty in accumulating foreign exchange reserves than Britain's. According to contemporary observers, French balance of payments problems were explained by domestic expansionary policies which led to a deterioration of the trade balance. Throughout the 1950s, exports refused to grow despite subsidies and other encouragements, while imports could only be restrained with extensive restrictions. *The Banker*, "The Economics of de Gaulle", July 1958, pp.432-438, and OEEC, *Economic Conditions in Member and Associated Countries of the OEEC, France - 1958*, 1958, p.5. See also chapter IV.

Table I.3: UK gold and dollar reserves, 1952-7 (million £)

	1952		1953		1954		1955		1956		1957	
	Jan. - June	July - Dec.	Jan. - June	July - Dec.	Jan. - June	July - Dec.	Jan. - June	July - Dec.	Jan. - June	July - Dec.	Jan. - June	July- Dec.
reserves at beg. of period	834	602	659	845	899	1078	986	957	757	852	799	850
UK transactions with $ area												
- current balance	-139	-27	+42	-34	+39	-99	-68	-116	+74	-76	-24	-65
- long-term and misc. capital (net)	+31	-3	+4	-19	+20	-10	+16	+2	-18	-36	+20	+107
- overseas sterling holdings (decrease -)	-19	+15	+7	+21	-1	+36	-11	-28	-20	-1	+13	-15
Total	-127	-15	+53	-32	+58	-73	-63	-142	+36	-113	+9	+27
gold and dollar transfers in respect of transactions with:												
(i)rest of sterling area												
- RSA sales of gold in UK (net)	+51	+20	+31	+47	+66	+72	+82	+94	+97	+123	+105	+118
- other	-31	+81	+54	+39	+29	+8	+11	+24	+43	-31	+78	-14
Total	+20	+101	+85	+86	+95	+80	+93	+118	+140	+92	+183	+104
(ii)non-dollar, non-sterling countries												
- other western hemisphere countries	+9	+13	-1	+10	+1	+20	--	-9	+6	+2	--	+11
- OEEC countries:												
EPU settlements	-129	+30	+49	-8	+24	-31	+14	-84	-5	-83	+5	-124
other	-3	-78	-19	-19	-20	-48	-73	-64	-77	-139	-120	-44
- other non-sterling countries	--	+8	+20	+19	+21	-4	-3	-12	-11	-7	-18	-14
Total	-123	-27	+49	+2	+26	-63	-62	-169	-87	-227	-133	-171
(iii)non-territorial orgs.	-2	-2	-1	-2	--	-36	+3	-7	+6	+195	-8	+2
Total (= change in reserves)	-232	+57	+186	+54	+179	-92	-29	-200	+95	-53	+51	-38

Source: HMSO, *UK balance of payments 1946-57*, 1959, Table 10, p.39.

A loss of competitiveness, due to relatively high inflation, partially explains Britain's inability to accumulate reserves.[70] In particular, the decline in export price competitiveness in manufacturing, played an important role in preventing Britain from achieving a more favorable trade balance.[71] E. Bernstein identified three causes for balance of payments deficits, "current inflation, price and cost disparity, and structural

[70] See, for example, J. Llewellyn and S. Potter, "Competitiveness and the Current Account", in A. Boltho (ed.), *The European Economy: Growth and Crisis*, Oxford University Press, 1982, pp.138-9.
[71] M. Surrey, "United Kingdom", in Boltho (ed.), *The European Economy*, p.538.

maladjustments".[72] According to Max Corden, in an "inflation-prone" country, monetary expansion will stimulate domestic demand.[73] As a result, domestic consumption will increase partially through an increase in imports and partially through an increase in the consumption of domestic goods that would otherwise be exported. Both are to the detriment of the trade balance. In addition, inflation feeds through to higher export prices. Consequently, domestic exports become less competitive while imports become more competitive because, at fixed exchange rates, they will become relatively cheaper compared to domestic goods.[74] Thus, higher than average inflation tends to lead to a current account deficit.

Michael Bordo and Lars Jonung calculated the means and standard deviations of national inflation rates of the G-11 countries[75] for what they call the "preconvertible Bretton Woods period", from 1946 until 1958.

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[72] E. M. Bernstein, "Strategic Factors in Balance of Payments Adjustment", in *The Review of Economics and Statistics*, February 1958, p.133.

[73] For an in-depth discussion of the effect of inflation on the balance of payments, see W. M. Corden, *Inflation, Exchange Rates and the World Economy: Lectures on International Monetary Economics*, third edition, University of Chicago Press, 1986, in particular pp.56-70.

[74] This analysis is simplified in that it assumes price elasticities of demand for imports and exports and it assumes that a monetary expansion will increase demand rather than simply resulting in an equivalent increase in prices without any real effects on the economy.

[75] United States, United Kingdom, Germany, France, Japan, Canada, Italy, Belgium, Netherlands, Sweden, and Switzerland.

Table I.4: Average national inflation rates 1946-1958 (per cent)

	mean	*standard deviation*
Switzerland	1.8	1.9
Germany	2.1	6.2
Belgium	2.4	4.4
United States	2.8	3.5
Canada	3.9	3.9
Sweden	4.1	5.4
Netherlands	4.5	3.2
United Kingdom	4.6	2.5
Japan	4.7	7.3
France	5.6	5.1
Italy	5.8	16.0
mean	3.8	5.4
convergence	1.1	2.2

Source: M. D. Bordo and L. Jonung, *Monetary Regimes, Inflation and Monetary Reform: An Essay in Honor of Axel Leijonhufvud*, Working Paper No. 16, Working Paper Series in Economics and Finance, Stockholm School of Economics, May, 1994, data appendix.

The calculations by Bordo and Jonung show that whereas Germany had the second lowest average inflation rate, the UK's average inflation rate was only exceeded by Japan, France and Italy (table I.4). Germany's average inflation rate was less than half that of the UK, placing Germany far below the G-11 average and the UK nearly one percent above. The high standard deviation in the case of Germany is explained by relatively high inflation during the Korean war contrasting with periods of extremely low inflation before and after the Korean War. Germany's average inflation rate, and its standard deviation, would be even smaller if the Korean War years of 1950/1 were excluded, whereas the removal of those high inflation years on countries with higher average inflation, and small standard deviation, would have a smaller effect. The price stability data is compatible with the relative strength of the DM compared to the pound sterling in the 1950s as exhibited in the bank note rates for both shown in figure III.2. Similarly, in accordance with a currency which was even more volatile and vulnerable than sterling, France's average inflation rate between 1946 and 1958 was only exceeded by Italy.[76]

Britain's and France's above average inflation rates explain these countries' poor reserves record.[77] According to Eichengreen's calculations, Britain's unit labor cost increased by 43 per cent between 1950 and 1958, whereas Germany's only grew by 27 per cent in the same period.[78] In addition, British labor productivity performed poorly compared to Germany.[79] In France, the unit labor cost was only 27 per cent higher in 1958 than in 1950, but this does not take into account a 20 per cent devaluation of the franc in 1957, which temporarily offset wage pressures.[80] The unit labor cost indices indicate a significant difference in wage inflation in France, Britain and Germany. Relatively high inflation increased domestic demand and undermined UK and French competitiveness through rising input costs, which in turn resulted in a trade balance deficit and an inability to accumulate foreign reserves.

Some contemporary observers in the 1950s attributed sterling's weakness to growing productivity differences and overexpansion at home.[81] Britain's and France's stagnant foreign exchange reserves were first and foremost the symptom of their balance of payments problems which centered around their trade balance. Contrary to Eichengreen's assertions, it is questionable whether wage discipline was adequate in

[76] For a discussion of France's inflationary problems and their effects on the balance of payments, see G. Saint-Paul, "Economic Reconstruction in France: 1945-1958", in R. Dornbusch, W. Nölling and R. Layard (eds.), *Postwar Economic Reconstruction and Lessons for the East Today*, MIT Press, 1993, pp.83-114, G. Saint-Paul, "France: Real and Monetary Aspects of French Exchange Rate Policy under the Fourth Republic", in Eichengreen, *Europe's Post-War Recovery*, pp.292-319, and C. Sautter, "France", in Boltho (ed.), *The European Economy*, pp.449-471.
[77] for France, see, Saint-Paul, "Economic Reconstruction".
[78] Eichengreen, *Reconstructing*, p.63.
[79] Milward, *The European Rescue*, p.151.
[80] Eichengreen, *Reconstructing*, p.63. In Eichengreen's measurement of unit labor cost a depreciation reduces unit labor costs.
[81] Kenen, *British Monetary Policy*, p.109.

France and Britain, particularly in comparison with Germany.

Reserves vs. liabilities

Large foreign exchange liabilities carried over from previous economic eras or wartime expenditure can present an exogenous threat to a country's reserves. In this case, reserves can be insufficient even for a country with a healthy trade balance. Throughout the 1950s, the large sterling balances held by non-residents appeared to present a constant threat to UK reserves, and sterling's stability, referred to as the sterling overhang. British policymakers argued in the 1950s that UK reserves were insufficient with regard to the huge sterling liabilities incurred during World War II. Regarding convertibility, many expressed the fear that if and as soon as non-resident holders of sterling became free to exchange them into any other currency, in particular into the dollar, they might rush to do so, especially if confidence in sterling was low.[82] This fear was not unfounded, since that was exactly what had happened in the 1947 attempt at convertibility. The size of the sterling overhang meant that the run on the pound thus unleashed would exceed Britain's reserve capacity by far. The sterling overhang was blamed for the weakness of sterling as can be seen in Judd Polk's "rebirth theory", coined in 1956, which expressed a widespread belief that "there is nothing wrong with sterling apart from the heavy volume of obligations that a country gets into in the course of two closely spaced all-out wars".[83] Similarly, more recently, John Fforde identified the sterling overhang, the volatility of untied balances combined with the ratio of UK reserves to external monetary liabilities, and the risk that sterling area countries would choose to accumulate US dollars as reserves

[82] PRO T236-5403, "Exchange Rate Policy (Note of a Meeting held in the Chancellor of the Exchequer's room at 4 p.m. on Tuesday, 24th April)", April 24, 1956.
[83] Polk, *Sterling*, p.251.

instead of sterling as the three dangers that threatened sterling in the 1940s and 1950s.[84]

Contrary to these views, Catherine Schenk claimed in a recent book that observers in the 1950s overestimated the danger and the volatility of the sterling balances.[85] Between 1950 and 1958 the geographical distribution and monetary composition of the sterling balances changed significantly, with an increase in the share of sterling balances held by the colonies while the balances of the independent sterling area declined. Thus, colonial sterling balances more than doubled from £673 million in 1950 to £1.45 billion in 1958, accounting for about one half of the total sterling area balances by the beginning of 1958, while sterling balances of the independent sterling area declined from £1.9 billion in 1950 to £1.4 billion in 1958.[86] According to Schenk, the increase of colonial sterling balances relative to the sterling balances held by the independent sterling area reduced the overall volatility of the sterling balances. The largest part of the colonial balances was "earmarked for a variety of specific purposes which restricted their liquidity".[87] The run-down in the sterling balances held by the independent sterling area meant that after the mid-1950s, most of the countries in the independent sterling area "held only minimal working balances so the image of large 'excess' reserves floating around the sterling area ready to be 'cashed in' is misleading".[88]

The sterling balances of the non-sterling area were the most volatile of the three categories. They were also different from the other two - colonial balances and independent sterling area balances - since:

> Most NSA [non-sterling area] balances were held privately as working balances. Britain excercised no control over these assets and so they were linked closely to

[84] Fforde, *The Bank of England*, p.275.
[85] Schenk, *Britain*, p.48.
[86] ibid., pp.20 & 25.
[87] ibid., p.22.
[88] ibid., p.25.

the volume of trade in sterling and to confidence in the pound.[89]

Schenk estimated these NSA holdings at about £1.6 billion in early 1950 and about £1.4 billion in September 1958.[90] However, a large part of the non-sterling area balances were held by non-territorial organizations, such as the International Monetary Fund, which meant that they were not very volatile. If sterling holdings of non-territorial organizations are excluded, the total non-sterling area balances, and thus the share which is considered the most volatile, becomes much smaller than it is often presented to be. As can be seen from the table below, sterling balances of non-sterling countries excluding holdings of non-territorial organizations only exceeded the UK's gold and dollar reserves in 1951 and 1952. These non-sterling balances dropped from £934 million to £727 million between 1950 and 1958, although the decline was not continuous.

[89] ibid., p.26.

[90] figures given are estimated from top chart in Schenk, *Britain*, p.21.

Table I.5: Sterling balances of the non-sterling countries compared to UK gold and dollar reserves 1950-7 (million £)

	total sterling balances of non-sterling countries, excluding holdings of non-territorial organizations	holdings of non-territorial organizations	UK gold and dollar reserves
December 31, 1950	934	577	1178
December 31, 1951	941	566	834
December 31, 1952	677	567	659
December 31, 1953	695	511	899
December 31, 1954	779	476	986
December 31, 1955	697	469	757
December 31, 1956	565	669	799
December 31, 1957	570	645	812
December 31, 1958	727	631[a]	1096

a: June 30, 1958.
Source: HMSO, *UK Balance of Payments 1946-57*,
BIS, *29th Annual Report, April 1, 1958 to March 31, 1959*,
p.141, and IMF *International Financial Statistics*.

These figures show that the threat presented by these sterling balances to British reservers was not as big as often portrayed.

To what extent did the foreign-held sterling balances affect UK policy on convertibility? Although the Bank of England and the Treasury disagreed on many issues regarding convertibility, as will be shown later, they agreed that convertibility would be limited to non-residents of the sterling area.[91] Consequently, the sterling balances held by residents of the sterling area did not immediately influence UK officials' stance on convertibility. An examination of the impact of the sterling overhang on progress towards convertibility must focus therefore primarily on the non-resident sterling balances, that is the balances held by non-residents of the sterling area, since only they were to become convertible upon the establishment of convertibility. In 1954 the sterling balances that

[91] Kaplan and Schleiminger, *The European Payments Union*, p.161.

were held neither by dollar area residents nor by sterling area residents became transferable sterling balances. Thus after March 1954, non-resident sterling balances fell largely into two categories: American account sterling, and transferable sterling.[92] By 1950, American account sterling, that is sterling belonging to residents of the dollar area, could already be converted into US dollars at the official rate. In addition, the size of these balances was negligible in relation to the total non-resident sterling holdings and small in relation to Britain's gold and foreign exchange reserves (see tables I.1 and I.3). Consequently, the monetary authorities' main concern when it came to convertibility centered on transferable sterling.

Table I.6: Sterling balances of non-sterling area residents (million £)

end of	total non-sterling area	dollar area	transferable sterling area	gold and dollar reserves
1951	941	38	n.a.	834
1952	677	34	n.a.	659
1953	695	62	n.a.	899
1954	779	97	682	986
1955	697	58	639	757
1956	565	37	528	799
1957	570	35	535	812
1958	727	48	679	1096

Source: Bank for International Settlements, *29th Annual Report, April 1, 1958 to March 31, 1959*, p.141. reserves from previous table.

Only the transferable sterling balances would have played a direct role in influencing UK policy choices regarding convertibility. After 1952, UK gold and dollar reserves always exceeded the size of these transferable sterling balances, although not by a comfortable margin. Certainly, the ratio of reserves to transferable sterling balances looked even

[92] See also section on path to convertibility in this chapter.

smaller when it was compared to the ratio of Germany's reserves to Bekomark holdings.[93] The development and characteristics of transferable sterling mirrored very closely the development of the German Bekomark. Transferable sterling and Bekomark obtained a very similar status in the spring of 1954. Both became transferable among non-residents throughout the non-dollar area. Both were traded unofficially at discounts in foreign exchange markets outside the currency-issuing country. Table I.7 compares the size of transferable sterling holdings of non-residents to Bekomark holdings of German non-residents. Germany's Bekomark holdings look irrelevant compared to the size of transferable sterling balances that the UK would have to be prepared to convert when convertibility was established.[94] The table shows that Bekomark holdings were too small to have ever been a serious concern for German monetary authorities when contemplating convertibility. Non-resident Bekomark balances definitely presented no threat to currency stability if presented for conversion, when measured against the amount of foreign exchange reserves available in Germany.

[93] Bekomark referred to DM accounts with limited convertibility ('beschränkt konvertierbare DM'). They were the German equivalent of the transferable sterling accounts in that they were the DM accounts of those non-residents who were residents of the non-dollar area countries. Similar to transferable sterling Bekomark could be used for payment of goods and services to all countries with which the FRG had payments agreements, that is with the non-dollar area. Bekomark holdings were also transferable among non-residents. For a more detailed discussion see the German chapter.

[94] DM and sterling holdings of dollar area residents need not be considered here since they were already convertible.

Table I.7: Holdings of transferable sterling and Bekomark compared to gold and convertible currency reserves (million US dollars at end of period)[a]

	UK[a]			FRG[b]		
	holdings of gold and convertible currency	transferable sterling holdings	ratio of reserves to transferable sterling	holdings of gold and convertible currency	Bekomark holdings	ratio of reserves to Bekomark
1953	2518	1772	1.42	1281	12	106.75
1954	2762	1907	1.45	1997	52	38.40
1955	2120	1789	1.19	2404	70	34.34
1956	2237	1478	1.51	3402	120	28.35
1957	2273	1498	1.52	4105	123	33.37
1958	3069	1901	1.61	4604	189[c]	24.36

a: converted at £1.00 = US $2.80.
b: converted at DM1.00 = US $0.238.
c: at the end of November.
gold and foreign exchange holdings of Bundesbank for FRG and of Exchange Equalization Account for UK.
Source: transferable sterling holdings from BIS, *27th Annual Report, April 1 1956 to March 31, 1957*, p.182 and BIS, *29th Annual Report, April 1, 1958 to March 31, 1959*, p.177; Bekomark holdings from Deutsche Bundesbank, *Monatsbericht für Januar 1958*, p.98 and *Monatsbericht für Januar 1959*, p.124; reserves calculated from IMF *International Financial Statistics*.

While the UK could not rely on a reserve to liabilities ratio as comfortable as Germany, the volume of sterling balances to which convertibility applied was not nearly as formidable as often presented. In discussions between the Treasury and the Bank on when to establish convertibility, Treasury officials often pointed to the non-sterling area sterling balances as an argument against the Bank's pressures to establish convertibility as quickly as possible.[95] The sterling balances were an excuse for the Treasury to postpone action and they allowed the Government to mask the real reasons for its reluctance to establish convertibility. Firstly, American account sterling was already convertible, and secondly, as Leslie Rowan from the Treasury wrote to Maude in February 1958, "[a] large part of this [transferable account sterling balances] represents the working balances of

[95] PRO T236-5403, "Exchange Rate Policy (Note of a Meeting held in the Chancellor of the Exchequer's Room at 4 p.m. on Tuesday, 24th April 1956)", April 24, 1956.

foreign banks operating in London".[96] Thus a large part of the transferable sterling balances were not very volatile and did not present a threat to the pound's stability.[97] Thirdly, and perhaps even more importantly, holders of transferable sterling balances could already convert these into dollars at only a small discount, and after the declaration by the Bank of England in the spring 1955 they could rest assured that the discount would not exceed one per cent. When the Treasury attempted to justify the postponement of convertibility by arguing that the transferable sterling balances would flood the exchange markets upon the establishment of convertibility, the Bank retorted that countries were not deterred by the discount on transferable sterling from converting it into dollars "if they so desire".[98] Thus, there was no reason to believe that convertibility would release a flood of sterling balances to be presented for conversion as the Treasury claimed, since these were already de facto convertible and even central banks were converting their transferable sterling in the unofficial market.[99]

The sterling liabilities in themselves might have affected policy on convertibility in the sense that they were a powerful obstacle to devaluation of the pound, which, according to Eichengreen would have been necessary for establishing viable convertibility. The argument was that devaluation was an option not open to the British since it would reduce the value of sterling holdings which in turn would damage Britain's relations with the rest of the sterling area.[100] However, the following chapter on UK policy on

[96] PRO T236-3945, Rowan to Maude, February 13, 1958.
[97] In contrast to the large part of the literature on the issue in the 1950s and 1960s, A. Hazelwood claimed in 1959 that, "[a] substantial, though not clearly definable, component of the sterling balances is not of a volatile character, but is held for long-term purposes, and changes in it could reasonably be considered as long-term investment or disinvestment in the United Kingdom". A. Hazelwood, "The Export and Import of Capital", in G.D.N. Worswick and P.H. Ady (eds.), *The British Economy in the Nineteen-Fifties*, Clarendon Press, 1962, pp.186-7.
[98] PRO T236-5403, Parsons (BoE) to Rowan, May, 16, 1956.
[99] ibid.
[100] see, fore example, Strange, *Sterling*, pp.336-7.

convertibility will show that the sterling balances did not stop UK governments from contemplating letting the pound float downwards. Therefore, the sterling balances do not explain why Britain refrained from devaluation, which according to Eichengreen, would have allowed it to establish convertibility way before 1958.

The sterling balances certainly increased the exposure of sterling and the costs for the UK of international fluctuations in exchange rate confidence, but they were neither the threat to the reserves often presented nor were they the cause of sterling's instability or 'weakness'.[101] Similarly, the mere existence of the sterling balances does not provide a satisfactory explanation for the pound's proneness to speculative attacks throughout the 1950s. Therefore, the sterling overhang alone provides no satisfactory explanation for the reluctance with which the UK approached convertibility.

Under the era of the gold standard, which lasted roughly from 1880 until 1914, Britain was able to run an international financial system of "international capital transfers of a magnitude that remains unrivaled" with a comparatively low level of gold reserves.[102] During the gold standard, sterling was a widely used reserve currency.[103] Similarly, after the war, many countries, albeit mainly from the sterling area, held sterling balances as reserve currency. However, during the gold standard UK reserves were much smaller. Thus Roy Harrod wrote in 1952:

> [t]he free gold in the Bank of England was usually of the order of £20 million. It is instructive to compare this with the present reserve (September 30th 1951) of £1,167 million, which is deemed to be so low as to spell perdition. Even after allowing for the change in the value of gold, this present-day reserve is gigantic by nineteenth century standards.[104]

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[101] Eichengreen argues that "Britain's overseas liabilities ... constituted less of a threat to convertibility after 1947, and especially after 1951, than before". Eichengreen, *Reconstructing*, p.78.
[102] Obstfeld, "The Adjustment Mechanism", p.212.
[103] Bordo, *The Gold Standard*, p.23, and Eichengreen, *Elusive Stability*, p.118.
[104] R. Harrod, *The Pound Sterling*, Essays in International Finance, No.13, Princeton University Press,

The principal difference between the large amount of sterling balances held as reserve currency under the gold standard and the sterling balances held by countries after World War II is the degree of international confidence in the pound and the credibility of Britain's commitment to the stability of the pound. Thus, a considerable excess of liabilities over reserves does not explain the weakness of a currency. The causes for the 'weakness' of the pound in the 1950s must be found elsewhere.

Reserves and confidence

Throughout the post-war era, concern for the stability of the pound has continuously played a decisive role in British economic policymaking,[105] beginning with the speculative attack on the pound that followed the first convertibility attempt in 1947 and continuing in the present with the severe speculative attacks on the pound in the spring of 1995. Many attempts have been made to explain sterling's instability and 'weakness', especially when compared to the DM. In general, the abundance of books on the problem of the pound, reflects both the importance attributed to the pound as international currency and to the concern about its health.[106] Many authors have explained a large share of the pound's fragility by the insufficiency of reserves. Thus, one criterion applied to reserve sufficiency was whether national reserves were large enough to be able to withstand a loss of confidence in the national currency. According to this measure, the level of reserves sufficiency varies according to the level of confidence in the currency. The lower the confidence, the higher the amount of reserves necessary to inspire

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1952, p.3.

[105] see, for example, J. Tomlinson, "British Economic Policy since 1945", in Floud and McCloskey (eds.), *The Economic History*, p.266.

[106] see, for example, Cairncross and Eichengreen, *Sterling in Decline*, B. Cohen, *The Future of Sterling as an International Currency*, Macmillan, 1971, Day, *The Future*, Harrod, *The Pound Sterling, 1951-1958*, Hawtrey, *The Pound*, Hirsch, *The Pound Sterling*, and Strange, *Sterling*.

confidence. Thus, L. Camu argued that the sufficiency level of reserves depended "tant de la confiance qu'inspire la monnaie que de l'état de la balance des paiements".[107] Moreover, a low level of reserves in itself could erode confidence in a currency.

M. FG. Scott argued in 1962 that the main cause for sterling's proneness to speculative attacks lay in the insufficiency of the UK's gold and dollar reserves. He agreed with the findings of the Radcliffe Committee[108] on this issue when he stated that,

> [i]t was this [inadequacy of gold and dollar reserves] which encouraged speculation against the pound, thus exaggerating our weakness, and it was this which compelled the Government to take countermeasures in a hurry. Had the reserves been larger, the measures could have been gentler, and some dislocation of the economy could have been avoided.[109]

Similarly, Camu claimed that "les autorités doivent détenir une masse de manoeuvre suffisante pour persuader l'opinion de la solidité de leur monnaie et pour se défendre contre des mouvements spéculatifs".[110] Thus, on the one hand, it was argued that low reserves led to a loss of confidence, and consequent weakening of the pound, while, on the

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[107] Camu, "La convertibilité", p.22.
'as much on confidence which the currency inspires as on the state of the balance of payments'.

[108] In May 1957, a Committee under the chairmanship of Lord Radcliffe was appointed to examine the monetary and credit system of the UK and in particular the role of monetary policy for the British economy. The Committtee reported two years later with the Radcliffe Report which was published in 1959, that is, after the establishment of convertibility. HMSO, *Report of the Committee on the Working of the Monetary System*, Cmnd.827, 1959. According to Cairncross, "[t]he main consequences of the Report lay less in the adoption of specific recommendations for policy than in a major improvement in financial statistics and information, closer working relations between the Bank and the Treasury, and a continuing debate over the role of monetary policy in which ideas very different from those of the Radcliffe Report received increasing attention". A. Cairncross "Economic Policy and Performance, 1945-1964", in Floud and McCloskey (eds.), *The Economic History*, p.59. The decision to appoint a Committee to examine the effectiveness of monetary policy was partially motivated by the experience and frustration with the instability of sterling. For a brief analysis of the report see N. Kaldor, "The Radcliffe Report", in *Review of Economics and Statistics*, Feb. 1960, pp.14-19 or *The Banker*, "The Report analysed", September 1959, p.497ff.

[109] M. FG. Scott, "The Balance of Payments Crises", Chapter 7 in Worswick and Ady, *The British Economy*, pp.224-5.

[110] Camu, "La convertibilité".
'the authorities must retain a quantity which allows sufficient room for maneouver to persuade the opinion of the solidity of their curreny and to defend themselves against shot term speculative movements'.

other hand, low confidence in the pound made reserves insufficient. This is a circuitous or spiral argument, with one element reinforcing the other.

As a result of both the 1947 experience of convertibility and the recurring sterling crises throughout the 1950s, policymakers questioned the sufficiency of UK reserves to withstand speculation. Some even attributed sterling's weakness to the level of reserves.[111] However, the level of reserves on its own fails to explain the weakness of the pound in the 1950s. Periods of sterling weakness were not preceded by adverse developments in UK reserves. Thus, in spite of continuously growing reserves throughout 1953 and 1954, sterling was subject to two weak periods.

While the trade balance, and underlying competitiveness problems, explain the lack of growth in Britain's and France's reserves in the 1950s, as compared to Germany, trade balance problems do not explain the occurrence of the speculative crises that plagued sterling in the 1950s. At least the later crises started at times when the trade balance was clearly improving and often doing better than usual. The speculative crisis in the third quarter of 1957 occurred at a time when Britain's trade balance was strengthening, leading observers to attribute the considerable reserve losses, $531 million or £190 million, between July and September to speculative pressures.[112] Similarly, the speculative crisis of the fourth quarter of 1956 occurred at a time when Britain's trade balance was improving.[113] The speculation against sterling that occurred between August 1954 and

[111] In an emphatic appeal to the Treasury to float the pound, the academic William Rees-Mogg claimed that "[s]peculation against the pound, ..., is greatly encouraged by the knowledge that the reserves are of inadequate size". PRO T236-4364, William Rees-Mogg, "British Currency Policy", April 1957 (no exact date).

[112] Federal Reserve Bank of New York, *Monthly Review*, January 1958, p.9.
Similarly, J.C.R. Dow pointed out that when the run on the pound occurred the UK current account was actually in "comfortable balance". Dow, *The Management*, p.96.

[113] Federal Reserve Bank of New York, *Monthly Review*, May 1957, p.59.

February 1955 was attributed more to disappointment after the realization that Britain would not make the pound convertible in 1955 as had been expected than to problems in the balance of payments.[114] Finally, the weakness of sterling in the second half of 1955 was caused by the belief that the government would let the pound float downward.

All the above sterling crises were accompanied by a loss of reserves. Samual Katz identified four sterling crises between 1955 and 1958. He estimated that during each of these periods of sterling weakness, the largest portion of the reserve drain could be attributed to speculation against sterling. The effect of speculation against sterling was proxied by the EPU non-trade residual which was calculated as the difference between Britain's monthly trade balance with the EPU and the payments results.

Table I.8: United Kingdom: selected official reserve changes, 1955-1957 (million US dollars)

Period	Number of months	Reserve losses		EPU non-trade residual
		Actual	Adjusted[a]	
I. 1955: July to Sept.	3	-355	-345	-412
II. 1956: May to July	3	+77	+63	-384
III. 1956: Aug. to Dec.	5	-272	-690	-397
IV. 1957: July to Sept.	3	-531	-628	-422

a: Actual reserves adjusted for known government capital transactions.
Source: reproduced from S. Katz, *Sterling Speculation and European Convertibility: 1955-1958*, Essays in International Finance, No.37, Princeton University Press, 1961, p.15.

Katz's calculations show that a large extent of reserve loss during sterling crises was explained by speculative short-term capital flows, rather than by trade deficits. To a large extent, the speculation against sterling in the 1950s took the form of leads and lags in the payment of trade,[115] with the conversion of foreign sterling holdings, that is, the sterling

[114] BIS, *25th Annual Report, April 1,1954 to March 31, 1955*, pp.110-1, and *The Economist*, "Astringent for the Pound", January 29, 1955, p.384.

[115] According to Katz, exchange rate speculation in the 1950s differed from exchange rate speculation before World War II in that it was carried out by merchants, through leads and lags in the payment of trade. For these merchants leads and lags was a way to reduce their exchange risks rather than incur risks if they anticipated a change in exchange rates in the near future. S. Katz, *Sterling Speculation and*

overhang, playing a subordinate role in these crises. Leads and lags of payments were generally linked to an expectation of exchange rate changes.[116] In the case of Britain, reserve losses due to leads and lags were triggered by expectations of a depreciation or a devaluation of the pound.[117] Deterioration of confidence in the pound seems, therefore, to have played a greater role in triggering pound weakness than the level of reserves, the trade balance or the sterling overhang. If the size of reserves or the trade balance were the determining factor of sterling strength in the 1950s, then the strengthening of sterling after each of the above-mentioned crises should be explainable by an improvement in these factors. However, none of the recoveries of sterling can be attributed to an increase in UK reserves or to an improvement in the trade balance, confirming the conclusion that these factors were not the catalysts in the sterling crises.

For the UK, the 1950s were characterized by recurring sterling crises. Similarly, the French franc was one of the weakest currencies in Europe in the 1950s. The inability of both countries to accumulate foreign exchange reserves can be attributed to problems of international competitiveness, due to rising costs, which prevented them from running the current account surpluses necessary for accumulating reserves. Similarly, Germany's rapidly rising reserves were the result of growing trade surpluses. The argument that reserves were too low to allow Britain to move to convertibility must be rejected as simplistic and misleading in that it failed to recognize the root of the problem which was

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European Convertibility: 1955-1958, Essays in International Finance, No. 37, Princeton University Press, 1961, p.3.

[116] Analyses of arbitrage and speculation in sterling are also provided in A. J. Bloomfield, *Speculative and Flight Movements of Capital in Postwar International Finance*, Princeton Studies in International Finance, February 1954, Spraos, "Speculation", pp.3-21, and B. Reading, "The Forward Pound 1951-1959", in *The Economic Journal*, Vol. 70, No.278, June 1960, pp.304-319.

[117] Katz, *Sterling Speculation*, pp.4-5.

lack of confidence in the pound caused by economic fundamentals and economic policy decisions. As Roy Harrod wrote to the Prime Minister in 1957: "The British throughout the heyday of sterling never did work on a large reserve. The idea that we must have one can be dismissed."[118] Similarly, the Bank for International Settlements pointed out in 1956 that, "[a]s regards the adequacy of monetary reserves, no single criterion is decisive, since ultimately the value of a currency depends not so much on the magnitude of the accumulated reserves as on the determination with which it is upheld in a period of strain".[119]

The professed aim of the UK government to return to convertibility sooner rather than later conflicted with the volatility of the pound and its proneness to speculative attacks. This section has argued that the weakness of the pound seems to have been the result of a lack of confidence, rather than insufficient reserves, as was often claimed. The bouts of sterling speculation generally were not triggered by a drop in reserves, an increase in liabilities, or a deterioration in the current account balance. Instead, the weakness of the sterling exchange rate for bank notes indicated a lack of confidence in the pound throughout the 1950s. The fact that reserve losses occurred mainly as a result of leads and lags, which were motivated by the expectation of an imminent sterling devaluation, and the forward rate for the pound confirm the claim that the pound suffered from a lack of confidence. The weakness of the pound in the 1950s presented a powerful obstacle to establishing convertibility in the 1950s. If reserves and liabilities do not explain the weakness of the pound, what were the causes of the lack of confidence in the pound? The

[118] PRO PREM11-2973, Roy Harrod to PM "Extract from letter of 21.9.1957", September 21, 1957.
[119] BIS, *Annual Report, April 1,1955 to March 31, 1956*, p.163.

chapter on UK convertibility suggests one explanation for the weakness of the pound.

Conclusion

In the 1950s, UK officials identified the level of gold and foreign exchange reserves as a crucial, if not the most important, measure of the strength or stability of sterling. Thus, the UK explained its policy on convertibility as a policy of waiting for the reserves to reach a level "at which it was thought safe to establish convertibility".[120] The UK often treated the reserves as an exogenous variable which determined currency stability. However, a country's level of reserves are only the reflection, or symptom, of a country's balance of payments. Sterling's weakness seems to have been the greater obstacle to UK convertibility in the 1950s.

In the 1950s, the pound was prone to weakness, as reflected by the recurring large drops in the bank note rate for the pound. In contrast to the pound, the DM went from strength to strength once it had overcome its balance of payments crisis in 1951. The documented inability to accumulate foreign exchange reserves is one indication of the weakness of pound. While Germany's current account ensured a continued increase in dollar and foreign exchange reserves, Britain's current account shows a constant trade deficit which invisible earnings failed to offset.

Part of sterling's weakness can be explained by the fact that in an adjustable peg exchange rate system speculators can only win.[121] If they detect downward pressure on a currency, speculators will seek to get out of that currency, because of the chance that it might be devalued. By selling the currency they increase downward pressure on the currency. Speculators will have an incentive to get out of a currency experiencing

[120] Milward, "Motives", pp.260-1.
[121] Tew, *The Evolution*, pp.84-5.

downward pressure or suffering from loss of confidence, because if the currency is devalued they will have hedged against that whereas if it is not devalued they do not lose anything, - assuming that they can freely buy and sell the currency and disregarding transactions costs -, by switching back into the original currency, since the currency will not be revalued in the near future. This one-way option for speculators undoubtedly increased sterling's vulnerability to speculation. However, unless speculation is assumed to be irrational or random, the one-way option for speculators does not explain what triggers the loss of confidence in the first place.

The factors undermining sterling in the 1950s consolidated the strength of the DM. Germany's trade ensured a continuously rising level of gold and foreign exchange reserves. Again, however, the importance for currency stability lies not so much in the actual size of the reserves but rather in the confidence in the DM created by the prospects of continued large reserve inflows due to large current account surpluses. Contrary to the widespread belief at the time, the fact that British gold and convertible currency reserves were small when compared with the sterling liabilities does not explain the recurring speculation against sterling in the 1950s. In addition to the fact that the UK had 'hidden reserves' which were not included in statements on Britain's reserves, in times of trouble the UK could back up its reserves with credit lines from both the IMF and the Export-Import Bank.[122] The inability to accumulate foreign exchange reserves is a reflection of a structural balance of payments problem rather than self sufficient cause of the weakness of sterling.

While trade considerations made convertibility desirable, the strength of

[122] *The Economist*, "To Defend the Pound", December 8, 1956, p.851; and Schenk, *British Management*, pp.298-9.

Germany's currency as documented in this chapter provided the necessary conditions for making the DM convertible. However, while trade considerations made a move to convertibility only attractive if it was collective, there were also currency considerations that prevented Germany from moving to convertibility before the rest of Europe, and, above all, before Britain. The German chapter will discuss the connection between German monetary policy and policy on convertibility.

The French franc was even more prone to downward pressure than the pound sterling. However, the situation of the franc differed significantly from that of both the DM and the pound sterling. France's external economic links were much more limited than Germany's or Britain's. Both trade and capital flows were strongly controlled, resulting in a much more closed economy. French policy on convertibility up until 1958 was consistent with both trade and currency considerations in that up until 1958, France showed very little interest in opening up the economy or freeing its currency from exchange control. France had neither the motivation, through trade, nor the satisfactory condition, from currency stability, to do so. The chapter on French convertibility policy will show the dramatic change that took place in French economic policy in 1958 and why France suddenly shot ahead to take the lead in the establishment of convertibility. Whereas the move to convertibility in 1958 represents a continuation of Britain's and Germany's monetary policy in the 1950s, for France the move was part of a break of continuity in French monetary and economic policy after World War II.

The fact that neither trade deficits nor changes in the sterling overhang triggered the speculative crises against sterling in the 1950s and the fact that announcements of increases in reserves did not stop speculation once it had started indicate that other factors were responsible for the weakness of the pound. The UK chapter will propose an alternative or complementary explanation for the weakness of the pound. It will show that there was a profound lack of confidence in the pound in the 1950s. It will also show that the lack of confidence was not irrational but that it can be attributed to UK government policy as well as economic fundamentals. British policy was torn between the conflicting goals of establishing the pound as international key currency and pursuing an independent monetary policy. British policy on convertibility played a crucial role in this dilemma. For the UK, policy on convertibility embodied the dilemma of the necessity to liberalize its currency for international transactions if it wanted to maintain its claim to international status on the one hand, and the fear of letting the external constraint curtail autonomy over domestic economic policy by removing exchange, and trade and capital, controls, on the other. This dilemma created a fundamental crisis of UK commitment to the tenets of the Bretton Woods system and this is what weakened the pound, not the other factors frequently listed.

PROGRESS TOWARD CONVERTIBILITY

This section briefly retraces Britain, France and Germany's technical progress towards convertibility after World War II. In addition to providing a historical overview, the aim is to show similarities and differences in the approach to exchange control removal in the three countries.

Like most other Western European countries, Britain emerged from World War II with an inconvertible currency, a huge dollar deficit, and a shortage of gold and dollar reserves.[123] After World War II most foreign currency earned by UK residents from exports, invisibles and capital investment had to be surrendered to authorized dealers. Exchange control generally governed all transactions between residents and non-residents except for those with other parts of the sterling area. A large portion of the sterling earned by non-dollar area countries during World War II was held in so-called 'special accounts' which were effectively blocked, that is, they could not be used for the payment of trade or investment, or converted. In 1952, this blocked sterling made up a little less than one third of all sterling balances - £1 billion out of £3.4 billion - held outside the UK and the dollar area.[124]

Under the pressure of the United States - in connection with the loan agreement negotiated in 1946 -, Britain undertook the first European attempt to restore currency convertibility in 1947.[125] Convertibility was limited to newly acquired sterling, thus excluding outstanding sterling balances held by countries outside the United Kingdom and accumulated before the convertibility date. These were estimated at the equivalent of $14.9 billion at the end of 1946, an amount far exceeding the unspent balance of US and Canadian loans, $2.2 billion in mid-1947, and British gold and dollar reserves, $2.4 billion in mid-1947, combined.[126] In spite of these efforts to limit the quantity available for conversion into dollars, as soon as sterling was freed the UK started losing US dollars at a dramatic and accelerating rate, forcing the suspension of convertibility only six weeks

[123] For a brief historical overview over the development of the system of exchange controls and of the path towards convertibility of the pound sterling, see Hinshaw, "Toward European Convertibility" and *Bank of England Quarterly Bulletin*, "The U.K. exchange control: a short history", Vol.7, No.3, September 1967, pp.245-260. For a history of the pound sterling see, for example A. Feaveryear, *The Pound Sterling: A History of English Money*, 2nd edition, Clarendon Press, 1963.

[124] B. Tew, *International Monetary Co-operation 1945-60*, fifth (revised) edition, Hutchinson & Co., 1960, p.134.

[125] For an account and analysis of the convertibility crisis, see, for example, Dow, *The Management*, Hinshaw, "Toward European Convertibility", Fforde, *The Bank of England*, Hirsch *The Pound Sterling*, Pressnell, *External Economic Policy*.

[126] Hinshaw, "Toward European Convertibility", p.10.

after it had been established. Hinshaw blamed the uncompetitiveness of the sterling area goods when compared with dollar area exports for the failure of convertibility.[127] The memory of the disaster of 1947 lingered with decisionmakers throughout the 1950s, up until the second official and successful attempt at the establishment of non-resident current account convertibility in December 1958.[128]

After 1947, Britain divided the world into four areas, according to the nature of the exchange control that it applied: the sterling area, the American account area, the transferable account area and a group of countries with which the UK maintained bilateral relationships. Table 1 shows the breakdown of countries according to the four sterling account types as of April 1952.

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[127] Hinshaw, "Toward European Convertibility", p.11.
[128] Polk, *Sterling*, pp.241-2.
See Germany chapter for a comparison of the UK and German historical experiences with convertibility or currency reform.

Table I.9: Sterling account system as of April 1952

sterling area	American account countries	transferable account countries	bilateral account countries
Australia			Argentina
New Zealand	USA	Austria	Brazil
South Africa	Bolivia	Chile	China
India	Central America	Czechoslovakia	Formosa
Pakistan	Venezuela	Denmark	France
Ceylon	Ecuador	Egypt	E. Germany
Burma	Philippines	Ethiopia	Hungary
Iceland	Cuba	Finland	Iran
Iraq	Colombia	W. Germany	Israel
Jordan	Dominica	Greece	Japan
Libya		Italy	Lebanon
Persian Gulf territories		Netherlands	Paraguay
		Norway	Peru
British Colonies		Poland	Portugal
		Spain	Romania
		Sweden	Switzerland
		Thailand	Syria
		USSR	Tangier
			Turkey
			Uruguay
			Yugoslavia

Source: reproduced from Schenk, *Britain*, p.9.

Within the sterling area "unconditional transferability was the rule, qualified by certain local controls mainly on capital transactions".[129] However, while payments into the sterling area were largely unrestricted and could be made in sterling, out-payments required authorization. No exchange control restricted the use of sterling that had reached an American account, except regarding its transfer to bilateral countries, and the British authorities stood ready to convert any American account sterling into US dollars on demand.[130] Officially, transferable account sterling could not be converted into US dollars or any other currency, but it could be transferred automatically for all payments to the

[129] Tew, *International Monetary Co-operation*, p.132.
[130] ibid.

sterling area and for current payments to any country in the transferable account area. Sterling held by residents of countries with bilateral agreements with the UK, finally, could be used for all payments to the sterling area, but required authorization for transfers to all other areas. The blocked sterling balances were excluded from all of these arrangements. In March 1954,

> the prescription of currency requirements for settlements with non-dollar countries other than Hungary, Iran, and Turkey were simplified by permitting receipts from and payments to those countries to be settled in sterling through any nonresident account (other than a Blocked Account) related to those countries. The facilities of transfer previously available only for Transferable Accounts in respect of current transactions were extended to all non-dollar countries (except Hungary, Iran, and Turkey) regardless of the nature of the transaction.[131]

In February 1955, the Exchange Equalization Account was authorized to intervene in foreign exchange markets abroad to maintain transferable sterling within one per cent of the official rate for sterling.

Britain exercised a restrictive policy regarding travel allowances and the import and export of banknotes. Generally, most foreign exchange receipts had to be surrendered, that is, residents had to offer foreign exchange receipts for sale to an authorized dealer. From February 1955 onwards, transferable sterling was unofficially convertible into US dollars at an exchange rate which remained roughly within one per cent of the official rate. On December 1958, American account, transferable account and bilateral account were unified into non-resident sterling and non-resident sterling became convertible officially into the US dollar. However, capital account restrictions continued to restrict the conversion of sterling for capital account purposes.

In Germany, 'Devisenzwangswirtschaft' - a system in which currency transactions

[131] IMF, *Sixth Annual Report on Exchange Restrictions*, p.308.

between residents and non-residents were governed largely by exchange controls - began in July 1931 with Chancellor Brüning's 'Notverordnungsgesetze' (emergency laws).[132] After World War II, the occupying powers prohibited all financial and commercial transactions between the German zones and the rest of the world. The first significant steps to liberalize financial transactions between German residents and non-residents were taken in connection with the currency reform in 1948.[133] As Germany gradually lifted exchange restrictions, several types of DM emerged, depending on the purpose for which the currency could be used and the country of residence of the holder of the currency.

Up until 1954, non-residents who resided in the free currency area - that is, the dollar area - were obliged to pay for German goods in convertible foreign currency. On April 1, 1954 the Runderlaß Außenwirtschaft (decree on external economic relations) 24/54 decreed that DM balances of residents of countries with freely convertible currencies, in particular the USA, Canada and Switzerland, could use their DM balances for all trade transactions which previously had required freely convertible currency.[134] To this purpose, free currency area residents could set up so-called 'frei konvertierbare DM-Konten', freely convertible DM accounts in the FRG.[135] Thus, they could use their DM balances to pay for German goods or for goods from third countries. DM balances of residents of convertible currency countries effectively became hard currency, at least for the payment of goods and services. Moreover, free currency area residents receiving payments could convert their holdings in these accounts into freely convertible currency,

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[132] Among other things, all foreign currency operations were centralized in the Reichsbank and all foreign exchange had to be turned in to the authorities. L. Köllner, *Chronik der deutschen Währungspolitik 1871-1991*, second edition, Fritz Knapp Verlag, 1991, pp.82-83.
[133] See German chapter for an account of the currency reform.
[134] BA B102-55340, "Stationen auf dem Wege zur Konvertibilität" (Abteilung VA), July 13, 1956. see also BA B102-55340, "Auszugsweise Übersetzung aus Foreign Report vom 18.2.1954 - Die D-Mark geht in Führung", undated.
[135] Bank deutscher Länder, *Geschäftsbericht für das Jahr 1953*, p.98.

regardless of whether the holdings were acquired from goods, services, or capital transactions.[136] However, capital investments by all non-residents in Germany still required permission.[137] Simultaneously, in 1954, the government allowed the establishment of DM accounts with limited convertibility, Bekomark accounts, for those non-residents who were residents of the non-dollar area countries.[138] Non-resident holders of Bekomark accounts could use these for payment of goods and services to all countries with which the FRG had payments agreements, that is, with the non-dollar area.[139] Bekomark holdings were also transferable among non-residents and were comparable to the transferable sterling accounts. The measures taken in 1954 effectively joined countries in two separate currency areas for the FRG, namely the dollar area and the area containing those countries with which the FRG had payments agreements.[140] The latter included the EPU countries but also those countries with which Germany still maintained bilateral trade agreements[141], with the exception of Brazil, Yugoslavia and Turkey which were excluded from this payments multilateralization.[142] The Bekomark was a significant step forward towards the transferability and convertibility of the DM for non-residents. However, Bekomark accounts could not be used for capital investment in Germany. Table I.10 shows the development of Bekomark and freely convertible DM accounts between 1953 and 1958.

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136 ibid.

137 ibid.

138 Bank deutscher Länder, *Geschäftsbericht für das Jahr 1953*, p.98.

139 BA B102-55340, "Stationen auf dem Wege zur Konvertibilität", July 13, 1956.

140 This development mirrors the unification of transferable sterling in the UK in the same year.

141 As of December 1953 these were Argentina, Chile Columbia, Ecuador, Paraguay and Uruguay in Latin America, Bulgaria, Finland, Poland, Czechoslovakia, Hungary in Eastern Europe, and Iran, Japan and Spain. Bank deutscher Länder, *Geschäftsbericht für das Jahr 1953*, p.92.

142 Bank for International Settlements, *25th Annual Report, 1.4.1954 to 31.3.1955*, p.114.

Table I.10: Holdings of Bekomark and freely convertible DM at end of year (million DM), 1952-1958

	1953	*1954*	*1955*	*1956*	*1957*	*1958*[a]
freely convertible DM accounts	3	22	50	74	180	668
Bekomark accounts	52	219	294	506	518	794

a: holdings the end of November

Source: reproduced from Deutsche Bundesbank, *Monatsbericht für Januar 1958*, p.98 and *Monatsbericht für Januar 1959*, p.124.

In 1931, non-resident accounts of Reichsmark were frozen into so-called Sperrmark, or 'blocked mark' accounts.[143] In 1950, the first steps were taken towards the liberalization of capital flows which had been prohibited under the military government after World War II.[144] Money was still not allowed to flow into or out of Germany but, starting in 1951, Sperrmark balances could be transferred among non-residents.[145] In addition, from August 1950 onwards, money in Sperrmark accounts could be used for investment in Germany. In 1953, after the London Debt Agreement, the Allied High Commission renounced its right to monitor the exchange control of the Federal Republic as it applied to capital flows.[146] Germany was now free to liberalize capital flows which it began in late 1953 when the repatriation of interest, dividends and company profits earned from Sperrmark account investments was permitted for all non-residents, including dollar area residents.[147] From April 1954, all holders of Sperrmark accounts could transfer abroad their balances, via clearing arrangements or payments agreements such as the

[143] This meant that the balances in German currency held by non-residents could not be invested, transferred to other non-residents, used for payment of trade, not to mention be repatriated by the foreign owners. The status of these holdings was not changed when World War II ended, nor in the transition from Reichsmark to Deutsche Mark during the currency reform of 1948. Bank deutscher Länder, *Geschäftsbericht für das Jahr 1954*, p.105.

[144] Köllner, *Chronik*, p.136.

[145] Buchheim, *Die Wiedereingliederung*, p.165.

[146] Bank deutscher Länder, *Geschäftsbericht für das Jahr 1953*, p.94.

[147] Bank deutscher Länder, *Geschäftsbericht für das Jahr 1953*, pp..96 and 99 and Bank deutscher Länder, *Geschäftsbericht für das Jahr 1954*, p.107.

EPU.[148] In September 1954, the Runderlaß Außenwirtschaft (RA) 78/54 decreed that all revenue earned on investments in Germany by non-residents could be transferred abroad. In addition, foreigners could withdraw limited of amounts money from Sperrmark accounts to be spent on travel expenses in the Federal Republic, and to be paid to residents of the FRG.[149] (In December 1953, total DM balances held by foreigners in blocked mark accounts totaled 774 million DM. Converted at DM4.20 for 1US dollar these holdings amounted to a mere 184.4 million US dollars, a very small amount compared to, especially, foreign-held sterling balances (see UK section). Moreover, contrary to the British case, these foreign-held balances made up only a little more than one tenth of Germany's federal gold and foreign exchange holdings, which were 1281 million US dollars in 1953.[150] From September 1954, all Sperrmark holdings could be transferred into 'beschränkt konvertierbare DM-Konten', also called Bekomark accounts.[151] Jointly with the significant relaxation of restrictions Sperrmark holdings were renamed 'liberalisierte Kapitalkonten' (liberalized capital accounts) or Libkamark accounts.[152] These Libkamark accounts could be used for investments in Germany, payments to Germany and limited repatriation of capital, that is, money invested in Germany could be exchanged back into non-dollar convertible currency.[153] Libkamark could be transferred into Bekomark accounts, but not the other way around. Like their predecessors, they could be drawn on for travel expenses in Germany, or to make payments or gifts to German residents.[154]

Until July 1958, when the Libkamark accounts were transformed into freely

[148] ibid., p.97.
[149] ibid., p.99.
[150] IMF, *International Financial Statistics*.
[151] Bank deutscher Länder, *Geschäftsbericht für das Jahr 1954*, p.105.
[152] ibid.
[153] B102-55340, "Stationen auf dem Wege zur Konvertibilität", (Abteilung VA), July 13, 1956. See also Buchheim, *Die Wiedereingliederung*, p.165.
[154] Bank deutscher Länder, *Geschäftsbericht für das Jahr 1954*, p.106.

convertible DM accounts,[155] Libkamark holdings were fed through capital gains, compensation payments, and the liquidation of capital investments, such as the sale of securities. They were run down through transferals to Bekomark accounts, investments, -such as the purchase of securities -, travel expenses, and transfer payments to residents.

Table I.11: Formation and use of Libkamark accounts between September 1954 and February 1955 (million DM)

total on August 31, 1954	629.6
increase	+969.2
decrease	-1136.0
total on February 28, 1955	462.8

Source: reproduced from Bank deutscher Länder, *Geschäftsbericht für das Jahr 1954*, p.106.

The cautious liberalization of Libkamark complemented Germany's general reluctance to liberalize capital inflows.[156] In contrast, Germany by far outpaced most Western European countries in freeing German investment abroad. Britain's, and most other Western European countries', monetary authorities took the reverse stance on capital flows. They welcomed foreign capital but tried to prevent domestic money from going abroad. New foreign investment in Germany was freed of most restrictions by mid-1958.[157] However, interest could still not be paid on non-resident accounts held in Germany until May 1959, at which time the obligation to obtain permission for the sale of German money market papers to foreigners was also abolished.[158]

[155] Deutsche Bundesbank, *Monatsbericht für Januar 1959*, p.124.
[156] This issue is discussed in chapter III.
[157] Buchheim, *Die Wiedereingliederung*, pp.161-166.
[158] Köllner, *Chronik*, p.160. However, according to Köllner, in June 1960, both liberalizations were revoked. ibid., p.161.

In France, exchange control was introduced in September 1939.[159] In 1958, looking back on France's recent history of exchange control, *La Vie Française* commented:

> La France, l'an prochain, pourra - si l'on ose dire - fêter le vingtième anniversaire de son contrôle des changes: depuis septembre 1939, elle ne s'en est pas évadée. Elle vit avec lui , par lui. L'ensemble des textes monétaires qu'elle a édités couvre des milliers de pages, et les spécialistes eux-mêmes hésitent à se prononcer avec certitude sur bien des points litigieux de cette étonnante réglementation.
> Pourtant, il faut bien la connaître, peu ou prou, qu'on veuille exporter, importer, voyager...
> Le Français qui désire souscrire à l'augmentation de capital d'une société hollandaise, doter sa fille qui se marie en Angleterre, recueillir une succession en Italie, est bien forcé de consulter ces textes touffus. Mais comment s'y recconaîtra-t-il? Aucun manuel, aucun vade-mecum ne s'offre à guider l'infortuné citoyen dans le labyrinthe du contrôle.[160]

After World War II, non-resident franc accounts were divided into "comptes francs libres" or free franc accounts, "comptes étrangers en francs" or nonresident accounts, and "comptes «capital» [sic]" or capital accounts. The free franc accounts were held mainly by residents of the dollar area.[161] They could be credited with the franc proceeds from the sale of freely convertible currencies, mainly US and Canadian dollars. Balances in these accounts could be used to purchase any currencies dealt in on the Paris exchange market including the US dollar.[162] They could also be used for payments in the French franc area

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[159] IMF *Fourth Annual Report on Exchange Restrictions*, 1953, p.152.
[160] *La Vie Française,* "ABC du Contrôle des Changes", 14.3.1958, p.18.
'Next year, France will be able to - if one dare say so - celebrate the twentieth anniversary of its exchange control: since September 1939, she has not escaped it. She lives with it, off it. The total of monetary texts which it has produced covers thousands of pages, and the experts themselves hesitate to comment with confidence on contentious points of this astounding body of regulations.
Nonetheless, anybody who wants to export, import, travel,..., has to know the rules, at least roughly.
The Frenchman who wants to invest in a Dutch company, provide his daughter who is getting married in England with a dowry, inherit in Italy, has to consult these abstruse texts. But how will he find his way around? No manual, no handbook offers to guide the unfortunate citizen through this maze of control.'
[161] Free franc accounts were also held by residents of Djibouti. *La Vie Française,* "ABC du Contrôle des Changes", March 14, 1958, p.18. See also, L. B. Yeager, *International Monetary Relations. Theory, History, and Policy,* second edition, Harper & Row, 1976, footnote 3, p.475.
[162] In 1958 this provision applied to the currencies of the following countries or monetary areas: Austria, Belgian monetary area, Czechoslovakia, Denmark, Egypt, Federal Republic of Germany, Italy,

or for transfers to other non-resident franc accounts.[163]

Nonresident accounts (comptes étrangers en francs) referred to accounts held by residents of the non-dollar and non-franc area countries.[164] Balances on these accounts could be transferred to other accounts within the same country. In addition, from July 1954 onwards, franc balances held in non-resident accounts of residents of the EPU could be transferred freely with one another. By March 1957, this transferable franc area had grown to include Argentina, Brazil, Mainland China, China (Taiwan), Paraguay, Japan and, to a limited extent, Hungary. From January 21, 1956, EPU holders of nonresident franc accounts could exchange their balances into EPU currencies and vice versa.[165] From July 1954 onwards, balances in capital accounts of dollar area residents could be transferred to other capital accounts within the dollar area. The same applied for capital account francs of EPU residents.[166]

Generally, foreign exchange proceeds from exports had to be surrendered within one month of their receipt. However, exporters were allowed to retain a percentage of their export proceeds in so-called EFAC (Exportation-Frais accessoires) accounts. These accounts "were set up after the war and enable exporters to hold balances for use in developing their export businesses".[167]

Netherlands monetary area, Norway, Portuguese monetary area, sterling area, Sweden, Switzerland and Yugoslavia. IMF, *Ninth Annual Report on Exchange Restrictions*, p.131.

[163] IMF, *Ninth Annual Report on Exchange Restrictions*, p.131.

Residents of the franc area could generally freely exchange their currencies. The exchange rates of the franc area currencies were pegged to the French franc.

[164] The French franc area comprised Continental France, Monaco, the Territory of the Saar, theFrench Overseas Departments (DOM) - Algeria, Guadeloupe, Martinique, Guiana, and Réunion -, Morocco, Tunisia, the French Overseas Territories (TOM) - French West Africa, French Equatorial Africa, the Trust Territories of Cameroon and Togo, Madagascar and its dependencies, Comoro Islands, St. Pierre and Miquelon, New Caledonia and dependencies, the French Establishments in Oceania, and the Condominium of New Hebrides), and Cambodia, Laos, and the Republic of Viet-Nam. IMF, *Ninth Annual Report on Exchange Restrictions*, pp.130-131.

[165] IMF, *Eighth Annual Report on Exchange Restrictions*, p.135.

[166] BIS, *25th Annual Report, April 1, 1954 to March 31, 1955*, p.117. *La Vie Française*, "ABC du Contrôle des Changes", March 14, 1958, p.18.

[167] BIS, *25th Annual Report, April 1, 1954 to March 31, 1955*, p.117.

France adjusted control regarding bank notes, travel allowances and capital exports in response to changes in the strengths or weaknesses of France's external financial situation. In periods of speculation against the franc, the government reduced travel allowances and the supply of foreign exchange for foreign investment reduced. Alternatively, travel allowances were increased when the balance of payments situation was favorable and the respective currency seemed stable. Travel allowances for French residents were increased in July 1954, when the French balance of payments was strong, while they were reduced in February 1957, when the balance of payments was deteriorating and foreign exchange reserves were dwindling. In September 1956, in response to growing balance of payments problems, the Office des Changes reduced the availability of foreign exchange for the purchase of foreign securities.[168]

In France, similar to Britain, in the mid-1950s, the government took measured steps to increase the transferability of francs within the EPU area and the dollar area, while maintaining the wall of exchange control between the EPU and the dollar area, and, of course, between resident and non-resident holders of francs. While steps were taken to liberalize and even encourage capital inflow, capital outflows remained strictly regulated by exchange control. In Britain, large steps were taken towards non-resident convertibility in 1954 and 1955. Capital inflow was also increasingly liberalized. In Germany, the period was characterized by the continuous dismantling of exchange control both for residents and non-residents, and for capital outflow, so that by 1958, the DM was virtually convertible for these three categories. In Germany, the only area where relatively little progress had been made towards the removal of exchange control was capital inflow.

[168] BIS, *27th Annual Report, April 1, 1956 to March 31, 1957*, p.191.

The comparison of the national paths to convertibility and of the steps taken in 1958 reveal national differences in the type of convertibility pursued and in the approach to payments liberalization. For France and Britain, the return to convertibility focused on non-resident convertibility for current account purposes and on measured liberalization of convertibility regarding capital imports. Moreover, between 1952 and 1958, France repeatedly revoked previous liberalizations of exchange control when the franc was under pressure. Thus, in France, exchange control served as a discretionary policy instrument aimed at manipulating supply and demand for the franc. After the initial suspension of trade and exchange liberalization in the balance of payments crisis in 1950/1951, Germany's path to convertibility was characterized by a continuous and comparatively rapid removal of exchange control not only on non-resident current account convertibility, but also on resident and on capital account convertibility. The significant exception to this restoration of general convertibility was the import of capital. German authorities retained exchange control on capital imports as a means of preventing foreign capital from flooding in.

CONCLUSION

Based on their evaluation of historical experience, the creators of the post-World War II international monetary system sought the establishment of non-resident current account convertibility at a pegged exchange rate. When the transitional period before the establishment of convertibility looked to last much longer than originally anticipated, the EPU was created in 1950 to provide a substitute mechanism for convertibility. Its aim was to increase the transferability of European currencies for intra-European trade. The establishment of convertibility was the natural termination point for the EPU. To understand Europe's path to convertibility one must examine the national policies of France, Britain and Germany on the EPU and on trade in general.

This chapter has argued that the widespread view that Western European countries were joined in a consensus on the desirability of convertibility and that the timing of its establishment can be explained by the fulfillment of certain economic preconditions is simplistic and incorrect. The Eichengreen hypothesis fails to explain why convertibility was established jointly and why it took place when it did. Similarly, this chapter has shown that the reserve insufficiency argument fails to explain both the timing of convertibility or the weakness of the pound and the franc in the 1950s. To understand Europe's path to convertibility one must examine convertibility within the context of national economic policymaking in France, Britain and Germany. National decisionmaking on trade, exchange rate, macroeconomic, and even foreign policy played important roles in both the establishment of convertibility, both the timing and the decision to move jointly. The following country chapters analyze national policy on convertibility within the context of the above-mentioned issues. A country-by country analysis reveals fundamental differences in national policy objectives between these three countries regarding convertibility. If the three leading countries pursued different, even incompatible, policies then this raises the question what motives prompted the three leading countries to cooperate on a joint return to currency convertibility.

II: BRITISH POLICY ON CONVERTIBILITY

INTRODUCTION

In the UK, convertibility was publicly reinstated as a top economic priority, after the five year moratorium that had reigned since the convertibility disaster in 1947, at the Commonwealth conference in January 1952.[1] 1952 was also the year when UK officials publicly proposed, in the 'Collective Approach' the type of convertibility that would be realized six years later, namely non-resident current account convertibility.[2] According to Kaplan and Schleiminger,

> Early in 1952, well before economic stability was firmly rooted in Britain or on the Continent, the UK government was again considering convertibility. By mid-1954, its subsequent initiatives had established convertibility as a serious and pressing issue.[3]

The UK Treasury liked to portray British path to convertibility in the 1950s as a case of consistent policy and continuous progress towards the proclaimed policy objective of sterling convertibility. Thus, when non-resident convertibility was officially established in December 1958, the Treasury proposed to announce the step to the press as a logical continuation of the steady progress made in the previous years by stating:

> It is the policy of the Government, a policy endorsed at various Commonwealth Conferences, to move forward in the freeing of trade and payments as and when such moves can be made safely and with advantage. This policy is to further the objective of sterling which has been the aim of Governments of both parties since the war.[4]

On the surface, UK policy might be viewed as a straightforward matter. As a large trading nation and co-founder of the Bretton Woods system, Britain could be expected to be an

[1] Dow, *The Management*, p.80.
[2] Kaplan and Schleiminger, *The European Payments Union*, p.168.
[3] Kaplan and Schleiminger, *The European Payments Union*, p.160.
[4] PRO T236-4822, UNICORN Draft Press Announcement, December 22, 1958.

ardent supporter of convertibility. The British government had set out three preconditions, that had to be fulfilled before convertibility could be established, namely a sound internal economy, sufficient financial support and a good creditor policy. Thus, the timing of convertibility should be explained by the fulfillment of these conditions.

A closer look reveals, however, that in the UK convertibility was in fact a very controversial issue the desirability of which was seriously and continuously questioned by policymakers throughout the 1950s. Policymakers questioned not only when and how convertibility should be established but also whether it should be established at all. Conflicting policy goals made convertibility an issue which was anything but a technical economic event the establishment of which depended merely on the fulfillment of certain economic preconditions.

TRADE CONSIDERATIONS

> In the early post-war period H.M.G. announced as a policy objective the return to convertibility for sterling and did not allow the 1947 debacle to deflect them from this as their continuing objective. Given our dependence on exports and foreign trade, H.M.G. decided that it is a major interest of the U.K. to promote a system which will give the best chance of expanding world trade and ourselves the best chance of getting a share in it. This was conceived to be a multilateral system with the greatest freedom of trade and payments and the restoration of convertibility of sterling as an integral part of any effective multilateral system....This step has therefore to be looked at as a further move in the series of steps which have been taken along the road to freer trade and payments and its advantages to be judged by the benefits to be derived as we attain what both parties have agreed upon as our objective.[5]

The above paragraph is taken from a brief which was prepared for presentation to the public upon the official establishment of convertibility. As the world's largest trader at the

[5] PRO T236-4819, "Brief: Why this step helps trade" (M.S.(S.G.)(58)13), October 29, 1958.

time, one would expect the UK to be a champion of currency convertibility, at least for current account transactions. Contrary to this expectation, however, in the 1950s, the facilitation of trade never figured significantly as an argument in favor of convertibility in the UK.[6] Neither the Bank of England nor the Treasury looked to convertibility to open the British economy to world trade. Rather, if trade considerations affected policy on convertibility, then the prospect of liberalized and multilateral trade deterred the UK Treasury from pursuing convertibility. Thus, one of the arguments presented by the Treasury throughout the 1950s against establishing sterling convertibility was that the move might increase pressure on the UK to end its discrimination against dollar imports.

In a Treasury memo in March 1958, Under Secretary A. W. France warned of "the additional pressure which bringing the rates together might bring on us and others to dismantle discrimination against the dollar and the strains which this might put on sterling".[7] In a report on exchange policy in April 1956, Third Secretary Rickett asked how the government would be able to justify to the financial press, the IMF, and the opposition party the continuation of "a system under which 85% to 90% of our imports from Europe are liberalised while only 50% of our imports from the dollar area are liberalised" once the rates had been unified since the move would certainly be widely regarded as constituting convertibility.[8] He disagreed with the Governor of the Bank of England on the overall desirability of the progress towards convertibility for the following reason:

[6] Milward, *The European Rescue*, p.356. According to Scammell, after World War II "trade policy appeared to many to be a secondary issue - second to the major problem of providing full employment in Britain after the war and insulating her economy from deflationary influences coming from abroad". Scammell, *International Monetary Policy*, p.120.
[7] T236-3946, A. W. France, "Bringing the Rates together - Arguments against action in the immediate future", March 20, 1958.
[8] PRO T236-3940, D. Rickett to T. L. Rowan, "Exchange Policy", April 19, 1956.

> It is true that whether or not a further step is taken towards convertibility, other countries, whatever we do, will continue to move towards greater freedom in their imports from the dollar area. There is surely little doubt however that a further step towards convertibility (followed as we have seen by similar action in Europe) would greatly accentuate this process... How could we justify buying motorcars from the French, Germans and Italians but not from the United States if the pound we paid to the Europeans can be freely turned into dollars?[9]

Rickett concluded that "we wish to be the judges of the rate at which we should move and not to have our hands forced as a result of steps taken in the exchange field". Table II.1 compares trade liberalization, in terms of quota removal, among OEEC countries. By 1958, Britain had reached 94 per cent of the OEEC Trade Liberalization Index regarding its OEEC imports and was thus in line with the rest of Europe. However, at 62 per cent in 1958, British quota removal vis-à vis trade with the United States and Canada was well below that of half of the OEEC countries.[10] Only Austria, Denmark, France, Iceland, Ireland, Portugal and Turkey exhibited a lower percentage of quota removal with trade with the United State and Canada in 1958. Overall, therefore, British performance on trade discrimination was mediocre.[11]

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[9] ibid. The report was written in response to a memo from the Governor to the Chancellor of the Exchequer urging the latter to finally go ahead with the establishment of convertibility. PRO T236-3940, the Governor of the Bank of England to the Chancellor of Exchequer, April 12, 1956.

[10] According to the Bank for International Settlements, in 1959, "[t]he setback [in quota removal] in the case of Germany was due entirely to the reintroduction of restrictions on coal imports", and thus did not reflect a significant turnaround in trade policy. BIS, *29th Annual Report, April 1, 1958 to March 31, 1959*, p.160. The restrictions were introduced to shelter Germany's already traditionally protected energy sector from the drop in world coal prices due to the international 1958 recession.

[11] The problem with the comparison of quota removal is that the percentages refer only to private trade. However, in the 1950s, a large portion of trade was not private but government-regulated, and the portion of public to private trade varied considerably across countries. In the case of the UK, government trade made up a comparatively large portion of total trade, with the effect that it allowed the UK to reach a higher liberalization index than other countries with a smaller share of government trade who undertook similar measures. In addition, the UK excluded a large number of goods from the list based on which the liberalization index was calculated, which led to a further artificial improvement in its trade liberalization index. The general justification used by the British, as well as other OEEC members, was that the goods were strategic for national defense. In the British case, there is evidence that this justification was stretched particularly far to include a wide range of products. Overall, therefore, British trade liberalization was far less exhaustive than the OEEC Trade Liberalization Index would indicate. A. S. Milward and G. Brennan, *Britain's Place in the World. A Statistical Study of Import Controls*, Routledge, 1996, chapter III. See also, *The Economist*, "Steps in convertibility", British Banking supplement, June 12, 1954, p.9.

Table II.1: OEEC countries: quota removal (percentage on January 1)

	Intra-European trade								Trade with the United States and Canada			
	1952[a]	1953[b]	1954[a]	1955[a]	1956	1957	1958	1959	1956	1957	1958	1959
Austria	0	0	65	82	89	90	90	90	8	40	40	45
Benelux	75[c]	90[c]	87	88	96	96	96	96	86	86	86	86
Denmark	65	75	76	76	78	86	86	86	55	55	55	66
France	0	0	51	75	78	82	0	90	11	11	0	50
Germany	77	84	90	90	91	92	93	91	68	90	94	78
Greece	0	0	90[d]	97[d]	95	95	95	96	99	99	99	99
Iceland	41	0	29	29	29	29	29	29	33	33	33	33
Ireland	75	75	77	77	90	90	90	90	15	15	15	15
Italy	77	99	100	100	99	99	99	98	24	39	68	68
Norway	75	75	75	75	75	78	81	81	0	84	87	91
Portugal	84	92	93	93	94	94	94	94	53	53	53	53
Sweden	75	91	91	91	93	93	93	93	64	68	68	68
Switzerland	75	91	92	92	93	91	91	91	98	99	99	93
Turkey	63	63	0	0	0	0	0	0	0	0	0	0
UK	46	44	80	84	85	94	94	95	56	59	62	73
members combined	n.a.	n.a.	81	84	86	89	83	89	54	61	64	73

Note: For intra-European trade the percentages relate to base year 1948, except for Austria and Germany, where base years are 1952 and 1949, respectively. For trade with the dollar area the base period is 1953.
a: April; b: mid-March;
c: does not include Netherlands; d: unofficial;
Source: BIS, annual reports.

In convertibility discussions, Treasury officials argued that while official convertibility did not directly increase pressure to remove dollar discrimination, it would weaken the UK's ability to resist such pressures, thus increasing the net pressure.[12] British defenses would be weakened by the fact that official currency convertibility removed the justification for discriminating against the exports of a country on the basis that its currency was scarce. Convertibility as a technical step would not increase the exposure of British industry to international competition. Moreover, since the UK did not plan to

[12] PRO T236-3946, "The Arguments Against an Early Amalgamation of the Official and Transferable Rates", April 2, 1958.

declare its currency convertible according to Article VIII of the IMF Articles of Agreement when it announced the unification of sterling rates, the move carried no legal obligation to remove discrimination. Rather, the move would reduce the justification of discrimination, putting pressure on Britain to liberalize US imports. In September 1955, Peter Thorneycroft, then President of the Board of Trade, wrote:

> It is inconvertibility, together with the European Payments Union and other payments agreements which are built upon it, that provides a basis of reason for the whole system of trade discrimination as we now have it in the Sterling Area and Western Europe.
> ...we should deploy all the ingenuity at our disposal, to avoid convertibility [sic] before we are ready for it [the removal of trade discrimination].[13]

The general dollar scarcity in Europe after World War II had justified the discrimination against goods for which the UK would have to pay with US dollars. As the 1950s progressed, the dollar gap, as it was called, began to close thus weakening the case for continued discrimination against dollar imports. As a result, countries in Western Europe began to liberalize their imports from the dollar area by removing quotas and reducing tariffs. UK policymakers saw no necessary positive correlation between the freeing of payments and the removal of dollar discrimination, as Hinshaw pointed out in 1958. While progressing towards convertibility, they

> not only intended to retain discrimination themselves, but expressed the hope that continental Western European countries would continue for an indefinite transitional period to maintain their discriminatory restrictions against the Dollar Area.[14]

In 1958 A. W. France even suggested expanding the use of quantitative restrictions when establishing convertibility. He proposed that in order to facilitate the unification of the non-resident sterling rates, the UK should "put on global quotas all the items remaining on

[13] PRO T236-3943, Peter Thorneycroft to R.A. Butler, September 6, 1955.
[14] Hinshaw, "Toward European Convertibility", p.19.

dollar quota, enlarging the quotas to take account of the existing non-dollar trade".[15] By deliberalizing trade with Europe to the level of that with the US, France argued, "[w]e could then unify the rates without the danger of an attack on discrimination".[16]

Some might argue that the UK's reluctance to remove discrimination against dollar imports is explained by consideration for members of the sterling area, many of which might feel threatened by dollar imports. However, Sir Alexander Cairncross rejected this argument, claiming that "[f]or all their talk on convertibility, Conservative ministers had no wish to abandon dollar discrimination but other members of the sterling area were less anxious to retain it".[17] Similarly, Schenk argued that the rest of the sterling area countries actually wanted a more rapid progress towards freer trade and payments.[18]

The reason given for the unwillingness to increase pressure on the UK to remove discrimination against dollar imports was that the removal of the remaining restrictions would lead to "an increase in imports which we cannot afford".[19] In 1954, officials in the Treasury's Economic Section and from the Board of Trade, - the latter of which consistently opposed convertibility -, produced several reports, such as the Dean report, which estimated the strain on the UK balance of payments of removing discrimination against dollar imports in the event that the establishment of convertibility in the near future should force the UK to remove dollar discrimination.[20] The lowest estimate came to £300 million, which Treasury officials regarded "quite a high price to pay for

[15] PRO T236-3945, A. W. France to Rowan, "Liberalisation and the Rates", February 27, 1958.
[16] ibid.
[17] A. Cairncross, *The British Economy since 1945: Economic policy and Performance*, Blackwell Publishers, 1992, p.121.
[18] Schenk, *Britain*, p.123.
[19] ibid.
[20] Cairncross and Watts, *The Economic Section*, p.310.

convertibility, if, as the continentals argued, it spelt an end to discrimination against dollar goods".[21]

While sterling convertibility was considered a necessary prerequisite for a global multilateral trading system, UK policymakers did not look to sterling convertibility as an impetus for liberalizing UK imports. Generally, trade considerations explain neither British policy on convertibility, nor the delay in the establishment of convertibility. The subsidiary role of trade considerations is reflected in Britain's policy on the EPU. From the beginning, Britain was a very reluctant member of the EPU, eager to end it or at least remove itself, and thus the entire sterling area, from the EPU as soon as possible.[22] One of the reasons listed by the Treasury for wanting to end the EPU as soon as possible and to establish convertibility was that the EPU was discriminating against non-EPU countries because of the easier terms of payment among EPU members.[23] Although this was true, this is unlikely to have been a big concern of British policymakers, considering Britain's view on trade discrimination as discussed in the previous section and given the fact that the sterling area was included in the EPU's settlement mechanism.

According to Cairncross, the UK entered the EPU "with some hesitation, fearing that the new payments system would limit the use of sterling as an international currency".[24] The principal reason why the UK contemplated, on several occasions, "torpedoing the EPU by making a unilateral dash for full convertibility",[25] was that sterling's membership in a preferential payments system, such as the EPU, conflicted with aspirations for a special role for sterling in the international monetary system. As long as

[21] ibid.
[22] for a discussion, see Milward, *The European Rescue*, pp.350-367.
[23] PRO T230-373, note by Rickett, March 7, 1958.
[24] Cairncross, "Economic Policy", p.42.
[25] ibid.

Britain remained in the EPU, sterling differed little from the other currencies in the clearing union. As a regional clearing system, the EPU made all member currencies equal, removing an important incentive to do business in, and thus hold, sterling rather than any other European currency. The EPU prevented members from accumulating reserves in sterling, "since all changes in member currency balances held by member central banks had to be reported monthly to the Union and to be compensated according to the EPU rules (i.e., to be transformed into EPU credit and gold)".[26] The latter component of the EPU agreement thus undermined sterling's status as international reserve currency. The preoccupation with the effect of EPU membership on sterling's status as international reserve currency is confirmed by Milward's statement that "in London little thought was given to overall consequences for British trade of a disruption of the EPU".[27]

Britain's strong dislike of the EPU and the pursuit of its dissolution stand in stark contrast with the fact that it was one of the principal beneficiaries of EPU's credit-granting facilities, as can be seen from Table II.2.[28] The pursuit of an early dissolution of the EPU in the mid-1950s can only be explained by Britain's aspirations for the pound as international key currency which conflicted with the continuation of EPU. The expectation of US financial support partially explains what Milward called a "high-handed diplomatic attitude towards the EPU" in the first half of the 1950s, which, "contrasted starkly with Britain's financial weakness".[29]

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[26] Hinshaw, "Toward European convertibility", p.18.
[27] Milward, *The European Rescue*, p.356.
[28] see also Strange, *Sterling*, p.63.
[29] Milward, *The European Rescue*, p.365.

Table II.2: Credits granted to (+) or received from (-) EPU (million US dollars)

	UK	France	FRG	Bel.-Lux.	Denmark	Italy	Netherl.	Norway	Switzerl.
1955	-339	-139	+547	+173	-108	-174	+178	-112	+109
1956	-350	-209	+688	+187	-92	-154	+113	-91	+76
1957	-382	-385	+1010	+137	-89	-111	+82	-77	+18
1958[a]	-378	-485	+1027	+154	-66	+7	+121	-87	-12

a: as of December 27, 1958.
Source: Deutsche Bundesbank, *Monatsbericht für Januar 1959*, 1959, p.124; BIS, *28th Annual Report, April 1, 1957 to March 31, 1958*, p.169.

In June 1955, when the Chancellor of the Exchequer, R. A. Butler, rejected one of several Bank requests to establish convertibility, he questioned whether convertibility was at all possible if it was allied to free trade.[30] The attraction to a floating exchange rate in conjunction with convertibility among UK policymakers[31], and the absence of any expression of concern of its effects on trade, lend further proof to the dismissal of trade considerations in the convertibility discussions, particularly in the first half of the 1950s. Many continental European countries expressed a great dislike for the "additional and unnecessary uncertainty for the trading world that would be brought about by more freely moving exchange rates", as they were propagated, in connection with convertibility, by the British.[32]

For Britain, trade considerations, in particular the desire to promote multilateral non-discriminatory trade, did not provide a motive for establishing currency convertibility. British trade policy in the 1950s reveals a reluctance to remove controls on trade and payments and to end trade discrimination, all of which are in conflict with the commitment made to free and multilateral trade and payments by joining the Bretton

[30] Kaplan and Schleiminger, *The European Payments Union*, p.228.
[31] See following section.
[32] Hirsch, *The Pound Sterling*, p.108.

Woods system. Trade was certainly not a sufficient motivation for Britain to champion convertibility. If, as G. John Ikenberry claimed, the British, in the Bretton Woods negotiations, joined the Americans in "a common belief in the desirability of currency stability and the convertibility of currencies", then other motivations than a shared interest in the expansion of world trade must have determined the British attitude.[33]

[33] Ikenberry, "The Political Origins", p.162.

KEEPING THE BACKDOOR OPEN

INTRODUCTION

UK policy on convertibility in the 1950s was characterized by dilemmas and inconsistencies. Throughout that decade, periods in which government statements and policy raised expectations of imminent convertibility alternated with periods where convertibility seemed to be postponed indefinitely.[34] At the Commonwealth Conference in December 1952, Britain presented its Collective Approach for Freer Trade and Payments.[35] In March, 1953, the Chancellor of the Exchequer announced to OEEC officials in Paris that Commonwealth members had agreed that a rapid return to convertibility would be in their countries' best interest and that they intended to proceed quickly towards convertibility.[36] However, the plans did not materialize, largely because of the US's refusal to provide the financial support to Britain or to the IMF which the British considered necessary.[37] By the third quarter of 1953 the public had realized that convertibility plans were off:

> The fairest judgment seems to be that a year ago Britain and the Commonwealth put convertibility first, and tried hopefully to insert liberalisation second; now, apparently, they put liberalisation first and convertibility nowhere (except in conditional perorations about the rather distant future).[38]

Mocking the government for its inconsistent policy, *The Economist* wrote that "...it would

[34] see also Dow, *Management*, pp.87-8.
[35] This was the first time convertibility plans were presented to the public since 1947; the preceding ROBOT plan for convertibility, which envisaged convertibility of non-resident sterling for current account purposes at a freely floating rate, was kept secret and quashed by the British Cabinet.
[36] Patterson, *Discrimination*, p.101.
[37] Continental European countries' hostility to the British plan which envisaged making plans for their currencies over their heads also played a role. For a discussion of the Collective Approach to Convertibility, see Milward, *The European Rescue*, pp.360-2 and Fforde, *The Bank of England*, pp.477-492.
[38] *The Economist*, "Britain against Convertibility", November 7, 1953, p.438.

be an act of decency towards the dead, between now and next March at any rate, to leave the word convertibility out of the politicians' perorations as completely as it is now out of their programme".[39] In March 1954 bilateral account sterling was abolished and the transferable account area was enlarged to include practically all sterling outside the sterling and dollar areas. At the same time, the London gold market was reopened. Both measures raised expectations about a move to convertibility in the near future. By June 1954 at the latest, government statements had rekindled expectations of the UK's "definite intention" to make sterling convertible "by or before next spring".[40] However, the statement of the Chancellor of the Exchequer at the annual IMF meeting in September 1954 made it clear that convertibility would be put off yet again.[41] On February 24, 1955, the UK government allowed the Exchange Equalization Account (EEA) to intervene in the transferable sterling market to prevent the transferable rate from dropping too far below the official rate. Many contemporary observers judged this step to constitute the 'de facto' establishment of convertibility, raising expectations of an imminent move toward the official unification of the sterling rates.[42] However, the combination of an apparent moratorium on government statements regarding convertibility and the sterling crises occurring in the second halves of 1955, 1956 and 1957 resulted in a quieting down of speculation about convertibility until 1958.[43] The apparent policy void on convertibility between February 1955 and 1958 was criticized in many circles, not least the Bank of England, as indicating Britain's half-heartedness regarding sterling and convertibility. The

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[39] ibid.
[40] *The Economist*, "Next Step for Sterling", June 12, 1954, p.869.
[41] BIS, *25th Annual Report, April 1,1954 to March 31. 1955*, p.110; see also *The Economist*, "Go-Slow for Sterling", and "Mr Butler Regrets", October 2, 1954, pp.23 & 60.
[42] Harrod, *The Pound Sterling, 1951-1958*, p.27; Cairncross, "Economic Policy", p.64. *The Economist* called the move "Backdoor Convertibility", November 3, 1955, p.827.
[43] Within the Bank of England and the Treasury, however, convertibility continued to be discussed heatedly between 1955 and 1958.

feeling was that Britain was not finishing the business it had started, when it had established de facto convertibility in 1955. The UK standstill on convertibility led *The Banker* to observe in 1956:

> While the signal for the formal move still rests with Britain, the continental countries, and notably Western Germany, Belgium and the Netherlands, have in recent months been flexing their convertibility muscles somewhat ostentatiously ... The sterling clock has momentarily stopped; but the latest German measures bring the D-mark so near the objective that the policy of waiting for a lead from London appears little more than a formality.
> ...it can be said that of all currencies with pretensions to international importance, sterling is very nearly bottom of the list in the extent of convertibility for residents.[44]

The impression gained by Britain's bumpy ride to convertibility in the 1950s is that British policy on convertibility in the 1950s must have been torn between the desire to move as quickly as possible, and ahead of everybody else, on the one hand, and a reluctance to take the plunge on the other. Overall, between 1952 and 1958, government statements and actions repeatedly fed rumors of imminent convertibility, leading *The Economist* to write in September 1958 that "[t]he light hearted economic historian of the 'fifties could have a fine time recalling the occasions through those years when convertibility was confidently expected and thought to be just around the corner".[45]

The apparent inconsistencies in British policy on convertibility are explained by a fundamental conflict between internal and external policy objectives. On the external side, British ambitions for international currency status for the pound sterling and for London as world financial center, rather than trade considerations, explain the keen interest in establishing convertibility sooner rather than later and the public statements to that effect.[46] At the same time, however, British governments were reluctant to implement an

[44] *The Banker*, "Sterling Now", June 1956, pp.333-4.
[45] *The Economist*, "Convertibility", September 27, 1958, p.1043.
[46] According to Day, convertibility was important "because of the position of sterling as an international

external monetary policy which might require domestic economic adjustment, and, moreover, which would be very difficult and very costly to revoke. The official establishment of convertibility would have constituted such a policy.

CONFLICTING POLICY GOALS

The most ardent advocates of the rapid return to convertibility came from the financial sector of the UK economy and, in particular, from the Bank of England.[47] From the early 1950s, the Bank of England was the driving force in the return to convertibility.[48] In its pursuit of a rapid return to currency convertibility, the Bank of England was motivated above all by the desire to "re-establish sterling as an international currency with unrestricted use".[49] To be able to claim an international key currency role, both as trade and as reserve currency, sterling had be widely convertible, and, moreover, it should, ideally, become convertible before other European currencies. For these reasons, the Bank of England wanted official convertibility, that is, the unification of the two non-resident rates for sterling for current account purposes, as soon as possible.[50] The election victory

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currency". Day, *The Future*, p.121. See also Hinshaw, "Toward European Convertibility", p. 18 and S. Strange, "International Monetary Relations", in Andrew Shonfield, (ed.), *International Economic Relations of the Western World 1959-1971*, Volume 2, Oxford University Press, 1976, p.71.

[47] The Bank of England's interest in the prestige of sterling is explained by the positive correlation between the international prestige of sterling and the influence and prestige, both nationally and internationally, of the Bank of England. Milward, *The European Rescue*, p.358. An assessment of the benefits and costs of sterling's role as international currency in the 1960s can be found in B. J. Cohen, "The Benefits and Cost of Sterling", *Reprints in International Finance*, No.15, Princeton University Press, 1970. In general, however it is extremely difficult to assess the financial or economic benefits of sterling's role as international currency. "What the real economic advantages, rather than the more general considerations of political power and prestige, of the international use of sterling actually were is an involved question about which there is little hard information." Milward, *The European Rescue*, p.353.

[48] Dow, *The Management*, 1964, p.84, and Schenk, *Britain and the Sterling Area*, p.124.

[49] Milward, *The European Rescue*, pp.352-3.

[50] Cobbold, the Governor of the Bank of England, and Bolton were instrumental in the drafting of ROBOT in 1952, the first plan put forward for sterling convertibility since the failed attempt in 1947. ROBOT envisaged making the pound convertible at an exchange rate which would be allowed to float between $2.40 and $3.20, while blocking 90 per cent of all foreign-held sterling balances and funding at least 80

of the Conservatives in 1951 brought a party to power which was more receptive than the previous government to advice from the financial sectors of the economy, namely the Bank of England and the City. According to Susan Strange,

> [w]hile the emphasis under the first Labour government had been on the exclusiveness of a defensive currency area, ringed by controls similar to, though less strict than, those round the Soviet East European monetary area in the 1960s, the emphasis from the end of 1951 onwards was on the re-establishment of sterling as general international currency and of London as an open financial market-place.[51]

This assessment is confirmed by the fact that in 1952, the Conservative government publicly declared the speedy restoration of convertibility to be one of its top priorities.[52] According to Milward, many Conservative ministers shared the Bank view that

> To restore Britain to its role as the chief decision-making power in the international financial system after the United States was ... the only international policy which guaranteed the nation's survival in worthwhile form.[53]

Thus, convertibility was seen as prerequisite for continued international financial power, which in turn was the channel through which Britain sought to assert its national interest in the international arena. In 1953, von Mangoldt, the German representative in the EPU Managing Board, wrote that Britain's policy on convertibility was determined by the ambition to reclaim Britain's key role in international trade and payments in order to establish a more favorable balance of power vis-à-vis the United States.[54] In spite of the

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per cent of sterling area sterling balances. Kaplan and Schleiminger, *The European Payments Union*, pp.164-5. For a discussion of ROBOT, see also Fforde, *The Bank of England*, pp.434-440 and Milward, *The European Rescue*, pp.351-353.

[51] Strange, *Sterling*, p.64.

[52] Dow, *The Management*, p.72.

[53] Milward, *The European Rescue*, p.354.

Hanrieder stated that "British political leaders and the Treasury were inclined to see sterling's international role as an imperial legacy, as embodying solemn responsibilities to Commonwealth governments that held sterling as a reserve asset, and as one more measure of Britain's continued great-power status. Under Harold Wilson in the late sixties sterling became a symbol of Britain's international virility and prestige, much like the independent nuclear deterrent". W. F. Hanrieder, *The Foreign Policies of West Germany, France, and Britain*, Prentice-Hall, Inc., 1980, p.219.

[54] BA B102-55345, report by von Mangoldt re. "Englische Konvertierbarkeitspläne; bisherige Entwicklung und gegenwärtiger Stand der Diskussionen in der OEEC", March 28, 1953.

combination of a Conservative government and the campaigning by the Bank of England, official convertibility was not established until 1958, raising the question what considerations held Britain back from moving more quickly towards its declared goal of restoring the pound to its pre-war glory.

The Treasury argued that if convertibility was to further the goal of increasing sterling's prestige then it had to be undertaken at a time when sterling was strong.[55] If not, Treasury officials feared, the move might lead to a run on the pound, as it had in 1947, which would defeat the purpose of establishing convertibility in the first place. Thus, it was argued, the weakness of sterling prevented the government from realizing its declared goal of rapid convertibility. In contradiction with the officially stated policy that convertibility was to be established when sterling was strong the move to de facto convertibility was actually "taken as an act of defence", that is, at a time when sterling was under attack.[56]

In direct response to adverse speculation against sterling, the government announced on February 24, 1955 that it had advised the Exchange Equalization Account (EEA) to intervene in the transferable sterling markets abroad to ensure that the transferable sterling rate did not fall below one per cent of the official rate. As a result, after February 1955, every non-resident of the sterling area could convert sterling into other currencies and vice versa for current account purposes at a rate which was

[55] Chancellor Butler stated publicly in July 1955 that convertibility had to be undertaken from a position of strength. *The Banker*, "Sterling under Strain", August 1955, p.86.

[56] *The Banker*, "No Backsliding on Sterling", December 1957, p.765 and Fforde, *The Bank of England*, p.525.

Foreseeing the government's decision to establish de fact convertibility as a means of ending sterling speculation *The Economist* remarked on the inconsistency of government statements and actions:

Having declared to the world that Britain cannot afford to embrace convertibility while economic conditions seem to be set fair, it is going to look very peculiar if it hurries to embrace it as soon as the barometer points to stormy. *The Economist*, "Go-Slow for Sterling", October 2, 1954, p.23.

guaranteed to remain within one per cent discount of the official rate.[57] Therefore, February 24, 1955 has rightly been identified as the date of the establishment of de facto convertibility.[58] Roy Harrod assessed the move according to the two characteristics which he claimed defined convertibility:

> First, the authorities responsible for the currency must be *de facto* willing to convert it. Secondly, there must be complete confidence that they will continue to be willing to convert it. If both these conditions are fulfilled, then the currency may be said to be 'convertible'.
> ...It cannot be said that [after February 1955] there was absolute confidence that the British authorities would continue to maintain transferable sterling above the commodity shunting point, but it can be said that there was a sufficient amount of confidence to justify the use of the word 'convertible'.[59]

After the move toward de facto convertibility the official unification of sterling rates as it finally took place on December 28, 1958, should have been a formality, since the step did not increase the actual freedom to exchange sterling. The question is, why it took the UK government nearly four years between committing itself to keeping the transferable and official rate for sterling within one percent of each other, and thus de facto convertible, and officially unifying the two rates. Why did the UK government agree to de facto convertibility while insisting on waiting with official convertibility?

The Bank was not satisfied with the 'backdoor convertibility' that was established in February 1955. The step effectively meant that the Bank of England stood ready to provide the dollars demanded in return for sterling that could not be found in the market,

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[57] Thus the commitment to maintain the transferable sterling rate within one per cent of the official rate provided the guarantee of the exchange value which was one of the defining characteristics of Bretton Woods convertibility (see chapter I).

[58] E.N. Helleiner, *American Hegemony and Global Economic Structure: From Closed to open Financial Relations in the Post War world*, Ph.D. Dissertation, University of London, 1991, p.119. Surrey, "United Kingdom", p.533.

[59] Harrod, *The Pound Sterling, 1951-1958*, p.28.

forcing the UK reserves to bear the burden of convertibility without enjoying its benefits. In order to maintain the transferable sterling rate within one per cent of the official rate, UK monetary authorities had to sell dollars for sterling every time the transferable sterling rate threatened to fall below the one per cent limit. Soon after the decision to intervene in the transferable market for sterling, in August 1955, the Bank renewed its pressure on the Treasury to unify non-resident sterling, thus establishing official non-resident convertibility. The Bank suggested the Istanbul conference in September of the same year as a suitable occasion for establishing and announcing official convertibility.[60] The main argument put forward by Bank officials for the official unification of non-resident sterling rates was that the move was necessary to restore confidence in the pound by removing uncertainty about the UK's intentions regarding exchange policy. They argued that "[t]he policy of bringing together the official and transferable rates was of the greatest importance in maintaining confidence abroad in sterling".[61] The dual rate system for sterling was a 'costly anomaly' and it undermined confidence in sterling.[62] For reasons of prestige and practicality, a major international currency could not afford to be divided into an official and a cheap version, and be traded at different rates in different markets. In addition, the turnover for the market for transferable sterling into dollars frequently exceeded that for official sterling, and, more importantly, it was conducted outside the United Kingdom, in the foreign exchange markets of New York and Zurich.[63] The fact that the larger part of sterling/dollar transactions was carried out outside the UK

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[60] PRO T236-3943, "Note of a meeting in Sir Edward Bridges' room at the Treasury, at 3 p.m. on Monday, 8th August 1955", August 8, 1955.

[61] ibid.

[62] see, for example, PRO T236-3946, "'Pros' for early amalgamation of official and transferable sterling", report sent by the Bank of England to Rowan, March 18, 1958.

[63] PRO T236-3946, "The Arguments in Favour of an Early Amalgamation of Official and Transferable Sterling - Views of the Bank of England", April 2, 1958.

constituted a loss of both face and money. [64] Britain lost income in terms of financial and transactions services of sterling to exchange centers outside the UK, which also undermined London's position as an international exchange center.[65] Another important implication of the dual sterling/dollar rate system was that through the transferable sterling rate the other European currencies also became de facto convertible into the dollar but at a cheaper rate, which led to distortions in European payments arrangements. Among other things, it forced the UK to redeem at the official sterling rate through the EPU sterling which had been acquired at a discount.[66] The Bank argued that, as long as the two non-resident rates were not officially united, people were not sure whether the government would not renege on its commitment to maintain the transferable sterling rate within one per cent of the official rate in times of strong speculation against sterling. This doubt exacerbated the downward tendency of the transferable rate when sterling was under pressure, as people sought to rid themselves of transferable sterling which they expected to depreciate, thus increasing the cost of maintaining a fixed exchange rate in general. The lack of complete segmentation between transferable and official sterling combined with the uncertainty over the future of the transferable rate forced British monetary authorities to intervene in the cheap sterling market just to preserve the official sterling rate, while, at the same time, making it very costly and difficult for them to do this effectively. In

[64] ibid.

[65] As stated above, the actual financial income loss is very difficult to assess. According to Clarke, in the second half of the 1950s, that is, when the Bank of England was already intervening in the transferable sterling markets in Zurich and New York, "[i]n some quarters an annual turnover of at least £1,000 million was estimated to be taking place outside the London market". In a meeting between Bank and Treasury officials in 1956 an estimate was presented according to which towards the end of each month when EPU settlement was approaching, "the daily turnover in transferable sterling was close on £5m". W. M. Clarke, *The City in the World Economy*, 1965, p.51 and PRO T236-5403, "Exchange rate policy (note of a meeting held in the Chancellor of the Exchequer's room at 4 p.m. on Tuesday, 24th April)", April 24, 1956.

[66] PRO T230-373, note of a meeting held in the Chancellor of the Exchequer's room on exchange rate policy between Bank of England and Treasury officials, March 5, 1958.

addition, effective intervention in the transferable sterling rate was made even more difficult by the fact that the transferable market was outside the UK.

The Bank of England summed up its case by saying that sterling rate unification was vital for restoring confidence in the pound as an international key currency and London as international financial center: "The one thing we must not do is to imagine that other people will have confidence in our currency if we manifestly exhibit no confidence in it ourselves".[67] By hesitating to act on the long avowed policy of sterling convertibility that had been on the agenda for over ten years the government was constantly encouraging speculation against the pound.

Treasury officials shared by no means the Bank's sense of urgency regarding the return to convertibility. They claimed that sterling rate unification represented far more than merely the removal of a costly anomaly. The overall Treasury attitude vis-à-vis the return to convertibility throughout most of the 1950s is best summed up in F. A. Bishop's reaction to Bank pressure to unify sterling in March 1958, when he remarked "[t]he real question is - what is the hurry?"[68]

Had the British government viewed the step taken in February 1955 as the achievement of convertibility, then it would not have agreed to it. According to Cairncross, as a result of the decision to intervene in transferable sterling, the government "ended up with *de facto* [sic] convertibility, something it never planned to adopt".[69] For the government, intervention in transferable sterling was a technical step, and was

[67] ibid.
[68] PRO PREM11-2671, Memo by F. Bishop to the Prime Minister, October 27, 1958.
[69] Cairncross and Watts, *The Economic Section*, p.316.

presented as such, which served two direct purposes.[70] The first one was to end the dollar drain caused by commodity shunting.[71] This term was used to describe a process whereby sterling area goods were purchased with transferable sterling, allegedly to be resold to a transferable account country, when in fact they were resold for dollars which would then not be surrendered to exchange control authorities. "In this roundabout way the holder of transferable sterling could obtain dollars, and the British Exchange Account would be deprived of dollars that it would normally have received from the sale of sterling-area goods in America."[72] The larger the discount of transferable sterling relative to official sterling, the more worthwhile commodity shunting became. With a discount of the transferable rate on the official rate of one percent or less, transactions costs ensured that commodity shunting was no longer profitable.[73] The second motivation for allowing the EEA to intervene in the transferable market was to end speculation against sterling. In response to the continuous deterioration of transferable sterling in the previous months, the government decided that the best way to prevent the transferable rate from dragging down the official rate was to intervene in foreign exchange markets to support the transferable rate.[74] Measured according to its latter purpose, the success of the move was limited. Intervention combined with a raise in bank rate from 3.5 per cent to 4.5 per cent and the reintroduction of hire-purchase restrictions temporarily ended speculation in the spring of 1955. However, the policy of intervention in the transferable sterling market could not prevent adverse speculation from flaring up again in the summer of 1955, in

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[70] Dow, *The Management*, p.86.
[71] Hinshaw, *Toward European Convertibility*, p.25. A good description of commodity shunting and the decision to intervene in transferable sterling to end it is found in Harrod, *The Pound Sterling, 1951-1958*, pp.24-27.
[72] Feaveryear, *The Pound Sterling*, p.421.
[73] Dow, *Management*, p.86. *The Economist*, "Backdoor Convertibility", March 5, 1955, pp.827-829.
[74] Fforde, *The Bank of England*, pp.524-527.

1956 and in 1957. For the Treasury and for the government, the decision to intervene in transferable sterling did not constitute convertibility. Rather it was a technical step which had the benefit, so Treasury officials thought at the time, that it could be revoked without too much difficulty. The UK government saw a big difference between the measures of February 1955 and official convertibility. According to Treasury officials, the formal unification of the two sterling rates would be an irrevocable and therefore major step, in that it would lead to the loss of the transferable rate as a policy instrument.[75] They argued that as long as the rates had not been officially unified the government could, in times of crisis, untie the transferable rate from the official rate and let the former float downward. Once the rates had been officially unified, however, this option would no longer be available, because it would be regarded at home and abroad as a major step.[76] The Treasury insisted that the official move to convertibility had to be made from strength, that is, when confidence in sterling was high, to assure that the event be confidence-boosting. In view of the repeated sterling crises, officials pointed out that, if not undertaken at a moment of strength, convertibility could unleash speculation against sterling, thus actually weakening it.[77] According to Scammell, official convertibility constituted

> a step which could not easily be retraced and was a declaration of strength and confidence by governments that convertibility was not just a passing phase made possible by temporarily favourable circumstances but was the normal condition for a strong currency and could now be held indefinitely.[78]

While policymakers were keen to convince the world that sterling was strong they feared precisely the fact that the step was difficult to revoke once it had been taken.

[75] PRO T236-3946, Rowan to Makins, March 23, 1958.
[76] PRO T236-3946, "The Arguments Against an Early Amalgamation of the Official and Transferable Rates - Views of the Treasury", April 2, 1958.
[77] PRO T236-3946, "The Arguments Against a Move Now", Rowan to Rickett, March 24, 1958.
[78] Scammell, *International Monetary Policy*, p.398.

The government's reluctance to establish official convertibility, thus sealing the de facto removal of exchange control, can be explained partially by a general reluctance to free the economy from controls and discriminatory practices after World War II.[79] In the early post-war period, economic policy in the UK was characterized by a widespread belief that "the country would have to defend its balance of payments by frequent recourse to direct controls and discriminatory measures".[80] Many economists and other observers of the UK economy frequently argued, both at the time of the events and afterwards looking back on the course of things, that controls provided a useful and entirely acceptable discretionary tool with which to manage the economy. It is widely accepted that the Labour government assigned an important role to controls as a means of containing inflation and solving balance of payments problems.[81] But, as Cairncross, who was part of the decisionmaking body, observed, although Conservative governments "attached more importance to market freedom" than Labour, even they were not reluctant to introduce controls when they thought it necessary.[82]

In 1962, M. FG. Scott suggested as one possible way to improve the UK balance of payments the imposition of import restrictions or tariffs.[83] Scott's view of the usefulness of controls is particularly interesting since he advised the government directly

[79] N. F. R. Crafts, "'You've never had it so good?' British economic policy and performance, 1945-1960", in Eichengreen, *Europe's Post-War Recovery*, pp.246-270 and P. Minford, "Reconstruction and the U.K. Postwar Welfare State: False Start and New Beginning", in Dornbusch, Nölling and Layard (eds.), *Postwar Economic Reconstruction*, pp.115-137.
[80] Scammell, *The International Economy*, pp.45-6.
[81] Howson, "Money", p.231.
[82] A. Cairncross, *The British Economy*, p.94. Patrick Minford claimed that the "new generation of Tory leaders" which governed Britain in the 1950s, - Butler, Macmillan and even Churchill -, "was in economic matters uncommitted to free market ideas". Minford, "Reconstruction", p.120.
[83] M. FG. Scott, "The Balance of Payments Crises", in Worswick and Ady (eds.), *The British Economy*, p.229.

on economic policy in 1953-4 as a member of the Economic Section, thus contributing to the formation of government policy, and then went on to comment on government policy and the UK economy from the outside as an academic observer.[84] During his spell in the Economic Section he wrote a report on the costs of removing dollar discrimination in the case of a move to convertibility which indicated that the costs of removing dollar discrimination, and thus of establishing convertibility, were too high.[85] Scott's view reflected the general stance taken by the Economic Section on convertibility, which, throughout most of the 1950s, "debated exchange rate policy without much wish to see an early introduction of convertibility".[86] After the return to convertibility Scott criticized the move, for having increased speculative capital flows.[87]

Prime Minister and former Chancellor of the Exchequer Harold Macmillan exhibited a particular attraction to exchange control or, at least, a reluctance to renounce its use as policy instrument. During the speculative crisis in the fall of 1957 he wrote a personal note to the Chancellor of the Exchequer in which he questioned the general desirability of the progress towards convertibility which had already been achieved and asked him to look into the possibility of backtracking on the removal of exchange control. He wondered: "[H]ow far is it possible to revert to the position before we slopped into practical convertibility, and so to prevent these raids by the enemy upon our currency", and argued that "[w]e might perfectly well consider reimposing some of the monetary

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[84] Another contribution by Scott to the literature on the balance of payments of the UK is M. FG. Scott, *A Study of United Kingdom Imports*, Cambridge University Press, 1963.
For a study on the role of the Economic Section in UK economic policy formation see Cairncross and Watts, *The Economic Section.*
[85] PRO T230-342, M. FG. Scott, "The effect of removing discrimination against dollar countries", EC(S)(54)9, April 21, 1954.
[86] Cairncross and Watts, *The Economic Section*, p.309.
[87] Scott, "The Balance of Payments Crises", p.227.

controls and exchange controls if it is practical to do so - again as a temporary measure".[88] As the crisis worsened Macmillan's disenchantment with the removal of exchange control grew and his attacks on a policy of payments liberalization became bolder. In late September he asserted that "[t]o say that this second course [a reversal of the extent of convertibility so far achieved] would 'represent a reversal of all that we have tried to achieve in the last ten years' does not prove it is wrong".[89]

Making de facto convertibility official would have only made it harder to renege on a policy that the Prime Minister viewed with great skepticism. An official move would have sealed the removal of exchange control, finalizing the renouncement of inconvertibility as an instrument of monetary policy. The reluctance to establish official convertibility was reinforced by the fear of political repercussions of a move that might be interpreted as a governmental tendency to put international financial considerations before domestic economic growth.

In the UK, contrary to Germany and France, convertibility was a political issue, rather than just a technical monetary problem. In a meeting on exchange rate policy in October 1958, the Chancellor of the Exchequer, Heathcoat Amory, remarked on the political importance of the return to non-resident current account convertibility in December 1958 since the move represented the achievement of a goal set out by the Conservative government in 1952.[90] Conservative policymakers worried that convertibility would be criticized by the Opposition as indicating the Government's willingness to put sterling before the economy.[91] In light of sterling's persistent weakness

[88] PRO T236-3945, Macmillan to Thorneycroft, September 18, 1957.
[89] PRO T236-3945, Macmillan to Economic Secretary of Treasury, September 29, 1957.
[90] PRO T236-4819, "Exchange Rate Policy: Note of Meeting held at 10, Downing Street, S.W.1, on Tuesday, 28th October 1958, at 12.15 p.m.", October 28, 1958.
[91] See, for example, PRO T236-3945, "Bringing the Rates together" to Makins and Rowan by Treasury

in the 1950s, a move to convertibility might have triggered a sterling crisis, forcing the government to raise interest rates or introduce other contractionary measures to defend sterling. Labour argued that there was a conflict between domestic goals, full employment and economic expansion, and international ambitions, in particular sterling's international currency role and the dealings of the City of London, and that convertibility catered to the latter at the expense of the former. The Labour Party viewed exchange control as a way of protecting the domestic economy from international speculation against sterling. The removal of exchange control, through the establishment of convertibility, was attacked as sacrificing the domestic economy to the international status of sterling.[92] Convertibility was at the heart of a general debate over what should be Britain's economic goals. Thus, policymaking on convertibility was weighed down by a more general political controversy. In 1954, *The Economist* described the politics of convertibility as the following:

> Next year is likely to be an election year. It is possible that convertibility might be achieved during it if Mr Gaitskell could be induced to meet the plan with passive acceptance; but it has always been clear that the project would not work if he was jostled by his own left wing into meeting it with implacable opposition. Now it seems likely that he is going to be jostled that way not only by the left wing of his party, but by its right wing as well. The latest economic report of the Trades Union Congress, in its search for some grounds for criticism of Tory financial policy, leaned heavily on the view that the removal of controls had already left Britain excessively vulnerable to fluctuations in world markets. It is important to recognise what this policy of Labour opposition to freer payments would mean if C-Day were, after all, allowed to dawn next spring. Foreigners would then in effect be told 'Britain is giving you the opportunity to convert your sterling into dollars. In six months' time there will probably be a general election, and the alternative government that may well be elected will probably take this opportunity away.' There is little doubt what foreigners' reactions would be; they would hurry forward to utilise their rights of conversion at a fast enough press to wreck the whole venture.[93]

official (unsigned), February 20, 1958.

92 "...Labour spokesmen have publicly stated that the recent strains could have been met by a tightening of exchange control". *The Banker*, "No Backsliding on Sterling", December 1957, p.763.

93 *The Economist*, "Patience for the Pound", September 11, 1954, p.792.

In October 1958, the Trades Union Congress (TUC) wrote to the Chancellor of the Exchequer, Heathcoat Amory, that it opposed any further moved to convertibility. This letter was also reported in the *Times* newspaper. The Treasury was concerned about the possible negative public reaction to convertibility as a result.[94] The convertibility issue was divided along party lines in the sense that the Conservative party had made it a top priority, while Labour was likely to oppose, and might attempt to revoke exchange control liberalization. Moreover, as Macmillan's views revealed, even within the Conservative party, convertibility was a controversial issue. In Britain, convertibility was a much more prominent and debated issue than in France or Germany. The public controversy surrounding convertibility in Britain in the 1950s contradicts A.C.L. Day's previously quoted comment from 1956 that "[w]ith the exception of the autarkists and imperialists of the extreme left and extreme right, the principle that we should move towards convertibility is remarkably generally accepted".[95]

The conclusion from this section is that in the 1950s several factors held the Treasury back from making sterling officially convertible for non-residents for current account purposes. All were linked to the symbolical importance of the move. First, officials, including the Prime Minister, feared the effect on speculation of a move to convertibility if it were undertaken at a moment of sterling weakness. Growing concern with sterling's weakness also explains why UK policy increasingly realized the necessity of a collective move to convertibility. Given sterling's proneness to drop, a unilateral

[94] PRO T236-4819, J. Downie to A. France and R. Hall, October 27, 1958. See also PRO PREM11-2671, October 28, 1958.
[95] Day, *The Future*, p.120.

move to sterling convertibility seemed a precarious policy.[96] Second, UK politicians were concerned, particularly before elections, about the message an official move to convertibility might send to the electorate. The step could be considered a threat to the government's commitment to full employment since official convertibility at a fixed rate implied the need for financial discipline for a country whose inflation was consistently higher than the European average. Although convertibility had already been established de facto, an official announcement of convertibility was likely to be a welcome bait for the Opposition. Third, there were strong reservations against giving up the transferable rate of sterling. Policymakers considered the dual exchange rate system an instrument of monetary policy which they were unwilling to give up. Moreover, they were reluctant to endorse a decision, and therefore make a reversal more difficult, which they thought limited their ability to pursue an independent economic policy. Thus, in the UK, policymaking on convertibility revolved around political, psychological and symbolical issues.

CONVERTIBILITY AND THE EXTERNAL CONSTRAINT

A floating exchange rate for the pound was viewed as a possible solution to the conflict between the establishment of convertibility and the maintenance of an independent monetary policy. Throughout the 1950s, both the Bank of England and the Treasury were very attracted to floating exchange rates or at least more flexible exchange rates, although for different reasons. Many of the supporters of a floating exchange rate in the Treasury opposed convertibility for the same reasons that they advocated floating

[96] "Official reserves were never growing fast enough in 1952-4 to justify British attempts to make sterling convertible outside a common European framework." Milward, *The European Rescue*, p.395.

rates. Alternatively, many policymakers thought that the return to sterling convertibility could or should only be undertaken jointly with a move towards greater exchange rate flexibility. Both the resistance to convertibility and the attraction to a floating, or flexible, pound exchange rate are explained by the view that the exchange rate was an instrument of monetary policy which the Treasury refused to give up. This section focuses on the attraction of policymakers in the Treasury and the Conservative government to floating exchange rates. The situation in the Bank of England was very different, since the Bank was Britain's most ardent advocate of the return to currency convertibility. A floating or more flexible exchange rate would have increased the importance of monetary policy, which in turn would have increased the role of the Bank of England.[97]

Many policymakers in the UK were opposed to convertibility unless it was accompanied by an increase in exchange rate flexibility. In his theory of system overdetermination, Holtfrerich explained why policymakers might consider convertibility and fixed exchange rates to be incompatible:

> Some autonomy in domestic stabilisation policy could peacefully coexist with fixed (but adjustable) exchange rates in the Bretton Woods era, as long as currency convertibility and thus international capital movements were still restricted. But with convertibility fully restored, the system was overdetermined and - when finally forced to make a choice and to eliminate one of the three elements (fixed exchange rates, full external convertibility, and national autonomy in stabilisation policy) - the participating countries finally agreed to remove the fixity of exchange rates in 1973.[98]

[97] "To return to convertibility at a floating rate would have not only established the external balance and foreign confidence in sterling as the first consideration in domestic policy formulation, but would have restored the Bank of England itself to an important role in policy formulation." Milward, *The European Rescue*, p.358.

[98] C.-L. Holtfrerich, "Introduction: The Evolution of World Trade, 1720 to the Present", in Carl-Ludwig Holtfrerich (ed.), *Interactions in the World Economy: Perspectives from International Economic History*, Harvester Wheatsheaf, 1989, p.21.

A country can only pursue an independent monetary policy, especially an inflationary monetary policy, when the economy is closed or when exchange rates are flexible, and even then its room for manoeuvre is limited. In the 1950s British policymakers were confronted with conflicting policy aims of national policy autonomy, convertibility and fixed exchange rates. As a result, the discussion over the return to convertibility was inextricably linked to the debate over fixed versus flexible exchange rates. Policymaking in the UK was pervaded by a strong distrust in the ability of an open multilateral system of free trade and payments combined with a fixed exchange rate to ensure the level of employment which the UK considered adequate.

Throughout the 1950s, British policymakers were attracted to the idea of a floating pound, in particular in connection with a move to convertibility. Thus, the plan for operation ROBOT, devised in 1950/1, envisaged a move to a floating or semi-floating exchange rate conjointly with the establishment of convertibility. There seems to be a belief that UK governments abandoned "the idea of increasing the use of monetary policy as an economic regulator by the use of floating exchange rates" in 1955.[99] But a host of Treasury and Bank memos show that as late as the spring of 1958, the idea of a floating exchange rate was far from dead. In the spring of 1958 there was an outpouring of Bank and Treasury memos exchanging views on the pros and cons of a floating rate for sterling or, more moderately, a widening of the margins of fluctuation.

[99] Milward, *The European Rescue*, p.358.
Kaplan and Schleiminger claim that Bank officials abandoned the idea of a floating rate after 1954 because they realized that a floating pound damaged confidence in sterling and thus the sterling's prestige as international currency. But the Bank still sought wider margins of fluctuation for sterling. In the negotiations for the European Monetary Agreement (EMA) which was to replace the EPU upon the establishment of convertibility, the British lobbied for a wider band around an official parity of three to four per cent on either side to which the continental countries were opposed. Kaplan and Schleiminger, *The European Payments Union*, p.221 and Fforde, *The Bank of England*, p.537.

In September 1955, Robert Hall, Director of the Economic Section questioned the general desirability of convertibility at a fixed exchange rate, since it represented a policy which, he claimed, restricted the UK's autonomy over its domestic economic policy. He criticized the abandonment of the idea of a floating exchange rate stating that this meant that the UK had

> ...made a radical change in the Collective Approach and removed from it what had always seemed to me to be its central feature and the one that was going to give us the latitude which is not present with convertibility at a fixed rate with narrow gold points. There is, to my mind, no doubt that convertibility at a fixed rate imposes rigid limitations on internal policy and especially when import and export controls are abandoned, so that changes in the foreign balance have to be primarily brought about by changes in the levels of activity and employment.[100]

The view of the director of the Economic Section is representative of a general reluctance of the Treasury to embark on any policy, including convertibility, which would force UK policymakers to respond to external pressures to combat inflation.

In 1956 Rowan wrote a memo which was then redrafted by Hall entitled "Why Convertibility".[101] This memo best summarized the UK dilemma with regard to the advancement towards convertibility. It juxtaposed the desirability to maintain the international currency status for sterling with the fear that convertibility, which formed part of a multilateral system of free trade and payments, would expose the UK to a wide area of trade which "increased the risk that individual countries may have to face painful economic adjustments". It saw a potential conflict between the advantages derived from "the widest possible system of trade and payments" and countries' need to "isolate themselves from a fully international system". The latter desire could be explained by countries' desire for independence "for example because they wish to be in a position to

[100] PRO T236-3943, Robert Hall, "Convertibility etc.", September 9, 1955.
[101] PRO T236-3940, R. Hall, suggested redraft of Rowan's memo "Why Convertibility" from May 18, 1956, June 8, 1956.

pursue an inflationary policy with impunity".[102] In 1955, Robert Hall stated more clearly that, "[t]he reason for which (in the end) we have not moved to convertibility is that we are afraid of the internal adjustments that will be required".[103] There was a general unwillingness in the Treasury to allow the rules of the game of a multilateral system of free trade and payments at a fixed exchange rates at convertible currencies to dictate the level of domestic economic expansion. Convertibility, particularly at fixed rates, was feared to increase the UK's exposure to the forces of adjustment, thus reducing the British government's freedom to manage its economy according to its priorities. In a memo to the Prime Minister, Burke Trend from the Treasury asked the revealing, and rhetorical, question: "Are we prepared to accept the psychological limitation on our foreign policy of the continuance of a tight internal economic policy which convertibility must entail"?[104]

There were a few voices in the Treasury which strongly criticized the general policy of refusing to take exchange rate problems as an indication of the need to adjust. In a paper written in late 1956, W. M. Scammell accused the Treasury policy of ignoring the danger signals sent out by the weakness of the pound. He criticized

> the tacit assumption that this country is in the happy position of being able to direct policy primarily in the interests of the domestic economic situation and to regard the balance of payments as a dependent variable which, while it is important, and must be watched, still is dependent.[105]

Scammell warned of the fallacy of viewing the balance of payments as something "subordinate to the level of employment". With the following passage he delivered an eloquent condemnation of British economic policy in the 1950s which he claimed had

[102] ibid.
[103] PRO T236-3943, R. Hall to Edward Bridges, "Convertibility, etc.", September 2, 1955.
[104] PRO PREM11-2671, Memo by B. Trend to the Prime Minister, September 10, 1958.
[105] PRO T230-305, W. M. Scammell to Downie, December 21, 1956.

been misguided by an erroneous assessment of the situation:

> If we adopt the view that the balance of payments is determined rather than determining then we fly in the face of the facts presented by the experience of recent years. Our policies for domestic equilibrium and steady growth are likely to be frequently impeded by their external consequences which will quickly assert themselves in claimant fashion. This is what I think has happened in the past. We have paid some lip service to the importance of the external position (as expressed in reserve levels) but we have, in the main, formed our domestic policies with scant regard for our changing international position. That is one reason why our domestic economic situation has been subjected to crisis after crisis, - in 1947, in 1952, and in 1955. As long as we assume the primacy of domestic planning that will go on: the sooner we recognise the primacy of the external forces the sooner it will be possible to move towards an integrated general economic policy.[106]

Rather than interpreting exchange rate pressure as an indication for necessary internal action, the Treasury sought to isolate the economy from its effects. Some authors have implied that British policy erred in letting the international status of sterling dominate domestic economic policy.[107] In fact, however, the problem lay with a British failure to recognize the inevitability of the external constraint on domestic policymaking. British policy towards fixed exchange rates and convertibility reveals a dismissal of the importance of the external constraint, which significantly contributed to sterling's general weakness in the 1950s. The lack of commitment to the Bretton Woods system of convertible currencies at a fixed rate undermined the stability of sterling, thus forcing the UK to apply drastic brakes to economic activity which interrupted a continuous expansion of the economy.

WHY A FLOATING EXCHANGE RATE WAS NOT ADOPTED

Conservative ministers believed that a floating exchange rate would allow the

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[106] ibid.

[107] One example is Tomlinson, "British Economic Policy", pp.266-7.

government to pursue an independent monetary policy. The Prime Minister, Harold Macmillan, was very attracted to a floating exchange rate for sterling.[108] He thought that floating would compensate for the perceived loss in monetary policy leeway caused by convertibility.[109] In August 1957, France wrote that in a meeting the Prime Minister "himself raised the question of floating rates and seemed attracted".[110] On March 10, 1958 Macmillan asked the Treasury to prepare memoranda discussing the pros and cons of unification and the pros and cons of a floating rate.[111] On March 21, 1958, he went even further, asking the Chancellor of the Exchequer to prepare a paper showing what constitutional and technical steps were required to be able to move to a floating rate: "I do not want an argument as to whether we ought to do it, I want a presentation of how we do it if we decide to do it".[112] The Prime Minister was not thrilled about the idea of convertibility. He feared that exchange rate unification would reduce the flexibility of monetary policy as an economic instrument at his disposal, and impose greater monetary discipline. Macmillan was worried about ensuing attacks by the opposition on the grounds that by establishing convertibility he sacrificed economic growth and full employment to the external position of the pound. In particular, for political reasons, Macmillan wanted to introduce an expansionary budget in April 1958 and he did not want sterling weakness to hamper his ability to do so. He thought that a floating pound would solve the problem, allowing him to inflate the economy without suffering a sterling crisis.[113] His plans led to a confrontation with Chancellor of the Exchequer, Peter Thorneycroft, on these issues in

[108] For a discussion of Macmillan's involvement in British economic policy, see R. Lamb, *The Macmillan Years 1957-1963: The Emerging Truth*, John Murray, 1995 and A. Horne, *Macmillan: 1894-1956, Volume I*, Macmillan, 1988, and A. Horne, *Macmillan: 1957-1986, Volume II*, Macmillan, 1989.
[109] Fforde, *The Bank of England*, p.589.
[110] PRO T236-3944, France to Rowan, August 23, 1957.
[111] PRO T230-373, note from Maude to Makins and Rowan, March 10, 1958.
[112] PRO T236-3946, March 21, 1958.
[113] for a discussion see Lamb, *The Macmillan Years*, pp.47-52.

the fall of 1957. Thorneycroft blamed inflationary pressures in the UK for the sterling crisis in 1957, and therefore advocated a disinflationary policy, to Macmillan's strong dislike. In the end, Macmillan got his way, when Thorneycroft resigned and Heathcoat Amory, "a more malleable colleague" took his place allowing Macmillan "in presidential fashion ... to exercise his own control over the Treasury".[114] Macmillan's attraction to a floating exchange rate was shared by a number of Treasury and Bank officials.[115] France from the Treasury stated that "[i]n general I think that to widen the margins (and we might very well have to operate without limits to begin with) is a course which is not unjustifiable when our own underlying position is sound and when we are dealing with speculation".[116] He saw a floating or flexible exchange rate not as an emergency solution when a fixed exchange rate could no longer be maintained but as an acceptable policy that should be considered when sterling was strong.

After the Thorneycroft affair, Treasury and Bank officials became increasingly worried that Macmillan saw a rate which was free to float, downwards, as a way of allowing him to pursue an inflationary economic policy without having to worry about the exchange rate. In their memos they started to caution against thinking that with a floating exchange rate the UK would be free to inflate its economy. In a Bank of England report from March 1958, while acknowledging that floating offered some advantages, such as protecting sterling against pure speculation, the Bank warned that "[i]t should <u>not</u> [sic] be thought, however, that among the advantages would be the acquisition by H.M.G. of

[114] Lamb, *The Macmillan Years*, p.51.
[115] Fforde, *The Bank of England*, pp.571-572.
[116] PRO T236-3944, France to Rowan, August 23, 1957.

greater freedom of manoeuvre in domestic monetary and economic policy".[117] In response to the Prime Minister's request for a memo on the pros and cons of floating in March 1958, Rickett produced a report discussing the desirability of a floating rate. While admitting that floating could be a successful weapon for dealing with speculators, he strongly warned against using a floating exchange rate as a subtle way of allowing depreciation in the face of domestic inflation, which is exactly what both the Bank and the Treasury suspected to be reason for the Prime Minister's attraction to it. Rickett stated that "wherever [...] exchange depreciation has been resorted to as an alternative to dealing with the causes of inflation, the relief gained has been at best temporary, while in many cases the effects can be positively harmful".[118] He softened his strong stand against floating by making his argument partially dependent on world prices and international economic conditions. He claimed that to let the pound float in the present conditions of rising or even relatively stable world prices would be equivalent to letting it depreciate, which in turn would hurt confidence in the pound of the holders of sterling reserves whose real value would drop through a depreciation. A situation of falling world prices and/or recession, however, would change the scenario, potentially making floating an attractive policy option, as it had been for the United Kingdom in 1931. Thus, he stated, "[a]n exchange adjustment may be helpful to a country seeking to avoid the need for deflation in conditions of severe world depression and falling prices, and dangerous to a country persisting in an inflationary policy against a background of rising or even relatively stable world prices".[119] Most likely, these cautionary statements were directed at Prime Minister Macmillan. Many in the Treasury and the Bank of England viewed a more flexible

[117] PRO T236-3946, Bank of England Report, "A Floating Rate System", March 18, 1958.
[118] PRO T236-3946, memo by Rickett on the pros and cons of flexible rates, March 24, 1958.
[119] ibid.

exchange rate as helpful in protecting the pound against pure speculative attacks, that is, attacks that were not linked to economic fundamentals. However, they were aware of the danger of thinking that a floating rate would allow a country to pursue an inflationary policy over an extended period of time. They feared that this was what Macmillan had in mind and archival evidence shows that their fears were justified.[120] A joint Bank/Treasury paper in April 1958 warned that "the advantages in relation to speculators would only be maintained if we were determined to deny ourselves any internal freedom gained by a more elastic system".[121] An inflationary policy would lead to a steady depreciation of the pound, due to rising import prices which would lead to rising wages, which in turn would lead to inflation and thus further currency depreciation.[122]

In April 1958, the Bank of England and the Treasury issued a joint paper on flexible exchange rates, presumably in response to the Prime Minister's inquiry, which drew up a time table for the establishment of convertibility that was adjusted for the joint introduction of a floating exchange rate. The paper concluded that if one were to consider the UK alone as any other country in the international system a case could be made for either regime, that is, floating and fixed, but that "from the point of view of our international interests, the disadvantages [of floating] far outweigh the advantages".[123] It expressed concern about the potentially damaging impact of a variable exchange rate for the credibility of the pound as a safe haven and reserve currency.[124] In late March, Rowan stated that, "[i]ndeed it would be very damaging if the action of bringing the rates together came to be regarded mainly as a prelude to action to widen the margins", and - claiming

[120] Lamb, *The Macmillan Years.*
[121] PRO T236-3946, "Joint Bank/Treasury paper on flexible exchange rates", April 2, 1958.
[122] ibid.
[123] PRO T236-3946, joint Bank of England and Treasury paper on flexible exchange rates, April 2, 1958.
[124] ibid.

that such was the prevailing perception - used this concern as an argument against establishing convertibility immediately.[125] The concern was that such a move would be perceived as masking a devaluation and would thus lead to a speculative attack against the pound. By the spring of 1958, Treasury officials were moving closer to the Bank of England's view on the disadvantages of the status quo, that is, two exchange rates and two markets for sterling, the larger of which was beyond their control. But the fear that under prevailing expectations the establishment of convertibility would be directly associated with the introduction of a floating exchange rate for sterling, which in turn might lead to speculation against the pound, prevented them from pressing for action.

Treasury officials increasingly realized that letting the pound float or even just widening the margins would inevitably be regarded as a move from weakness "and a confession that we did not expect our recent policy, with its increased emphasis on the stability of the £, to succeed".[126] Moreover, officials argued that even if the pound could be floated from a position of strength, it was still not advisable, since the IMF did not condone such a policy. Far from endorsing the IMF view on exchange rates, the concern was that the UK could not afford losing access to the IMF's resources when it needed support for the pound. Rowan criticized the IMF system of fixed exchange rates with a narrow margin, remarking that "if the founders of I.M.F. had, in their wisdom decided upon somewhat wider margins it would now be helpful in that it would give us greater freedom of manoeuvre to deal with speculators".[127] His view was thus that, were it not for fear of IMF disapproval, a widening of the margins would be the suitable policy to adopt. The fear of being refused the financial support from the IMF which was considered

[125] PRO T236-3946, Rowan to Rickett, "The Arguments Against a Move Now", March 24, 1958.
[126] PRO T236-3945, Rowan, "Margins for Sterling", October 31, 1957.
[127] ibid.

necessary for a move to convertibility played an important role in the Treasury's decision not to float the pound when establishing convertibility. In addition, however, the realization that people equated floating the pound or widening the margins with a devaluation deterred policymakers from letting the pound float. The experience after 1955 showed that this expectation alone could already lead to speculative pressure against the pound. Both frequent adverse speculation and the anticipation of a devaluation weakened the pound and endangered its role as reserve currency. Continental European resistance to more flexible rates meant that British insistence on floating in spite of the rejection of wider margins in the EMA negotiations was likely to be seen as anti-European.[128] Once the British decided that sterling convertibility could only be established together with Europe, they were concerned not to jeopardize a collective European move to convertibility. Moreover, in 1958 concerns about the creation of European Economic Community (EEC) and the failure of a European free trade area added a new and decisive dimension to British policy on convertibility.[129]

Even though most officials in the Bank and the Treasury accepted after 1955 that, on the whole, floating was not an advisable policy choice for the establishment of sterling convertibility, neither the Bank nor the Treasury were willing completely to renounce floating as a possible policy option. During the crisis of 1957, most Treasury officials saw floating as an emergency solution to the problem. In July 1957, H. A. Copeman from the Treasury prepared a paper presenting the official position adopted by the Treasury on the issue. The memorandum stated was that floating was not a desirable policy in the given circumstances. While acknowledging the need to denounce publicly any rumors that the

[128] PRO T236-3946, joint Bank/Treasury paper on flexible exchange rates, April 2, 1958.
[129] This will be discussed in Chapter V.

Treasury might consider floating because of the damaging effects this had on the pound, Copeman was anxious not to condemn floating categorically:

> I have, I hope, stated the case against a floating rate strongly, but I have attempted to avoid prophesying irretrievable woe if we do float. If it is ever found that conditions are developing where floating is the right policy, we shall not wish to have burnt our boats.[130]

In the years leading up to the establishment of nonresident current account convertibility, the British government seriously considered making the pound convertible at a floating exchange rate.[131] Throughout the 1950s and up until 1958, the internal discussions on how and when to achieve convertibility by unifying sterling exchange rates, were accompanied by parallel discussions on whether to go convertible with a unitary fluctuating exchange rate for sterling or not.[132] According to Joseph Gold in an official IMF pamphlet, the IMF's Articles of Agreement clearly conveyed that under Article VIII "[a]n exchange rate regime which the Fund cannot approve is one that consists of a unitary fluctuating exchange rate".[133] However, this is precisely what the British had in mind. The British considered a floating exchange for sterling at a time when, at least internationally and officially, floating was not even discussed as policy option, and when they thought they depended on an IMF loan for their return to convertibility. Under the "Collective Approach to Freer Trade and Currencies", for example, suggested by the UK in 1953, the British proposed to let sterling float - or at least to widen the margins way beyond the one per cent permitted by the Fund - while at

[130] PRO T236-4364, H. A. Copeman to Symons: "Mr. Rees-Mogg on the Floating Exchange Rate", July 18, 1957.
[131] see, for example, Fforde, *The Bank of England.*
[132] see, for example, "A Floating Rate System", Bank of England Report, 18.3.1958, PRO T236-3946.
[133] J. Gold, *The Fund's Concept of Convertibility*, Pamphlet Series No.14, International Monetary Fund, 1971, p.19.

the same time seeking an IMF loan to finance the operation.[134] In other words, on several occasions the British considered making the pound convertible at a floating rate with the financial help of a loan from the organization that was designed among other things to prevent a fluctuating exchange rate system. The UK was at the forefront of the move for restoration of convertibility, at a time when "fluctuating exchange rates challenged the par value system enshrined in the IMF Articles of Agreement", but it did not view a fixed exchange rate as a necessary condition of convertibility.[135]

CONCLUSION

Compared to the other OEEC partners, "trade and industry had a lesser place in policy formulation than the status of the currency and the international financial considerations on which that was thought to depend". "It is in no way surprising that in Britain the will to national reassertion should have gathered its forces behind the financial service sector. Relative to the rest of the economy it was far more important than in other European economies."[136]

E.N. Helleiner claimed that the decisive leadership in shifting Europe towards convertibility in the 1950s came from the UK.[137] The careful examination of Britain's policy on convertibility throws doubts on this view. While Britain's pursuit of international financial ambitions dictated that sterling lead Europe into convertibility, the government was not willing to commit to an external monetary policy which was a controversial issue in domestic policy and which would be difficult to reverse once

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[134] Kaplan and Schleiminger, *The European Payments Union*, pp.168-74.
[135] Kaplan and Schleiminger, *The European Payments Union*, p.171.
[136] Milward, *The European Rescue*, p.390.
[137] Helleiner, *American Hegemony*, p.118.

convertibility had been officially established. The reluctance to establish official convertibility, even after de facto convertibility had already been established, and the attraction to a floating rate in connection with convertibility are explained by the need to keep the backdoor open for British domestic policy to escape the constraints which a system of multilateral trade, convertible currencies, and fixed exchange rates puts on the sovereignty of domestic economic policy.

ECONOMIC POLICY AND STERLING'S WEAKNESS

INTRODUCTION

This section argues that British economic policy, in particular its monetary policy, undermined the credibility of Britain's commitment to a stable pound. Many policymakers and authors argued that in the 1950s British reserves were insufficient to establish convertibility. The insufficiency of reserves was blamed for undermining the stability of the pound. According to this view the resulting weakness of the pound, particularly its proneness to speculative attacks, explained why convertibility had to be postponed repeatedly throughout the 1950s. Between 1952 and 1958, nearly every Treasury memo, and a large part of Bank of England memos, on convertibility linked any possible action or inaction on convertibility to its effect on the stability of the pound exchange rate. Thus, in 1953, L. A. Martin at the Bank of England stated that "the crux of full convertibility is, of course, confidence in the currency as reflected in the in- or out-flow of capital".[138] Within the UK Treasury, the test for any proposal for progress towards convertibility, or any monetary policy suggestion, appears to have been whether it would increase or decrease confidence in the pound as expressed in adverse speculation. The concern with the weakness of the pound and the effect of convertibility on the pound was a persistent issue in UK policymaking throughout the 1950s, even after the establishment

[138] BoE OV34/39, L. A. Martin to Tansley, "Germany and Convertibility", October 6, 1953. For other Treasury or Bank views on the importance of confidence in sterling as a prerequisite for a move to convertibility, see, for example, PRO T236-3943, "Note of a meeting in Sir Edward Bridges' room at the Treasury, at 3 p.m. on Monday, 8th August, 1955", August 8, 1955, PRO T236-3940, Hall's suggested redraft of Rowan's memo "Why Convertibility", June 8, 1956, PRO T236-3944, R. Makins to the Chancellor of Exchequer, August 23, 1957, and A. France to T. L. Rowan, August 23, 1957, PRO T236-3946, Bank of England Report by E. Parson sent to T. L . Rowan, "'Pros' for early amalgamation of official and transferable sterling", March 18, 1958, and T. L. Rowan to D. Rickett "The arguments against a move now", March 24, 1958, PRO PREM11-2671, memo by the Chancellor of the Exchequer, "Exchange rate policy and related matters", September 8, 1958.

of de facto convertibility after 1955. The fear was that a move to official convertibility when sterling was weak would unleash a run on the pound.

In the UK, the inadequacy of foreign exchange reserves was blamed for undermining the confidence of the pound and making it prone to adverse speculation.[139] The weakness of the pound, in turn, it was argued, made it impossible to consider the return to convertibility. UK policymakers maintained that an improvement in the reserve position and a strengthening of the pound were prerequisites for a move to convertibility. Fred Hirsch claimed that one of the causes of sterling's weakness lay in the insufficiency of British reserves that "have never been high enough to withstand any substantial loss of funds that starts either through Britain's own deficit or through finance of other countries' deficits through the sterling banking mechanism".[140] According to the supporters of the reserve-liability explanation of sterling's weakness, the sterling balances presented a huge danger to the stability of the pound because of the constant threat of an onslaught of holders demanding their conversion.[141] Such a run, by the non-resident holders of sterling, could be triggered by the slightest adverse development in Britain's external situation or simply by an, apparently, irrational loss of confidence.

As chapter I has shown, Britain's level of reserves only explain sterling's weakness insofar as they reflect the inability of the UK economy to accumulate reserves, due to structural balance of payments problems. However, changes in UK reserves cannot

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[139] PRO T236-4363, "Exchange Flexibility for Sterling", by Fleming, November 11, 1955.
[140] ibid.
[141] A. P. Thirlwall claimed that "[b]ecause of the large holding of sterling by foreigners and the persistent threat of their removal from London, the exchange rate was ... continually under threat in the 1950s and 1960s, notwithstanding surpluses earned on the current account. It was eventually weakness on the capital account (both short and long term), unrelated to any *serious* weakening on the current account, that precipitated devaluation in 1967, and which has led sterling to depreciate so dramatically and unfortunately since 1972." [141] A. P. Thirlwall, *Balance-of-Payments Theory and the United Kingdom Experience*, Macmillan, 1980, p.143.

explain the occurrence and the timing of the crises which sterling experienced in the 1950s. Recurring speculative runs on a currency are one indicator of the 'weakness' or instability of a currency. In his book on the pound sterling written in 1965, Hirsch identified and compared eight sterling crises between 1947 and 1965 alone. In Hirsch's table, reproduced below, he documented the magnitude of the crises in terms of the massive drain on the reserves they produced.[142] Table II.3 shows the extent of the gold and dollar drain and the lowest level of reserves in each crisis. According to Hirsch's analysis, trade deficits of relatively small magnitude set off massive speculation against the pound. The frequency and magnitude of the speculation against the pound which was prompted by the slightest apparently adverse change in economic conditions - and sometimes even without any visible change - reflects the volatility of confidence in the pound and its general vulnerability and instability, or what Hirsch called its "long-run weakness".[143]

[142] see my comment on the difficulty of interpreting reserve data.
[143] Hirsch, *The Pound Sterling*, p.47.

Table II.3: Sterling crises 1947-65

crisis period	*gold and dollar drain (million $)*	*net reserves at lowest point (million $)*
convertibility crisis 1947, 7 months (February to August)	-2500	2000
devaluation crisis 1949, 5½ months (March 31 to September 18)	-1265	1330
Korean aftermath, 10 months (July 1951 to April 1952)	-2284	1662
floating rates crisis, 3 months (July to September 1955)	-345	2345
Suez crisis 1956, 5 months (August to December)	-845	1572
1957 crisis, 2 months (August to September)	-700	1850
1961 crisis, 5 months (March to July)	-1620	1560
crisis 1964-5, 8 months (September 1964 to April 1965)	-2408	342

Source: reproduced from Hirsch, *The Pound Sterling*, pp.48-9.

In addition the crises identified by Hirsch, other bouts of sterling weakness occurred between August 1954 and February 1955. The last big sterling crisis before convertibility was established, the crisis of September 1957, must have been particularly traumatic for British monetary authorities. Speculation against the pound seemed to develop out of nowhere, since it occurred at a time when Britain was actually running a current account surplus that almost covered its capital outflow.[144] According to Hirsch, the causes of the 1957 sterling crisis were purely speculative, that is, there was no 'real economic' reason to doubt the stability of the pound.[145] The run on the pound was stopped when Britain and Germany jointly and publicly assured sterling holders of their commitment to the existing exchange rates.

In each of the crises, Hirsch assigned a significant, and sometimes exclusive, role

[144] Hirsch, *The Pound Sterling*, p.49.
[145] ibid.

to speculation in triggering or aggravating the crisis. In this sense, he viewed speculation as the cause rather than the consequence of the weakness of the pound.[146] Attributing weakness of a currency purely to speculation implies that without speculation the currency would be healthy since the underlying economy is healthy. In other words, the argument that speculation on its own causes currency weakness implies that speculation is random and speculators are either irrational or draw false conclusions from the state of an economy.

Eichengreen, Rose and Wyplosz examined speculative attacks on pegged exchange rates between 1967 and 1992. The question they sought to answer was "whether speculative attacks on pegged exchange rates are necessarily prompted by the inadequate convergence of national policies or whether such attacks can occur even in the absence of policy imbalances".[147] In addition, a growing body of literature has concerned itself with the importance of a government's commitment to an exchange rate regime for currency stability. The literature on exchange rate speculation and the importance of credibility is fairly young. However, in the last couple of years, the body of work on this topic has been growing rapidly.[148] Due to the relative youth of the topic in economic theory most

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[146] This is what is generally referred to as 'self-fulfilling speculation': if a large enough group of speculators believes that a currency will be devalued, their speculation against a currency, will eventually force it into devaluation. There need not have been any problems in the economy or any indications of currency weakness to start the speculation, aside from the speculation itself. See, for example, Eichengreen, Rose, and Wyplosz, *Speculative Attacks*, p.4.

[147] ibid., p.5.

[148] See, for example, D. Backus and E. J. Driffill, "Inflation and Reputation", in *American Economic Review*, June 1985, pp.530-538, D. Backus and E. J. Driffill, "Rational Expectations and Policy Credibility Following a Change in Regime", in *Review of Economic Studies*, April 1985, pp.211-221, de Grauwe, *International Money*, H. Henrik and T. Persson, "Exchange Rate Policy, Wage Formation and Credibility", in *European Economic Review*, October 1988, pp.1621-36, P. R. Masson, *The Credibility of the United Kingdom's Commitment to the ERM: Intentions versus Actions*, IMF Working Paper 94/147, December 1994, P. Krugman, "A Model of Balance of Payments Crises", in *Journal of Money, Credit and Banking*, 1979, pp.311-325, and A. K. Rose and L. E. Svensson, *European Exchange Rate Credibility Before the Fall*, Centre for Economic Policy Research Discussion Paper No.852, Centre for Economic Policy Research (CEPR), November 1993. For a discussion and an overview over the literature on exchange rate speculation, see Eichengreen, Rose and Wyplosz, *Speculative Attacks*.

empirical research focuses largely on exchange rate speculation in the past two decades.[149] No attempt has been made so far to apply the theory on confidence and credibility to the relative weakness of sterling and the strength of the DM in the 1950s. This is partially explained by the general belief that the reserve-liability explanation combined with 'pure' speculation explain the troubles of the pound in this period. This section argues that, contrary to the random speculation theory for the weakness of the pound, in the 1950s there were clear indications, so called 'policy imbalances', in the British economy, and, particularly, in British monetary policy that led rational decisionmakers to expect a sterling devaluation and consequently to speculate against sterling.

INFLATION AND FULL EMPLOYMENT

The previous chapter showed that Britain's average inflation between 1946 and 1958 was one of the highest in Western Europe compared to Germany where average inflation was one of the lowest. According to the theory of purchasing power parity (PPP), all other things equal, different rates of inflation in two countries, which are connected through trade and/or capital flows, should result in corresponding changes in the exchange rate.[150] If one country's price level grows faster than another country's, then, according to the theory that purchasing power parity holds, the currency of the country with the higher rate of inflation should experience pressure to depreciate relative to the currency of the country with the lower rate of inflation. Britain's higher than average inflation after World War II eroded the value of the pound. Thus, economic fundamentals go a long way in

[149] One exception to this is Bordo, *The Gold Standard.*

[150] A. Stevenson, V. Muscatelli and M. Gregory, *Macroeconomic Theory and Stabilisation Policy*, Philip Allen, 1988, p.266 and de Grauwe, *International Money*, pp.61-72.

explaining sterling's weakness in the 1950s. Moreover, in the 1950s while inflation was higher than in countries with higher growth rates, such as the US and Germany, unemployment in the UK was lower.[151] The combination of lower than average unemployment and higher than average inflation indicated and signaled to people a strong UK commitment to full employment.

Table II.4: Inflation and standardized unemployment rates (per cent), 1950-64

	Unemployment	*Inflation*
Japan	1.8	4.2
France	1.9	6.0
UK	2.5	4.0
Germany	3.6	3.2
US	4.8	2.2

Source: N. F. R. Crafts and N. W. C. Woodward, "Introduction and Overview", in Crafts and Woodward (eds.), *The British Economy*, p.6.

J. Tomlinson noted that "[i]n comparative perspective the strength of this commitment to full employment seems to mark Britain out" and that "[c]ertainly in other European countries there was not the same emphasis".[152] The apparent choice of full employment over price stability hurt confidence in the pound. Thus, according to the Federal Reserve Bank of New York, the speculative pressures on sterling between July and September 1957, "reflected the doubts, in Britain as well as elsewhere, about the likelihood of maintaining the existing value of sterling in view of the greater rise in prices and wages in

[151] In late 1958, A. J. Brown reflected on "the astonishing absence of unemployment" in the British economy over the past decade. A. J. Brown, "Inflation and the British Economy", in *The Economic Journal*, September 1958, p.449.

[152] Tomlinson, "British economic policy since 1945", p.259. Bernstein most likely had Britain in mind, when he categorically stated, in 1958, that, "...with full employment the existence of a payments deficit is a clear indication of current inflation". Bernstein, "Strategic Factors", p.135. See also S. Broadberry, "Employment and Unemployment", in Floud and McCloskey (eds.), *The Economic History*, pp.211-212.

Britain than in other industrial nations".[153] People form expectations about a government's willingness and ability to resist devaluation. In Eichengreen, Rose and Wyplosz's research on speculative attacks on pegged exchange rates, governments which are perceived to attribute a high priority to price stability are considered strong governments as opposed to weak governments which place a relatively lower value on price stability. The 'stronger' the government appears to be the smaller the probability, and thus the greater the expectations, that it will devalue its currency even under pressure. The weaker a government is considered to be the greater the belief that it will devalue and therefore the greater the speculative pressure on the currency to devalue. Widespread doubts about a government's commitment to a given exchange rate and price stability increase the likelihood and extent of speculation against a currency, especially if low unemployment is assumed to be a high priority for the government.[154] In the 1950s, the British government was perceived to accept inflationary wage settlements and, consequently, "was accused by the press of having 'given up the fight against inflation'".[155] Dow spoke of the institutionalization of annual wage increases and Keith Middlemas claimed that the "reluctance of Conservative governments of the 1950s to upset industrial harmony" was partially responsible for the fact that between 1945 and 1957 wages increases exceeded productivity growth.[156] The government's commitment to full employment curtailed its bargaining power with the trade unions. Judging the British economic policy as an

[153] Federal Reserve Bank of New York, *Monthly Review*, January 1958, p.9.

[154] According to P. Masson "a 'credibility crisis', in which, for instance, investors doubt that the government is committed to a particular parity or gives as much weight to inflation as it says that it does, may make the costs of maintaining the parity very high, if the government also cares about unemployment, as is assumed. This circumstance may then trigger a devaluation". Masson, *The Credibility*, p.iii. See also Tomlinson, "British Economic Policy", p.263.

[155] Cairncross, "Economic Policy", p.57.

[156] Dow, *The Management*, pp.98-9, and K. Middlemas, *Politics in Industrial Society: The Experience of the British System Since 1911*, André Deutsch, 1979, p.397. For a discussion of Britain's commitment to full employment after World War II see, for example, Minford, "Reconstruction".

outsider, von Herwarth, from the German embassy in London wrote in August 1955:

> Das Hauptproblem der britischen Wirtschaftschaftspolitik liegt nach wie vor bei der Frage, ob der britische Arbeiter gewillt ist, der Situation Rechnung zu tragen, und ob es der Gewerkschaftsführung in Zusammenarbeit mit der Regierung doch noch gelingt, der unsinnigen Lohnforderungen und Wünsche auf Arbeitszeitverkürzung in den unteren Instanzen der Gewerkschaftshierarchie Herr zu werden.[157]

According to Dow, the rapid expansion of demand and output in the years 1952-1955 and 1958-1960 were both due to the influence of government policy: "As far as internal conditions are concerned ... budgetary and monetary policy failed to be stabilizing."[158] Looking back in the 1990s on the UK's economic problems of the 1950s, W. M. Kirby claimed that:

> It was inflationary pressure, itself the product of the full employment commitment, which was the prime cause of the successive balance of payments and exchange rate crises which underpinned the stop-go cycle, while the UK's failure to match the growth performance of its principal overseas competitors had serious implications for relative living standards and also for the long-term stability of the external account.[159]

CRISIS MANAGEMENT

The handling of exchange rate crises contributed to the weakening of sterling. Particularly the inflationary boom of 1955-1956 and the government's inability or unwillingness to contain it in time undermined the credibility of the British government's commitment to exchange rate stability. Dow claimed that although the signs of the economy overheating were clear, government action "proved neither consistent nor

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[157] BA B102-6106, "Die britische Wirtschaftslage", von Herwarth, August 12, 1955.
'The main problem of British economic policy continues to be centered around the question, whether the British worker is willing to adapt to the circumstances, and whether the trade union leaders, together with the government, can withstand the unreasonable wage demands and calls for reduction of working hours coming from the lower echalons of the trade union hierarchy.'

[158] Dow, *The Management*, p.384.

[159] M. W. Kirby "Supply-Side Management", in Crafts and Woodward (eds.), *The British Economy*, p.243.

timely".[160] Bank rate was raised from three per cent to 4.5 per cent in February 1955 and hire purchase restrictions were introduced. As soon as these measures, together with the intervention in transferable sterling, had halted adverse speculation the Chancellor of the Exchequer took the opportunity to present an expansionary budget in April, that is, a mere two months after the imposition of restrictive measures and right in time before the elections in May 1955. In June, sterling weakened again, forcing the government to introduce a supplementary contractionary budget in October. The expansionary budget before the elections followed by the contractionary budget shortly after the elections, created the strong impression that the government was pursuing political aims at the expense of economic and monetary stability.[161] Dow criticized government policy during the 1955-1956 boom, arguing that "Mr. Butler appears to have relied on monetary control, exercised with his right hand, to balance the budget concessions given by his left".[162] Warren Smith and Raymond Mikesell examined British monetary policy in the 1950s and concluded that a greater reliance on contractionary fiscal policy, in the 1955 inflationary boom but also thereafter, would have produced better results than resorting to monetary policy only.[163] The reluctance to resort to contractionary fiscal policy can be explained by the fear of UK governments of political repercussions of unpopular tax raises and cuts in government expenditure which were more difficult to reverse than Bank rate raises.[164]

[160] ibid., p.78.
[161] ibid., p.79 and Surrey, "United Kingdom", p.532.
[162] Dow, *The Management*, p.79.
[163] W. L. Smith and R. F. Mikesell, "The Effectiveness of Monetary Policy: Recent British Experience", in *The Journal of Political Economy*, February 1957, pp.18-39.
[164] The determining influence of political issues on fiscal policy decisions in Britain in the 1950s is illustrated in Macmillan's efforts to push through an expansionary budget for 1958. "Through all the Prime Minister's minutes runs the theme that the 1958 Budget must be designed to make possible a soft vote-winning Budget in 1959, and he was worried that if the brakes were not taken off in 1958 there would be insufficient time to get Britain out of slump before the votes were counted." Lamb, *The Macmillan Years*, p. 53. See also pp.54-7 and p.93 for Macmillan's often successful efforts to push through expansionary budgets for political reasons.

Monetary policy was a more flexible instrument than fiscal policy in that interest rates and credit availability could be changed more quickly, in both directions, and with less public scrutiny than changes in taxes or government spending. According to Jim Tomlinson, in the UK,

> the whole history of policy on inflation [since 1945] is one of episodic scares and hurried policy initiatives, unsustained once the immediate scare is passed. ... [F]or the period up to the early 1970s much of the concern with inflation flowed from its impact on international competitiveness, given a fixed exchange rate under the Bretton Woods system. Thus attempts to control aggregate demand to contain inflation were usually triggered not by the level of an inflation index but by a run on the pound which threatened to drive it from the fixed level.[165]

One reason why the government was reluctant to undertake far-reaching economic adjustment in response to sterling's weakness was that many Treasury officials viewed the speculative crises as triggered by pure speculation, and thus refused to undertake painful economic adjustment in response to the exchange crises. Most Treasury officials did not interpret the pound's weakness as a reflection of an underlying economic disequilibrium requiring an adjustment of the internal economy. Instead, they viewed speculation against sterling as unrelated to economic fundamentals. The government only took action when speculative pressure against the pound threatened to get out of hand and wipe out the reserves. UK governments saw speculation against the pound as an isolated, exogenous problem, like a natural disaster, which they tackled with measures aimed directly at stopping speculation. Thus, in every exchange crisis the measures taken aimed only at producing the immediate effect of ending the flight from the pound, rather than at tackling the problem which caused the flight from the pound.

The Treasury justified its unwillingness to let external pressure dictate policy to

[165] Tomlinson, "British Economic Policy", pp.262-3.

restrain the domestic economy by arguing that external factors, or other countries, were responsible for the weakness of the pound. In the second half of the 1950s, when sterling was plagued by frequent adverse speculative pressure, the Treasury argued that the cause of the problem lay not with an excessively expansionary UK domestic policy. Rather, "overcautious budgetary and monetary policies pursued by the German authorities" were to blame for the destabilization of European exchange rates.[166] In 1957, Treasury officials produced a whole string of papers comparing certain aspects of the UK and the German economy.[167] They concluded that the Germans were responsible for exchange rate instability in Europe and that they should and could therefore restore exchange rate equilibrium, either by adjusting through inflation or by revaluing their currency vis-à-vis the US dollar. In a paper in September 1957, P. E. Watts from the Economic Section claimed that the proof that the DM was undervalued lay in the fact that "the U.K. has failed to maintain its share of international trade in manufactures whereas Germany has increased hers".[168] In the same memo, Watts listed as further evidence of the undervaluation of the DM the fact that Germany enjoyed the highest percentage increase in gold and foreign exchange holdings between 1954 and 1956 of all Western European countries and of Canada and the US. The paper failed to mention that the UK came last in the table which suggests that while Germany might be creating problems on the one end of the spectrum, the UK was creating problems on the other end. The trouble with the UK's attempt to blame Germany for exchange rate instability, which Watts acknowledged in his paper, was that any argument produced to prove that the DM was undervalued could

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[166] PRO T236-3944, "Memorandum by the Bank of England: Germany", September 5, 1957.
[167] see, for example, PRO T236-3944, R. Hall to T. L. Rowan, "Floating Rates", September 9, 1957, and PRO T236-3944, joint Bank/Treasury document, "Sterling", September 10, 1957,
[168] PRO T236-3945, P. E. Watts (Economic Section), "Second Draft: Exchange Rates", September 17, 1957.

equally be used to prove that the disequilibrium was caused by the UK's inability or unwillingness to fight higher than average inflation.[169] Overall, Watts failed to make a convincing case that the responsibility for action lay with Germany and not with the UK.

In Anglo-American talks in 1958 the Treasury sought IMF assistance to support the pound. The Treasury justified its request for support by arguing that sterling's weakness was not caused by excessive domestic inflation and that therefore there was no reason for measures to restrict domestic expansion, which would have been unpopular. Instead, the US recession was partially responsible for the pound's problems and, consequently, the responsibility for action lay with the Americans, not with the UK. The US delegation rejected the argument, attacking instead the UK's refusal to tackle domestic inflation. The Americans hardly concealed their criticism of UK policy by claiming that those who argued that a US recession would hurt the world were probably seeking to "continue to inflate and to live permanently beyond their means - the soft way".[170] In their view, "any country should be able, by adopting the right policies to increase their reserves within a short period; failure to do so for whatever reason, is regarded as a lack of dependability", and they suggested that UK economic policy should aim at establishing long-term confidence in the pound, "[i]nstead of thinking of new ways of borrowing to add to reserves".[171] The UK response to the criticism reflects policymakers" conviction that the weakness of the pound was no reflection of an underlying problem in the UK economy:

> [I]t is clear that although the Americans are aware that sterling is in a special position, they are far from grasping the full significance of that position. ... It is

[169] PRO T236-3945, P. E. Watts (Economic Section), "Second Draft: Exchange Rates", September 17, 1957.
[170] PRO T236-3945, "Anglo-U.S. Economic Talks: Report by Sir Leslie Rowan and Sir Robert Hall on visit to Washington, 15th-21st February, 1958", February 24, 1958.
[171] ibid.

> important to note that the U.S. pay much more regard to the building up of reserves than to the external monetary position as a whole - i.e. the ratio of reserves to liabilities.[172]

Placing the blame for sterling's weakness on other countries justified British governments' policy of tackling speculation rather than looking further, to the domestic economy and economic policy, for causes of sterling weakness.

The drastic short-term and short-sighted measures introduced by the Treasury when pressure against sterling mounted prove the resistance to implement policies which would have assured a stable fixed exchange rate. In addition to rises in bank rate and the introduction of hire-purchase regulations, both of which were rescinded as soon as pressure had abated, UK governments relied heavily on public statements which reiterated their commitment to the existing rate and announced their determination to act as means to tackling exchange crises in the 1950s. Thus, the government ended the run on the pound during the Suez crisis in 1956 "by statements of determination to maintain sterling's $2.80 parity and by recourse to international assistance".[173] The lack of any internal adjustment measures to restore exchange rate stability was justified by the claim that the flight from the pound was caused by speculation alone, that is, that the problem lay not with the internal state of the economy. Similarly, the 1957 exchange crisis was considered to be caused purely by adverse speculation.[174] Thus, in August 1957, A. W. France from the Treasury claimed that the UK's underlying position was fine and that, "[o]ur present problems are entirely due to speculation".[175] In the same paper, however, he

[172] ibid.
[173] Yeager, *International Monetary Relations*, p.450.
[174] Hirsch, *The Pound Sterling*, p.49.
[175] PRO T236-3944, A. W. France to Makins, August 21, 1957.

acknowledged that "there are fears about our rate in the longer term due to the doubts about whether the Government will contain inflation and whether repeated wage increases will make us uncompetitive".[176] In response to the speculative crisis in the fall of 1957, the Treasury tried to persuade Germany to revalue the DM in 1957, while admitting that a DM revaluation would only be effective if accompanied by internal measures, both in Germany and the UK towards economic adjustment if the revaluation was to have a lasting effect.[177] The fundamental aim was to stop speculation not to correct the underlying disequilibrium. A DM revaluation would have removed the pressure to implement corrective internal measures, both on the German and on the British side, albeit only temporarily. In the end, the government tackled the 1957 crisis by raising bank rate to seven per cent, obtaining an IMF standby loan, and joining Germany in publicly announcing its commitment to defend the existing exchange rate parities.[178] Thus, the 1957 crisis "led to explicit official pronouncements (though little action) on the latterly central issues of inflation and monetary control".[179] Policymakers attributed greater importance to public statements pronouncing German and British intentions to act than to actions themselves.[180] In fact, the UK saw currency realignments as a substitute for measures to correct the economic imbalance. Both the Treasury and the Bank of England preferred DM revaluation to pound devaluation because they thought the latter more likely to reduce further confidence in the pound and thus jeopardize its position as international transactions and reserve currency. A devaluation would have been in direct conflict with

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[176] ibid.

[177] PRO T236-3944, "Memorandum by the Bank of England: Germany", September 5, 1957, and PRO T236-3944, D. F. Hubback, "Germany", September 6, 1957.

[178] Yeager, *International Monetary Relations*, p.452.

[179] Surrey, "United Kingdom", p.534.

[180] PRO T236-3944, "Memorandum by the Bank of England: Germany", September 5, 1957.

the aim pursued by the establishment of convertibility, which was to strengthen sterling's prestige as a strong international currency. While policymakers, in particular the Prime Minister, could well envisage a floating rate to camouflage a depreciation, in the policy discussions devaluation was never even mentioned as an option. According to Wolfram Hanrieder, "British leaders...feared that devaluation would irremediably undermine sterling's role as an international reserve currency, a role that for political and economic reasons - prestige and an ability to run up long-term payments deficits - they wanted to preserve".[181]

> The decision to change an exchange parity is ultimately political. Necessary changes in parities have often been delayed because of the political costs. One hangover from the gold standard era was the notion that there is something sacrosanct about a parity and that devaluation is an admission that domestic financial policies have failed.
> The monetary authorities always hoped that events would somehow save them from the need to devalue - that next month's trade data would show a healthy rise in exports, or that other countries would revalue their currencies so that their own devaluation would be unnecessary.[182]

In any case, devaluation alone would not have solved Britain's balance of payments problems. A successful devaluation would have required additional domestic policy measures aimed at a lasting reduction in inflationary pressures.[183]

Throughout the 1950s, repeated runs on the pound depleted reserves at an alarming rate. For a while, the UK successfully combated speculation with temporary solutions, such as IMF standby loans and public statements, which required no lasting change in domestic policy. But these policies only had limited viability, and there was a limit to the

[181] Hanrieder, *The Foreign Policies*, p.219.
[182] R. Z. Aliber, *The International Money Game*, second and expanded edition, Basic Books, 1976, p.55.
[183] Schenk, *British Management*, pp.319-321. Milivoje Panic showed that exchange rate realignment alone is insufficient in correcting fundamental disequilibria. Panic, *National Management*, pp.105-110.

amount of times they could be successful in stopping speculation. As long as there were two rates for sterling, the official and the transferable rate, the government thought it could resist pressure for adjustment by letting the transferable rate drop. A floating or more flexible rate adopted together with the establishment of convertibility would have also reduced the direct pressure to adjust. It would not, however, have removed the economic problems.

EXCHANGE RATE POLICY AND CONFIDENCE

Advocates of fixed exchange rate regimes consider the exchange value guarantee provided by pegging or fixing one's currency as a necessary "confidence building scheme" to induce people to hold a domestic currency when they are free to convert domestic currency into other currencies.[184] The exchange value guarantee closely resembles one of Paul de Grauwe's four characteristics of money, according to which "[t]he willingness to hold money balances is based on the confidence of the holder that these assets will not lose their value".[185] One way of convincing people to hold money is "to guarantee that the money can be converted at a fixed price into another asset over whose value the supplier has no control".[186] This is precisely the guarantee that existed during the gold standard. The exchange value guarantee combined with the exchangeability guarantee become a "confidence building device", with the aim of inducing people to hold the domestic currency. According to de Grauwe,

> The convertibility of the domestic currency into foreign currency at a fixed price was the main confidence building device used by countries to have their currency

[184] De Grauwe, *International Money*, p.2.
[185] ibid.
[186] ibid.

accepted in international transactions.[187]

If people lack confidence in the stability of the value of a currency then they will not be willing to hold that currency or accept it in international transactions if they can avoid it. When the UK made sterling convertible in 1947, holders of sterling used the opportunity to rid themselves of a currency in which they had little confidence, expecting it to be devalued or be made inconvertible again soon, and converting their holdings into a currency in which they had more confidence, that is, the US dollar. Lack of confidence in sterling led to a run on the pound and forced the consequent suspension of convertibility. Like devaluation, the suspension of convertibility is likely to lead to a loss of value of a currency, because the shadow price of a currency is most likely to be higher under convertibility, when people can use it for current international transactions than when they cannot. When a currency can be freely exchanged for other currencies, then a country competes - to a certain extent - with other countries' currencies for people who will be willing to hold its currency and to use and accept it in international payments. Rather than accept a currency with a highly volatile exchange rate, people will prefer a currency whose value is stable, thus minimizing the risk of loss of value of their currency holdings.[188] The attraction of the British government to a floating pound was widely known.[189] Particularly

[187] ibid., p.3.

[188] The current international monetary system defies the theory that a currency must have a fixed exchange rate as a confidence building scheme to convince people of its stability and thus of the desirability of holding that currency. In a world of floating rates, holders cannot rely upon a fixed exchange rate as a measure of currency stability. Rather, currency holders might look to the stability of a currency - for example, what is the spread of its average fluctuation - and/or to the trend of its exchange rate path - that is, does the exchange rate seem to be on its way up or down. Consequently, perhaps the definition of convertibility that calls for a fixed exchange rate should be updated to require stability, rather than fixity of exchange value. De Grauwe has modified the previous definition of convertibility by requiring stability of purchasing power as a confidence building measure, rather than fixity of the exchange rate, stating that "a national currency can graduate as an international currency if there is confidence that it will maintain a stable purchasing power". De Grauwe, *International Money*, p.9.

[189] see for example *The Banker*, "Sterling Fixed or Flexible?", July 1955, pp.7-14, and "Sterling after Istanbul", October 1955, pp.211-216. As late as the fall of 1957, the public knew of government

in times of speculation against the pound, the discussion flamed up in the press and within the government. Letting the pound float was seriously contemplated as a policy response to adverse speculation. Public knowledge of this played a considerable role in weakening the pound and exposing it to more pressure than it might have otherwise had to endure.[190] By the second half of the 1950s, policymakers began to realize that the mere consideration of a floating rate especially at times when sterling was already vulnerable, increased speculative pressure against sterling. In September 1957, the Prime Minister sent a note to the Treasury in which he warned officials not to question publicly the desirability of the current fixed exchange rate regime and the parity of the pound since these doubts alone might trigger speculation against the pound.[191] Since rumors about letting the pound float tended to spark up in periods of speculative pressure against the pound, letting the pound float had come to be regarded as equivalent to a depreciation of sterling.[192] Floating was envisaged together with convertibility, as a policy to take the strain of the establishment of convertibility off the reserves and putting it instead on the exchange rate, that is, to let the pound depreciate with the hope of thus preventing a drain of reserves.[193] As a result, any discussion about the possibility of floating was frequently interpreted as indicating a 'weakness' of the pound and the possibility of a future devaluation, consequently triggering or intensifying speculative pressure against sterling.[194]

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considerations to float the pound. Lamb, *The Macmillan Years*, p.46.

[190] *The Economist*, "Sterling's Strength through Tribulation", in "British Banking", Special Supplement, June 14, 1958, p.8.

[191] PRO T236-3945, "Economic Situation: Note by the Prime Minister", September 26, 1957.

[192] PRO T236-3940, the Governor of Bank of England to the Chancellor of the Exchequer, April, 12, 1956.

[193] Dow, *The Management*, p.83.

[194] see, for example, *The Economist*, "Pound up to the Mark?", August 24, 1957, pp.595-7.

CONCLUSION

Throughout the 1950s, but increasingly so after 1955, fear of sterling's weakness played an important role in British policy on convertibility. A growing loss of confidence in the pound sterling throughout the 1950s, due to both economic fundamentals and government policy, played an important role in sterling's weakness in the 1950s. Chapter I showed that reserves in themselves cannot be blamed for sterling's weakness. Rather, inflationary pressures, which the government was unwilling to contain, and public awareness of the priority given to unemployment over inflation, of the government's serious consideration to let the pound float in times of adverse speculation, and of the unwillingness to open the economy to foreign competition undermined the credibility of the government's commitment to a strong pound. UK policy on convertibility was an important part of a monetary policy that gradually undermined the confidence in the stability of sterling.

> ...[I]n order for ...commitments to have credibility, they must be 'time consistent'. That is, it must be in the interest of the authorities to continue to honour them in the future. If a commitment is made which economic agents expect to go counter to the interests of the authorities in some future period, they will realize today that the commitment will not be held. [195]

Doubts over the government's commitment to a fixed stable exchange rate undermined sterling in the 1950s. Complacency about inflationary pressures, particularly obvious in 1955, and the priority given by the government to full employment conflicted with a stable exchange rate for the pound. The attraction to floating and the apparent ambivalence regarding convertibility conveyed a lack of determination to maintain a

[195] De Grauwe, *International Money*, p.194.

strong pound. All factors combined to erode confidence in the British currency making it prone to speculative attacks. UK external monetary policy exhibited unwillingness to accept the commitment anchors which would have been necessary to build lasting confidence in the pound, namely a fixed exchange rate combined with currency convertibility. Even when restricted by capital and exchange controls, economic agents could and did incorporate their expectations into their economic transactions to affect sterling and the UK reserves.[196] In 1957 Triffin observed that "the obstacles to the restoration of currency convertibility in Europe no longer lie in the weakness of its economy, in its persistent inflationary proclivities or in its shortage of dollars, but in fears and uncertainties regarding the future harmonization of nationalistic trade and monetary policies in an interdependent world".[197] The lack of commitment to the tenets of the Bretton Woods system had far-reaching consequences. De Grauwe argued that "[t]he Bretton Woods system collapsed because the commitments towards convertibility (at a fixed price) were not credible".[198] The lack of credibility was already evident to economic agents in the 1950s.

CONCLUSION

Throughout the 1950s British policy on convertibility was characterized by inconsistencies and indecisiveness. The lack of a clear and determined policy on sterling

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[196] Besides leads and lags which account for the bulk of speculative movements against the pound there were other significant channels through which speculators sold sterling in times of uncertainty. These channels, most importantly the Kuweit and the Hong Kong Gap were inofficial markets in which sterling area residents sold sterling for dollar securities. The Hong Kong Gap, is discussed in detail in C. Schenk, "Closing the Hong Kong Gap: Hong Kong and the Free Dollar Market in the 1950s", in *The Economic History Review*, May 1994, pp.335-353.
[197] R. Triffin, *Europe and the Money Muddle*, New Haven, 1957, p.86.
[198] De Grauwe, *International Money*, p.54.

and on convertibility reflected the dilemma between external and internal policy goals in Britain's monetary policy in the 1950s which undermined long-term confidence in the pound, thus contributing significantly to its weakness throughout and beyond the decade in question. The dilemma can be expressed as the conflict between the pursuit of full employment on the one hand, and the need for external stability and usability of sterling and Britain's international political ambitions, on the other hand.[199] The desire to pursue an independent domestic economic policy, aimed at economic growth and full employment was incompatible with a currency which was convertible and fixed or pegged.[200] In 1956, A. C. L. Day argued that convertibility would facilitate capital movements even if convertibility were only applied to current transactions since the removal of exchange control would make all flows more difficult to control. He warned that "[t]he result would be that the strain on sterling and the British economy might be quite intolerable" and concluded that "complete convertibility would impose a quite impossible strain".[201] Some Treasury officials, and particularly Prime Minister Harold Macmillan, considered the duality of sterling rates an important instrument of monetary policy, since it theoretically enabled them to let the transferable rate drop in times of adverse speculation, thus letting the exchange rate take the pressure instead of the domestic economy.[202] However, if sterling was to continue to be the world's trading

[199] A. C. L. Day summarized the dilemma as the tradeoff between the costs and advantages of convertibility which revolved around "first, the arguments for and against a more liberal international trading and payments system; and secondly, the arguments for an against the extension of London's importance as an international banker (and, to a lesser extent, as an international trading centre)". Day, *The Future*, p.136. For discussion of the problems and benefits of convertibility see also Polk, *Sterling*.

[200] This argument refers to Holtfrerich's theory of overdetermination of the system, explained earlier in this chapter.
see also Milward, *The European Rescue*, p.355.

[201] Day, *The Future*, p.132.

[202] The Bank of England rejected the idea that letting the transferable rate float was an instrument of monetary policy at the disposal of the government mainly because of the danger of such a policy to sterling credibility.

currency, a reserve currency, and if London was to remain an international capital market, sterling had to become convertible sooner rather than later. An international reserve status for sterling was important both for the continuation of the sterling area and for Britain's international power ambitions.

Without the protection of exchange control, UK policymakers believed that a floating exchange rate would let the exchange rate take the strain resulting from Britain's pursuit of a full employment policy. In this sense, the exchange rate was viewed as an instrument of monetary policy which policymakers were unwilling to give up. Sterling convertibility at a fixed rate would have reduced the exchange rate to a dependent variable, which would be determined by inflation differentials, between Britain and the world average, and by Britain's balance of payments. With a fixed convertible currency, Britain's domestic economic policy would be determined by its external balance. For a government committed to full employment, even at the expense of price stability, an external constraint which limited domestic policy choices was not an attractive option.

The commitment of UK governments to full employment and their reluctance to do anything about inflation unless they were forced to act in order to stem speculation against the pound seriously undermined confidence in the pound. Public awareness of the policy priorities of UK governments repeatedly led speculators and traders to expect a devaluation of the pound whereas a revaluation was never a realistic possibility. UK policymakers' attraction to a floating exchange rate for the pound, especially in times where the pound was already under speculative attack, confirmed widespread anticipation that the pound exchange rate would be allowed to drop in times of crisis. International comparisons of purchasing power parity or competitiveness further reinforced the belief that the pound would fall sooner or later. Anybody speculating on the future value of the pound had nothing, or next to nothing, to lose by selling the pound in the present, since all the above factors indicated that the only way for the pound to move was down.[203] In the second half of the 1950s, the frequent sterling crises increased policymakers' concern that convertibility would lead to a repeat of 1947.

The way in which UK governments tackled, and temporarily ended, speculation against the pound in the later 1950s, undermined the government's credibility and its ability to deal with crises in the future. The Government stopped pound speculation largely through public announcements without backing the words up with any real lasting corrective action. The rises in bank rate and controls on hire-purchase did nothing to address the underlying inflationary tendency of the economy which reappeared every time as soon as the temporary restrictive measures had been lifted. UK governments refused to fight the longer-term inflationary trend because they saw inflation as an acceptable price to pay for full employment.

Britain was the first country publicly to make the return to convertibility a government priority after 1947.[204] Moreover, the Treasury and Conservative governments were very concerned with appearing to be the leader in the return to currency convertibility of the European currencies. By leading Europe into convertibility they hoped to inject confidence into holders of sterling that the pound was worth holding.

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[203] Foreman-Peck, "Trade", p.173.

[204] "Dans les années 50, la pression exercée en vue de restaurer la convertibilité en dollar de devises européennes ne vint pas des États-Unis mais de Londres." Milward, "La livre sterling", p.408.
'In the 1950s, the pressure exerted to restore the dollar convertibility of the European currencies did not come from the US but from London.'

However, domestic policy considerations and doubts about the strength of the pound, and the effect of convertibility on confidence in the pound, presented powerful obstacles to a return to convertibility, particularly to an official announcement thereof. By 1958, the dilemmas facing UK policymakers with regard to convertibility had not disappeared, on the contrary. Moreover, by 1958 other factors came into play which further complicated the decision making process in Britain. These new factors, European integration, presented an additional dilemma for policy on convertibility, which is discussed in the chapter on monetary cooperation and European integration.

While the size of sterling balances held by non-residents put the British currency in a category of its own, this alone need not have caused the severe problems for currency management that Britain encountered, if domestic monetary policy had shown a greater commitment to currency stability. According to Dow, irresolution and vacillation when it came to monetary policy in general and the establishment of convertibility in particular, contributed significantly to the fluctuations in the confidence in sterling.[205] Thus, sterling's weakness cannot be blamed exclusively on the international nature and exposure of the currency that distinguished it from other Western European currencies. *The Economist* pointed out in 1958:

> One striking aspect of the whole experience of 1958, indeed, is that, when confidence in Britain's domestic policy is strong, sterling's relative status is not always and necessarily affected adversely by an international political crisis.[206]

Significant responsibility for sterling weakness goes to the lack of domestic policy commitment to currency stability. Britain's monetary policy throughout the 1950s constantly reminded sterling holders of this lack of commitment, thus seriously

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[205] Dow, *The Management*, p.87.

[206] *The Economist*, "Assessment for Sterling", November 29, 1958, p.812.

undermining confidence in sterling, both in Britain and abroad. Overall, the issues linked with convertibility presented the British with many dilemmas, due to the conflicting policy goals pursued. This was not the case in Germany, where, for reasons of historical and economic necessity, the economic situation and the political issues forged a strong and nearly all-encompassing consensus on convertibility that embraced political parties and economic factions alike.

In Britain, external policy objectives dictated a return to convertibility as soon as possible, while the freedom to pursue domestic policy aims was believed to be threatened by the establishment of convertibility, particularly by convertibility at a fixed exchange rate. This dilemma, unique to Britain, paralyzed decision making on convertibility in the UK. Whereas in Britain convertibility was a highly divisive, and very political, issue, in Germany and France, policy on convertibility was never encumbered by conflicts of the nature that was troubling the UK. The dilemma which convertibility posed explains the indecisiveness of British exchange rate policy in the 1950s.

One widespread interpretation of the problems of the UK economy in the 1950s and 1960s is that the stop-go cycle was caused by the conflicting commitment to both a high level of employment and a fixed exchange rate.[207] J. Foreman-Peck claimed that the UK commitment to a fixed exchange rate "proved to be a constraint upon policy from the beginning".[208] While the UK was strongly committed to high employment in the 1950s, the commitment to fixed exchange rates is questionable. The discussions between the Treasury, the Bank and the Prime Minister reveal the fragility of the UK commitment to

[207] Foreman-Peck, "Trade", p.165.
[208] ibid., p.167, and Yeager, *International Monetary Relations*, p.471.

fixed exchange rates. Even when it became clear that the lack of public commitment to a fixed exchange rate destabilized the pound, policymakers continued to discuss the possibility. Moreover, economic agents strongly doubted Britain's commitment to a stable pound. They expected a devaluation of the pound and, as rational decisionmakers, acted accordingly, in turn further weakening the pound.

A possible solution to the credibility problem would have been an independent central bank. According to Bordo, an independent conservative central bank "may avoid the perceived disadvantage of sacrificing national sovereignty to the supernational dictates of a fixed exchange rate".[209] Thus, a more independent and powerful Bank of England might have provided the credible commitment mechanism necessary for exchange rate stability.[210] As this chapter has shown, had the Bank of England had a greater say in monetary policy in Britain, convertibility would have been established earlier. The next chapter looks at a country with a, relatively, independent conservative central bank.

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[209] Bordo, *The Gold Standard*, p.4.
[210] ibid.

II: GERMAN POLICY ON CONVERTIBILITY

INTRODUCTION

In terms of both economic and political considerations, the return to convertibility presented an entirely different issue for the Federal Republic of Germany than for the United Kingdom. An analysis of the approach to convertibility in Germany reveals fundamental disparities between the UK and Germany in economic conditions, but also in the importance and the meaning attributed to, and in the goals pursued by, convertibility. One indication of the striking disparity between Germany and the UK can be found in the fact that after 1955 convertibility was no longer an issue, whereas the convertibility debate in Britain lasted until the day of the establishment of convertibility in December 1958, if not longer.[1] By 1955, at the very latest, all the major factions of the German economy had accepted that convertibility was a necessary and desirable prerequisite for securing Germany's position in the international arena, both economically and politically. The country should therefore seek its establishment the sooner the better.

This chapter argues that a fortunate combination of historical experience, institutional setting, economic and political conditions unique to the Federal Republic made rapid progress towards convertibility uncontroversial, desirable and feasible. By 1954, at the latest, Germany could have already 'gone convertible', on its own, at a time when in Britain it was highly controversial and in France unthinkable. This chapter explains why, when it could have established convertibility much earlier than anybody else, Germany waited for the rest of Western Europe to ensure that the move to

[1] PRO T230-400, A memo by Watts on the current status of the international trading system, suggested that it might be advisable to return to bilateralism were it not for the reaction that might provoke in the IMF. March 11, 1959.

convertibility would be a collective one, and that Germany would not be seen as the leader in such a move.

TRADE

Contrary to Britain, in Germany policy on convertibility was determined by the desire to promote trade. In Germany trade dependence provided the principal common denominator which united economic and political factions in a consensus on the desirability of convertibility and the necessity of a collective move. An overview over the development of trade in the 1950s illustrates the difference in the role of trade in the German economy, and, consequently, in economic policy compared to Britain and France (see table III.1). The development of German trade is characterized by an outstanding growth of exports and imports, both in absolute figures and as a percentage of national output.

Table III.1: Development of trade, 1950-1961[a]

Year	exports[b], annual % change (exports as % of GDP in brackets)			imports[b], annual % change (imports as % of GDP in brackets)			Trade (imports plus exports) as a percentage of GDP		
	FRG	UK	France	FRG	UK	France	FRG	UK	France
1950	**n.a.** (14.8)	**n.a.** (31.0)	**n.a.** (14.2)	**n.a.** (13.7)	**n.a.** (27.9)	**n.a.** (13.9)	28.5	59.0	28.0
1951	**34.1** (17.9)	**-4.9** (28.6)	**13.9** (15.2)	**6.0** (13.2)	**7.5** (29.0)	**13.0** (14.8)	31.1	57.6	30.0
1952	**15.1** (19.1)	**-2.7** (27.9)	**-2.7** (14.4)	**24.1** (15.1)	**-6.9** (27.1)	**4.9** (15.1)	34.2	55.0	29.5
1953	**17.4** (20.9)	**4.9** (28.1)	**1.4** (14.2)	**17.5** (16.6)	**8.3** (28.2)	**-0.9** (14.5)	37.4	56.2	28.8
1954	**22.6** (23.7)	**6.4** (28.7)	**17.3** (15.9)	**28.7** (19.8)	**3.8** (28.1)	**5.2** (14.6)	43.5	56.8	30.5
1955	**16.9** (24.9)	**4.4** (29.1)	**6.2** (16.0)	**23.0** (21.9)	**10.1** (30.0)	**4.7** (14.5)	46.8	59.1	30.4
1956	**16.1** (27.1)	**4.9** (29.7)	**-7.9** (14.0)	**12.4** (23.0)	**-0.2** (29.2)	**16.1** (16.0)	50.2	58.9	30.0
1957	**4.5** (29.9)	**2.4** (30.0)	**5.2** (13.9)	**15.0** (25.1)	**1.6** (29.2)	**6.0** (16.0)	55.0	59.1	29.9
1958	**13.7** (30.3)	**1.7** (30.6)	**3.4** (14.2)	**10.3** (26.9)	**1.2** (29.6)	**-3.9** (15.1)	57.2	60.1	29.3
1959	**13.7** (32.3)	**2.8** (30.5)	**13.4** (15.6)	**18.6** (29.9)	**6.9** (30.7)	**0.5** (14.8)	62.2	61.2	30.3
1960	**13.5** (33.7)	**5.0** (30.7)	**15.5** (17.0)	**16.8** (32.2)	**12.3** (33.1)	**16.8** (16.3)	65.9	63.8	33.3
1961	**3.8** (32.7)	**3.2** (31.1)	**17.2** (17.2)	**9.5** (32.9)	**0.3** (32.6)	**6.8** (16.7)	65.5	63.7	33.9

a: all 1954 prices
b: goods and services
GDP at factor cost
Source: calculated from OEEC, *Statistical Bulletins, General Statistics 1962.*

Between 1950 and 1958, exports of the FRG grew by 266 per cent. In comparison, in both the UK and the US, exports in 1958 were only 18 per cent more than in 1950, while in France exports grew by 40 per cent.[2] Between 1950 and 1961, Germany's exports grew at an annual compounded rate of 15.5 per cent, compared to a mere 2.5 per cent in the UK and 6.2 per cent in France. In the same period, the annual compounded growth rate for real GDP was 7.5 per cent for the FRG, compared to 2.5 per cent for the UK and 4.3 per cent

[2] The growth in German exports was largely due to growth in manufactured exports, whereas Britain witnessed a shrinkage of the proportion of exports made up of manufactured goods. See, for example, R. Millward, "Industrial and commercial performance since 1950", in Floud and McCloskey, (eds.), *The Economic History*, pp.123-167.

for France, respectively. Thus German exports grew at a rate that was twice as fast as its GDP growth, which, in turn, was much higher than in Britain or France. By comparison, Britain's exports grew just as sluggishly as GDP, while France fared slightly better with both higher GDP growth and exports rising faster than its GDP but neither rate came even close to Germany's. Between 1950 and 1958, Germany's exports as a percentage of GDP grew from 14.8 per cent to 29.9 per cent. This represents a rise in export dependence - defined here as exports as a percentage of GDP - of 15.1 per cent. By comparison, British and French export dependence hardly changed between 1950 and 1950, hovering around 30 per cent and 14 per cent, respectively. While Britain's export dependence was more than double that of Germany in 1950 - 31 per cent compared to 14 per cent -, by 1958, exports made up the same proportion of GDP in both countries, with Germany's export dependence having shot up to the level of Britain's which had remained roughly stagnant. As important as Germany's rapid rise in both exports and export dependence is the continuity of the growth in the two figures for West Germany. Germany's continuity stands in stark contrast to the development of exports and export dependence in Britain and France.

Table III.2: Real GDP growth (per cent)[a]

	1951	1952	1953	1954	1955	1956	1957	1958	1959	1960	1961	average[b]
FRG	10.4	8.1	7.5	7.7	11.4	6.7	5.3	3.1	6.8	8.5	7.2	7.5
UK	3.4	-0.3	4.2	4.0	3.2	2.7	1.5	-0.4	3.1	4.2	1.9	2.5
France	6.0	2.5	3.0	4.9	5.6	4.9	6.0	1.8	2.9	5.8	4.4	4.3

a: GDP at factor cost at 1954 prices
b: annual compounded growth rate
Source: OECD *Statistical Bulletins, General Statistics* 1962.

The results for import dependence mirror fairly closely those for export dependence. Germany's import dependence, - defined here as imports as a percentage of GDP -, more than doubled between 1950 and 1958, implying again that imports grew at a considerably quicker pace than GDP. In contrast, imports as a percentage of GDP increased by a meager 1.2 per cent for the UK and 1.3 per cent for France.[3] The continuity of the rapid growth of the FRG's trade dependence, or, what Bergsten has called its "economic openness", between 1950 and 1958 stands in stark contrast with the development of the UK and France in the same time period.[4]

Much of the speed of Germany's export growth reflects the return of exports to their prewar levels.[5] In this sense, it is not surprising that the German growth of exports should have exceeded that of Britain in the early post-war period, since Britain's export levels had not been similarly reduced by autarky, war and destruction. This observation does not, however, take away from the fact that the actual rapidity of the export growth, combined with a concurrent general rapid economic expansion and increase in economic welfare created an important self-reinforcing dynamic which, in turn, affected economic policy decisions and confirmed the desirability of Germany's outward orientation. Germany's rapid export growth combined with strong economic growth lends support to the theory of export-led growth as an explanation for the FRG's 'economic miracle'.[6]

Throughout the 1950s, the growth of German exports and imports outstripped by far the growth of its national output in this period, thus continuously increasing Germany's dependence on international transactions, or its openness. Germany's dependence on international transactions, as measured by trade as a proportion of GDP, doubled between

[3] For an in-depth discussion of the pivotal importance of the size and growth of Germany's imports, as a motor for the growth of the European economies see Milward, *The European Rescue*, pp.134-167. For a definition of 'openness', see also Panic, *National Management*, pp.3-5.
[4] C. F. Bergsten. *The Dilemmas of the Dollar*, New York University Press, 1975, pp.20-23.
[5] W. Abelshauser, *Wirtschaftsgeschichte der Bundesrepublik Deutschland*, Suhrkamp, 1983, pp.147-148.
[6] According to Milward, in Germany "attributing the country's economic and political success to exports became a political cult". Milward, *The European Rescue*, p.126.

1950 and 1958 from 28.5 per cent in 1950 to 57.2 per cent in 1958, having increased steadily throughout the period. In contrast, Britain's trade as percentage of GDP was little more than one per cent higher in 1958 than it was in 1950. France's trade dependence fluctuated around 29 per cent in the same period. Neither France nor the UK experienced a similar continuous upward trend in trade dependence. As a country whose prosperity depended to a large and increasing extent on trade, the FRG required a currency that was widely usable, as an international means of payment for current account transactions.[7] However, for a country as dependent on access to international markets, both for imports and exports, currency convertibility only made sense if its establishment did not jeopardize this access. In Germany, in line with the economic theory discussed in chapter I, the primary purpose of convertibility was to promote trade. Thus, contrary to Britain, in Germany the advantages associated with convertibility were inextricably linked to trade considerations. A unilateral convertibility would have turned the DM into a hard and therefore scarce currency in Europe. This might have prompted Germany's European trading partners to discriminate against German goods. In 1953, the Economics Ministry warned that a German move to convertibility before its OEEC trading partners would only be advantageous if the countries whose currencies remained inconvertible would commit themselves to renouncing discrimination against the countries whose currencies had become convertible.[8] The Economics Ministry asserted that what was important for Germany was "commercial convertibility": "Wenn in Deutschland von Konvertibilität gesprochen werde, so werde dabei an einen freien Zahlungsverkehr und [sic] einen freien

[7] see, for example, E. Owen Smith, *The German Economy*, Routledge, 1994, pp.499-504.
[8] BA B102-55345, "Allgemeine Auffassungen der deutschen Bundesregierung (BR) zur Frage der Konvertibilität", April 27, 1953 and "Beiträge zur Diskussion über die Herstellung eines freieren Handels-und Zahlungsverkehrs (Konvertibilität)", June 5, 1953.

Handel gedacht."[9] Contrary to German motivations for convertibility, the Economics Ministry pointed out, Britain was more concerned with "financial convertibility", explaining why in Britain convertibility was compatible with trade restrictions. Convertibility combined with trade discrimination was not an acceptable policy to Germany, since it contained the risk of discrimination against German exports.[10]

In light of Germany's interest in maintaining access to export markets, the Advisory Council to the Economics Ministry wrote in 1952 that the only way for Germany to establish convertibility was jointly with the other OEEC countries.[11] This view was conveyed to the British government in May 1953. In an Anglo-German meeting on convertibility in London the German representatives declared that Germany advocated a collective return to convertibility by all EPU countries.[12] Similarly, representatives of business and industry favored convertibility on one important condition: the simultaneous establishment of convertibility with as many countries as possible to prevent discrimination against its exports by soft currency countries. While convertibility was judged to be beneficial for German business since it helped exports by establishing the DM as an internationally acceptable means of exchange and payment, business sectors were not keen on convertibility if Germany were to establish it before most of its trading partners. The Bundesverband der Deutschen Industrie (BDI) - the German equivalent of

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[9] BA B102-56894, "Entwurf: Ergebnisse der deutschen-britischen Besprechungen über einen freieren Handels- und Zahlungsverkehr (Konvertibilität)", May 19, 1953.
'When convertibility is discussed in Germany, one is thinking of a system of free payments <u>and</u> [sic] free trade.'

[10] BA B102-55345, "Grundsätze, über die zwischen dem Bundeswirtschaftsminister Erhard, dem belgischen Aussenminister van Zeeland und dem Aussenhandelsminister Meurice in der Aussprache am 4. Mai 1953, nachmittags, Übereinstimmung festgestellt wurde", draft, May 26, 1953.

[11] Der Wissenschaftliche Beirat beim Bundeswirtschaftsministerium, "31. Gutachten vom 16. November 1952: Konvertierbarkeit der Währungen", in *Sammelband der Gutachten von 1948-1966, 2. Band: Gutachten vom Juni 1950 bis November 1952*, Otto Schwarz & Co., 1967, pp.95-97.

[12] BA B102-55340, "Entwurf: Ergebnisse der deutsch-britischen Besprechungen über einen freieren Handels- und Zahlungsverkehr (Konvertibilität) am 12. und 13. Mai 1953 in London", by Stedtfeldt, May 19, 1953.

the Federation of British Industries -, sent a memo to the Economics Ministry on this matter in 1955, in which it warned against the discrimination against German exports that might result if only the pound, the US dollar and the DM were convertible.[13] Discrimination could only be avoided, the BDI pointed out, if as many trading nations as possible established convertibility simultaneously. Similarly, in a statement made in 1954, the committee for international economic issues of the Deutsche Industrie- und Handelstag (DIHT) - the German Trade and Industry Association -, emphasized the necessity of re-establishing convertibility as soon as possible, and it assured the government of its support in the matter.[14] However, a collective move to convertibility by as large a group of countries as possible was considered urgently necessary ("dringend erforderlich") to avoid any damage to German exports through discrimination. Since, in 1955, some of Germany's most important trading partners were not yet prepared to take this step, the DIHT wanted Germany to wait for these partners rather than establish convertibility by itself or only with Britain.[15] German industry advocated the rapid liberalization of German payments, but only on the condition that Germany would not risk discrimination against its exports by establishing convertibility unilaterally before most of its trading partners.

While most German economic factions were in favor of rapid convertibility, decisionmakers had no interest in pressuring Britain to establish official convertibility before it was ready, since that might have only resulted in a British retreat on trade liberalization.[16] In particular, German policymakers were concerned about the breakup of

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[13] BA B102-55345, Memo by the BDI to the Economics Ministry: "Die Handelspolitik in der Übergangsphase zur Konvertibilität", June 7, 1955.
[14] BA B102-12145, statement by the DIHT: "Stellungnahme des Aussenwirtschaftsausschusses des Deutschen Industrie- und Handelstages zur Frage der Konvertierbarkeit", September 29, 1954.
[15] ibid.
[16] BA B102-55345, "Grundsätze, über die zwischen dem Bundeswirtschaftsminister Erhard, dem belgischen Aussenminister van Zeeland und dem Aussenhandelsminister Meurice in der Aussprache am 4. Mai 1953, nachmittags, Übereinstimmung festgestellt wurde", draft, May 26, 1953.

the EPU as a result of a unilateral British move to convertibility. The EPU bound Germany's principal trading partners together in a mutual commitment to intra-OEEC trade liberalization. As Germany's biggest export and import market the EPU provided the ideal forum for the expansion of German trade. In the 1950s nearly three quarters of German exports went to the EPU area while two thirds of German imports came from the EPU (see table III.3). Even if a unilateral British move to convertibility had not ended the EPU, a British withdrawal from the EPU would have reduced significantly the benefits of the EPU for Germany. Britain's membership and the consequent incorporation of the sterling area in the EPU settlement mechanism was a particularly important advantage for Germany throughout the 1950s, although for changing reasons. In the first half of the 1950s, the settlement area allowed Germany to offset its trade deficits with the sterling area with its overall surpluses with the EPU (see tables III.3 and III.4).[17] In the second half of the 1950s, when Germany ran a surplus with the sterling area, the EPU guaranteed access to the sterling area for German exports, which made up around 12 per cent of total German exports.

[17] BA B102-55340, Vocke, president of the German central bank to Erhard, February 23, 1954.

Table III.3: German trade with EPU area (million US dollars)

	imports[a]			exports[b]			trade balance	
	EPU area	% of total	world	EPU area	% of total	world	EPU area	world
1950	1802	67	2697	1479	75	1976	-323	-720
1951	2027	58	3492	2477	72	3463	450	-28
1952	2373	62	3814	2879	72	4002	506	188
1953	2474	66	3771	3132	71	4389	659	618
1954	2886	63	4571	3753	72	5248	867	677
1955	3644	63	5793	4417	72	6135	772	341
1956	3946	60	6617	5231	71	7358	1285	741
1957	4358	58	7499	6011	70	8575	1654	1076
1958	4458	61	7361	6044	69	8807	1586	1446

a: c.i.f.; b: f.o.b.

Source: OEEC *Statistical Bulletins, Series IV.*

The principle advantage of the EPU for Germany was that it committed its members to a code of liberalization of intra-OEEC trade, which ensured continued German access to its most important export market. If convertibility was not collective, then German policymakers and industry feared that a division of the OEEC into convertible and inconvertible currencies would lead to discrimination against countries whose currencies had become convertible. Moreover, it would endanger intra-OEEC trade liberalization and the EPU settlement mechanism. To prevent a reversal of intra-OEEC trade liberalization, Germany policymakers wanted, first, a collective move to convertibility and, secondly, some forum for cooperation which would safeguard intra-European trade liberalization after the introduction of convertibility.[18] This forum could be either a modified EPU or a new organization. German trade interests were against a dissolution of the EPU unless the commitment to reciprocal trade liberalization in a post-EPU Europe could be guaranteed.

[18] BA B102-55340, "Entwurf: Ergebnisse der deutsch-britischen Besprechungen über einen freieren Handels- und Zahlungsverkehr (Konvertibilität) am 12. und 13. Mai 1953 in London", May 19, 1953, and memo from the Economics Minister re. Anglo-German consultations on convertibility, "Vorläufige Liste der Besprechungspunkte", May 22, 1953.

Table III.4: German trade with the sterling area (million US dollars)

	imports[a] (in brackets percentage of total imports)	exports[b] (in brackets percentage of total exports)	trade balance
1953	590(15.6)	533 (12.1)	-57
1954	721(15.8)	635 (12.1)	-86
1955	876 (15.1)	791 (12.9)	-85
1956	954 (14.4)	943 (12.8)	-11
1957	1025 (13.7)	1141 (13.3)	116
1958	1022 (13.9)	1215 (13.8)	193

a: c.i.f.; b: f.o.b.
Source: OEEC *Statistical Bulletins, Series IV.*

The EPU was a suitable forum for ensuring collective progress towards convertibility. While waiting for the rest of Europe to be ready to establish convertibility without reneging on trade liberalization, Germany lobbied for a hardening of the EPU's settlement mechanism. From 1951 onwards, while Germany ran large and growing surpluses with the EPU area as a whole, it ran continuous, though not as large, deficits with the dollar area (see table III.5). In contrast, both Britain and France ran deficits with the EPU as well as the dollar area throughout most of the period. Through the EPU settlement mechanism, Germany received gold and hard currency only for a portion of this surplus.[19] The rest constituted an automatic credit to the EPU and thus to those member countries that ran deficits with the Union. At the same time, Germany had to pay hard currency for its deficits with the dollar area. With convertibility of European currencies into the dollar, Germany would have easily been able to offset its dollar deficits with currency earnings from its EPU surpluses. A hardening of the EPU, that is, an increase in the portion of credits and debts to be settled in dollars or gold, increased the share of Germany's EPU surpluses for which Germany received hard currency. In this sense,

[19] The settlement mechanism was gradually raised from a gold:credit ratio of 40:60, to 50:50 in 1954, and finally to 75:25 in 1955; for a detailed discussion of the EPU, see Kaplan and Schleiminger, *The European Payments Union.*

hardening increased the convertibility of Germany's EPU surpluses. In 1954, the Bank deutscher Länder emphasized the importance of increasing the convertibility of Germany's EPU surpluses, so that they could be used to offset the deficits with the currently limited dollar area. It argued that this was necessary if progress towards liberalization of imports from the dollar area was to continue.[20] In fact, however, Germany's gold foreign exchange reserves allowed Germany to cover easily the trade deficits with the dollar area. However, Germany preferred to make its surpluses from the EPU convertible, to be able to use them to offset dollar area deficits, rather than having to dig into its foreign exchange reserves.

In addition to increasing the convertibility of Germany's EPU surpluses, a more important advantage of the gradual hardening of the settlements mechanism was that it progressively brought all EPU currencies, not just the DM, closer to convertibility without dismantling the OEEC forum for intra-European trade liberalization. From a trade perspective, for Germany, the convertibility of other currencies was at least as important as the convertibility of the DM.

> If trade liberalization within OEEC could be combined with a parallel gradual hardening of the settlements within EPU, until all settlements were made in hard currency the EPU and its non-retaliatory trade rules could be preserved, at the same time as convertibility was achieved generally.[21]

Thus, with regard to the EPU the best policy option for Germany was a gradual hardening of the EPU until the large portion of the OEEC countries were ready to move to convertibility jointly.

[20] Bank deutscher Länder, *Geschäftsbericht für das Jahr 1954*, p.32.
[21] Milward, *The European Rescue*, p.379.

Table III.5: Trade balance according to area (monthly average)

	UK (million pounds)		FRG (million DM)		France (billion francs)	
	EPU area	$ area	EPU area	$ area	EPU area	$ area
1950	-5.64	-15.15	-127	-114	1.8	-8.7
1951	-29.32	-35.78	148	-156	-14.7	-10.3
1952	-12.54	-29.14	171	-159	-17.8	-12.1
1953	-0.92	-19.91	222	-58	-11.2	-5.7
1954	-3.12	-20.37	296	-77	-5	-5.7
1955	-11.15	-35.42	258	-158	-3.8	-7.2
1956	-4.55	-25.89	436	-203	-18	-13.3
1957	-2.86	-32.68	592	-300	-19.4	-19
1958	-12.77	-18.94	544	-190	-19.6	-9.4

Source: OEEC *Statistical Bulletins, General Statistics.*

From the beginning, trade considerations were a determining factor in Germany's policy on convertibility, and, in particular, in its advocacy of a collective move to currency convertibility. Overall, trade dependence created a strong consensus for convertibility, provided it was undertaken collectively. Germany's economic situation and its trade dependence ensured general domestic support for economic cooperation with its main trading partners, - the OEEC -, and particularly for any policy that benefited the country's exports. The collective return to currency convertibility at fixed exchange rates combined both. Thus, contrary to Britain and France, growing trade dependence created an environment conducive to the establishment and the maintenance of convertibility.

CONVERTIBILITY AND THE FOUNDATIONS OF GERMAN ECONOMIC POLICY ORIENTATION

In addition to trade dependence, political circumstances and the general economic policy orientation created an environment which was conducive to a widespread consensus on the desirability of convertibility. Thus, as this section will show, contrary to Britain, the delay in establishing convertibility in Germany cannot be explained by a general skepticism about the desirability of convertibility at a fixed exchange rate and the domestic economic policy constraints associated with it.

For Germany, 1945 marked the beginning of a new era. The country was defeated, divided and occupied, and the economy lay in shambles. Germany had to be recreated along new geographical, political and economic lines.[22] The occupation powers regulated Germany's economy and particularly the external relations between the German occupied zones and other countries in the early post-war years. As a result, the Allied powers played an important role in shaping the economic policy of the nascent Federal Republic. Independent of the Allied powers, a heated debate on economic policy orientation took place within Germany itself in the first years after World War II. According to Anthony Nicholls, the struggle over economic policy in Germany "was not between *laissez-faire* [sic] free enterprise and a totalitarian command-economy, but between a free-price mechanism operating within a set of rules laid down by the state, and a mixed economy in which private business produced according to a global plan and operated within a state-regulated system of rationing".[23] Thus, "[t]he real conflict of opinion was between those

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[22] For a an account of Germany post war reconstruction see, for example, Abelshauser, *Wirtschaftsgeschichte*, Buchheim, *Die Wiedereingliederung*, Milward, *The Reconstruction*, Nicholls, *Freedom with Responsibility*.
[23] Nicholls, *Freedom with Responsibility*, p.193.

who felt that the price mechanism must be reintroduced into Germany as quickly as possible as a means of distribution, and those who thought it must be severely limited in its applications so as to fulfill social and economic priorities which the market could not be expected to accomplish by itself".[24] The unique post war situation in Germany at the same time necessitated and made possible a profound reshuffle of economic policy orientation. The immediate post war years witnessed a fierce but constructive debate over Germany's economic policy orientation among politicians, economists and administrators, the outcome of which was by no means a foregone conclusion with particularly members of the Social Democratic Party advocating a more dirigiste economic policy than the one eventually adopted.[25] The outcome of this debate was the creation of the so-called social market economy along the lines advocated by its intellectual creator, Alfred Müller-Armack.[26] The concept developed by Müller-Armack between 1946 and 1948 combined "a legally protected system of competition" on the one hand and government intervention to overcome "unhealthy inequalities of wealth" and to ensure social security on the other.[27]

By 1948 the battle was decided in favor of a market economy with a strong element of social responsibility and after 1951 the economic success made it difficult for any economic or political faction to object to the path chosen. The victory of the Christian Democratic Union (CDU) in the first federal elections of 1949 "implied a rejection of the SPD's critique of the Christian Democratic social market economy" and an endorsement

[24] Nicholls, *Freedom with Responsibility*, p.180. Nicholls provides an extensive account of the debate in Germany over the future course of Germany's economic policy. In addition to Nicholls, see also Giersch, Paqué and Schmieding, *The Fading Miracle*, pp.28-38.
[25] see Nicholls, *Freedom with Responsibility*, chapter 12, "The SPD and the Social Market Economy", pp.248-269 and W. E. Paterson, *The SPD and European Integration*, Saxon House, 1974.
[26] Alfred Müller-Armack was economics professor and later become secretary of state in the Economics Ministry and one of Erhard's closest associates.
[27] Nicholls, *Freedom with Responsibility*, p.143. For a discussion of Müller-Armack and the concept of social market economy see pp.136-144.

of Economics Minister Erhard's liberal economic policy.[28] Germany differed significantly from France or Britain in that from the early 1950s there was a fairly widespread consensus, among policymakers, academics and citizens alike that the key to economic success lay in an open economy, a stable currency, and "a rejection of policies designed to push output and employment at the cost of rising prices or controls".[29] Compared to Britain in the 1950s, where economic policies, especially policies aimed at stabilizing prices, implemented by the ruling Conservative Party could nearly always be expected to be attacked by the Labour Party, in Germany, there was a much greater consensus on the general aims and means of economic policy. The success of the social market economy, reflected in high growth rates and a rapid improvement in living standards, undermined any criticism from the SPD of the economic model chosen or its implementation by the ruling CDU.[30] The historical experience with the special combination of war, inflation, unemployment and economic collapse forged a consensus on the social market economy.[31] To German citizens full employment policies "carr[ied] the threat of inflation and controls and thus touch[ed] the two most sensitive spots in German economic experience".[32] Throughout the 1950s, the Federal Republic was concerned with "Währungsstabilität" (currency stability) as a necessary condition for trade and thus economic growth.[33]

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[28] Paterson, *The SPD*, p.43.

[29] Wallich, *Mainsprings of the German Revival*, Yale University Press, 1955, p.107. See also H. Giersch, K.-H. Paqué and H. Schmieding, "Openness, Wage Restraint and Macroeconomic Stability: West Germany's Road to Prosperity 1948-1958", in Dornbusch, Nölling and Layard (eds.), *Postwar Economic Reconstruction*, pp.1-27 and K. H. Hennings, "West Germany" in Boltho (ed.), *The European Economy*, p.479.

[30] Nicholls, *Freedom with Responsibility*, chapter 14, "The SPD and the Struggle for Reform", pp.300-321, Giersch, Paqué and Schmieding, "Openness", and Hennings, "West Germany".

[31] W. Abelshauser, "Die ordnungspolitische Epochenbedeutung der Weltwirtschaftskrise in Deutschland: Ein Beitrag zur Entstehungsgeschichte der Sozialen Marktwirtschaft", in D. Petzina (ed.), *Ordnungspolitische Weichenstellungen nach dem Zweiten Weltkrieg*, Duncker und Humblot, 1991, pp.12-99.

[32] Wallich, *Mainsprings*, p.112.

[33] H.-P. Schwarz, *Die Ära Adenauer: Gründerjahre der Republik 1949-1957*, Geschichte der

For Germany, the economic trauma carried over from the interwar period was the hyperinflation of the early 1920s, whereas, in contrast, the corresponding trauma in Britain was unemployment. In Germany, the traumatic experience with hyperinflation in the 1920s created a widespread consensus, even grassroots support for price stability.[34] When the pound sterling was devalued in 1949 by 30 per cent and most Western European countries followed suit, Germany decided to devalue its currency only by 20 per cent. This meant effectively a revaluation of the DM vis-à-vis most Western European currencies. The revaluation was intentional in that the authorities saw the DM appreciation as a means of imposing price stability on the German economy. Thus, according to Nicholls, "[t]he Bank deutscher Länder and Erhard were happier with a smaller devaluation since it would cheapen imports and force price discipline on exporters".[35] Revaluation would reduce the import prices of raw materials which would benefit Germany's manufacturing industry. Unemployment and an initial loss of competitiveness were the cost of price stability and an expected eventual rise in competitiveness which the authorities were conscious of and willing to accept. The German policy response to the UK devaluation shows that, contrary to the UK, German policymakers' commitment was to price stability rather than full

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Bundesrepublik Band 2, Deutsche Verlags-Anstalt GmbH, 1981, p.80. For a very good analysis of the Federal Republic's early monetary policy, see R. E. Emmer, "West German Monetary Policy, 1948-54", in *The Journal of Political Economy*, Vol.63, No.1, February-December, 1955, pp.52-69.

[34] Dickhaus points to a collection of letters from German citizens in which they express their concern to the government amount price stability. Dickhaus, *Zwischen Europa und der Welt*, p.44. Giersch, Paqué and Schmieding claimed that "the trauma of inflation remained severe, particularly among low- and middle-income workers who had lost most of their savings in the currency reform. Clearly, an aggressive stance in wage policy which would have run the risk of spurring a wage-price spiral was not very popular among the rank-and-file, and union leaders could not simply by-pass this mood", and they pointed to "repeated warnings of the liberal press not to rekindle inflation". Giersch, Paqué and Schmieding, *The Fading Miracle*, p.78 and "Openness", p.13. Bergsten claimed that Germany tended to fear inflation, that is, financing, more than unemployment, that is, adjustment. Bergsten, *The Dilemmas*, p. 23. See also, H.-P. Schwarz (1981), *Die Ära Adenauer: Epochenwechsel 1957-1963*, Geschichte der Bundesrepublik Deutschland, Band 2, Deutsche Verlags-Anstalt GmbH, 1981, p.80, E. Thiel, "Macroeconomic Policy Preference and Co-ordination: A View from Germany", in Guerrieri and Padoan, (eds.), *The Political Economy*, pp.202-230, and Wallich, *Mainsprings*, pp.111-2.

[35] Nicholls, *Freedom with Responsibility*, p.275; see also, Dickhaus, *Zwischen Europa und der Welt*, pp.77-8.

employment.[36]

The way to ensure price stability, aside from an independent central bank, was an open, economy in which free competition kept prices low and export-led growth prevented the economy from overheating. The creators of the German economic model believed that "free market entry for new firms and for products from abroad" would force German producers to become more competitive and ensured price stability.[37] The way to establish an open economy was through the removal of controls both on the domestic economy and on external transactions. On the domestic side, the currency reform and the accompanying internal reforms of 1948 marked the decisive step in Germany's transition to a market economy.[38] Among other things, the reforms eliminated the monetary overhang, removed price controls on a wide range of goods, and instated a German central bank as an independent institution whose main purpose was the safeguarding of the value of the domestic currency. Trade and payments liberalization were the external counterpart to the decontrol of the internal economy.

The liberalization of trade and payments, including the rapid establishment of currency convertibility, belonged to the set of predetermined policy orientations which had been 'assigned' to the Federal Republic before it was allowed to formulate its own foreign

[36] According to Carlin, "until 1968 the government steadfastly refused to undertake a commitment to maintain domestic demand". W. Carlin "West German Growth and Institutions, 1945-90", *Centre for Economic Policy Research Discussion Paper Series*, No.896, January 1994, p.17.

[37] Giersch, Paqué and Schmieding, *The Fading Miracle*, p-30.

[38] Analyses and accounts of the internal reforms in 1948 are provided in Abelshauser, *Wirtschaftsgeschichte*, pp.46-54, J. Dingwort-Nusseck, "Economic Growth, Economic Policy, and Foreign Affairs", in W. F. Hanrieder (ed.), *West German Foreign Policy, 1949-1979*, Westview Press, 1980. p.213, Giersch, Paqué and Schmieding, "Openness", pp.2-10 and p.15, W. F. Hanrieder, *West German Foreign Policy 1949-1963: International Pressure and Domestic Response*, Stanford University Press, 1967, pp.21-22, O. Pfleiderer, "Two Types of Inflation, Two Types of Currency Reform: The German Currency Miracles of 1923 and 1948", in *Zeitschrift für die gesamte Staatswissenschaft*, Vol.135, No.3, 1979, pp.352-364, and H. C. Wallich and J. F. Wilson, "Economic Orientations in Postwar Germany: Critical Choices on the Road Toward Currency Convertibility", in *Zeitschrift für die gesamte Staatswissenschaft*, Vol. 137, No.3, 1981, pp.390-406.

policy.[39] Some observers claimed that Allied economic policy played a decisive role in creating Germany's orientation towards trade liberalization and free markets.[40] Others argued that Germany made its fundamental economic policy choices, - choosing the free market over planning and trade liberalization over protectionism -, independently of Allied policy and influence.[41] The former view generally brushes over the fact that the Allied powers were far from united in their beliefs regarding economic policy in general and economic policy for Germany in particular.[42] Whereas Britain and France endorsed economic controls and macroeconomic planning, the United States wanted an economy in which market forces were allowed to operate as freely as possible.[43] Although the Western Allies, in particular the United States, initially put Germany on the road of trade liberalization - with the aim of creating a model economy -, domestic policymakers and Germany industry agreed that trade liberalization was the way to export-led growth and price stability and they continued on this course after the Federal Republic had obtained sovereignty over its economic policy. Thus, Wolf argued that "[f]ollowing the free trade tenet of the ordo-liberal approach, the German government had opted to pursue unilateral liberalization and was committed to early convertibility".[44] Moreover, public support of trade liberalization was much stronger than in Britain. According to Giersch, Paqué and

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[39] see, for example, W. Bührer, "Erzwungene oder freiwillige Liberalisierung? Die USA, die OEEC und die westdeutsche Außenhandelspolitik 1949-1952", in L. Herbst, W. Bührer and H. Sowade (eds.), *Vom Marshallplan zur EWG: die Eingliederung der Bundesrepublik Deutschland in die westliche Welt*, R. Oldenbourg Verlag, 1990, pp.139-163.

[40] "In addition to initiating the currency reform and channeling counterpart funds into critical sectors of the economy, Allied economic policy made a most important and lasting impact on the West German economy by stressing the need to free markets and liberalize trade." Hanrieder, *West German Foreign Policy 1949-1963*, p.21-2. see also Abelshauser, *Wirtschaftsgeschichte*, p.147.

[41] Bührer, "Erzwungene oder freiwillige Liberalisierung?", pp.161-2.

[42] for a discussion of Allied economic goals and policies regarding Germany, see Nicholls, *Freedom with Responsibility*, chapters 5 to 9.

[43] The US wanted Germany to become the model of trade liberalization in the OEEC. Abelshauser, *Wirtschaftsgeschichte*, p.152, Bührer, "Erzwungene oder freiwillige Liberalisierung?", and Hanrieder, *West German Foreign Policy 1949-1963*, p.22.

[44] H. Wolf, "Post-war Germany in the European context: domestic and external determinants of growth" in Eichengreen (ed.), *Europe's Post-War Recovery*, p.342.

Schmieding, "protectionist pressures arising from sectoral lobbies were effectively dampened by the umbrella organizations of capital and labor". In particular, the Deutsche Gewerkschaftsbund, the German trade union council (DGB), actively supported the removal of import restrictions which it saw as a way of reducing consumer prices.[45] Bergsten argued that, due to its economic openness, Germany favored and promoted the setting up of conditions conducive to free trade and capital movements.[46] There were important exceptions to Germany's general endorsement of free trade and capital movements. Agriculture, energy and textiles were some of the sectors in which powerful protectionist lobbies worked against trade liberalization. However, aside from these important exceptions, Germany's general policy orientation was towards the removal of barriers to trade. Currency convertibility was one of the instruments with which economic policymakers hoped to achieve an open, competitive economy and thus price stability.[47]

Wallich and Wilson pointed out that particularly Germany's export dependence and its corresponding large creditor position provided an important stimulus to "the rapid liberalization of other external transactions besides merchandise trade".[48] Thus, Germany removed quotas faster (see table 1 in chapter II) and reduced tariffs earlier than Britain and France.[49] The pursuit of trade liberalization was a rational policy choice given Germany's conscious decision in favor of export-led growth and the resulting increasing trade dependence. According to Milward, "[a]ccess to European markets was a matter of life and death for the German economy and it was understandable that there should be no

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[45] Giersch, Paqué and Schmieding, "Openness", p.19. See also Hennings, "West Germany", pp.476 & 479.
[46] Bergsten, *The Dilemmas*, p.23.
[47] M. Dickhaus. *Zwischen Europa und der Welt*, p.46.
[48] Wallich and Wilson, "Economic Orientations", p.402.
[49] Milward, *The European Rescue*, p.145.

firmer advocate of trade liberalization than the Federal Republic".[50] Germany's successful economic performance in the 1950s was inextricably tied to the growth of trade, explaining the fact that "the Federal Republic not merely passively acquiesced in the liberalization of trade and invisible transactions within the OEEC, but that it actively supported this policy in several instances".[51] In 1949, Germany liberalized its imports from OEEC countries, that is, it removed quantitative restrictions, to a much greater extent than its OEEC partners.[52] When Germany was hit by a severe balance of payments crisis, partially as a result of its rapid and higher than average rate of trade liberalization, the government was reluctant to impose import controls to reduce the current account deficits, and it rapidly reliberalized as soon as the worst was over.[53] In general, Germany's economic policy, compared to France's and Britain's can be explained by the different reconstruction model chosen by the former after World War II:

> The British and French model sought salvation in a greater role of the state in organizing and shepherding economic life. In this model, the government centrally coordinated investment - helped by the nationalization of key industries - used demand management to guarantee full employment, employed trade restrictions to insulate the domestic economy from external shocks, and used price controls to check the inflationary consequences of demand stimulation.
> The alternative, the German model, de-emphasized the role of the government as a macroeconomic agent. Instead, the intellectual leaders of the ordo-liberal school around Eucken, Müller-Armack and - on the political side - Ludwig Erhard, dominated early post-war economic thinking in Germany and envisaged a return to the competitive ideal of the nineteenth century, though tempered by the provision of social support for those less favored by the market processes. To prevent a repeat of interwar disasters attributed to the erosion of competition, the government was to assume a new function as guarantor of competitive market structures. Yet it would shun demand stabilization and direct investment planning, limiting its activities to the provision of a stable environment facilitating private long-term decisionmaking. ... The ordo-liberals welcomed free trade as an

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[50] Milward, *The Reconstruction*, p.426.
[51] H. Möller, "The Reconstruction of the International Economic Order After the Second World War and the Integration of the Federal Republic of Germany into the World Economy", in *Zeitschrift für die gesamte Staatswissenschaft*, 1981, p.361.
[52] Buchheim, *Die Wiedereingliederung*, p.123.
[53] Bührer, "Erzwungene oder freiwillige Liberalisierung?", pp.156-162 and Kaplan and Schleiminger, *The European Payments Union*, chapter 6.

additional source of competitive pressures for domestic producers and for the same reasons rejected restrictions on current account convertibility.[54]

Economics Minister Ludwig Erhard played a crucial role in the adoption and maintenance of a liberal economic policy after World War II.[55] While most economic factions in Germany soon agreed that the only way to economic prosperity was free competition and trade, it was Erhard's zeal that drove forward Germany's rapid progress towards that state. When the German balance of payments crisis of 1950/1 was at its worst, Erhard still stubbornly resisted pressure exerted by Chancellor Adenauer, Finance Minister Schäffer and even the Allies to restore price controls: "as a notorious optimist, Erhard stuck to his predictions that the adjustment flexibility of the market economy was great enough to cope with the problem in due course".[56] Erhard was instrumental in the passing of an anti-cartel law which was an important signal to German business and to the rest of the world that Germany would not fall back into the price-distorting and inefficient prewar system of monopolies, price controls and protectionism.[57] The liberalization of imports was one of Erhard's instruments with which he sought to achieve price stability and force German producers to become more competitive.[58] It was under Erhard's

[54] Wolf, "Post-War Germany", p.329. Similarly, Carlin claimed that the German model of the social market economy "stood in sharp contrast to the 'post-war settlement' in the UK. The UK's post-war settlement is often taken to include interventionist macroeconomic policy associated with a commitment to full employment; the build-up of the welfare state; the use of 'non-market techniques' such as nationalization to deal with market failures and government agreement with the trade unions to secure wage restraint in exchange for the continuation of trade union 'privileges' on the shop floor regarding the organization of work". W. Carlin, *West German Growth and Institutions, 1945-1990*, Centre for Economic Policy Research, Discussion Paper Series No. 896, January 1994, p.31.

[55] Abelshauser, *Wirtschaftsgeschichte*, p.52, Nicholls, *Freedom with Responsibility*, pp.328-366, Giersch, Paqué and Schmieding, *The Fading Miracle*, D. Koerfer. *Kampf ums Kanzleramt - Erhard und Adenauer*, Deutsche Verlags-Anstalt, Stuttgart, 1987, and D. Koerfer, "Wirtschaftspolitische Kontroversen zwischen Konrad Adenauer und Ludwig Erhard (1956-1963)", in Hans Pohl (ed.), *Adenauers Verhältnis zu Wirtschaft und Gesellschaft*, Rhöndorfer Gespräche Band 12, Stiftung Bundeskanzler-Adenauer-Haus, Bouvier Verlag, 1992, and U. Lappenküper, "'Ich bin wirklich ein guter Europäer' - Ludwig Erhards Europapolitik 1949-1966", in *Francia*, Vol.18, No.3, 1991.

[56] Giersch, Paqué and Schmieding, "Openness", p.17.

[57] For an account of the discussions surrounding Erhard's role in the passing of an anti-cartel law, see Nicholls, *Freedom with Responsibility*, pp.326-338.

[58] Buchheim, *Die Wiedereingliederung*, p.XV.

economic reign that Germany unilaterally reduced tariffs to cut the level of effective tariff-protection from 19.6 per cent to 10.6 per cent.[59]

The external economic policy of the first Economics Minister of the Federal Republic focused on the restoration of the liberal global economic order as it existed before World War I.[60] Convertibility formed an integral part of this plan. Thus, Erhard wrote:

> The spirit of liberalization and the sterility of currency control are like fire and water. Currency control of any kind symbolizes everything that is bad for man....In my view only the free convertibility of currencies can form a sane basis for a truly functioning free world market...The all-embracing function of convertible currencies can never be replaced in as complete a fashion by other measures.[61]

Already in June 1953 *Der Spiegel* stated that, "Er [Erhard] würde mit der D-Mark den Kopfsprung in die Konvertierbarkeit lieber heute als morgen wagen".[62] Erhard's sense of urgency with regard to DM convertibility contrasted sharply with the cautious stance of the Finance Ministry on payments liberalization.[63] Comparing the enthusiasm of the German Economics Minister for rapid convertibility with his counterparts in other European countries the German news magazine wrote that "[w]ährend Ludwig Erhard schon in der Badehose auf dem Sprungterm seine Muskeln spielen läßt, stehen die anderen hochzitternd um den großen Währungsteich herum".[64]

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[59] Giersch, Paqué and Schmieding, p.111 and Nicholls, *Freedom with Responsibility*, p.355.
[60] H. J. Küsters, "Der Streit um Kompetenzen und Konzeptionen deutscher Europapolitik 1949-1958", in Herbst, Bührer and Sowade (eds.), *Vom Marshallplan*, p.350.
[61] L. Erhard, *Prosperity through Competition: The Economics of the German Miracle*, third and revised edition, Thames and Hudson, 1962, pp.239 & 241.
[62] *Der Spiegel*, "Goldwährung: In einer andern Welt wieder", No.24, June 10, 1953, p.20.
'For him the plunge of the DM into convertibility cannot happen soon enough'.
[63] After Germany had regained sovereignty over its international monetary policy, the Finance Ministry, the Economics Ministry and the German central bank, battled for the authority over Germany's payments liberalization. This battle is discussed in Appendix A.
[64] ibid., p.21
'while Ludwig Erhard is already on the springboard in his swimming trunks flexing his muscles, the others are standing around the currency pool shivering'.

The rapid progress in Germany towards de facto convertibility and towards resident convertibility proves the positive stance on convertibility. In Germany, contrary to Britain, progress towards non-resident convertibility was continuously matched by progress towards resident convertibility.[65] By 1954, it was clear that when the Germans spoke of establishing convertibility, they meant "a great deal more than Mr. Butler aims at for sterling".[66] From 1953 onwards, Germany rapidly increased travel allowances so that by mid-1954 the allowance was "so high that it is beyond the means of any but the richest man to spend it on pleasure".[67] From October 15, 1956, German travelers could exchange and take into or out of Germany any amount of German or foreign means of payment.[68] In contrast, France and Britain restricted travel allowances and the import and export of banknotes and coins beyond the official establishment of convertibility. In May and June 1956, the German government undertook a number of steps to relax exchange control for residents. Among other things, exporters were freed from the obligation to surrender foreign exchange receipts. They were allowed to keep the proceeds of their sales indefinitely in accounts abroad. In addition, residents were allowed to purchase foreign securities dealt in on foreign stock exchanges and the import of gold was liberalized.[69] *The Banker* commented that "[t]he combined effect of these measures will be to grant virtually complete convertibility to the German resident."[70] In contrast, in Britain, as in most other European countries, resident convertibility was nothing but "a distant and hazy

[65] BA B102-55340, "Auszugsweise Übersetzung aus Foreign Report vom 18.2.1954 - Die D-Mark geht in Führung", February 18, 1954.
[66] *The Economist*, "Five Minutes After Britain", June 19, 1954, p.962.
[67] *The Economist*, "German Travel Shows the Way", June 5, 1954, p.790. See also the IMF's *Annual Reports on Exchange Restrictions* and BIS annual reports.
[68] IMF, *Eighth Annual Report on Exchange Restrictions*, p.148.
[69] IMF, *Eighth Annual Report on Exchange Restrictions*, p.145 and Bank Deutscher Länder, *Geschäftsbericht für das Jahr 1956*, pp.110-111.
[70] *The Banker*, "Sterling Now", Vol.CVI, June 56, pp.331-336. For a similar comment see also *The Economist*, "Convertible D-Mark", May 19, 1956, p.717.

prospect".[71] Overall, *The Economist* remarked that Germany began to remove exchange control long before their EPU surpluses made it safe for it to do so and concluded that "[t]he spirit of 'convertibility' and free trade in a new Europe has been shown by the Germans in a number of ways that might well be copied by the British".[72]

The strong export orientation of the German economy, which was consolidated but not created by the Allies, nipped in the bud any latent opposition to convertibility that might have existed.[73] The unique 'conditioning' by the Allies combined with West Germany's export orientation - the two of which cannot be easily separated - and the FRG's decision in favor of the market economy forged a strong consensus on the pursuit of a rapid establishment of currency convertibility. Convertibility, as a principle, was not questioned as it was in Britain. In the press, in 1953, *Der Spiegel* condemned exchange control as a serious impediment to the expansion of trade and thus economic welfare and argued for the quickest possible re-establishment of currency convertibility.[74] Similarly, the national weekly German magazine, *Der Volkswirt* wrote in January 1959, in response to the collective establishment of currency convertibility, that exchange control violated the principles of a market economy. Exchange restrictions could therefore only exist as emergency laws which by definition could be no more than temporary aberrations of the norm, with the establishment of currency convertibility simply represented a return to the norm. The paper described the gradual establishment of convertibility as the path from the general prohibition to the normal state of things ("...[der] Weg vom allgemeinen Verbot

[71] *The Economist*, "How Convertible is Sterling?", July 17, 1954, p.211.
[72] *The Economist*, "German Travel shows the Way", June 5, 1954, p.790.
[73] Germany was traditionally a very trade-dependent country. Abelshauser, *Wirtschaftsgeschichte*, p.27.
[74] *Der Spiegel*, "Goldwährung: In einer andern Welt wieder", No.24, June 10, 1953, pp.15-19.

zum Normalzustand").[75] Indicative of the general tone of the article, the title, "Trotz Konvertibilität noch Devisenbewirtschaftungs-Reste", rather than praise the events of December 1958 as an extraordinary achievement, criticized the Bundesbank and the Economics Ministry for still hesitating to take the final steps in removing all exchange control and fully restoring the German currency to the 'normal state of affairs'.[76]

The widespread consensus in Germany on price stability and export-led growth as the keys to German recovery and prosperity produced economic conditions which were highly favorable to the establishment of convertibility. A widespread concern with inflation found its expression in an independent central bank whose principal function was to maintain price stability and in wage restraint.[77] The statutory independence of the German central bank and its clear commitment to price stability assured the credibility of continued DM strength. According to Bordo and Jonung, the establishment of an independent central bank whose sole responsibility is to maintain price stability is one way to anchor inflationary expectations: "One method to create strong credibility for the purchasing power of the currency is to take the money supply out of the control of the political system".[78] Several studies on the link between central bank independence and price inflation find that "lower average inflation is associated with higher central bank independence".[79] The German case seems to fit this rule. The primary policy goal of the

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[75] *Der Volkswirt*, "Trotz Konvertibilität noch Devisenbewirtschaftungs-Reste", No.7, February 14, 1959, p.273.

[76] ibid.

[77] The German press repeatedly appealed to the unions to exercise wage restraint by warning that high wage claims would set off an inflationary spiral. Giersch, Paqué and Schmieding, "Openness", p.12.

[78] Bordo and Jonung, *Monetary Regimes*, p.10.

[79] M. D. Bordo and B. Eschweiler, *Rules, Discretion, and Central Bank Independence: The German Experience 1880-1989*, Working Paper No. 4547, Working Paper Series, National Bureau of Economic Research, Cambridge, MA, November 1993, p.30. For a comparative anlysis of the importance of central bank independence, see J. B. Goodman, "Monetary Policies in France, Italy, and Germany: 1973-1985", in Guerrieri and Padoan, (eds.), *The Political Economy*, pp.171-201.

German central bank was, and still is, the safeguarding of the value of the DM. In order to achieve this goal the Bank deutscher Länder and later the Bundesbank "can and has pursued its own policies, at times against the wishes of Bonn".[80] Contrary to Britain and France, where the independence of the central banks was severely restricted after World War II, the statutory independence of the German central bank guaranteed price stability in the present and in the foreseeable future, thus affecting people's price expectations and their own pricing decisions. Wages which increased at a markedly slower pace than productivity, reinforced price stability and ensured continued competitive advantages vis-à-vis other countries where the wage-productivity ratio was not as favorable. Due to the vivid memory of Germany's devastating experiences with inflation, "an aggressive stance in wage policy, which would have run the risk of spurring a wage-price spiral, was not very popular among the rank and file, and union leaders could not simply disregard this mood".[81]

Wage increases which were offset by productivity increases, high private savings and, from 1957 onwards, falling raw material costs and compression of profits reinforced price stability and were conducive to Germany's international competitiveness.[82] According to Wolf, between 1948 and 1960, German producer wages increased by 53 per cent whereas productivity increased by 88 per cent. For Britain the corresponding figures are 22 per cent and 30 per cent.[83] The price competitiveness of German goods is illustrated

[80] Hennings, "West Germany", p.475.
[81] Giersch, Paqué and Schmieding, "Openness", p.13.
[82] OEEC, *Economic Conditions in the Federal Republic of Germany 1958*, p.5. According to Carlin, the combination of "very long periods of fixed exchange rates" and wage restraint maintained the German competitiveness which in turn secured export growth until 1969. Strong export growth made it unnecessary for German policy makers to stimulate the economy since it enabled the continued maintenance of high capacity utilization when domestic demand flagged. Carlin, "West German Growth", p.17.
[83] Wolf, "Post-War Germany", p.333. Scammell wrote in 1961 that, "[t]he real strength of the German surplus is the very strong competitive position the Germans have secured for themselves in export markets, - a position based upon the importance conceded to the export drive in the past by German

in the development of export prices which, between 1953 and 1957, grew at a slower rate than those of France, Britain or the US and than the OEEC average (table III.6).

Table III.6: Development of export prices

Area	*Export prices in 1957*	
	1950 = 100	1953 = 100
All OEEC	127	105
United Kingdom	131	110
West Germany	127	103
United States	122	107
France	131	107

Source: reproduced from Scammell, *International Monetary Policy*, p.362, footnote.

Liberalization of imports kept prices down. Cheaper imports forced domestic producers to become more competitive, while cheaper raw material imports kept production costs down, further enhancing the competitiveness of German manufacturing exports. Both of these effects were an important motivation for trade liberalization. Similarly, the decontrol of large sectors of the economy was conducive to efficiency and competitiveness. While the currency reform of 1948 had led to the elimination of the monetary overhang, economic policy and industrial organization ensured a strong currency and kept German goods competitive.[84] Table 2 in chapter I showed that Germany's inflation was consistently below the European average. The 1950s marked a decade of continuous and growing German trade surpluses, with the exception of the 1955 trade surplus which remained below that of the previous year.[85] In fact, since 1951 Germany's trade balance has remained positive until the present day.[86] Similarly, Germany's current account balance exhibited continuous, albeit stagnant, surpluses between 1951 and 1960.[87] With

industrialists, the competitive prices at which goods have been offered, the short and well-honoured delivery dates for capital goods and the attention given to selling and marketing techniques." Scammell, *International Monetary Policy*, pp.361-362.

[84] For a comparison of wage inflation and price stability see chapter II.

[85] OECD, *Statistics of the Balance of Payments, 1950-1961.*

[86] Owen Smith, *The German Economy*, p.501.

[87] OECD, *Statistics of the Balance of Payments, 1950-1961.* According to Scammell, since the invisible

the exception of 1959, deficits on the capital account never even came close to offsetting the current account surplus. As a result, between 1951 and 1960 Germany amassed a considerable amount of gold and foreign exchange.

In addition to economic policy, fortunate circumstances reinforced the strength of the DM. According to Giersch, Paqué and Schmieding, wage restraint can partially be attributed to the fact that "most professional observers underestimated quite considerably the potential for productivity growth".[88] Moreover, the huge and constant inflow of refugees from Eastern Europe, constituted a constant supply shock to the labor market, preventing wages from rising more rapidly.[89] Second, dollar earnings from US troops stationed in Germany provided a guaranteed source of reserves earnings. These dollar earnings contributed significantly to the consolidation of Germany's foreign exchange reserves: "Jeder Soldat, der ein deutsches Auto kaufte oder in Berchtesgaden seinen Urlaub verbrachte, stärkte die deutschen Währungsreserven."[90] These earnings were certain and largely independent of economic fluctuations. Already in 1953, a Bank of England official identified dollar payments by US troops in Germany as an "artificial" boost for the confidence of the DM, hinting perhaps at what he considered an unfair advantage of the DM over sterling in the fight for currency stability.[91] Between 1954 and 1958, these dollar earnings made up roughly between 10 per cent and 12 per cent of the

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balance was relatively small, the merchandise trade surpluses were the determinating item in Germany's current account surpluses. Scammell, *International Monetary Policy*, p.361.

[88] Giersch, Paqué and Schmieding, "Openness", pp.13 & 21.

[89] An analysis of the effect of the constant inflow of refugees on the German economy can be found in Abelshauser, *Wirtschaftsgeschichte*, pp.95-98.

[90] G. Stolper, K. Häuser and K. Borchardt, *Deutsche Wirtschaft seit 1870*, J. C. B. Mohr, 1964, p.281.
'Every soldier who bought a German car or spent his vacation in Berchtesgaden strengthened German foreign exchange reserves.'

[91] BoE OV 34/39, L. A. Martin (Overseas and Foreign Office) to Tansley, "Germany and Convertibility", October 6, 1953.
Similarly, in April 1954, a Bank official listed the expenditure of US armed forces in Germany as a significant contributor to the large increases in German gold and dollar holdings. BoE OV 34/39, "Germany: Visit to Frankfurt, Bonn, Cologne, Düsseldorf and Hamburg 10th-20th March 1954", April 7, 1954.

FRG's annual total gold and convertible foreign exchange assets.[92] They were more than sufficient to offset Germany's trade deficit vis-à-vis the dollar area. The guarantee of a certain inflow of US dollars into Germany, independent of cyclical fluctuations and economic conditions, contributed to the continued strength of the DM.

A third fortunate circumstance consolidating the strength of the DM related to Germany's external liabilities. The debts owed by Germany after the war presented the only potential threat to Germany's otherwise solid currency. The generous terms of the London Debt Agreement, ratified in 1953, which cut external indebtedness by 50 per cent, and the obstacles to a renegotiation of this settlement, however, ensured that the repayment of the outstanding debts never endangered the stability of the DM.[93] In addition, by clarifying the size and status of Germany's external liabilities and by presenting a schedule for their repayment, the Agreement removed uncertainty regarding Germany's debts, that is, when how much would have to be repaid, which in itself increased confidence in the DM.[94] The settlement of Germany's external debts was a fortunate circumstance which was exogenous to German policymaking. One might argue, however, that the favorable settlement of German debts was partially the result of the German economic policy. Germany's demonstration of its willingness to be a good citizen of Europe, by cooperating with the USA and the EPU Managing Board during the balance of payments crisis and by liberalizing trade at a faster rate than demanded, persuaded the Allies to be lenient in the debt negotiations. In any case, the Agreement ensured a steady, and thus predictable, manageable annual repayment of Germany's external debts and

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[92] The percentage is obtained by dividing dollar earnings listed in monthly reports of the Bundesbank, converted into US dollars at DM4.20 = 1.00 US$, by reserve figures from IMF *International Financial Statistics*.
[93] Giersch, Paqué and Schmieding, *The Fading Miracle*, p.113.
[94] G. Gutmann, H.-J. Hochstrate and R. Schlüter, *Die Wirtschaftsverfassung der Bundesrepublik Deutschland: Entwicklung und ordnungspolitische Grundlagen*, Gustav Fischer Verlag, 1964, p.256.

compensation payments. In contrast, Britain's significant external debts, the sterling overhang accumulated during World War II, were not settled in a similar way, posing a relatively greater instability risk to Britain's reserves and its currency through the danger of large, sudden, conversion demands by foreign creditors.

The fortunate circumstances consolidated a favorable external economic situation and solidified an economic policy which allowed Germany to move rapidly and safely towards de facto convertibility. Germany's policy on convertibility was characterized by the rapid removal of exchange control on current as well as most capital account transactions and on non-resident as well as resident convertibility, on the one hand, and the public commitment not to establish official convertibility before the rest of Europe on the other hand. The decision to wait for Britain, and the rest of Europe to undertake the official move is not explained by lack of soundness of German economic position or by an aversion to convertibility. Instead, the decision to postpone official convertibility even when it was a mere formality for the DM can be ascribed to several factors. A unilateral German move to convertibility would have fundamentally disrupted the functioning of the EPU. As has been shown in the first section of this chapter, Germany did not want to undermine the cohesion of a regional payments mechanism which ensured the access to Germany's largest export, and import, market. As far as German trade interests were concerned, the convertibility of other currencies was at least as important as DM convertibility. The risk with officially making the DM a hard currency was that this might allow other countries to justify the reimposition of trade discrimination against German goods. If DM convertibility had been established unilaterally and at the expense of other countries' trade and payments liberalization, it would have defeated its fundamental purpose. By giving the UK the promise to move only upon British lead, Germany sought to prevent Britain rushing into convertibility simply to pre-empt German action. Such a defensive move to convertibility might be accompanied by the reimposition of discrimination against German goods not only in Britain but throughout the sterling area. Contrary to Britain, a unilateral move to official convertibility ahead of the rest of Europe offered no advantage to Germany.

This thesis does not claim that the first post-war decade in Germany was characterized by total harmony and consensus on economic policy. The important point made here is that, contrary to Britain, there was a general agreement that the interwar experience with hyperinflation should be avoided. This agreement, combined with a strong support for the liberalization of trade and payments and export-led growth as the way to reconstruction and prosperity, ensured that convertibility was not the controversial issue in Germany that it was in Britain.

In addition to the general economic policy orientation which was conducive to the establishment of convertibility, the Kornai preconditions for viable convertibility were fulfilled by the early 1950s.[95] Monetary overhangs were removed by the currency reform as early as 1948, foreign reserves were abundant in relation to foreign debts and import needs, the exchange rate did not threaten balance of payments surpluses and wage increases, both monetary and in relation to productivity, were very moderate. German goods were highly competitive, and the currency was strong, especially compared to the pound.

In spite of these favorable conditions, German policymakers never seriously considered a unilateral move to convertibility or taking the official lead in convertibility

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[95] See chapter I.

in Europe. In addition to trade dependence and the fear of discrimination, several other factors ensured that in Germany DM convertibility was only envisaged as a collective move.

THE CONSENSUS ON A COLLECTIVE MOVE

SOVEREIGNTY AND NORMALITY

The Allies' occupation of Germany after World War II clearly distinguishes Germany's path to convertibility from that of France and Britain, at least in the early stages. The laws No.52 and No.53 decreed by the military government categorically prohibited all commercial and financial transaction between German residents and non-residents, except for specifically permitted transactions. The power of the Allied High Command to devolve economic sovereignty gradually to Germany when it saw fit, implied an important leverage of the Allied powers over Germany's economic policy. Had German economic policy conflicted with what the Allies had in mind for Germany's economy, it is possible that Germany would have had to wait longer to obtain sovereignty. For example, a decision in favor of an economic policy orientation which was protectionist and strongly based on economic planning, as was suggested by many Social Democrats after 1945 when the foundation for Germany's economic model was hammered out, might have caused the Western Allies to wait. If anything, the liberal economic policy orientation of the first Economics Minister of the Federal Republic, Ludwig Erhard, and his reputation as "opponent of socialization, planning and cheap money" persuaded the Allies to hand over sovereignty relatively early.[96]

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[96] Nicholls, *Freedom with Responsibility*, p.157. See also p.151.

Although the FRG officially gained sovereignty over its currency ('Devisenhoheit') in 1952 and sovereignty in most other respects by 1955, the FRG was still a young state burdened with a very difficult national past. Even after the restoration of sovereignty, Germany struggled for acceptance and for its full reintegration as an equal state in the international community. For Germany, the establishment of convertibility signified above all the removal of an abnormal and therefore undesirable condition. On the one hand, convertibility enabled the restoration of normality of payments in the international economic system. But on the other hand, Germany saw convertibility as an event that would bring it closer to political normalization and reintegration into the international system of nation-states. Thus, Germany's push for currency equality and normality was simultaneously a reflection of and an instrument for its quest for political normalization and re-establishment as a sovereign and equal nation-state. Joint leadership in convertibility with the UK and France must be analyzed in this light.

The relevance attributed to convertibility by the FRG exceeded the monetary or even economic realm. In restoring the DM to a 'normal' state ('Normalzustand'), convertibility was also expected to contribute to the restoration of the German state to normality. At the top of the political agenda of the emerging Federal Republic of Germany stood the integration into the international community of nation states as an equal, 'normal' state .[97] Germany's desire for and pursuit of political normality through economic policy is reflected in its early trade policy. As Giersch, Paqué and Schmieding point out that "[t]he most remarkable features of West Germany's trade policy in the first

[97] see Hanrieder, *West German Foreign Policy 1949-1963*, p.50.

years after the country had come into being in late 1949 was that it tried to behave almost exactly like everybody else".[98] Economic cooperation offered an important opportunity for Germany to demonstrate to Western Europe a sense of collectivity, responsibility and goodwill. At the same time, other countries allowing or even inviting Germany to participate in collective international actions or institutions proved to Germany that its efforts were paying off, and that it was on its way to what Hanrieder calls "political recovery", that is, "the right to have a foreign policy and the return of a democratic Germany to the society of free nations".[99] The closer Germany moved towards currency convertibility the further it distanced itself from the era of exchange control, a period which coincided roughly with Hitler's reign in Germany, and which the new Republic was anxious to put behind it. The creation of the DM itself in 1948, together with the currency reform, symbolized a new beginning, a departure from the old misguided ways and the birth of a new era. For many the reform marked a new beginning for the German state and a step towards normality.

> Für die meisten Zeitgenossen stand weder der Tag der Verkündung des Grundgesetzes am 23. Mai 1949 noch die Konstituierung des Bonner Parlaments am 7. September 1949 für den entscheidenden Neubeginn in Staat und Wirtschaft, sondern eben der 20. Juni 1948 [the date of the currency reform]...
> Jede Reform, die das überkommene Erbe der Kriegswirtschaft überwinden wollte, mußte mit einer Reform der Währung beginnen. Für die neoliberale Wirtschaftsrerform Erhards galt dies besonders, vertraute er doch weitgehend auf den Wettbewerbsmechanismus des Marktes, der dem Geld eine wichtige Funktion bei der Steuerung der wirtschaftlichen Prozesse zumißt.[100]

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[98] Giersch, Paqué and Schmieding, *The Fading Miracle*, p.108.
[99] Hanrieder, *West German Foreign Policy 1949-1963*, p.50.
[100] Abelshauser, *Wirtschaftsgeschichte*, pp.51&52.

> 'Any reform that wanted to overcome the legacy of the war economy had to start with the reform of the currency. This was especially the case for Erhard's neoliberal economic reform, since he relied mainly on the competition mechanism of the market, which attributes to money an important role in the steering of the economic processes...
> For most contemporaries the decisive new beginning in state and economy was embodied neither in the day of the proclamation of the basic law on May 23, 1949 nor in the establishment of parliament in Bonn on September 7, 1949, but rather in the events of June 20, 1948.'

As the economic miracle unfolded, the DM became inextricably associated with Germany's new prosperity but also with the new image the Republic sought to convey. The celebrations of the DM's tenth birthday, in 1958, were fit for a king.[101] The DM was venerated as the symbol of a new and prosperous beginning and a break with the past. Therefore, it is not surprising that policymakers saw in monetary cooperation and in the 'normalization' of the DM a side entrance to political 'normalization'. An earlier example of the pursuit of political 'normalization' through economic 'normalization' is the admission of the FRG to the Organization for European Economic Cooperation (OEEC). This was regarded as the "first step towards the rehabilitation of the country on an international level".[102] The first international act of the government of the Federal Republic, the Treaty for the European Recovery Program (ERP) signed with the United States in 1949 was an economic act.[103] Buchheim asserted that the establishment of non-resident current account convertibility marks the completion of the process of the FRG's reintegration into the world economy, since the FRG belonged to the leading group of countries involved in the move.[104] Through participation in the collective return to currency convertibility West Germany thus worked towards its goal of normalization and reintegration into Europe and the world. The desire for reintegration into the world economy and for a normalization of its economic and political international status, together with the recognition that convertibility represented a crucial step in that direction, united the major West German economic and political institutions in this common goal. The faith in the DM and the desire to leave behind exchange control and the regime that

[101] The occasion was even "considered worthy of commemoration by postage stamp". *The Economist*, "The D-Mark's Tenth Birthday", June 21, 1958, pp.1090-1091.
[102] Giersch, Paqué and Schmieding, *The Fading Miracle*, p.96.
[103] Gutmann, Hochstrate and Schlüter, *Die Wirtschaftsverfassung*, p.244.
[104] Buchheim, *Die Wiedereingliederung*, p.170.

was associated with it, made convertibility an uncontroversial policy.

CONVERTIBILITY AND ECONOMIC INTEGRATION

Among German economic and political factions, trade was largely regarded as one of the foundation stones of Germany's economic success. Currency convertibility was generally accepted as a necessary pre-condition for the flourishing of German trade. Thus, policy on convertibility was not encumbered by the policy dilemmas that affected UK policy. However, there was room for debate on the direction of trade to be envisaged for Germany and convertibility played a role in determining this fundamental policy choice for Germany's trade.

The controversy within the FRG on trade direction revolved around the question of European economic integration and Germany's role in it. As in France and Britain, German economic and political factions were divided over what was the appropriate geographic and economic forum for integration. In all three countries, European economic integration raised political issues that were at least as important and contentious as the economic issues, and both influenced the choice of timing and cooperation in the return to currency convertibility in December 1958.

Starting with the plans for a European Coal and Steel Community (ECSC) a strong opposition to Germany's membership in a European customs union developed that transcended party lines and posed a serious challenge to party cohesion.[105] The most prominent, and the most vehement, opposition to the EEC within the CDU came from Ludwig Erhard, the first Economics Minister of the Federal Republic and later Chancellor.

[105] Nicholls, *Freedom with Responsibility*, pp.341-349.

A 'weltoffene Handelspolitik' formed one of the pillars of Erhard's economic policy.[106] The trade order he envisaged did not include tying West Germany into a framework of economic discrimination by a small group of countries against the rest of the world. On the contrary, Erhard feared that as a member of the EEC, the FRG might not be able to trade as freely with other parts of the world as it could otherwise.

Erhard was convinced that a supranational Common Market, especially in its then envisaged limited geographic form, threatened to cut off Germany's trade with countries outside the Common Market.[107] The European Economic Community (EEC) of the Six excluded such important trading partners as the Scandinavian countries, Austria, Switzerland and the UK. Table III.7 compares Germany's exports to what would later become the EEC countries with its exports to its most important other European trading partners which would be excluded by the EEC. Together the latter countries made up between 26 per cent and 29 per cent of Germany's total exports between 1950 and 1958. Throughout the period, the volume of exports to the UK, Scandinavia, Austria and Switzerland roughly equaled the exports to Germany's EEC trading partners.

[106] R. Neebe, "Optionen westdeutscher Außenwirtschaftspolitik 1949-1953", in Herbst, Bührer, and Sowade, (eds.), *Vom Marshallplan*, pp.192-193. For an in-depth analysis of Erhard's views on European integration and the conflict between Erhard and Adenauer see Lappenküper, "'Ich bin wirklich ein guter Europäer'".
'world open trade policy'.
[107] Küsters, "Der Streit", p.350.

Table III.7: Trade direction: German exports to EEC and selected non-EEC European trading partners (million US dollars)

	Belgium Luxembourg, the Netherlands France, Italy	UK, Scandinavia[a], Austria, Switzerland
1950	732	512
1951	1024	960
1952	1139	1155
1953	1314	1188
1954	1533	1470
1955	1768	1712
1956	2169	1990
1957	2503	2252
1958	2406	2336

a: excludes Finland.
Source: calculated from *OEEC Statistical Bulletins IV Series.*

Erhard rejected a supranational organization that would divert trade from other areas and, which he felt, threatened to drag the FRG into France's web of protectionism. He believed that a supranational institutional integration would expose Germany to French 'contagious' dirigisme which he despised. The European free trade area, proposed by the British, presented, in Erhard's eyes, the ideal solution. It envisaged not only an increase in the geographical extent of trade liberalization, but also limited integration to trade liberalization rather than extending it to institutional integration. As a free trade area it would not shut out other trade areas since there would be no common external tariff. For Erhard, the free trade area offered

> eine Chance, den Gemeinsamen Markt einer supranationalen Sechser-Gemeinschaft in ein multilaterales Wirtschaftsabkommen überzuleiten, wegzukommen von der Frankreichorientierung und die Briten stärker ins Spiel zu bringen.[108]

[108] Küsters, "Der Streit", p.360.
'a chance to transform the Common Market of a supranational community of six into a multilateral economic agreement, to get away from the France orientation and to bring the British more into play'.

Erhard warned against the politically and economically exclusive nature of the EEC, advocating that, if it had to happen, then at least "Britain be given membership in the EEC, and that her accession be made as easy and inviting as possible".[109]

Many important officials in the Economics Ministry preferred a European free trade area to a Europe of the Six. The Advisory Council to the Economics Ministry shared Erhard's skepticism of a 'little Europe'. In 1953, the Advisory Council warned that the geographically limited European Coal and Steel Community (ECSC) should be no more than an intermediate goal on the way to worldwide economic integration.[110] In March 1958, Hans Gocht, an official from the Economics Ministry emphasized the urgency of Germany's coming up with a proposal for a free trade area which was palatable both to France and the other OEEC members. He warned that a breakdown of the free trade area negotiations would end OEEC-wide European cooperation, leaving only cooperation within the EEC.[111] In November 1958, Alfred Müller-Armack, also from the Economics Ministry, expressed disappointment at the failure of the Maudling negotiations for a free trade area, especially in light of the compatibility of British desires for a free trade area with the Germany Economics Ministry's ideas of European integration.[112] The Economics Minister and his Advisory Council were not alone in their opposition to the EEC. The SPD did not oppose integration on principle. However, it was not at all thrilled by "the prospect of a European union with strong Catholic conservative tendencies" which would exclude those countries whose social, political and economic leanings were closer to those

[109] Hanrieder, *West German Foreign Policy 1949-1963*, Stanford, 1967, p.165.
[110] Wissenschaftlicher Beirat Beim Bundeswirtschaftsministerium, "Vorbemerkungen zu den Gutachten des Wissenschaftlichen Beirats beim Bundeswirtschaftsministerium", in *Sammelband der Gutachten von 1948-1966, 3. Band: Gutachten vom Dezember 1952 bis November 1954*, p.24.
[111] BA B102-12624, Gocht, "Versuch einer Wertung des französischen Memorandums über die Freihandelszone", March 5, 1958.
[112] BA B102-11160, Müller-Armack to Erhard regarding FTA, the meeting of the Maudling Committee October 22 to October 30, 1958, March 3 or 4, 1958.

of the SPD, that is, Great Britain and Scandinavia.[113] In *10 Jahre Bundesrepublik Deutschland*, a special commemorative edition on the tenth birthday of the Federal Republic, the press and information office of the government took particular care to stress the importance of the close partnership between Britain and Germany. It went on to state clearly that the founding of the EEC did not deflect from the plan to substitute it for a free trade area, which contained all eleven member states of the OEEC.[114] A European free trade area would avert the danger of the EEC's, and thus Germany's, isolation from the rest of the world. Regarding business and labor, Giersch, Paqué and Schmieding claim that, "...neither trade unions nor industry in general favored the 'little Europe' which finally materialized".[115] Erhard kept calling for a less restrictive European economic association, and, according to Hanrieder, "there is considerable evidence that he was right when he said German economic interests were solidly behind him".[116]

Among the important political and economic factions in West Germany, the only continuous and fervent support for European integration along the lines of the EEC came from Adenauer, the first Chancellor of the FRG, and his close followers. Within the CDU, many were at least skeptical of the benefits of the geographical limitations and the supranational character of the integration pursued by Adenauer in his preoccupation with Franco-German cooperation. Noack claimed that, from the German side, the Common Market of the Six was only accepted because the Chancellor was willing and able to push through a solution that sacrificed economic interests to his political goals.[117]

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[113] Hanrieder, *West German Foreign Policy 1949-1963*, p.100. See also Paterson, *The SPD*, p.52.
[114] Presse- und Informationsamt der Bundesregierung, *10 Jahre Bundesrepublik*, Wiesbaden, 1959, p.182.
[115] Giersch, Paqué and Schmieding, *The Fading Miracle*, p.121.
[116] Hanrieder, *West German Foreign Policy 1949-1963*, p. 220.
[117] P. Noack, *Deutsche Außenpolitik seit 1945*, Verlag W. Kohlhammer, 1972, p.64.

Opposition to a 'little Europe' provided one of the motivations for Erhard to assure cooperation with Britain in the move to convertibility. The collective establishment of convertibility in cooperation with an important non-EEC member was a way of, symbolically, keeping a back door open to what he considered a truly 'weltoffene Handelspolitik', that is, a liberal trade order that was not limited to the EEC. According to Nicholls, Erhard and his supporters "wanted the economic integration of the Western world as a whole, including Britain and the USA, and they wanted this to be achieved by lowering tariffs, establishing convertible currencies and breaking down other commercial barriers".[118]

Erhard hoped to counter-balance the France-oriented penchant of Adenauer's foreign policy with Anglo-German cooperation on convertibility. The frequent talks and negotiations between the British Treasury and the German Economics Ministry on convertibility and on the free trade area talks throughout the 1950s contrast with the striking dearth of records of any communication between officials from the German Economics Ministry and their French counterpart.[119] The meetings that did take place between France and Germany on the free trade negotiations tended to be between Adenauer and de Gaulle, and convertibility is unlikely to have been a major topic of conversation. In contrast, Erhard and his officials met frequently with British Treasury officials to discuss convertibility and European integration. The different preferences in the choice of negotiation partners between Adenauer and Erhard, reflect fundamental differences in the policy stance on European integration taken by the Chancellor as opposed to his Economics Mnister.[120] Erhard strongly criticized, as bluntly as politically

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[118] Nicholls, *Freedom with Responsibility*, p.343.

[119] See, for example, BA B102-11161 and BA B102-12624, which contain records of talks between the German Economics Ministry and Britain.

[120] For a discussion of the rift between Ludwig Erhard and Konrad Adenauer over European integration

possible, Adenauer's attachment to France, and the resulting Common Market of the Six. But aside from occasional vocal outbursts[121], in his opposition to the EEC and his propagation of a free trade area, Erhard's hands were tied by the political undesirability of splitting the governing coalition over the issue and thus threatening its hold on power. The archives reveal frequent communications between the German Economics Ministry and the British Treasury in which the Germans voice their disagreement over French opposition to the free trade area and express their approval of British plans for wider European economic integration.[122] Beyond these, in the end, empty promises of solidarity, and, given the political constraints of the time, Anglo-German cooperation on convertibility and the pursuit of an OEEC-wide establishment of convertibility, which transcended the EEC boundaries, presented a subtle, or perhaps helpless, way of undermining Adenauer's European policy. The policy was subtle in that Adenauer is unlikely to have concerned himself with an issue which he must have considered merely technical and of a 'low politics' type. Throughout the 1950s, Adenauer and Erhard clashed over European integration, with Adenauer trying to assert his power in the realm of economic affairs. On several occasions, the power struggle led to near escalation and all out public confrontation. Similarly, Adenauer attempted to impose his will on the Bank deutscher Länder in the debate on the financing of Germany's rearmament in 1955/56.[123] This conflict culminated in a statement by the BdL president Vocke in which he

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and the EEC, see, for example, Koerfer, *Kampf*, and Koerfer, "Wirtschaftspolitische Kontroversen", pp.33-45.

[121] On one occasion, he went so far as to declare in front of members of the press that the EEC in the form which it had been decided upon, might be necessary politically, but that it remained "ein volkswirtschaftlicher Unsinn" ('an economic nonsense'). Quoted from Schwarz *Die Ära Adenauer: Gründerjahre* p.346.

[122] see, for example, BA B102-11161, Werkmeister reports on Anglo-German and Franco-German negotiations, May 16, 1957.

[123] T. Horstmann, "Die Entstehung der Bank deutscher Länder als geldpolitische Lenkungsinstanz in der Bundesrepublik Deutschland", in H. Riese and H.-P. Spahn (eds.), *Geldpolitik und ökonomische Entwicklung: ein Symposium*, Transfer Verlag GmbH, 1990, p.217.

questioned publicly Adenauer's competence in the realm of economics, finance and currency matters.[124] Regarding policy on exchange control and convertibility, however, Adenauer never seems to have tried actively to influence policy with the BMW or the BdL. Monthly reports to the Chancellor from the Economics Ministry prove that he was kept informed about the state of the progress towards convertibility. However, the archival files on the move to convertibility in the Economics Ministry contain no evidence that he tried to affect policy decision regarding policy regarding convertibility.[125] If Vocke's assessment of Adenauer's competence in currency matters is correct, then Adenauer simply did not realize the potential economic relevance of the seemingly technical and minor move to convertibility for European cooperation. He generally was uninterested in currency matters. According to a official who worked with him, he hardly knew the difference between devaluation and revaluation.[126]

When the chances for a European free trade area dwindled in late 1958, the OEEC-wide establishment of convertibility offered one way of resisting the looming EEC straitjacket, as Erhard perceived it. In a book on Germany's economic constitution written in 1964, Hans-Joachim Hochstrate, one of the authors, cautioned against the dangers of the co-existence of two separate trade organizations for European cooperation. He argued that the divisive potential of the co-existence of EEC and the European Free Trade Association (EFTA), which was created in 1959 after the breakdown of the free trade area negotiations, was mitigated by currency convertibility and the general liberalization of trade, services and capital flows.[127] Currency convertibility promoted pan-European

[124] ibid.
[125] See BA B102-37571, "Monatliche Berichte der Referate V zur Unterrichtung des Kanzlers", 1957-9.
[126] Comment by W. Langer in Pohl (ed.) *Adenauers Verhältnis*, pp.54-5.
[127] A good history of the creation of the EFTA is provided in Camps, *Britain and the European*

economic interdependence, which allowed for greater cooperation between all countries in Europe, but also between Western Europe and North America.[128] Thus, currency convertibility came to have the extra advantage, and even became an imperative for, counterbalancing the centrifugal tendencies embodied in the rival existences of EEC and EFTA.

Like Erhard, the Advisory Council to the Economics Ministry saw convertibility as a means of preventing Germany from being trapped in the geographically limited ECSC, and later EEC and instead of furthering a more extensive economic integration. The Council expressed its belief that collective convertibility could pave the way to include all EPU members in a process of integration and trade liberalization.[129] It emphasized the desirability and the importance of establishing convertibility jointly with all EPU members, as opposed to within the limited ECSC context.

By 1958, Germany's currency was already largely de facto convertible, particularly within Europe. Thus, the events of December 1958 did not increase Germany's openness and interdependence vis-à-vis the rest of Europe. However, the establishment of currency convertibility in 1958 increased the exchangeability of other European currencies. In doing so, it weakened the ability of the members of the EEC to isolate their economies from the rest of Europe. The collective establishment of convertibility by nearly all of Western Europe opened the economies of 'Little Europe' to the rest of Europe via foreign exchange markets.[130]

Community, chapter VII.

[128] Gutmann, Hochstrate and Schlüter, *Die Wirtschaftsverfassung*, p.272.

[129] Wissenschaftlicher Beirat Beim Bundeswirtschaftsministerium, "Gutachten vom 11. Oktober 1953: Thema: Fragen des Gemeinsamen Marktes" in *Sammelband der Gutachten von 1948-1966, 3. Band: Gutachten vom Dezember 1952 bis November 1954*, pp.75-77.

[130] See also Milward, *The European Rescue*, p.201.

The strength of the DM would have allowed Germany to establish convertibility long before December 1958 without having to wait for other countries, including the UK, to join in a collective move. Instead, Erhard whose ministry decided on the issue for Germany chose to wait until the UK and the rest of Europe were ready to move to convertibility. Erhard was happy with the UK's choice of timing in the move, among other things because the cooperation with the UK and the timing were both compatible with his vision for European integration. The economic and political factions within the FRG that opposed the restrictive EEC policy of Konrad Adenauer wanted to wait until the pound was ready to lead the collective move to convertibility. A collective move that extended beyond the EEC, and, in particular, included the UK was hoped to offset, at least partially, the EEC bias of the FRG, especially when it became clear that a free trade area was going to be boycotted by the French. Opposition also explains Germany's approval of the timing of the move to coincide with the beginning of the EEC.

GERMAN SURPLUSES AND ECONOMIC ADJUSTMENT

In addition to political and trade considerations, monetary considerations mitigated against a unilateral official move to convertibility before the rest of Europe, and, in particular, Britain. An international key currency status for the DM was not one of Germany's economic priorities in the 1950. In contrast to Britain, Germany had no desire to strengthen the DM through leadership in the European return to currency convertibility. On the contrary, as pressure on the DM progressively increased in the 1950s, policymakers sought to downplay the strength of its currency. A unilateral move would have only increased the international focus on the strength of the DM, further increasing the pressure to revalue.

Under a fixed exchange rate system, exchange rates are not free to move according to demand and supply conditions.[131] Therefore, changes in currency strength are difficult to measure. The problem is exacerbated when foreign exchange markets are restrained by extensive exchange control regulations, preventing people from buying and selling currencies freely. The existence of parallel or unofficial markets for foreign exchange, emerging due to the limited convertibility of the official currency, might provide greater insight into market conditions, especially where these markets are removed from the reach of government or central bank intervention.[132] The free exchange market for banknotes in Zurich quoted an exchange rate for German DM, pound sterling and French franc, among others. Although some intervention in the market for banknotes is also likely to have taken place, the extent and the effectiveness with which UK, German and other monetary authorities controlled movements in the rate for banknotes remained much smaller than for any of the other types of sterling, DM, etc.[133] According to the IMF and the Bank for International Settlements, the exchange rate for banknotes was a good indicator for

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[131] According to orthodox balance of payments theory, under a fixed exchange rate regime, internal economic adjustments, through changes in prices and consumption, ensure that demand and supply are in equilibrium at the fixed currency price.

[132] In the case of sterling, for example, the Exchange Equalization Account (EEA) intervened in the foreign exchange markets in New York and Zurich to ensure that the official rate for sterling remained within 0.75 per cent either side of the parity of sterling. From 1955 onwards, the EEA also intervened in the market for transferable sterling to ensure that the transferable rate stayed within one per cent either side of the official exchange rate. Thus, official intervention prevented both the official, and, from 1955, the transferable rate for sterling from reflecting changes in demand and supply conditions for sterling. Security sterling comprised non-resident sterling accounts for capital transactions in the UK. The rate for security sterling reflected movements in a type of sterling which remained very limited in its use and volume. In addition, the demand for security sterling was strongly affected by changes in regulations of capital flows and in investment climate in the UK. UK authorities could control relatively effectively both the use and volume of security sterling. All of these characteristics of security sterling render it inappropriate for an assessment of sterling's relative strength or weakness. Of all the different exchange rates for sterling, the exchange rate for sterling bank notes offers the best indication of changes in sterling's position in foreign exchange markets.

[133] In a public statement in November 1953, in connection with a court trial, the BdL declared that it had not intervened in the foreign exchange market in Zurich to support the exchange rate for DM banknotes. BBA B330-02050, Dr. von der Lippe (BdL) to F. O. Weber, chief editor of the *Mannheimer Morgen*, November, 26, 1953.

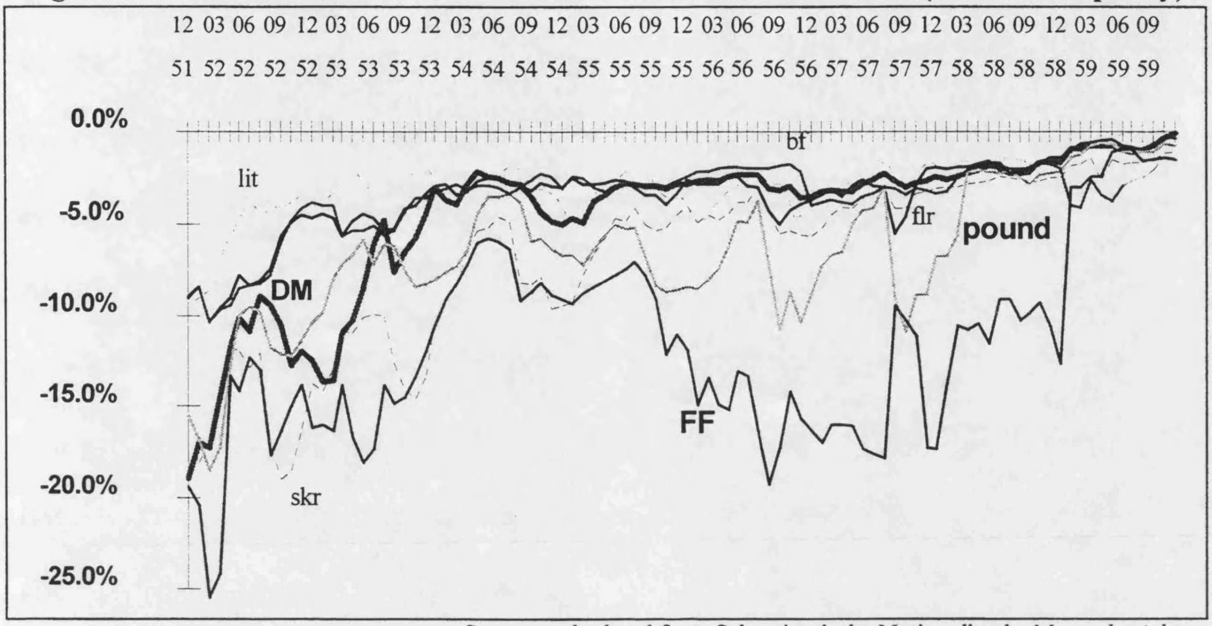
strength, or weakness, of an otherwise not freely traded currency in the 1950s, since fluctuations in the rates for banknotes reflected changes in confidence in currencies.[134] The market in Zurich for banknotes consisted largely of notes which "have been smuggled out of their countries of origin and must be smuggled in again".[135] The principal actors in the banknote market were banks that bought and sold currencies, which were largely obtained through tourist conversions. In addition, depending on national restrictions on the import and export of banknotes, individuals, other than tourists, bought and sold banknotes through Zurich.

Figure III.1 shows the discounts of banknote rates of European currencies on their parities which were traded in Zurich.[136] It compares the French franc, the DM and the pound with the Belgian franc, the Dutch florint, the Swedish krona and the Italian lira. The banknote rates for French franc and pound sterling consistently exhibit both the largest discounts and the largest fluctuations in the discount on parity for both currencies. The performance of the banknote rate for French franc, together with the two devaluations, reveal the franc as by far the weakest and most unstable of the European currencies examined here. Moreover, the graph fails to reflect the two devaluations of the official franc rate in August 1957 and December 1958. The DM exchange rate experienced a very different development in the same period. Starting from a very large discount on its official rate in December 1951, the DM rate exhibited a strong upward trend, implying a rapid reduction in the discount of the banknote rate on parity. From late 1953 onwards, the

[134] IMF, *Ninth Annual Report on Exchange Restrictions*, 1958, p.8 and BIS, *23rd Annual Report April 1, 1952 to March 31, 1953*, p.6. According to the Bank for International Settlements, in the 1950s, confidence in a currency could be measured "by the closeness of ...free-market quotations to the official rates for bank-notes".
[135] Bloomfield, *Speculative*, p.30.
[136] The Austrian schilling and the Portuguese escudor were not included although bank notes in these currencies were traded, since there was no official rate (no consistent parity) for these listed in Zurich.

discount never dropped below five per cent, with the DM rate for banknotes thus consistently remaining in the group of European currencies with the smallest discounts of banknote rates on their parities.

Figure III.1: Banknote rates in Zurich December 1951 - June 1959 (discount on parity)



Source: calculated from Schweizerische Nationalbank, *Monatsberichte*.

Figure III.2 compares the discount of the exchange rates for banknotes in Swiss francs per pound sterling and DM, respectively, on the official exchange rate in the foreign exchange market in Zurich.[137] The rate for German banknotes shows a continuous strengthening of the DM rate for banknotes vis-à-vis the official exchange rate. The lack of sharp fluctuations in the curve for DM banknotes after the fall of 1954 mirrors the absence of any serious exchange crises in Germany. In addition, from September 1953 onwards the discount of the rate for German banknotes on the official rate was always smaller than the discount for UK banknotes, with the exception of a period between March

[137] The banknote rates are depicted in terms of their discount on official rates, so as to eliminate fluctuations in bank note rates due to fluctuations in the official rate, the latter of which was strongly influenced by central bank intervention, and to facilitate comparison between different currencies.

and July 1958. As early as 1953, the Bank for International Settlements noted that "[t]he strength of the Deutsche Mark note reflects the improvement in the economic and financial position of western Germany".[138]

Roughly speaking, the exchange rates for DM and pound sterling moved in symmetry, with a strong movement in one direction in the UK pound matched by a very subdued movement in the same direction by the DM. The symmetry in the direction of the movements of the two exchange rates might indicate that both were affected similarly by events and economic conditions, or that they responded to the same events or conditions. At the same time, however, the elasticity of response of the factors determining the swings in both rates was much greater in the case of the UK pound than in the case of the DM. Compared to the DM rate, the rate for UK banknotes is characterized by large swings. Moreover, the UK exchange rate was particularly prone to rapid large downward movements. With the exception of the 1954/5 crisis, the leftward bias of the troughs in the pound exchange rate in the chart indicate that pound banknotes depreciated faster than it took them to regain their previous value. This proneness to depreciate faster than to appreciate is absent in the case of the DM. Thus, contrary to the DM, the pound banknote exhibited a certain 'tendency to drop'. The pound's proneness to drop more in value than the DM and to drop quickly indicates a certain weakness of the pound. A more thorough analysis of the causes for the behavior of the pound exchange rate observed in the chart will be undertaken in the following sections.

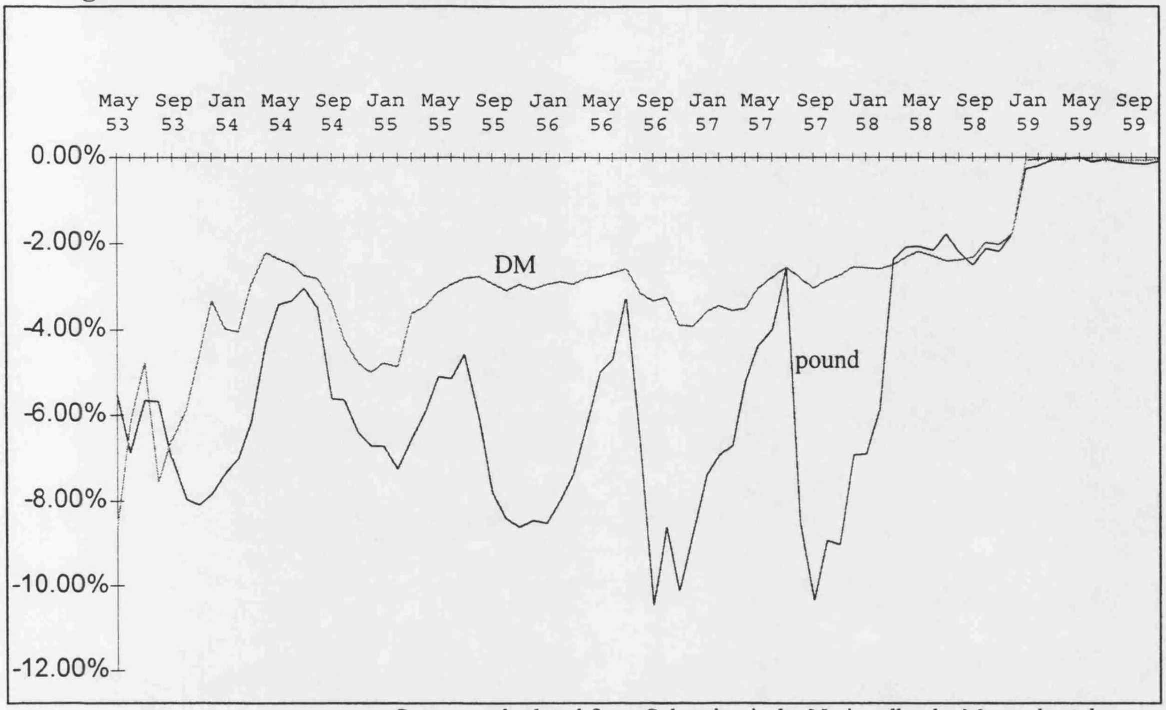
The relative 'weakness' of the pound compared to the DM in this period thus manifested itself in two ways. Both, the large fluctuations of the rate for UK banknotes contrasted with Germany's smooth upwards trend, and the fact that after September 1953

[138]BIS, *23rd Annual Report, April 1, 1952 to March 31, 1953*, p.135.

the discount of the UK banknote rate relative to the official exchange rate generally exceeded the discount for German banknotes, reflect the greater stability or strength of the German DM vis-à-vis the British pound. Moreover, the pound's 'tendency to drop' supports the idea that it was unstable and weak. One of the problems with using banknote rates as a basis for comparing strengths and weaknesses of different currencies in the 1950s is that national differences in exchange control might have affected banknote rates. Thus, the UK was much slower to remove controls both on the trade and on the import and export of banknotes into and out of the UK and the sterling area than Germany.[139] The resulting limitations on the trade and use of sterling banknotes might account for a portion of the greater discount of the banknote rate for pound sterling than for the DM. However, it would not explain the greater variations of the pound compared to the DM. In general, the share of sterling's weakness explained by the fact that it was harder to import and export banknotes is believed to be fairly small and, above all, fairly constant.

[139] See IMF annual reports on exchange restrictions.

Figure III.2: Discount of banknote rates on official rates in Switzerland, 1953-9



Source: calculated from Schweizerische Nationalbank, *Monatsberichte*.

To most foreign observers the strength of the German currency indicated that the DM was "clearly undervalued".[140] This view was strengthened by Germany's persistent balance of payments surpluses. An examination of Germany's balance of payments reveals that trade surpluses, with a few exceptions, showed a constant upward trend in the 1950s. Correspondingly, gold and foreign exchange reserves increased continuously and rapidly in the same period (see figure 1 and table 2 in chapter I).

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[140] Fforde, *The Bank of England*, p.569.
It should be pointed out that subsequent experiences showed that a DM revaluation failed to bring about a lasting change in Germany's balance of payments. The DM revaluation in 1961 only temporarily alleviated the situation. The ensuing brief period of current account deficit and short-term capital outflow was quickly replaced by the previous trend of growing balance of payments surpluses and speculative capital inflow. See Owen Smith, *The German Economy*, p.172.

Table III.8: Germany's external balance 1950-1960 (million DM)

year	current account			overall balance[a]
	current account	trade balance	compensation payments	
1950	-427	-2492	0	-564
1951	2301	772	0	2038
1952	2478	2318	0	2900
1953	3873	4324	268	3646
1954	3669	4143	508	2971
1955	2235	3069	617	1851
1956	4459	5680	924	5010
1957	5901	7783	1396	5122
1958	5998	7998	1505	3444
1959	4152	7431	1738	-1692
1960	4783	8271	2259	8019

a: current account minus capital account.

Source: compiled from Deutsche Bundesbank, *Deutsches Geld- und Bankwesen in Zahlen 1875-1974*, pp.339 and 342, tables 1.01 and 1.04.

Table III.8 shows that only large and rising official government transfers, mainly in the form of compensation payments, prevented the current account surpluses from growing at the same rate as the trade surpluses.[141] Between 1953 and 1958, Germany paid DM5,218 million in compensation payments.[142] The repayment of Germany's war debts consistently constituted the largest negative item on the capital account. Both compensation payments and debt repayments were independent of the market. Between 1953 and 1958, the public and the private sector of the Federal Republic together repaid DM5,377 million of outstanding debts to foreigners.[143] The London Debt Agreement committed Germany to predetermined annual payments. However, Germany was free to negotiate accelerated debt payments, an option which it used increasingly after 1955 to offset rapidly rising

[141] OECD, *Statistics of the Balance of Payments, 1950-61* and Deutsche Bundesbank, *Deutsches Geld- und Bankwesen in Zahlen 1876-1975*, Fritz Knapp Verlag, 1976. pp.339-342.
[142] Deutsche Bundesbank, *40 Jahre Deutsche Mark: Monetäre Statistiken 1948-1987*, Fritz Knapp Verlag, 1988, pp.263-4, Table 1.40.
[143] Deutsche Bundesbank, *Deutsches Geld- und Bankwesen*, p.344, table 1.05 d).

trade surpluses.

Table III.9: Capital account balance, 1950-1959 (million DM)

	Balance on goods and services	Capital account balance	of which balance on private capital flows
1950	-2492	+637	+30
1951	+772	-543	+70
1952	+2318	+6	+75
1953	+4324	-698	-41
1954	+4143	-106	-184
1955	+3069	-640	0
1956	+5680	-162	+224
1957	+7783	-2655	+372
1958	+7998	-2329	-487
1959	+7431	-6398	-1255

Source: Deutsche Bundesbank, *Deutsches Geld- und Bankwesen in Zahlen 1876-1975*, p.339.

Had private capital been free to flow, it is more likely that it would have flown in than out, due to the favorable investment climate in Germany. A large portion of private capital exports was made up of special credits, in particular in connection with the large credit made by German banks to the Indian government in 1957, and credits to facilitate the payment for German exports.[144] Regarding private portfolio investment, purchases by foreigners of German securities exceeded purchases of foreign securities by Germans between 1955, when capital outflows were considerably liberalized, and 1958.[145] Consequently, the largest counterweights to Germany's trade surplus were settled by politicians and international agreements, and occasional special credits, instead of being determined by demand and supply conditions in the capital or goods markets. Table III.9

[144] Deutsche Bundesbank, *Geschäftsbericht für das Jahr 1957*, p.55

[145]

Private portfolio investment, 1954-1958 (million DM)

	net German portfolio investment abroad	net foreign portfolio investment in Germany
1954	0	1
1955	0	90
1956	17	289
1957	81	772
1958	292	592

Source: Deutsche Bundesbank, *Deutsches Geld- und Bankenwesen in Zahlen 1876-1975*, p.343.
See also E. Dürr, *Konjunkturpolitik bei Konvertibilität*, Universität Köln, 1961, p.17.

shows that private capital flows were no reliable or significant counterweight to the trade surpluses. The Bundesbank conceded in 1957 that

> die gegenwärtige - und wohl auch in nächster Zukunft zu erwartende - deutsche Kapitalausfuhr weder in ihrem Umfange noch in ihrer Richtung einen Faktor darstellt, der einen ins Gewicht fallenden Beitrag zum Ausgleich der deutschen Zahlungsbilanzüberschüsse, insbesondere in der EZU, leisten, noch auch den zu hoch geschraubten Erwartungen zahlreicher Handelspartner der Bundesrepublik gerecht werden könnte.[146]

Within and beyond the period in question, therefore, Germany's balance of payments was dominated by large trade surpluses, which were only slightly mitigated by discretionary and predictable government transfers and debt repayments. This balance of payments record indicated a structural disequilibrium in Germany's balance of payments since private, that is market-determined, trade or capital flows, proved consistently incapable of counterbalancing Germany's export surpluses.[147]

The impression gained by the persistent German surpluses was that they were structural, implying that there was no tendency towards equilibrium.[148] The apparent structural nature of the balance of payments surpluses combined with the persistent strength of the DM led trading partners to exert increasing pressure on Germany to undertake some form of economic adjustment to correct what they considered a fundamental disequilibrium.[149] Britain was at the head of the group of countries that put increasing pressure on Germany to appreciate what it considered to be a "clearly undervalued" currency.[150] Many identified the 'undervaluation' of the DM as the root of

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[146] Deutsche Bundesbank, *Geschäftsbericht für das Jahr 1957*, p.55.

> 'neither the volume nor the direction of the present - and most likely the future - German capital exports will constitute a factor that could make a significant contribution to offsetting the German balance of payments exports, particularly in the EPU, nor will they be able to meet the albeit excessive expectations of many of Germany's trading partners.'

[147] Scammell, *International Monetary Policy*, chapter 12 "The problem of the German surplus".
[148] Scammell, *International Monetary Policy*, p.355.
[149] Deutsche Bundesbank, *Geschäftsbericht für das Jahr 1957*, p.50.
[150] Fforde, *The Bank of England*, p.569 and Scammell, *International Monetary Policy*, pp.363-370.
It should be pointed out that subsequent experiences showed that a DM revaluation failed to bring about a

the European trade imbalances.[151] Similarly, Dingwort-Nusseck claimed in 1980 that in the 1950s, the German export surpluses were "especially supported by the undervaluation of the deutsche mark".[152] Germany was reproached for impeding the automatic adjustment mechanism of a fixed exchange rate system according to which the balance of payments surpluses, through rising foreign exchange earnings, should have stimulated domestic consumption, thus raising prices and imports, which in turn would have restored external balance and removed upwards pressure on the DM. Instead, critics claimed that Germany was sterilizing surpluses and pursuing a policy of tight money, while, at the same time, refusing to revalue, thus further exacerbating international trade imbalances and exchange rate instability. *The Banker* remarked that

> In a country that has been gaining gold and foreign exchange at the rate recently experienced by Germany - ... - it is paradoxical, to say the least, that the rates for commercial borrowing should range between 8 and 12 per cent. It is difficult to reconcile the German complaints of a capital famine with the massive and largely sterilized exchange reserve accumulated by the central bank. It should be possible to ease credit and capital without incurring the risk of runaway inflation.[153]

But most German policymakers rejected the argument that German economic policy was responsible for the European imbalances. Consequently, the FRG was equally persistent in its refusal to be coaxed or pressured into appreciation of the DM as it was in its resistance to respond to international demands to stimulate domestic demand.[154] In response to international criticism, German observers argued first, that the surpluses were only temporary, and, second, that the trade deficits with the dollar area proved that the DM

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lasting change in Germany's balance of payments. The DM revaluation in 1961 only temporarily alleviated the situation. The ensuing brief period of current account deficit and short-term capital outflow was quickly replaced by the previous trend of growing balance of payments surpluses and speculative capital inflow. See Owen Smith, *The German Economy*, p.172.

[151] See, for example, *The Banker*, "Europe's Problem Currencies", July 1954, p.425, Owen Smith, *The German Economy*, pp.187 and 504-5, and Giersch, Paqué and Schmieding, *The Fading Miracle*, pp.93 and 116. See also chapter II.

[152] Dingwort-Nusseck, "Economic Growth", p.213.

[153] *The Banker*, "Europe's Problem Currencies", July 1954, p.427.

[154] *The Banker*, "Europe's Problem Currencies", July 1954, pp.426-427.

was not generally undervalued. However, even if surpluses were structural, the Economics Ministry, as well as the Bundesbank, and many academics argued that it was not up to Germany to correct them. Rather, the surpluses were the direct result of an international inflationary epidemic that was raging outside of Germany and that was overheating demand worldwide, except in the Federal Republic. Worldwide inflationary pressure bullied Germany to appreciate while - at the same time - threatening to drag it into the inflationary spiral which, for historic reasons, it feared so much. The German solution to the problem was neither DM appreciation nor inflationary monetary policy in Germany, but to stem world inflation. A lecture by Professor Dr. Otto Veit at the Industrie- und Handelskammer Frankfurt in 1957 summed up the German view:

> Heute darf ein Land wie Deutschland, das heißt ein Land mit internationaler Gläubigerposition, keine Geldausweitung zulassen, wenn die inflatorische Bewegung in der Außenwelt, aus der diese Gläubigerposition erwächst, mit mangelnder Kontraktion in den Schuldnerländern zusammenhängt.[155]

Rather than succumb to outside pressure, Veit considered it Germany's duty to erect a dam to stem the worldwide inflationary flood by resisting both appreciation and inflation:

> Käme es in einer Periode steigender Weltmarktspreise und sinkender Geldwerte in der Welt dahin, daß die am wenigsten betroffenen Gläubigerländer über den Wechselkurs vor der Weltinflationstendenz ausweichen - also dasselbe mit umgekehrter Zielrichtung tun wie 1931 England -, so fiele ein wesentlicher Hemmschuh und Gegenhalt der internationalen Expansionsbewegung fort.[156]

Veit's views were representative of German policymakers in the 1950s who believed that

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[155] BA B102-12654, "Währungspolitik auf dem richtigen Kurs" - Professor Dr. Otto Veit (erweiterte Fassung eines Vortrages in der IHK Frankfurt), April 1, 1957.

> 'Today a country such as Germany, that is to say a country with an international creditor position, must not permit a monetary expansion, if the inflationary trend of the outside world, from which the creditor position results, is linked to insufficient contraction in the debtor countries.'

[156] ibid.

> 'If, in a period of rising world prices and falling money values in the world, the least affected creditor countries evaded the world inflationary trend through the exchange rate - i.e. if they did the same as England did in 1931 but with the opposite sign -, then an essential brake and counterforce to the international expansionary movement would be removed.'

it was not up to Germany to solve the other countries' balance of payments problems by inflating to their level.[157]

As the 1950s progressed, Germany increasingly came under attack for its apparent unwillingness to do anything about the persistent surpluses.[158] In particular, Germany was reproached of sterilizing the expansionary impact of its balance of payments surpluses and resulting inflow of gold and foreign exchange. In 1956, the Bank of England issued a veiled threat of retaliation should Germany not act to reduce its surpluses either through inflation or revaluation, thus underlining the accusation that Germany was boycotting the working of the fixed exchange rate system.[159] The criticism from trading partners and the growing strength of the DM led to increasing concern in the Economics Ministry that other countries might discriminate against German exports on the basis that the DM was de facto a hard currency.[160] To avert this danger and to resolve the problem in Europe, Erhard and many officials in the Economics Ministry suggested a multilateral exchange rate adjustment. The Economics Ministry was thinking primarily about a devaluation of those currencies where inflation was above average.[161] However, if these countries resisted devaluation, then Gocht from the Economics Ministry argued, Germany should revalue. Erhard shared that view but the Bundesbank categorically rejected a DM revaluation.[162] In a stinging attack, the Economics Ministry accused the Bundesbank of

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[157] Scammell, *International Monetary Policy*, p.365.
[158] BA B102-25878/9, "Ergebnisbericht über die Sitzung der Ministerstellvertreter (Arbeitsgruppe 19 'Finananzielle Stabilität' der OEEC) am 17. und 18. Juni 1957 in Paris", June 24, 1957.
[159] BoE OV34/42, Rootham to Stevens and Parsons: "Note of Conversations in Basle: 1st - 3rd June", June 6, 1956.
[160] BA B102-12654, "Drohende Diskriminierung des deutschen Exports", article in *Wirtschafts- und Sozialpolitik*, June 24, 1957 and BA B102-12654, "Notwendigkeit einer Bereinigung der Währungsrelationen", Gocht, August 19, 1957.
[161] BA B102-12654, "Notwendigkeit einer Bereinigung der Währungsrelationen", Gocht, August 19, 1957.
[162] O. Emminger, "Deutsche Geld- und Währungspolitik im Spannungsfeld zwischen innerem un äusserem Gleichgweicht 1948-1975", in Deutsche Bundesbank, *Währung und Wirtschaft in Deutschland 1876-1975*, Fritz Knapp Verlag, 1976, p.495 and Dickhaus, *Zwischen Europa und der Welt*, p.217.

sacrificing free trade and price stability to the maintenance of the exchange rate.[163] However, the Bundesbank was not alone in its unyielding resistance to revaluation. The Ministry for Foreign Affairs, the German OEEC delegation, the majority of the German export industry, and, influenced by their advisors, Adenauer and Vice-Chancellor Blücher also opposed revaluation.[164] As a result, instead of giving in to foreign pressure to relax monetary policy or revalue the DM, several policies were employed to prevent growing surpluses from having an inflationary effect on the German economy, while, simultaneously, reducing pressure on the DM to revalue.

The Juliusturm that was created by Fnance Mnister Schäffer in 1954 was one instrument for sterilizing balance of payments surpluses, although the monetary authorities denied this. Foreign exchange earnings were stored away and thus withdrawn from circulation, supposedly to save money for future defense expenses.[165] The acceleration of German debt payments and of payments for defense imports was another tool employed by the German government to reduce exorbitant external surpluses. In 1956, 1957 and 1958, when Germany's trade surpluses shot up, foreign reserves rose dramatically and capital inflows increased in response to high real interest rates and in anticipation of a revaluation. In response, the government made large advance payments abroad for armament. These advance payments were classified as short term capital outflows since, until the arms were actually imported, they were in effect a credit to the arms supplying countries.[166] Advance payments for defense imports made up 56 per cent of total short

[163] BA B102-12654, "Vermerk - Reaktion auf Vockes Schreiben und den Artikel von Dr Steffe", October 24, 1957.
[164] Emminger, "Deutsche", p.495 and Dickhaus *Zwischen*, p.219.
[165] H. Schlesinger,"Geldpolitik in der Phase des Wiederaufbaus (1950-1958)", pp. 592-4, in Deutsche Bundesbank, *Währung*, 1976, pp. 555-607.
[166] Deutsche Bundesbank, *Monatsbericht für März 1959*, pp.14-15.

term capital exports in 1956, 76 per cent in 1957, and 59 per cent in 1958.[167] In addition, the acceleration of debt repayments starting in 1957 reduced Germany's external surpluses. Thus, the German central bank advanced £75 million to the UK in the form of a special account at the Bank of England from which Germany was to pay its annual installments for its debt repayment between 1957 and 1966.[168] This measure fulfilled a double function: as a capital export it reduced Germany's external surplus in 1957 while at the same time providing a credit to the UK to increase its liquidity in times of adverse speculation.

Overall, German economic policy was aimed at sterilizing the expansionary effect of its balance of payments surpluses and thus prevented them from having the expansionary effect that was necessary to restore equilibrium.[169] Herring and Marston analyzed national monetary policies in the 1960s and showed that the Bundesbank deliberately and successfully sterilized the expansionary impact of balance of payments surpluses. They examined the period between 1960 and 1971 and concluded that the Bundesbank "did *in fact* [sic] sterilize most of the impact of foreign exchange flows on the reserve base".[170] They went on to state that:

> Our estimates of the reaction function imply that the Bundesbank varied its monetary policy instruments systematically in an attempt to achieve price stability and finance the needs of expanding internal trade. The Bundesbank's success in pursuing these domestic objectives was such that toward the end of the decade the German trade balance was registering increasingly larger surpluses.[171]

According to Yeager, the German central bank "sought, in its domestic operations, to counteract rather than reinforce the expansionary effect of its foreign-exchange

[167] Deutsche Bundesbank, *Monatsbericht für März 1959*, p.17.
[168] Deutsche Bundesbank, *Geschäftsbericht für das Jahr 1957*, p.52.
[169] Obstfeld, "The Adjustment Mechanism", p.221.
[170] R. J. Herring and R. C. Marston, *National Monetary Policies and International Financial Markets*, North Holland Publishing Company, 1977, p.161.
[171] ibid.

acquisitions".[172] This point is illustrated in table III.10. In all three periods shown in the table, foreign exchange transfers would have increased liquidity, all other things equal. However, the government and the central bank employed a range of discretionary tools to offset the expansionary impact of the foreign exchange inflow. In addition to the Juliusturm and accelerated debt repayment, the central bank resorted to open market sales of government securities, the reduction of bank liquidity through rises in minimum reserve requirements and raises in discount rates whenever it deemed that inflationary pressures were rising, such as, for example, in mid-1956.[173] Higher interest rates were likely to increase capital inflow into Germany while dampening domestic consumption demand, and, consequently, imports. The result was an increase in already rising external surpluses. Monika Dickhaus argued that the German central bank's monetary policy between 1955 and 1958 was determined by the aim to preserve price stability and that bank officials were not concerned about the consequences of restrictive policy on the balance of payments.[174]

Table III.10: Changes in commercial bank liquidity (million DM)

	1956 1st half	1956 2nd half	1957 1st half
Foreign exchange transfers	+2,325	+3,547	+3,981
Transfers from the public sector	-1,472	-323	-950
Change in note circulation	-550	-398	-937
Central bank operations	-737	+7	-2,202
Commercial bank borrowing from the central bank	-440	-1,067	+4
Other factors	+74	-260	+147
Total	-800	+1,506	+43

Source: reproduced from OEEC, *Economic Conditions in the Federal Republic of Germany 1957*, p.9

The desire to maintain price stability even in the presence of growing foreign exchange inflows played a crucial role in the German central bank's policy on

[172] Yeager, *International Monetary Relations*, p.489.
[173] OEEC, *Economic Conditions in the Federal Republic of Germany 1957*, pp.8-9.
[174] Dickhaus, *Zwischen Europa und der Welt*, p.226.

convertibility. The central bank condoned resident convertibility since it was considered compatible with, even conducive to, price stability. Regarding the relaxations of exchange and capital restrictions for German residents, *The Economist* recognized that the measures were also

> part of the anti-inflation campaign that is being waged in Germany. It is hoped that if exporters take advantage of the right to leave some of their exports proceeds abroad, the Bank Deutscher Länder will not be called to buy dollars or other foreign currencies and to issue marks against them. Similarly, any German demand for foreign securities would reduce the inflationary pressure at home.[175]

Conversely, the central bank opposed the liberalization of capital imports. While capital outflows were largely liberalized before the establishment of currency convertibility, controls on capital inflows provided German monetary authorities with a tool to regulate, at least to a certain extent, the amount of foreign money flowing into German.[176] Large, and particularly uncontrollable, capital inflows were considered undesirable for two reasons. Firstly, they were feared to have an inflationary effect, especially when Germany was trying to regulate the money supply by raising interest rates.[177] Thus, controls on capital inflows allowed Germany to preserve a degree of monetary autonomy, in particular in its pursuit of relatively tight monetary policy when compared with the rest of Europe. Secondly, Germany's currency stability and its commitment to low inflation repeatedly triggered speculative flows into Germany as people anticipated a DM revaluation.[178] The central bank was supported in its resistance by the prominent economics professor Dr. Otto Veit who claimed that the control of capital imports was vital for Germany in its struggle against revaluation and imported inflation.[179]

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[175] *The Economist*, "Convertible D-Mark", May 19, 1956, pp.717-718.

[176] Capital inflow was discouraged through high reserve requirements on foreign deposits and the prohibition of interest payments to foreigners, among other things.

[177] Gutmann, Hochstrate and Schlüter, *Die Wirtschaftsverfassung*, p.283.

[178] One example of such a speculative inflow was the currency crisis in September 1957.

[179] BA B102-12654, Professor Dr. Otto Veit, "Währungspolitik auf dem richtigen Kurs?", April, 1, 1957.

The BdL's, and later the Bundesbank's, reluctance to liberalize capital imports met with strong criticism from the Economics Ministry, which wrote in 1958: "Die Bundesbank hat sich trotz unserer Bemühungen nicht entschließen können, einer völligen Freigabe der Kapitaleinfuhr zuzustimmen".[180] After the collective return to currency convertibility in 1958, the Economics Ministry reiterated its disapproval of the Bundesbank's continued unwillingness to free capital imports of all restrictions, claiming that the Bundesbank's motivation was to restrict the free functioning of the money markets.[181] The central bank, in contrast to the Economics Ministry, shied away from expanding convertibility to include non-resident capital inflows, since restrictions on capital imports provided the central bank with an effective means of intervening in the capital market to regulate capital flows. Moreover, the central bank was not reluctant to reintroduce restrictions when it was deemed appropriate. During the speculative crisis in August and September 1957, the Bundesbank and the Economics Ministry clashed over the former's suggestion to reimpose restrictions on the use of Libkamark accounts, that is, the accounts through which foreigners could invest in Germany.[182] In May and September 1957, the central bank raised the reserve requirements for non-resident accounts to levels that were three times as high as for resident accounts. The main function of this action was to reduce the liquidity effect of the surpluses. The difference between reserve requirements for non-resident and resident accounts was removed in April 1959, but in 1960, when the DM experiencing renewed speculative pressure to revalue, the Bundesbank quickly

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[180] BA B102-57661, "Niederschrift über die Besprechung am 5. März 1958 über die Lockerung der Beschränkungen für die Kapitaleinfuhr, Abschaffung der liberalisierten Kapitalmark", March 5, 1958. For a detailed account of the German central bank's views and policy on convertibility, see Dickhaus, *Zwischen Europa und der Welt.*
'In spite of our efforts, the Bundesbank has not agreed to a complete liberalization of capital imports.'
[181] BA B102-57689, "Beabsichtigte Einschränkung der Deutschen Bundesbank für die Kapitaleinfuhr", attached to a letter by Sperl (Economics Ministry), January 5, 1959.
[182] BA B102-57708, Westrick, Economics Ministry, to Bundesbank re. "Einschränkung der Zuflüsse auf liberalisierte Kapitalguthaben", September 3, 1957.

reimposed higher reserve requirements for foreign accounts. In addition, it reintroduced the prohibition to pay interest on foreign accounts and to sell German securities and shares to non-residents.[183] The German central bank feared that capital imports would curtail its control over the money supply and make Germany more vulnerable through increasing foreign indebtedness.[184] In general, in contrast to Erhard's policy orientation, convertibility was not one of the central bank's top priorities. The central bank put regionalism, in particular the EPU, before convertibility.[185] The use of capital controls to regulate the capital inflow provides further evidence of the central bank's refusal to adjust even in the presence of growing market pressure to do so.[186] Capital controls allowed Germany to "postpone for long periods the choice between domestic inflation and revaluation".[187]

Throughout the 1950s upward pressure on the DM was generally matched by downward pressure on the pound sterling.[188] Both countries shared the desire to keep the sterling-DM exchange rate where it was. Britain wanted to avoid devaluation while Germany wanted to avoid revaluation, although the reasons for wanting to maintain the existing sterling-DM exchange rate differed significantly. A unilateral move to official convertibility, even when it was technically no more than a formality, would have reinforced confidence in the DM thus further increasing speculative capital inflows. Given the strong opposition to revaluation and the concern about imported inflation, there cannot

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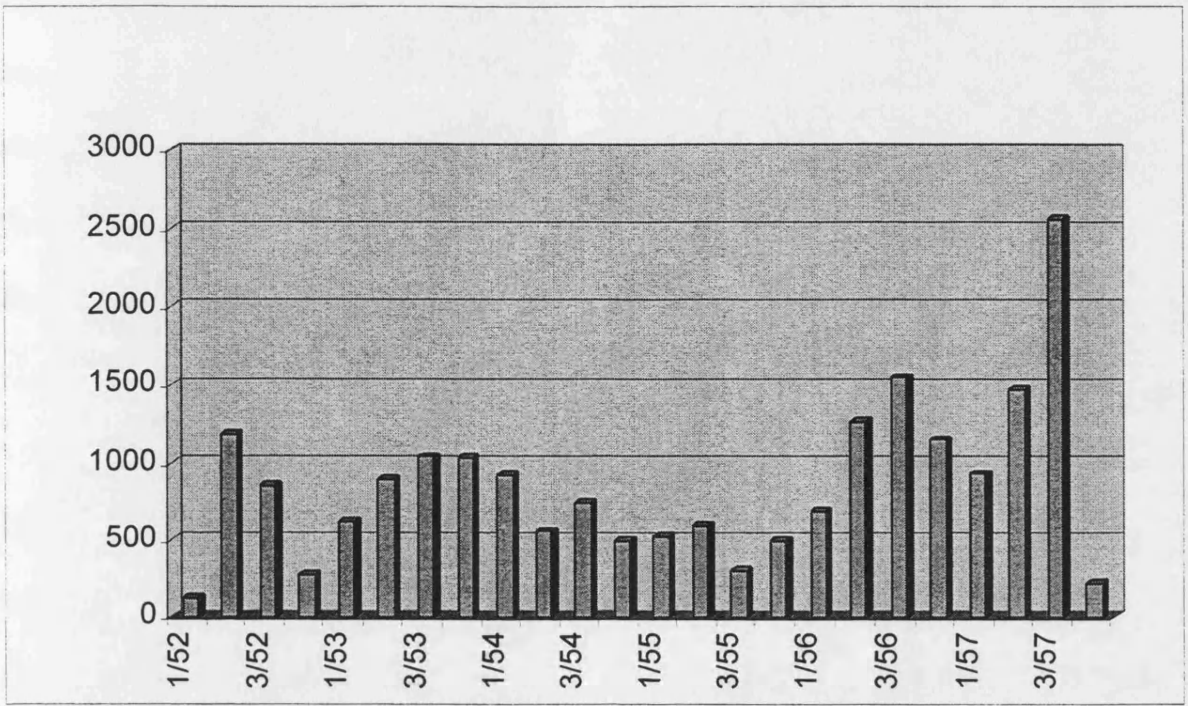
[183] Dürr, *Konjunkturpolitik*, pp.30-33.
[184] Dickhaus, *Zwischen Europa und der Welt*, p.150.
[185] Dickhaus, *Zwischen Europa*, pp.126, 134-40, 166-7 & 252.
[186] According to Eschweiler and Bordo, the central bank used capital controls to isolate "the capital account from the effects of higher real interest rates". Eschweiler and Bordo, *Rules*, p.23.
[187] Obstfeld, "The Adjustment Mechanism", p.221.
[188] See chapter II for a discussion of the weakness of sterling.

have been many supporters of such a move, particularly not in the Bundesbank. Similarly, obvious German leadership in the move to convertibility would have probably also increased speculation and thus pressure for a DM revaluation, and it would have almost certainly weakened the position of the pound, especially since it had been established since the early 1950s that Britain was to lead Europe into convertibility. International policy coordination resulting in a collective official move under British leadership was hoped to reinforce confidence in the pound, and thus, indirectly, ease speculative pressures for a DM revaluation.

In the fall of 1957, the German government had already resorted to international policy coordination to reduce the speculative pressure on the DM. In the late summer of 1957, funds started to shift from sterling into DM as a result of spreading rumors of an impending DM revaluation.[189] The flows were successfully halted and partially reversed in September 1957, when a joint statement by German and British representatives at the annual IMF meeting and with the support of IMF director Per Jacobsson reiterated that neither would the DM be appreciated nor would the pound be devalued.[190] In connection with the joint public statement, the Bundesbank lowered the discount rate from five to 4.5 per cent while the Bank of England simultaneously raised Bank rate from five to seven per cent. The strong speculative inflow into Germany in the fall of 1957, when rumors of a DM revaluation were rife and the subsequent sharp drop of foreign reserve inflow in response to the joint Anglo-German public statement are clearly illustrated in figure III.3. The figure also shows that between 1952 and 1957 there was never a net quarterly outflow of foreign exchange reserves.

[189] BIS, *28th Annual Report April 1, 1957 to March 31, 1958*, p.171.
[190] ibid.

Figure III.3: Quarterly changes in German foreign reserve holdings, 1952-1957 (million DM)



Source: Deutsche Bundesbank, *Monatsbericht der Deutschen Bundesbank, September 1958*, p.51.

Similarly, the collective move to currency convertibility under official British leadership took pressure off the DM to revalue, albeit only temporarily. Participation in the collective move thus allowed Germany to avoid, or at least postpone, the unpleasant choice between letting the surpluses inflate the economy or revaluing the DM, neither of which appealed to the German policymakers.[191] Germany's participation in the collective move to currency convertibility, undertaken at the right time, and led by anybody but Germany, presented an opportunity to reduce market pressure on the DM to revalue, while at the same time avoiding other equally undesirable forms of economic adjustment.

As Obstfeld pointed out, such displays of central bank solidarity only postponed speculative attacks, because they did nothing to correct the underlying causes for

[191] Obstfeld, "The Adjustment Mechanism", p.207.

speculation in the first place and thus they could only temporarily discourage speculations about a DM revaluation.[192] The DM revaluation of 1961 proves that the Bundesbank's success in averting exchange rate readjustment was short-lived. The central bank's attempts to maintain the stability of the DM led to the currency being "increasingly threatened by international speculative short-term capital flows attracted by the Bundesbank's Council's strict adherence to its monetary code".[193]

Today, many economists and historians today agree that "Germany resisted adjustment during the Bretton Woods system".[194] Capital controls, the Juliusturm, official capital exports in the form of accelerated debt repayments and advance payments on defense imports either served to reduce existing surpluses or to prevent them from having an inflationary effect on the German economy. While German economic policymakers were concerned with reducing the immediate effects of growing surpluses, they refused to correct what their trading partners claimed were structural surpluses, either because they questioned the 'structural' nature of the persistent balance of payments surpluses or because they were quite happy to maintain them. As one official from the Bank of England correctly recognized in 1954, the acceleration of the debt repayment did nothing to change the trade pattern, which he asserted should be the main object of any policy to reduce surpluses. He warned that, "[i]t may be worth mentioning, therefore, that anything done to accelerate debt collection would help the Germans to delay other action which could be of a more permanent and beneficial nature".[195] Scammell evaluated German

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[192] ibid., p.220.
[193] Owen Smith, *The German Economy*, p.143.
[194] Bordo, "The Bretton Woods International Monetary System: A Historical Overview", p.55.
[195] BoE OV34/39, Macdonald to Thompson-McCausland, "Germany: Acceleration of payments of Germany's external debts", March 25, 1954. According to the Bank of England the German suggestions for advance repayments of German debt were motivated by the aim to reduce Germany's extreme creditor

economic policy vis-à-vis the structural surpluses in 1961:

> To their credit the German government has shown itself ready in OEEC and elsewhere to recognise the existence of a surplus problem and to take some measures for its alleviation. It has liberalised import policies, lent abroad in modest amount and is anxious to widen its foreign lending through the establishment of a capital market in Germany. Critics argue, however, that such measures are peripheral and, while they may alleviate, they do nothing to end the surplus and that, on the fundamental issues of the problem, i.e., the DM exchange rate, domestic monetary policy and the demand structure within the economy, the Germans are unco-operative.[196]

Similar to Britain, Germany's exchange rate and monetary policy reveals an unwillingness to adjust. Contrary to Britain, however, convertibility was not a threat to German economic policy since, as a persistent surpluses country, the disequilibrium presented no immediate danger to its economic stability. Thus, "Germany's example illustrates the absence of forces pushing surplus countries towards balance-of-payments equilibrium".[197] Similar to Britain, policies were aimed at fighting the symptoms, currency instability, rather than tackling the causes of the fundamental disequilibrium.

CONCLUSION

This section has shown that, in addition to trade dependence, several other factors explain why in Germany the official establishment of convertibility was only envisioned within a collective move incorporating as many countries as possible. First, the unique international political situation of the Federal Republic after World War II mitigated against a unilateral move to convertibility. The second reason for the insistence on collectivity can be found in the rather widespread opposition within Germany to the EEC.

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position in the EPU. BoE OV34/39, L. A. Martin to Macdonald, Watson, O'Brien, Niemeyer: "Acceleration of the repayment of German external debt in order to relieve Germany's extreme creditor position in the European Payments Union", March 18, 1954.

[196] Scammell, *International Monetary Policy*, p.363.

[197] Obstfeld, "The Adjustment Mechanism", p. 220. See also Eschweiler and Bordo, *Rules*, pp.23-24.

The economic and political factions within the FRG that opposed the restrictive EEC policy of Konrad Adenauer wanted to wait until the pound was ready to lead a collective move to convertibility which was hoped to provide a counterweight to the Common Market. Third, Germany's postponement of official convertibility until the other countries, above all the UK, were ready to move, and its conspicuously low-key role in the move, were motivated by the desire to make the DM look weaker, and the pound stronger, than it was. This, in turn, allowed Germany to avoid a revaluation or any other form of economic adjustment in spite of persistent and growing external payments surpluses. Overall, while its economic conditions would have permitted a unilateral move to convertibility before the rest of Europe, Germany had nothing to gain from such a move.

CONCLUSION

> It is hardly necessary to point out that a country will be more willing to accept a greater degree of economic dependence on the rest of the world if it expects the existing international economic order to promote rather than hinder the achievement of its major policy objectives.

This observation by Milivoje Panic can be applied perfectly to explain the motivations for Germany's economic openness and its cooperative stance on convertibility in the 1950s.[198]

For the major parties and interest groups in the Federal Republic of Germany, the rapid establishment of convertibility was not contestable, provided it was undertaken jointly with as many OEEC countries as possible. Contrary to Britain, convertibility, especially a collective move, did not infringe on Germany's ability to pursue its own economic and monetary policy objectives. In fact, economically, there was no reason to

[198] Panic, *National Management*, p.161.

oppose convertibility. Large and growing current account surpluses, and, more importantly, the prospect of a continuation of this trend in the future, provided an assured large influx of foreign exchange reserves which in turn guaranteed confidence in the DM, even after the DM became convertible. Simultaneously, Germany's large and growing trade dependence furnished a convincing motivation for liberalizing payments.

The limitations on Germany's 'sovereignty', legally, but more importantly, politically and economically, predetermined Germany's foreign policy, including its international economic policy. In terms of trade policy this meant integration, in terms of monetary policy it implied cooperation in the return to currency convertibility. It also implied letting somebody else take the official lead in the move, even though Germany had been the pacemaker of the process leading up to the achievement of convertibility. There was no sufficient political platform for opposing convertibility in principle nor European cooperation in the establishment of convertibility. Currency convertibility formed a vital part of the international economic system of liberalized trade and payments, as envisaged and laid out by the United States after World War II, into which the Federal Republic was born.

Germany's smooth road to the establishment of currency convertibility in December 1958 thus differs drastically from Britain's or France's route to convertibility. The fortunate compatibility of the overriding political and economic goals in West Germany at the time accounts for the speedy progress towards payments liberalization and the consensus on a collective move. Moreover, however, a collective move was compatible with German ambitions for the development of trade and with its monetary policy.

As the strength of the German DM increased rapidly, unwelcome speculative capital started to flow into Germany at the same time as countries were putting pressures on Germany to revalue the DM or to inflate its economy, both of which monetary authorities wanted to avoid. A unilateral move to convertibility would have only underlined the strength of the DM, in addition to undermining the OEEC forum for European economic cooperation, which many policymakers preferred to the EEC. The implication of this conclusion is that convertibility did not force Germany to subordinate its monetary policy to the rules of the games of a fixed exchange rate system. As a persistent surplus country, Germany could sterilize its domestic economy from its growing balance of payments surpluses at the expense of international monetary stability.

IV: FRENCH POLICY ON CONVERTIBILITY

INTRODUCTION

Between 1945 and 1958, the French economy was characterized by balance of payments crises, currency instability and high inflation. The franc was officially devalued five times between 1945 and 1959, evidencing a long term erosion of the franc. French exports remained largely stagnant at a time when world trade was expanding rapidly, forcing the French government to use high barriers against imports, export subsidies, and multiple exchange rates to prevent large trade deficits. Exchange control was pervasive, and few steps were taken to increase franc convertibility before 1958. The French scenario thus appeared strongly adverse to the establishment of convertibility, making it all the more surprising that France participated in the collective return to currency convertibility in December 1958. Considering both French general economic policy and economic and financial conditions up until mid-1958, few would have predicted that France would be able or willing to participate in the establishment of non-resident currency convertibility. This chapter examines the conditions and policy considerations that explain the change from a protected, highly regulated economy with an unstable currency to currency convertibility.

TRADE

France began the 1950s as a promoter of trade liberalization within the OEEC. In 1950 it campaigned for automatic tariff reductions in Western Europe, and, by 1951, France had removed quotas on 75 per cent of its 1948 list of private imports, far more than most other OEEC countries. However, in 1952 France's balance of payments surpluses with the EPU turned into substantial deficits, forcing it to suspend its liberalization. As a result, between 1952 and 1955, France was one of the most protected countries, if not the most, in Western Europe, with import barriers covering the whole scale from prohibitive tariffs to quotas to import surcharges to exchange control (see table 1 in chapter II).[1]

As can be seen in table 1 on export growth in chapter III, France's main balance of payments problem in the 1950s was the stagnation of its exports. Throughout the 1950s, there was great concern about the competitiveness of French goods.[2] Lower productivity levels and higher wages were blamed for the lack of competitiveness. Years of inflation rate which was continuously higher than that of France's major trading partners had led to an overvalued franc, which, in turn, made French goods unattractive abroad. It was believed that the fact that a large portion of France's exports went to the franc area was a fundamental problem.[3] Between 1950 and 1956, on average, 36 per cent of exports, in value terms, went to the franc area. In 1957 and 1958, the share dropped slightly but was still around 30 per cent.

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[1] Lynch, "Restoring France", p.65.

[2] For an in-depth analysis of France's trade performance, see P. Arnaud-Ameller, *La France à l'épreuve de la concurrence internationale 1951-1966*, Armand Colin, 1970.

[3] For a detailed contemporary perspective of the economic and financial relations between France and the franc area see F. Bloch-Lainé et. al., *La Zone Franc*, Presses Universitaires de France, 1956 and C. Perret, "Le Sous-développement des pays d'outre-mer et la politique française actuelle", in *Revue d'économie politique*, July-October 1960, pp.613-633.

Table IV.1: France: distribution of foreign trade by currency areas: 1951-6 (billion francs)

Areas	Imports							Exports							Balance						
	1950	1951	1952	1953	1954	1955	1956	1950	1951	1952	1953	1954	1955	1956	1950	1951	1952	1953	1954	1955	1956
franc area	281	336	360	366	412	415	462	388	547	598	520	547	559	522	+107	+211	+238	+154	+135	+144	+60
rest of world																					
continental OEEC[a]	261	402	391	347	373	473	583	353	420	418	466	518	622	616	+92	+18	+27	+119	+145	+149	+33
sterling area	247	449	435	416	393	421	449	141	209	152	142	153	207	179	-106	-240	-283	-274	-240	-214	-270
dollar area	163	227	215	168	166	197	280	58	110	77	97	95	113	121	-105	-117	-138	-71	-71	-84	-159
others	121	201	191	161	178	168	202	138	198	171	181	196	235	185	+17	-3	-20	+20	+18	+67	-17
total for rest of the world	792	1279	1232	1092	1110	1259	1514	690	937	818	886	962	1177	1101	-102	-342	-414	-206	-148	-82	-413
grand total	1073	1615	1592	1458	1522	1674	1976	1078	1484	1416	1406	1509	1736	1623	+5	-131	-176	-52	-13	+62	-353

a: including their overseas territories.

Source: BIS, annual reports.

The franc area was sheltered from international competition through a nearly impenetrable protectionist wall, allowing French producers to sell their goods at uncompetitive prices.[4]

> Protégées contre la concurrence étrangère, les exportations françaises vers les pays d'outre-mer s'effectuaient à prix élevés, au détriment d'ailleurs des exportations des mêmes produits vers le monde extérieur, moins rémunératrices, plus difficiles à réaliser, mais qui eussent davantage contribué à améliorer l'état de nos réserves en devises.[5]

The sluggish growth of the franc area economies, compared to Western European economies and the USA, explained the stagnation of the growth of French exports at a time when, for example, Germany, which exported to high growth countries, witnessed unprecedented export growth.

While exports refused to grow only protectionism prevented imports from exploding. The combination of export stagnation, in spite of substantial export promotion, and stifling protection to prevent imports from skyrocketing meant that trade dependence remained low, in comparison with most other Western European economies, throughout the 1950s (see table 1 in chapter III). The widespread concern over France's apparently structural trade problems generated a heated controversy over what policies should be implemented to help France solve its external problems.[6] Industry, agriculture, trade unions, and some sections of the Ministry of Foreign Affairs shared a strong dislike for opening up the obviously 'vulnerable' French market to international competition.[7] The trade performance seemed to indicate that France would not be able to stand foreign competition, at least not from other OEEC members, above all Germany.

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[4] J.-M. Jeanneney, *Forces et faiblesses de l'économie française 1945-1959*, Librarie Armand Colin, 1959, p.145. See also Lynch, "Restoring France", p.62.
[5] A. de Lattre, *Politique économique de la France depuis 1945*, Editions Sirey, 1966, p.407.
'Protected against foreign competition, French exports to the franc area were sold at elevated prices, to the detriment of exports of the same products to the rest of the world, which would have been less profitable and more difficult to realize, but which would have contributed more to improving the level of our reserves and currencies.'
[6] for a discussion, see Lynch, "Restoring France".
[7] ibid.

Although there were proponents of trade and payments liberalization, - particularly in the Ministry of Finance -, who argued that only the opening up of the French economy to international pressures could cure inflation and make French goods competitive, there was an over-riding fear and reluctance to remove controls over trade and exchange.[8] Looking back on the 1950s, Maurice Couve de Murville, - Foreign Minister between 1958 and 1968, Economics and Finance Minister in 1968 and Prime Minister between 1968 and 1969 -, criticized what he called "l'ignorance extraordinaire et le poids de préjugés séculaires, qu'on appelle en France le colbertisme, qui imprégnait alors les milieux dirigeants et leur rendaient inconcevable qu'on puisse ouvrir le marché français à la concurrence internationale".[9] In general, there seems to have been a strong belief that free trade was an unobtainable illusion and that in the future controls over trade and payments would continue to be necessary and acceptable policy instruments at the disposal of nation states to regulate their external balances. Thus, Jean Weiller stated in 1958 that "il semble bien qu'après des années de discussion, l'idée d'une simple consécration des libres mécanismes du marché grâce au renoncement aux dirigismes nationaux ne soit généralement plus retenue, du moins dans sa simplicité première".[10] He saw nothing wrong with a system in which "[d]es 'libérations d'échange', dans certains secteurs, à l'intérieur de certaines zones ou régions, au cours de phases plus ou moins longues,

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[8] Pierre Mendès-France, Radical and former Prime Minister, was at the forefront of the critics of French protectionism which he believed was suffocating the French economy. M. Camps, *Britain and the European Community 1955-1963*, Princeton University Press, 1964, p.80.

[9] M. Couve de Murville comment in Institut Charles de Gaulle (ed.), *1958 - la faillite ou le miracle: Le plan de Gaulle-Rueff*, Economica, 1986, p.57.
'the extraordinary ignorance and the weight of century-old prejudices, which in France one terms colbertism, which at the time pervaded the dirgiste circles and made it impossible for them to conceive that one could open the French market to foreign competition'.

[10] J. Weiller, "De la protection rigide aux contrôles souples", in *Revue économique*, No.3, May 1958, pp.341-2 & p.346. Kaplan and Schleiminger stated that "As applied to foreign trade, the system reinforced traditionally high tariff levels." Kaplan and Schleiminger, *The European Payments Union*, p.267.
'it seems that after years of discussion, the idea of the establishment of free market mechanismes due to the renouncement of national dirigismes has generally been abandoned, at least in its initial simplicity'...'trade liberalization, in certain sectors, within certain zones or regions, for longer or shorter periods, can coincide or alternate with a reinforcement of protection or controls for other sectors, zones or regions'.

pourrant fort bien coïncider ou alterner avec un renforcement des 'protections' ou de 'contrôles' pour d'autres secteurs, zones ou régions". In the years immediately following the end of World War II, politicians of all denominations were very attracted by the idea of autarky for the French economy.[11] Similarly, although for other reasons, industry saw great advantages in "une autarcie relative qui permettrait une reconstruction à l'abri des offensives des concurrents".[12] Fear of French inability to compete internationally, combined with politically motivated aims for autarky, created an environment where free trade and payments were viewed with great skepticism. As the 1950s progressed, the political arguments for autarky began to wane. However the fear that French producers would not be able to withstand international competition lingered throughout the decade, thus constituting an important argument against dismantling exchange control and trade discrimination, particularly since it would be difficult to reintroduce them once they had been removed.[13]

Moreover, there was a strong desire in France to ensure the continuation of strong trading links between France and the franc area countries. Since imports from the franc area were consistently lower than exports to it, France's trade balance with the franc area was in constant surplus (see table IV.1). A large share of the trade flows between France and the associated franc area, both from France to the franc area and vice versa, was only maintained through preferential trading arrangements and import barriers preventing the inflow of goods from countries outside the franc area. Without trade discrimination and with general convertibility, French exporters stood to lose sheltered markets, while French

[11] H. Bonin, *Histoire économique de la France depuis 1880*, Masson, 1988, p.167.
[12] ibid.
[13] One of the obstacles was that under the IMF Articles of Agreement the reduction of restrictions led to an attrition of the privileges of Article XIV, since Art. XIV allowed a country, during the transitional phase, to maintain and adapt but not to introduce restrictions on payments and transfers. Gold, *The Fund's Concept*, p.23.

importers would look for cheaper goods outside the franc area. The result would be an erosion of the cohesion of the franc area.[14] According to Lynch, "the Ministry of Foreign Affairs saw the trade and payments arrangements within the French Union as offering a more stable and secure basis for restoring French independence than the closer association with western Europe advocated by the United States and supported by the Ministry of Finance".[15] The political ambitions of keeping together the French union favored trade discrimination and exchange control and were therefore unconducive to convertibility.

In addition to rejecting convertibility for fear of international competition, up until 1958, French policymakers wanted to prevent the rest of Europe from moving to convertibility. In particular, they did not want a breakup of the EPU and a division of Europe into convertible and inconvertible currencies. France benefited from the EPU in two ways. First, as an overall debtor since 1951, France received large automatic credits from the EPU. Second, the settlements mechanism allowed France to offset, at least partially, large deficits with the sterling area, on which it relied for certain key raw materials, with surpluses with the metropolitan OEEC (see table IV.1). Throughout the 1950s, France ran trade deficits with the sterling area and the dollar area, whereas its trade balance was generally in surplus with the metropolitan OEEC and the franc area.[16] A breakup of the EPU, initiated most likely by the UK, would disrupt the settlement mechanism between the sterling area, France and the OEEC, and it would force France to settle its sizable EPU debts with its trading partners. Table IV.2 shows net annual credits or surpluses within the EPU during the course of the existence of the EPU. By the end of

[14] see, de Lattre, *Politique économique*, pp.407-9; Lynch, "Restoring France", p.62; Camps, *Britain*, p.83; Patterson, *Discrimination*, pp.234-5.
[15]Lynch, "Restoring France", p.70.
[16] Milward, *The European Rescue*, p.369.

1958, France had accumulated a total debt of just below $3 billion. As a result, France would be deprived of the chance of recovering the gold and foreign exchange paid to the surplus countries during the existence of the EPU and would instead be forced to settle on the spot its substantial debts with its EPU creditors. The fact that Germany was the biggest creditor in the EPU and that France would have to negotiate its debts with the loser of World War II was a particularly humiliating prospect. France had not given up the hope of becoming an EPU creditor and thus being able to recover, upon dissolution of the EPU, a portion of the gold and dollars it had paid out as EPU debtor.

Table IV.2: Net annual surpluses (+) or deficits within EPU 1951-8 (1 July - 30 June) (million US dollars)

	1950-1	1951-2	1952-3	1953-4	1954-5	1955-6	1956-7	1957-8	1958[a]
Austria	-104	-38	+42	+106	-103	-6	+23	-4	+24
Bel.-Lux.	+236	+509	-33	-55	+80	+222	+14	+153	+66
Denmark	-68	+46	-17	-92	-94	+4	-43	+10	-1
France	+194	-602	-417	-149	+115	-180	-969	-576	-317
FRG	-281	+584	+260	+518	+296	584	+1336	+826	+350
Greece	-140	-83	-28	-40	-27	+40	+5	+7	-49
Iceland	-7	-6	-4	-5	-2	-4	-3	-3	-9
Italy	-30	+194	-223	-210	-225	-125	-94	+219	+73
Netherlands	-270	+477	+139	-42	+84	-62	-36	+86	+181
Norway	-80	+21	-59	-61	-70	-27	+41	-78	-30
Portugal	+59	+28	-23	-19	-59	-27	+41	-78	-30
Sweden	-59	+284	-44	-37	-104	+6	+111	-30	+11
Switzerland	+11	+158	+85	+73	+10	-66	-83	-189	+20
Turkey	-64	-96	-50	-94	-38	-27	-36	-50	-14
UK	+604	-1476	+371	+107	+136	-327	-225	-317	-267

a: 1 July to 27 December

Source: reproduced from Milward, *The European Rescue*, p.364.

In early 1954, the French government feared that the British were preparing to establish sterling convertibility some time after July 1, 1954 and at the latest by 30 June, 1955.[17] French policymakers also anticipated that such a move would be followed by Germany, the Netherlands and Belgium. Aside from the disadvantages associated with the breakup of the EPU, a move by the UK, Germany and perhaps other EPU members would leave France with the unpleasant choice of "retaining a non-convertible currency or being forced into a more competitive multilateral system at a time not of its own choosing".[18]

> If the franc did not become convertible this would obstruct the workings of the ECSC through which the French steel industry was exporting increasing amounts of steel to the German Federal Republic. It would also undermine the modernization of French industry which was being stimulated with imports of German machines, machine tools and parts - the demand for which far exceeded the capacity of France itself to supply. But if the franc did become convertible then French industry would lose most of the protection which it enjoyed in the French overseas territories.[19]

If the franc remained inconvertible then sterling convertibility meant that France would no longer be able to offset its deficits with the sterling area with its surpluses with other countries which might not have gone convertible, such as Turkey, Greece, Italy, etc.[20] Thus, France's deficits with convertible currency countries would increase. But if the franc became convertible, France would lose an important import barrier, and there would be pressure to remove discrimination against imports from the dollar area.[21] In a note for the President of the French Republic, the Economic and Financial affairs in the Ministry of Foreign Affairs claimed:

> On peut légitimement se demander si l'Europe Occidentale est mûre pour la convertibilité. Le redressement spectaculaire de l'économie européenne depuis 1945 ne s'explique-t-il pas, dans une large mesure par les mécanismes de paiements créés dans le cadre de l'O.E.C.E. d'une part, et par la politique de discrimination commerciale à l'égard de la zone dollar d'autre part?[22]

[17] AEF B44744, "Les conséquences de la convertibilité", May 24, 1954.
[18] Lynch, "Restoring France", p.67.
[19] ibid.
[20] AEF B44744, "Les conséquences de la convertibilité", May 24, 1955.
[21] ibid.
[22] MAE DE CE 203, "Note pour le Président", "a.s. Convertibilité des monnaies" from the Director of Economic and Financial affairs, May 24, 1955.

'One can legitimately ask one self whether Western Europe is ready for convertibility. Cannot the spectacular recovery of the European economy since 1945 be explained, to a large extent, by the

Throughout most of the 1950s, trade considerations led France to reject the establishment of convertibility not only for themselves, but also for the other European currencies, and thus to do everything in their power to prevent Britain, and other countries, from establishing convertibility.[23] French efforts to prevent other countries from establishing convertibility correspond to simultaneous French initiatives to prevent other European countries, for example, Belgium, from abolishing trade discrimination.[24] The aim was to delay Europe's return to convertibility until France's internal economy was stable and competitive so as to allow it to liberalize its trade and payments.[25]

In addition to trade considerations, a British or German move to convertibility without French participation was likely to be interpreted as a sign of weakness, undermining further the international position of the franc. According to the above mentioned report, the political consequences would be a weakening of European political cooperation, and a weakening of France's international political power in favor of a "direction anglo-américaine".[26] A French decision to follow the pound into convertibility, however, would expose the French economy to precisely those risks and incur precisely those costs which policymakers had sought to avoid by postponing convertibility in the first place.[27] In order to avoid these dilemmas, France not only put off establishing convertibility for the franc but also pursued a policy aimed at ensuring that Britain and

payments mechanisms created within the framework of the OEEC on the one hand, and by the policy of commercial discrimination of the dollar zone on the other?'

[23] AEF B44744, "Le handicap de la France dans la course à la convertibilité", June 10, 1954.

[24] For an account of French efforts to stop other countries from adopting universal non-discrimination, see, Patterson, *Discrimination*, pp.96 and 106-7.

[25] AEF B44744, "Le handicap de la France dans la course à la convertibilité", June 10, 1954.

[26] AEF B44744, "Le handicap de la France dans la course à la convertibilité", June 10, 1954.

[27] Among other things, convertibility would have forced France to abandon its policy of multiple exchange rates. Starting in early 1952, France subsidized exports up to 15 per cent, while imports were taxed up to 20 per cent, with the aim of stimulating exports while curbing import demand. The result was an effective devaluation, with importer having to pay more francs per foreign currency unit, whereas exporters received more more francs per foreign currency unit. J.-P. Patat and M. Lutfalla. *Histoire monétaire de la France au XX^e siècle*, Economica, 1986, pp.146 & 157.

Germany did not establish convertibility. Policymakers wanted to ensure that Britain stayed in the EPU and out of convertibility.

In France, trade considerations, if anything, influenced policy against the establishment of convertibility. France's trade performance was not conducive to rapid progress towards convertibility since convertibility would only make it more difficult to contain import growth while not helping exports. On the contrary, the initial effect of convertibility was likely to be a reduction in exports as franc area countries shifted their purchases away from France and towards cheaper producers of industrial goods. Many countries of the franc area did not have tariffs. This meant that exchange control was the principal means of ensuring "privileged access for French exports".[28] The fear was that, "[n]ot only would convertibility open up these markets to foreign competitors but it would reveal the full extent of French privilege at a particularly sensitive time politically".[29] Moreover, a move to non-resident convertibility would have increased French dollar payments, since France was in overall deficit with the non-franc area (see table IV.1).[30] It is not surprising, therefore, that French governments were very reluctant about convertibility, especially when they were keenly aware of the fact that "[l]es sondages effectués en France ont confirmé, ..., que les milieux économiques français appréhendaient très vivement le retour à la convertibilité et qu'ils en différeraient volontier l'échéance pendant des années".[31]

Trade considerations, that is trade dependence and distribution as well as trade

[28] Lynch, "Restoring France", p.67.
[29] ibid.
[30] In contrast Germany stood to increase its dollar earnings as a result of convertibility (see chapter III).
[31] MAE DE CE 198, French Ambassador to the FRG (A. François-Poncet) to Pinay "a.s. du rétablissement de la convertibilité", June 24, 1955.
'Opion polls carried out in France have confirmed, ..., that French economic factions dreaded the return to convertibility and that they would gladly defer its occurrence for several years'.

policy, played an important role in explaining France's unwillingness to establish convertibility, or allowing other countries in Europe to establish convertibility, at least up until 1956. France's insistence that social charges had to be harmonized among European countries before trade, and, implicitly, payments, could be freed seemed to indicate that trade and payments liberalization were part of a distant and uncertain future.[32]

POLICY ON CONVERTIBILITY

BEFORE 1958: THE PRIMACY OF THE 'RELANCE'[33]

French economic policy after World War II was defined by the aim of restoring and modernizing France's productive capacity and the pursuit of economic expansion to raise average living standards.[34] Already during the German occupation period, politicians and academics in the French resistance movement drafted detailed plans and proposals for sweeping economic reforms, which should be implemented when France was liberated. The common theme in these proposals and reports was the desire to restore France's position as a great power. This was to be achieved by an interventionist and dirigiste economic policy aimed at increasing production and expanding the

[32] Camps, *Britain and the European Community*, pp.36-7, 65, 71-2 & 79.
[33] The term is generally used to describe the policy of getting France back on its feet economically by restoring the productive apparatus.
[34] For a discussion of French post-war economic policy orientations, see, for example, Bonin, *Histoire économique*, F. Braudel and E. Labrousse (eds.), *Histoire économique et sociale de la France: Tome IV: L'ère industrielle et la société d'aujourd'hui (siècle 1880-1980)*, Presses Universitaires de France, 1982, F. Caron, *An economic history of modern France*, translated by Barbara Bray, Columbia University Press 1979, H. Koch, *Histoire de la Banque de France et de la Monnaie sous la IV République*, Dunod, 1983, De Lattre, *Politique économique*, pp.446-486, Jeanneney, *Forces et faiblesses*, 1959, S. Nordengren, *Economic and Social Targets for Postwar France; Studies of Frech Economic Planning, Social Development and Industrial Structure 1940-1962*, Lund University, 1972, P. Petit, "Expansionary Policies in a Restrictive World: The Case of France", in Guerrieri and Padoan (eds.), *The Political Economy*, pp.231-263, Saint-Paul, "Economic Reconstruction", and Sautter, "France".

economy to ensure that France could revive its economic power and independence.[35] The reports generally advocated a nationalization of important sectors of industry and protection from international competition while France was in its expansionist phase, combined with medium-term plans and targets for expansion, production, prices and wages. These proposals set the tone for the economic policy orientation after the liberation.

The first post-war government under de Gaulle undertook a series of nationalizations, which included the coal mines, the central bank, the main car manufacturer Renault, the four major deposit banks, the insurance system and public utilities. In addition, prices and wages were heavily controlled. "As a result", Gilles Saint-Paul wrote, "the French economy was organized on a basis quite different from that which prevailed in the prewar period, when free-market principles were more influential: 25 percent of the workforce was employed in the public sector - about twice the prewar figure".[36] Thus, in the late 1940s and throughout most of the 1950s the French economy was characterized by a high degree of state intervention, planning and regulation. The makers of French economic policy generally believed that the way to restore France's economic prowess was through planning and policies aimed at promoting production. Contrary to the policies pursued before World War I, after World War II, the liberalization of the economy was not a top priority. Rather controls on prices, domestically, and trade and payments, externally, were seen as instruments which were used to achieve the goals of reconstruction and full employment. Many economic and political factions in France questioned the desirability of opening up France to foreign

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[35] See, for example, the "Rapport sur la politique économique d'après-guerre", written by the Comité Général d'Études (C.G.E.), a research organ made up of academics and politicians, and the writings by socialist Léon Blum and by Maxime Blocq-Marcart, one of the leading figures in the French resistance movement, all of which are discussed in Nordengren, *Economic and Social Targets*, pp.32-65.

[36] Saint-Paul, "Economic reconstruction", p.85.

influences through the liberalization of trade, payments and capital flows. Contrary to in Britain and Germany, some form of autarky was considered the best policy choice for France economically and politically.[37] Once France had become competitive and the economy expanded sufficiently, trade, exchange and price controls could be lifted. Thus, analogously to the infant industry argument, in the early postwar period, French governments argued that economic reconstruction and the restoration of productive capacity had to come before liberalization. Attributing this policy orientation to historically proven tendencies, Thierry de Montbrial claimed that "[s]uivant l'inclination traditionnelle des Français, les gouvernments de l'après-guerre avaient choisi de reconstituer l'appareil productif du pays en le préservant de la concurrence étrangère".[38] As the trade section has shown, the poor performance of France's exports and the high demand for imports made French governments very reluctant towards convertibility, leading them instead to pursue a protectionist trade policy combined with tight exchange controls.[39] In general, convertibility conflicted with the dirigisme which characterized French economic policy after World War II and with the desire to isolate the economy from foreign influence and competition until it had regained its economic prowess.

[37] According to Bonin, after World War II France faced the conscious choice between imperial and protectionist autarky and "l'ouverture à la «comparaison» des forces et faiblesses". He claimed that "[d]ans les années 1945-1950, la majorité des hommes politiques - en particulier- et des patrons français sont partisans d'une autarcie relative qui permettrait une reconstruction à l'abri des offesnsives des concurrents". Bonin, *Histoire économique*, pp.165 & 167.

[38] T. de Montbrial, "L'Économie française en 1958", in Institut Charles de Gaulle (ed.), *1958*, p.9. 'Following the traditional French inclination, the post-war governments had chosen to reconstruct the productive apparatus of the country by protecting it against foreign competition.'

[39] According to René Girault, France's participation in the European Common Market might be interpreted as a continuation of France's protectionist trade policies, since the Common Market's external tariff, on which France insisted adamantly, sheltered the French economy within a slightly increased internal market from the competitive pressures of the global market. R. Girault, "Les relations économiques avec l'extérieur (1945-1975): mutations et permanences", Chapter VI in Braudel and Labrousse (eds.), *Histoire économique*, p.1381.

The primacy of the relance in French economic policy after World War II also implied that governments ignored the financial constraint or considered it of secondary importance. Similar to Germany, France emerged from World War II carrying the burden of a history of inflation and currency instability. Contrary to Germany, however, the French franc did not benefit from a substantial currency reform, an independent central bank or a general consensus on the importance of price stability, all of which contributed to restoring monetary stability and credibility in the German currency.

Table IV.3: France: annual inflation rates, 1946-1959 (per cent)

1946	28.0
1947	26.5
1948	4.8
1949	4.8
1950	8.6
1951	23.0
1952	3.1
1953	-0.6
1954	1.1
1955	2.5
1956	5.0
1957	7.9
1958	9.1
1959	5.9

Source: Saint-Paul, "Economic Reconstruction", p.86.

With the benefit of hindsight, most observers today blame fiscal and monetary policy for France's inflationary problems in the 1940s and 1950s. Between 1950 and 1958, France's average inflation rate was 5.7 per cent (see table IV.3). In this time period, France's inflation rates varied widely from year to year, between 23.0 per cent in 1950 and -0.6 per cent in 1953. Germany experienced much lower inflation and much less variability in inflation than France in the same time period.[40] Measured by the large swings in inflation, France experienced much more drastic stop-go cycles than Britain. In

[40] See table 4 in chapter I for an international comparison of means and standard deviations of inflation rates between 1946 and 1958.

France, periods of rampant inflation and strong economic growth, encouraged by lax fiscal and monetary policy, were abruptly replaced by periods of price stability, resulting from drastic government measures aimed at halting inflation.[41]

The erosion of the franc can be attributed to a conscious policy choice in favor of expansion and against monetary stability. Thus, René Girault claimed that, after World War II, the French government made a conscious choice in favor of growth and against currency stability. He stated that:

> malgré de traditionnelles déclarations officielles sur la défense de notre monnaie, un choix relativement aisé est fait en 1945-1946: mieux vaut relancer et reconstituer les forces productives plutôt que donner la priorité au maintien de la valeur du franc; au demeurant l'austérité dont font preuve au même moment les Britanniques était-elle possible dans une France économiquement bouleversée, politiquement agitée, socialement changeante? On peut en douter...[42]

Whereas in Germany, price and currency stability were goals of top priority, and whereas in Britain, concern for the external value and the key currency status of the pound at least confined expansionary monetary policy to certain limits, in France the stability of the franc came a long way after the goal of economic growth on the list of policy priorities. Henri Koch claimed that, in the post-war period and at least up until 1958, "le franc semble avoir été sacrifié à l'expansion, le monétaire à l'économique".[43] Koch blamed lax and misguided fiscal and monetary policy for France's inflationary problems:

> Une fausse interprétation de la pensée de lord Keynes, selon laquelle le déficit des finances publiques peut être un stimulant pour une économie faiblissante, a conduit à appliquer ce stimulant, même en période de plein-emploi des moyens de production. Une politique trop laxiste en matière de prix agricoles, et partant de

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[41] Sautter claims that the inflation swings "were largely the result of changing economic behaviour and eocnomic policies". Sautter, "France", p.450. see also Caron, *An economic history*, pp.319-323.

[42] Girault, "Les relations", p.1388.

> 'in spite of traditional official declarations on the defense of our currency, a relatively easy decision was made in 1945-1946: better to relaunch and restore the productive forces rather than give priority to the preservation of the value of the franc; incidentally the austerity which the British are currently displaying would it be possible in France which is economically shaken, politically agitated, socially changing? One might question this...'

[43] H. Koch, *Histoire de la Banque de France*, p.370.

'the franc seems to have been sacrificed to expansion, the monetary [realm] to the economic'.

salaires, a poussé de son côté à l'inflation.[44]

Similarly, Patat and Lutfalla claimed that the priority accorded to expansion over monetary stability constituted "une des grandes faiblesses du premier plan de modernisation et d'équipement, dans lequel les orientations financières et monétaires tiennent une place très modeste".[45]

The period of relative price stability, between 1953 and 1955, can be explained by a fortunate combination of large inflows of US aid to cover military expenditure in Indochina, favorable international economic conditions, - in particular, low international raw material prices -, and a temporary improvement in consumer confidence, rather than by the abandonment of inflationary financial policies.[46] The persistence of inflationary pressures even in the years when inflation remained moderate is reflected in the liquidity ratio which compares the money supply (M2) to GDP (see table IV.4). This ratio increased in from 28.9 per cent to 34.9 per cent between 1952 and 1955.

Table IV.4: Liquidity ratio in France (M2/GDP), 1950 to 1958 (per cent)

1950	31.1
1951	29.2
1952	28.9
1953	30.8
1954	33.1
1955	34.9
1956	34.8
1957	33.8
1958	31.6

Source: M2: Koch, *Histoire de la Banque de France*, table IV, p.410; GDP at market prices:

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[44] ibid, p.371.

'A misinterpretation of Lord Keynes's theories, according to which government expenditure can serve to stimulate a sluggish economy, has led to the application of this stimulus, even in periods of full employment of the means of production. A too lax policy regarding agricultural prices, and, consequently, vis-à-vis salaries, in turn boosted inflation.'

[45] Patat and Lutfalla. *Histoire monétaire*, p.121.

[46] Thus, according to Patat and Lutfalla, "la politique financière menée entre 1953 et 1955 était lourde de potentialités inflationnistes, potentialités qui ne se sont pas manifestées durant cette période car, et c'est là le plus grand mérite des responsables de l'époque, un climat de confiance avait été instauré". Patat and Lutfalla, *Histoire Monétaire*, p.139.

'the financial policy pursued between 1953 and 1955 was laden with inflationary potential, a potential which did not manifest itself during this period because, and this is the biggest achievement of the policymakers at the time, a climate of confidence had been established.'

OECD Statistical Bulletins, General Statistics, 1962.

Moreover, budget deficits remained high, especially when compared to British and German figures (see table IV.5). A highly regulated and therefore rigid labor market, wage indexation, and the lack of competition in many sectors due to nationalization, regulations, cartelization and protectionism made inflation a structural phenomenon in the 1950s.[47] In addition, a policy of easy credit and the generous financing of budget deficits, contributed significantly to growing inflationary pressures.

Table IV.5: Government deficit or surplus (per cent of GNP): 1950-1958

	France	Germany	UK
1950	-5.9	-0.7	2.9
1951	-4.2	-0.6	-1.3
1952	-6.2	0.6	-3.6
1953	-5.6	1.0	-1.6
1954	-5.0	0.9	-0.2
1955	-4.6	1.1	-0.9
1956	-5.8	0.6	-0.6
1957	-5.0	-1.1	-1.1
1958	-2.7	-0.1	-0.9

Source: IMF, *International Financial Statistics.*

The nationalization of the French central bank confirmed the priority attributed to the economic expansion at the expense of monetary stability. Deprived of its independence after World War II, the Banque de France had to provide generous credits to finance government deficits, and was severely restricted in its ability to defend the stability of the currency. "Newly nationalized at the end of 1945, it had become an instrument of the Finance Ministry. Lacking a fixed term of office, its Governor served at the pleasure of the government and could readily be replaced. His power rested wholly on his ability to

[47] F. Caron and J. Bouvier, "Indices majeurs" in Braudel and Labrousse (eds.), *Histoire économique*, p.1019. For a contemporary assessment of the French economy, see the annual reviews "La France économique en ..." in the July-October issues of *Revue d'économie politique*. See also J.-M. Jeanneney, "Les recessions françaises d'après guerre" in *Revue économique*, No. 6, November 1957, pp.939-978.

persuade the Finance Minister to accept his advice."[48]

In addition to fiscal policy and the loss of central bank independence, the political situation after World War II was not conducive to a policy of stable money:

> The two main characteristics of the French economy during the 1945-1959 period are, first, the persistent climate of political and economic instability: governments were rotating at a dizzying pace, budgetary and balance of payments crises were recurrent, inflation was rarely controlled, and so forth; and second - this was a novelty compared to the prewar period - the major involvement of the state in all sectors of the economy, in particular in the financial sector and heavy industry.[49]

Whereas in Germany the trio Adenauer, Erhard and Vocke ensured consistency in economic policymaking throughout the 1950s, in France, the frequent changes in top-level figures and political parties resulted in a zigzag path in economic policy, further complicating the already difficult task of reconstructing the French economy while maintaining monetary stability. The large electoral support of the Communist party deterred French governments from implementing unpopular expenditure cuts or stricter monetary policy. Kaplan and Schleiminger wrote:

> A quarter to a third of the electorate voted regularly for a Communist party that promised all sorts of material beneficence. The other political parties of the Fourth Republic had to combine in an endless succession of short-lived cabinets, each unwilling to emphasize anti-inflationary policies. Entitlement programmes and housing subsidies soon became exceedingly generous, and concessions were made repeatedly to the unremitting demands for higher wages.[50]

The history of franc instability combined with the clear post-war government commitment to growth and the lack of competition both in labor and product markets eroded confidence in the franc, inducing people to hold their wealth in gold or abroad and in foreign currencies, rather than at home in francs. As Bloomfield observed in 1954:

No major country has, over the years, suffered more from wars and from

[48] Kaplan and Schleiminger, *The European Payments Union*, p.268.
[49] Saint-Paul, "Economic reconstruction", pp.83-4. See also Koch, *Histoire de la Banque de France*, p.371.
[50] Kaplan and Schleiminger, *The European Payments Union*, pp.267-268.

continuous internal and external depreciation in the value of its money. As a result, the French people have long since become exceedingly conscious of and sensitive to these developments and rumors of such; and the tradition has been firmly established of keeping substantial funds abroad, and of hoarding gold, to ensure against such contingencies. In such a psychological atmosphere, every little development that would seem to presage inflation, exchange depreciation, or war is sufficient to provoke a flight of capital.

The major financial and political disturbances that have occurred in France during the postwar years, including inflation, exchange depreciation, internal political instability, and war scares, have perpetuated and indeed intensified this capital flight sensitivity on the part of the French people.[51]

Bloomfield referred to "unofficial estimates, of uncertain value", which, "generally place the total of French postwar capital flight into hard currencies and gold at between 400 million and 600 million dollars a year".[52]

In light of the weakness of the French franc, convertibility was certain to unleash a run on the franc, not by foreign holders, as in Britain, but by French residents anxious to move their wealth into more stable currencies.[53] Thus, in contrast to the British situation, policymakers worried more about resident conversions of the franc than about non-resident holdings of French franc, that is, francs held by non-residents of the franc zone, which were very limited.[54]

In 1952, a committee of economists, members of the central bank and some politicians, convened to discuss convertibility as a possible solution to France's

[51] Bloomfield, *Speculative*, p.42.
[52] ibid., p.43.
[53] The weakness of the French franc is clearly reflected in the bank note rate shown in figure 1 in chapter III.
The French tendency to hoard gold, due to the lack of credibility of the government's ability to check inflation, is mentioned in a report from a Bank of England official in BoE OV45/91, "Paris: Sundry points of interest, supplementary to Mr. Bridge's memorandum of the 21st November 1952", by E.M.H., March 12, 1953.
[54] It is very difficult to obtain figures of non-resident holdings. In 1955, the Director of Finance and Economics in the Ministry of Foreign Affairs noted that "les avoirs en francs des non résidents de la zone franc sont très peu élevés". MAE DE CE 203, "Note pour le président" "a.s. Convertibilité des monnaies", from the Director for economic and financial affairs, May 24, 1955. Similarly, the Bank for International Settlements stated in its 24th annual report in 1954 that "there are no great amounts of French francs in the hands of residents of other countries". BIS, *24th Annual Report April 1, 1953 to March 31,1954*, p.129.

monetary problems.[55] The three principal questions addressed were, first, whether gold convertibility could restore monetary stability, second, whether, and under which conditions, convertibility could be maintained, and, third, whether, once monetary stability was reestablished, convertibility would become superfluous. Among the committee of experts, there were several fervent advocates of currency convertibility, among them Wilfried Baumgartner, the governor of the Banque de France who spoke of "ce paradis terrestre où toutes les monnaies seraient convertibles".[56] The advocates argued that gold convertibility assured monetary stability by imposing monetary discipline on the government and by securing confidence in the currency in addition to facilitating trade. They claimed that the problem with the existing system of inconvertible currencies was that budgetary discipline was viewed not as an unconditional impossibility but as one of several policy choices.

The opponents of convertibility argued, in contrast, that convertibility severely hampered the government's ability to manage the economy. They contended that full employment combined with a satisfactory standard of living could not be assured when the franc was convertible. Moreover, they argued that convertibility was not a wonder drug against inflation. In spite of the differences in opinion, the experts generally agreed that convertibility could not be established unilaterally by France alone. The general conclusion reached by the group of experts was that financial discipline and the restoration of monetary stability should become a top government priority since a sound currency was crucial for a stable and favorable economic development and for an improved trade performance.[57] Contrary to British policymakers and some economists

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[55] Conseil économique, *Étude sur la remise en vigueur d'une monnaie librement convertible en or*, Études et travaux No.24, Presses Universitaires de France, 1952.
[56] Conseil économique. *Études sur la remise en vigueur*, p.11.
'this earthly paradise where all the currencies would be convertible'.
[57] ibid., p.16.

who argued that insufficient international liquidity and other exogenous factors undermined the pound, the expert committee pointed out that external causes could not be blamed for France's problems, and it rejected devaluation as a single-handed remedy for France's inflationary and trade problems. Contrary to Britain, in France aspirations for international key currency status do not appear to have played a crucial role in France's policy on convertibility. Comparing the franc to sterling in 1956, the Director of External Finance in the Finance Ministry observed that in the case of France, "les considérations de prestige monétaire sont relativement secondaires en raison du rôle très limité que remplit le franc en tant que monnaie internationale".[58] For this reason, among other things, the director argued, the creation of a transferable franc identical to transferable sterling was not considered. Domestic economic concerns, thus, played a greater role in determining French policy on convertibility than considerations regarding a potential international key currency status for the franc.

In the postwar period, US aid was a controversial issue in France which also surfaced in connection with convertibility. US aid alleviated significantly France's balance of payments problems in the 1950s, turning deficits into surpluses in 1950 and 1953 (see tables IV.5 and IV.6).[59] In 1955 and 1956, a large part of the US aid was in the form of military aid for the war in Indochina. Overall, France relied on US assistance to finance its budget deficits, to increase its foreign exchange reserves and to offset external deficits. While foreign aid was viewed as necessary to stabilize the balance of payments, it

[58] AEF B44242, Memo by the Directeur des Finances extérieures: "Note pour le Ministre - Objet: Évolution du régime des paiements internationaux - convertibilité et 'transférabilité' des monnaies européennes." February 20, 1956.
'considerations of monetary prestige are relatively secondary due to the very limited role which the franc plays as international currency'.
[59] Koch, *Histoire de la Banque de France*, pp.195-199.

seriously piqued French national pride. Jean-Marcel Jeanneney, member of the Rueff committee which designed the 1958 economic reform, characterized France's dependence on US aid as "à la fois moralement humiliant et politiquement dangereux".[60] His impression was that "tous les fonctionnaires ou économistes français ressentaient profondément cette humiliation dès qu'ils se trouvaient en contact avec des étrangers".[61] Aid was particularly resented because it gave the US a right to assess and even interfere in France's economic policy.

Table IV.6: US aid to France, 1948-1956 (million US dollars)

1948	1,366
1949	612
1950	480
1951	480
1952	340
1953	340
1954	507
1955	537
1956	96

Source: *Revue d'économie politique*, July-October 1956, p.533 and July-October 1957, p.767, and Institut Charles de Gaulle (ed.), *1958*, chapter I.

The resentment over France's reliance on American goodwill and money flared up particularly in connection with convertibility in 1954 and 1955. In 1954, and again in 1955, it seemed possible that Britain or Germany or both would move to convertibility soon. The US Finance Ministry judged the situation to be favorable for France to use the opportunity to combine franc convertibility with a devaluation.[62] Pierre Mendès-France, Foreign Minister at the time and future Prime Minister, vehemently opposed the establishment of convertibility for the franc, arguing that the French economy was not

[60] Jeanneney comment, Institut Charles De Gaulle (ed.), *1958*, chapter I, p.17.
'both morally humiliating and politically dangerous'.
[61] 'all French civil servants and economists acutely resented this humiliation when they were dealing with foreigners'.
[62] Lynch, "Le franc français 1952-1956: Le débat sur la convertibilité", in Comité pour l'histoire économique et financière de la France (ed.), *Du franc Poincaré à l'écu*, Colloque tenu à Bercy les 3 et 4 décember 1992, Presses de l'imprimerie nationale, 1993, p.390.

sufficiently prepared for the step. He criticized US aid for concealing the gravity of France's balance of payments problems and for making France dependent on foreign aid. France should not move to convertibility until it was strong enough to do so on its own, that is, without foreign help. Therefore, what was needed, was an improvement in French competitiveness, budgetary consolidation and greater price stability. He advocated opening the French market up to foreign competition.[63]

France was much more sensitive and hostile to foreign intervention in its economy and economic policy than Germany. One of the paramount concerns of French policymakers was that nobody, in particular not the US or UK, should have the power to interfere with, or shape its policy decisions.[64] According to Hanrieder, the need for political and economic independence and diplomatic self-reliance conflicted sharply with the need to participate in European integration and the dependence on US aid. The strong French reaction to its dependence on foreign aid can be explained by what Hanrieder called "a quest for self-definition and self-assurance after living through the humiliating conditions of the German occupation and the political uncertainties that followed in the wake of the liberation". The goal was to regain "freedom of action, flexibility of diplomacy, international prestige, and national pride".[65] In 1955, the Director of Economic and Financial affairs wrote that:

> l'adoption par la France de la convertibilité, qui suppose la ratification, par le Parlement, du GATT et, de la part de la France, la recherche d'un soutien positif auprès du Fonds Monétaire International, nous mettra obligatoirement dans un état de dépendance accru à l'égard de la politique américaine et de la politique britannique ... Dans la mesure où nous aurons, en nous engageant dans une telle voie, outrepassé nos forces, nous serons amenés à solliciter une aide et des dérogations auprès due GATT et du F.M.I., c'est-à-dire auprès du Commonwealth britannique pour le premier de ces organismes, et auprès de la Trésorerie

[63] AEF B44744, Pierre Mendès-France to Edgar Faure, Finance and Economics Minister, July 10, 1954. See also, Lynch, "Le franc", p.390.
[64] See cooperation chapter for discussion on French attitudes toward foreign advice on how to handle economic problems.
[65] Hanrieder, *The Foreign Policies*, pp.115-116 & 119.

américaine pour ce qui est du second. Cette perspective, qui est loin d'être encourageante, devrait à elle seule nous amener à prendre une position restrictive.[66]

Whereas Britain regarded US financial assistance as a prerequisite for a move to sterling convertibility, France ideally wanted to establish convertibility, when it was no longer dependent on US or other foreign aid, and, consequently, when it was no longer forced to listen to foreign advice on how to run its economy.

Table IV.7: French balance of payments, 1950-1960 (million US dollars)

	Balance on goods & services	Overall balance
1950	3	354
1951	-630	-566
1952	-771	-179
1953	-4	168
1954	356	620
1955	506	745
1956	-686	-718
1957	-1,015	-1,305
1958	-492	25
1959	627	1,590
1960	780	485

Source: OECD, *Statistics of the Balance of Payments, 1950-1961.*

Throughout the period, the Banque de France took a more favorable stance towards convertibility than the successive French governments. From 1952 onwards, the stability of the franc was the prime concern of Baumgartner, governor of the Banque de France.[67] He saw convertibility as a way of drawing France out of its inflationary isolation

[66] MAE DE CE 203, "Note pour le président" "a.s. Convertibilité des monnaies", by the Director for economic and financial affairs, May 24, 1955.

> 'the adoption of convertibility by France, which presupposes the ratification, by Parliament, by GATT, and, from the French side, the securing of IMF support, will necessarily put us in a state of increased dependence vis-à-vis US and British policy. ... To the extent that, in committing us in this direction, we will have exceeded our capabilities, we will be forced to plead for financial support and for derogations to GATT and the IMF, that is, to the British Commonwealth first of all, and, secondly, to the US Treasury. This prospect, which is far from encouraging, should, on its own, lead us to take a restrictive position.'

[67] For a discussion of the policies and influence of the French central bank between 1945 and 1958, see O. Feiertag, "Entre la défense du franc et les impératifs de l'économie nationale, les pouvoirs de la

and forcing it to recognize the external constraint. His views are best summarized in his dramatic appeal to Edgar Faure, President of the Republic, in 1952 to preserve the value of the franc: "La monnaie, c'est l'expression de la valeur d'un pays, le franc, c'est la France. La dégradation du franc, c'est l'abaissement de la France."[68] Baumgartner strongly advocated a collective return to currency convertibility. In particular, he worried about the effects of a dissolution of the EPU on France's balance of payments as a result of a move to convertibility by Britain or Germany or both.[69] However, the influence of the French central bank on monetary policy was severely curtailed when it was nationalized in 1945.[70]

The Ministry of Foreign Affairs was a key player in the return to currency convertibility in France. The influence of this ministry be explained by the fact that convertibility was considered an important step for the French economy and for the international economic system. Since the economic recovery of France was considered to be a stepping stone to the international political recovery of France as a major power, the Foreign Affairs Ministry was involved in any issues which were thought to affect the French economy, in particular France's economic relations with the rest of the world. Throughout most of the 1950s the Ministry of Foreign Affairs viewed convertibility as

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Banque de France et de son gouverneur sous la IV[e] République", in Comité pour l'histoire économique et financière de la France (ed.), *Du franc Poincaré*, pp.362-383.

[68] quoted in Feiertag, "Entre la défense", p.374.

[69] "Alors qu'il était nettement favorable au rétablissement de la convertibilité du franc, Baumgartner était conscient des problèmes qui se poseraient au niveau de la stabilité politique et économique du pays si les pays adhérents de l'UEP ne coordonnaient pas leurs politiques au moment du retour à la convertibilité". Lynch, "Le franc", p.394.
'While he was clearly in favor of the return to franc convertibility, Baumgartner was conscious of the problems which presented themselves regarding economic and political stability if the EPU members did not coordinate their policies at in the return to convertibility.'

[70] In 1953, the overseas and foreign office of the Bank of England remarked on the limited power of the Banque de France in matters of exchange control. OV 45/91, "Paris - January 1953", by R.S.W., January 16, 1953. Similarly, Kaplan and Schleiminger claimed that in the 1950s, the French central bank was an instrumetn of the finance miniatry. Kaplan and Schleiminger, *The European Payments Union*, p.268.

something which was more dangerous to the reconstruction of the French economy, and thus to political recovery, than it was beneficial. Frances Lynch asserted that between 1952 and 1956,

> le Quai d'Orsay fut hostile au rétablissement de la convertibilité, en raison à la fois d'une optique impérialiste quelque peu désuète et des doutes que ce ministère nourrissait à l'égard de l'idéal du libre-échange et de la libre convertibilité des monnaies, alors prônés par l'Administration américaine et qu'il prétendait invoqués à la seule fin de protéger les intérêts des grandes puissances.[71]

Up until 1958, the position of French policymakers, both in the Finance and in the Foreign Affairs Ministry, regarding convertibility is best summarized by the statement that France's national interest "n'est surement pas ni de se précipiter dans la convertibilité, ... ni que les autres pays l'établissent, avant qu'elle ait pu combler son retard".[72] In fact, the strongest opposition to convertibility definitely came from the Ministry of Foreign Affairs. The statement by Pierre Sadrin, Director of Economic and Financial Affairs in the Foreign Affairs Ministry, made in May 1955, illustrates the view of that ministry:

> Toute la philosophie de la convertibilité repose sur une fiction, à savoir que les pays, leur monnaie, leurs conditions de développement, leur structure économique, sont à peu près comparables et qu'ils sont, par conséquent, interchangeables. Rien n'est plus faux.
> Les partisans de la convertibilité, pour justifier leur thèse, font miroiter un monde où régnerait la concurrence à l'état pur et la non discrimination. Ils ne poursuivent en réalité que des chimères, dans la mesure où ils ne cherchent pas à atteindre des buts de politique purement nationale.[73]

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[71] Lynch "Le franc", p.394.

> 'The Quai d'Orsay was hostile to the re-establishment of convertibility due to a slightly outdated imperialist point of view and the doubts which this ministry harbored regarding free trade and currency convertibility which were extolled by the US administration and which the ministry claimed were appealed to for the sole purpose of furthering the interest great powers.'

[72] AEF-B44744, "Le handicap de la France dans la course à la convertibilité", June 10, 1954.
'was surely not to rush into convertibility,... nor that the other countries established it before it had been able to catch up.'

[73] MAE DE CE 203, "Note pour le président", "a.s. Convertibilité des monnaies", from le Directeur des Affaires Économiques et financières, May 24, 1955.

> ' The philosophy of convertibility rests entirely on a ficticious idea, that countries, their currencies, their conditions of development, their economic structure, are roughly comparable and that they are consequently, interchangeable. Nothing is more fallacious. The advocates of convertibility, to justify their hypothesis, convey a world where free competition would reign in its pur and non-discriminatory form. In reality they are pursuing an illusion, in so far as they are merely seeking to reach purely national political goals.'

The primacy of political and economic renewal limited the room of maneouvre of the French Ministry of Finance in the return to convertibility. Moreover, throughout the 1950s, convertibility was closely linked to questions of European cooperation and integration, making it a high politics issue.

In 1949 and 1950, the French economy experienced, what turned out to be a brief period of monetary stability, satisfactory growth and a rapid improvement in its balance of payments. As a result, the government started to liberalize trade and remove exchange control. The liberalization measures were based on the expectation that the economy would remain healthy in the future. However, with the outbreak of the Korean War inflation shot up, to 23 per cent in 1951, and France's balance of payments deteriorated rapidly.[74] In response to the worsening external balance, France quickly retreated into protectionism and exchange control, suspending all trade liberalization completely in February 1952. When things improved again, the government ventured back into trade and payments liberalization in 1954 and 1955. As in 1950, however, the period of favorable external balances was ended abruptly in 1956. Again the government deliberalized trade and re-introduced exchange controls. In addition, policymakers resorted to a multiple exchange rate by increasing both import taxes and export subsidies, a practice which ran counter to the spirit of the IMF. The result was an effective devaluation of the franc. While the French ministers were willing to progress towards freer trade and convertibility when the economic situation was favorable, they did not hesitate

[74] According to Patat and Lutfalla, international circumstances initially pushed up inflation but "le relâchement des contraintes de la politique interne y contribue dans une large mesure". Patat and Lutfalla, *Histoire monétaire*, p.125.
'the relaxation of constraints in the internal policy contributed to a large extent'.

to reintroduce trade and payments restrictions when conditions deteriorated. Overall, Gilles Saint-Paul claimed that "[t]here was no increase in openness of the French economy over the period 1946-1959 period".[75] Up until 1958, the resort to trade and payments restrictions, and multiple exchange rates, belonged to a range of discretionary policy tools with which France managed its economy. Official convertibility would have deprived French ministers of the freedom to resort to these three policy tools when the economy was faltering. French policymakers were more than reluctant to give up these instruments.

Currency convertibility conflicted with the general policy orientation in France throughout most of the 1950s. The ability to exchange money freely was incompatible with the protectionism and *dirigisme* with which policymakers managed the French economy.[76] Policymakers agreed that France had very little to gain and very much to lose from establishing convertibility. Successive governments shared the belief that France was not ready to open up its economy until French exports had become competitive, price stability had improved, budget finances had been consolidated, and both residents and non-residents had regained confidence in the franc. The Nathan Commission created to examine the root of France's inflationary problems concluded in 1954 that "la convertibilité du franc ne pourrait être rétablie qu'une fois la stabilité des prix assurée, les échanges libéralisés et le solde extérieur rééquilibré".[77]

In France, convertibility was not attributed the symbolic importance that it was

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[75] Saint-Paul, "France", p.309.

[76] France's financial system after World War II was characterized by pervasive controls and government intervention and allocation. See, for example, J. Mélitz, *Monetary Policy in France*, Centre for Economic Policy Research Discussion Paper No.509, January 1991.

[77] Lynch, "Le franc", p.390. See also de Lattre, *Politique économique*, p.468 and Lynch, "Restoring France", p.66. See also Ministère des Affaires Financières et Économiques, *Commission créée par arrêté du 6 janvier 1954 pour l'étude des disparités entre les prix français et étrangers*, 1954.
'franc convertibility could not be re-established until price stability was assured, trade liberalized and the external balance back in equilibrium'.

in Britain, where it was simultaneously a token of the British claim to its position of international financial power and of the Conservative Party's prestige, and in Germany, where convertibility stood for political and economic normalization. Rather, up until 1958, French ministers viewed convertibility as an important but technical monetary condition, the establishment of which depended purely on the achievement of France's economic reconstruction. Successive governments shared the view that restrictions on trade and payments could not be removed until the French economy had become competitive enough to be opened up to world competition. Since monetary stability was accorded secondary importance, after economic reconstruction, the establishment of convertibility was also relegated to the group of secondary policy goals.

The development of the French economy in the 1950s led to the growing realization, among policymakers, that state intervention, protectionism and exchange control were not having the desired effect of strengthening the French economy. On the contrary, the external balance failed to show lasting improvement and inflationary pressures continued to plague economic stability. In response to this realization, 1958 saw a fundamental change of tactics, which included a change in the policy on convertibility.

CHANGING COURSE

The deterioration

In 1956 and 1957, French economic problems exploded. Inflation accelerated and the balance of payments deteriorated rapidly (see tables IV.3 and IV.8). In addition, budget deficits worsened (see table IV.5). Speculation against the French franc grew at an alarming pace, particularly during the Suez crisis, in August and September 1956, and in the fall of 1957 (see figure 1 in chapter III). From mid-1957 on, the government implemented economic policies that were aimed at improving France's external economic problems.[78] In 1957 Economics and Finance Minister Félix Gaillard suspended liberalization and effectively devalued the franc by 20 per cent. In addition, measures were introduced to reduce rapidly rising budget deficits, which increased from fr658 billion in 1955 to fr1,011 billion in 1956 and fr1,041billion in 1957. The discount rate was raised from three per cent to four per cent in April 1957 and to five per cent in August 1957. Patat and Lutfalla claimed that, starting in spring 1957, France implemented "pour la première fois une politique de limitation de la croissance de la monnaie et du crédit, particulièrement rigoureuse, et qui peut être considérée comme la première expérience francaise d'encadrement du crédit".[79] While the measures were successful in cutting the budget deficit for 1958 back to pre-1956 proportions, they failed to reverse the deterioration of the balance of payments or to reduce inflationary pressures. Moreover, the 1959 budget deficit looked likely to exceed again the fr1,000 billion threshold. Although the combination of restrictive monetary policy, modest budget cuts, the renewed suspension of trade liberalization, and a devaluation, granted brief respite, the policies failed to correct France's external economic problems. France's trade performance continued to indicate a structural inability of exports to offset imports even when exports were subsidized and imports were taxed. In addition, the franc was volatile and reserves remained precariously low.

Accordingly, many observers saw the problems in 1956 and 1957 not as passing

[78] B. de Jouvenel, "France Takes the Big Way", in *The Banker*, February 1959, p.91.
[79] Patat and Lutfalla, *Histoire monétaire*, p.151.
'for the first time a particularly rigorous policy of limiting the growth of the money supply and of credit, which can be considered as the first French experience with credit restriction'.

economic crises, caused by extraordinary circumstances, but as a reflection of the general malaise that had been troubling the French economy since World War II. In this climate of economic crisis, the realization grew that a drastic policy change was necessary. Domestic and foreign criticism of French economic policies became stronger. The OEEC's 1957 economic report openly criticized French policy for its failure to resist inflationary pressures and outlined the need for a policy change to restore monetary stability:

> The crisis that France now faces, like those of the past, is the result of the fact that relatively small adjustments to economic policy were not made at the appropriate moment. As a result, France has tended to live beyond its means and to get itself into difficulties which have hampered rather than stimulated the economic growth of the country...It is essential that adequate steps should be taken now - before the Common Market and proposed Free Trade Area come into effect - to extricate the economy from its present difficulties, and that the rate of development should be limited to the real resources available. Unless such a change occurs, France will be unable to play an appropriate leading role in the creation of a freer trade and payments system and in the consequential strengthening of the economy of Western Europe as a whole.[80]

Elsewhere, French governments were criticized for tackling France's structural problems with temporary solutions.[81] Writing for *The Banker*, Jo Saxe argued that to restore economic stability, one would have to "attack the roots of the malaise, an exercise that no government of the Fourth Republic carried through; few enough had the courage to identify the true causes of weakness".[82]

At home, some contemporary observers blamed the increased military expenditure in connection with the war in Algeria, rising petrol prices, currency instability caused by the Suez crisis, and crop failures for the inflationary pressures that built up in 1956 and 1957.[83] However, a growing number of policymakers correctly interpreted these factors as unfortunate circumstances which only made an already bad situation worse.[84] Guitton

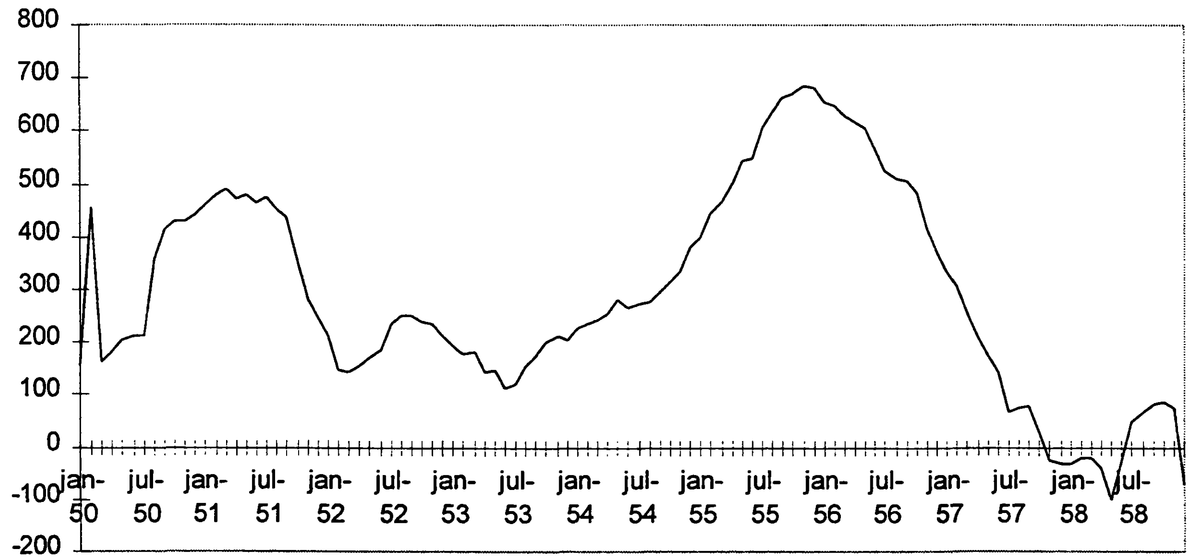
80 OEEC, *Economic Conditions in France, 1957*, p.20.
81 *The Banker*, "Europe's Problem Currencies", July 1957, p.428.
82 J. W. Saxe, "The Economics of de Gaulle", in *The Banker*, July 1958, p.433.
83 A. Grosser, *La IV^e^ République et sa politique extérieure*, Librairie Armand Colin, 1961, p. 349
84 The report by the government commission on the state of France's national accounts asserted: "Ces

spoke of the "hantise...de l'inflation" ('the ghost of inflation') which had been present throughout the post-war period.[85] Persistent inflationary pressures had eroded the franc as illustrated by the three devaluations that had taken place between 1948 and 1957, with a fourth devaluation in 1954/5 only avoided by implementing drastic protectionist measures. In addition to the French central bank and economists, who had warned about persistent inflationary pressures since 1952, by 1957, policymakers began to recognize that inflation was a structural problem.[86] Assessing the situation in July 1957, the Foreign Affairs Ministry's finance and economics section warned, in a report to the President of the Republic, that current measures to reduce inflation, consolidate the budget deficit and deliberalize trade were not sufficient to solve France's economic problems. Only a sweeping economic reform could restore economic stability.[87]

The development of France's foreign exchange reserves reflected very clearly the deterioration of the external situation. By mid-1957, France's reserves had virtually disappeared, having dropped rapidly and continuously from their post war peak in January 1956 of fr656 billion. These figures included France's drawing rights in the IMF, its EPU credit facilities and a special EPU credit, financed mainly by Germany, of $150 million accorded in early 1958.

événements exceptionnels ont rendu plus brutal le retournement naturel de notre balance commerciale, qui date de la fin de 1955".
Le Monde, "C'est la perte de nos réserves de devises qui a été le prix de l'expansion", May 11-12, 1958, p.7.
'These exceptional circumstances have aggravated the natural reversal of our trade balance, which started in the end of 1955.'
[85] H. Guitton, "Avant-Propos", in *Revue d'économie politique*, July-October 1960, p.38.
[86] MAE DE CE 354, "L'instabilité financière en France", July 25, 1957.
[87] MAE DE-CE 362, "Note pour le President", "a.s. Pénurie de devises et politique externe", by the Department of Economic and Financial Affairs of the Foreign Ministry, July 20, 1957.

Figure IV.1: Gold and foreign exchange reserves, 1950-1958 (billion fr) (monthly figures)



Source: Patat, and Lutfalla, *Histoire monétaire*, p.265.

As a result of the continuous deterioration of foreign exchange reserve holdings, by late 1957/early 1958, it was clear to most policymakers that drastic and far-reaching measures would be necessary to improve France's balance of payments and to reverse the large outflow of reserves.[88] In May 1958, the report by the government commission on the state of France's national accounts stated: "C'est la perte de nos réserves de devises qui a été le prix de l'expansion".[89] The recent history of repeated franc devaluations and inflationary pressures had created an environment in which inflationary expectations had become an integral part of people's economic behavior.[90] Inflationary expectations constantly threatened price stability and thus international competitiveness.[91] Only a drastic and far-

[88] MAE DE CE 362, "Note pour le Président, a.s. Pénurie de devises et politique externe", from the direction of economic and financial affairs, July 20, 1957.
[89] *Le Monde*, "C'est la perte de nos réserves de devises qui a été le prix de l'expansion", May 11-12, 1958, p.7.
[90] Jeanneney, *Forces et faiblesses*, p.164.
[91] Arnaud-Ameller, *La France*, pp.73-82.

reaching economic reform could restore credibility in the French franc and thus create the environment necessary for stable growth. The restoration of the stability of the franc had to be the principal objective.

The official establishment of convertibility was regarded as an important step which would profoundly affect the French economy and international economic and monetary relations. A report by the finance and economics section of the Foreign Affairs Ministry from 1955 emphasized that there was a big difference between the gradual relaxation of exchange restrictions which had established de facto convertibility in many countries, particularly Britain and Germany, by 1955 and the official establishment of convertibility, as it took place in 1958.

> [L]a convertibilité de fait se réalise par étapes insensibles, sans porter gravement atteinte aux institutions existantes; surtout elle n'ose pas dire son nom. La convertibilité de droit, au contraire, procède d'une action volontaire et spectaculaire. Elle s'accompagne moins que la convertibilité de fait des nuances et des compromis. Elle repose sur une base psychologique tout autant que sur des droits au profit des tiers; elle vit de leur confiance. C'est pourquoi le rétablissement de la convertibilité rendrait manifestes des contradictions qui ne sont aujourd'hui que virtuelles, cristalliseraient des conflits latents. Elle serait inconciliable avec le maintien de l'U.E.P., elle comprometterait l'œuvre de l'O.E.C.E.[92]

Throughout the 1950s, it was clear to French policymakers that currency convertibility would have to be preceded by or linked with a far-reaching adjustment of the economy.[93]

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[92] MAE DE CE 198, "Note" "a.s. Quelques aspects de la convertibilité", by the Department of Economic and Financial Affairs of the Ministry of Foreign Affairs, April 22, 1955.

> 'de facto convertibility can be realized by inconspicuous imperceptible steps, without undermining existing institutions; above all it does not dare to say its name. Legal [or official] convertibility, in contrast, is a deliberate and conspicuous step. Compared to de facto convertibility it is less characterized by degrees and compromises. Instead it is based as much on psychological foundations as on rights granted to third parties; it depends on their faith. That is why the re-establishment of convertibility would bring to the surface the contradictions which today are only potential, it would cristallize dormant conflicts. It would be incompatible with the maintenaince of the EPU, it would compromise the work of the OEEC.'

[93] AEF B44744, "Le handicap de la France dans la course à la convertibilité", June 10, 1954. and MAE DE CE 203, "Note pour le président" " a.s. Convertibilité des monnaies", from the Director of Economic and Financial affairs, May 24, 1955.

Thus, contrary to Britain, 'a dash to convertibility' was not considered as a policy option, nor as a solution to French economic problems. Neither did French policymakers contemplate a floating exchange rate in connection with the establishment of convertibility.

Up until 1958, the argument that convertibility could only take place after the French economy was stable and competitive was successfully used to justify the postponement of convertibility.[94] By 1958, however, the view of convertibility had changed. French ministers increasingly realized that painful, and, therefore, unpopular, economic adjustment measures would be necessary to restore economic stability. Instead of considering convertibility as something that had to be postponed until the French economy was ready to face international competition, French policymakers now saw collective convertibility as an opportunity which would facilitate the introduction of restrictive monetary and fiscal measures. Thus, Cottier from the Finance and Economics Ministry commented on the "avantage psychologique de la convertibilité elle-même" (the psychological advantage of convertibility itself) which was that it "faciliterait la présentation d'une mesure monétaire" (would facilitate the presentation of monetary measures).[95] "By setting them [measures for trade and payments liberalization, budget cuts, etc.], and the accompanying devaluation, in a wider context of convertibility they could be rendered more palatable politically."[96]

Before 1958, France was not ready to make the sacrifices that a 'cleaning-up' of the French economy would necessitate. However, the balance of payments crisis of 1957

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[94] See, for example, *Le Monde*, "Perspectives monétaires européennes: IV - Le franc", March 7, 1954, p.III.

[95] AEF B44744, "Les Conséquences de la Convertibilité", May 24, 1954.

[96] *The Banker*, "Convertibility - at what Risk?", February 1959, p.81.

and the speculative attack against the franc, exposed the severity of the economic problems. Moreover, the crisis revealed to the French population the full extent of the economic malaise and thus prepared the ground for cooperation in a painful economic adjustment. Thus, the advantage of France's economic problems was that the severity of the crisis ensured that most people understood that a drastic change was needed. De Montrial wrote that between 1956 and 1958 there was an increasingly widespread concern, that France's national identity was "menacée de déclin économique" ('threatened by economic decline') and that financial disaster was imminent.[97] In comparison, such an acute and widespread feeling of imminent disaster was missing in Britain. The advantage of France's economic problems was that the severity of the crisis ensured that everybody understood that a drastic change was needed.

The redressement

After 1957, the stage was set for the appearance of a hard line economic reformer who had been active backstage for years, Jacques Rueff. He designed and orchestrated the economic reform of 1958. However, his importance in the 'redressement' of the French economy must be seen in the context of the political and economic events preceding and accompanying his reforms. Without the political change which occurred in mid-1958, Rueff would not have been commissioned to reform the economy, and even if he had, he would not have been free to take such drastic measures.

The return of de Gaulle to power in May 1958 created a political environment which was vital to the implementation of economic reform. As France's biggest hero of the Résistance in World War II, de Gaulle enjoyed a popularity and public support which

[97] De Montbrial, "L'Économie française en 1958", in Institut Charles de Gaulle (ed.), *1958*, pp.7-9. 'threatened by economic decline'.

few, if any, politicians could ever hope to enlicit.[98] According to Maurice Pérouse, member of de Gaulle's cabinet, the authority of and public faith in de Gaulle were crucial in the public acceptance of the redressement in December 1958, which in turn was vital to its success.[99] De Gaulle came to power at a time when France was exhausted by 13 changes of government since 1950, by the erratic performance of the economy and by the Algerian conflict. The population longed for a strong leader to solve the Algerian conflict, which was tearing the country apart as well as being an important source of France's monetary instability, and to restore both economic and political stability. De Gaulle offered the leadership qualities, which were perceived to be necessary to solve France's problems.[100]

De Gaulle's choice of Antoine Pinay as his Finance Minister was motivated among other things by the latter's association with the economic stabilization that took place in 1952 when Pinay was Prime Minister. At that time the Pinay loan (a large issue of government bonds to finance public borrowing) and a "campaign of 'persuasion' to keep prices down" coincided with a fall in world prices. The result was a temporary halting of France's rampant inflation. Consequently, *The Economist* wrote in 1958: "For millions of Frenchmen the small industrialist from St. Chamond is still the man who brought postwar inflation to an end."[101] In the summer of 1958, Pinay again resorted to

[98] "L'adoption le 28 septembre de la nouvelle constitution par près de 80% des votants confère au referendum une allure de plèbiscite et quelques semaines plus tard l'élection d'Une Chambre Introuvable témoigne à nouveau de la confiance inconditionnelle accordée par la nation au chef qui, en quelques mois, a tout bousculé et tout reconstruit." R. Courtin, "Avant-Propos", in *Revue d'économie politique*, July-October 1959, p.11. See also *The Economist*, "The Gaullist Tide", October 4, 1958, pp.15-16.
'The adoption on September 28 of the new constitution by nearly 80% of the voters confers to the referendum the air of plebiscite and a few weeks later the election of Une Chambre Introuvable reconfirms the unconditional confidence granted by the nation to the leader who, in the course of a few months, has first turned everything on its head and then rebuilt it.'
[99] Pérouse comment in Institut Charles de Gaulle (ed.), *1958*, chapter II, p.64.
[100] "The general alone has the stature to make a national appeal and a past that makes him immune to charges of defeatism." *The Economist*, "France's Misdirected Fury", April 19, 1958, p.187.
[101] *The Economist*, "Opération Napoléon", June 21, 1958, p.1091.

the, apparently proven, remedies of a public loan, through the issue of government bonds, to stabilize public finances. In addition, a number of measures aimed primarily at restoring confidence in the franc, such as limits on salary raises, de-indexation of agricultural prices, and supplementary taxes. Finally, the automatic allocation of F35,000 in travel allowance for French tourists was suspended. As in 1952, Pinay relied on what Didier Bévant called a doctrine of "rigueur et confiance" ('rigor and confidence') to cure the French economy.[102]

When it became clear in late summer 1958 that the Pinay measures were not producing the same success as in 1952, Jacques Rueff was appointed to head a committee of financial experts, bankers, economists and government officials, which was to examine the state of French economy and suggest policies for improvement. Rueff's economic philosophy differed fundamentally from that of Pinay. Paul Fabra highlighted the differences between the Rueff and the Pinay approach to economic policy in the following comment:

> On faisait ... confiance à la 'politique de confiance', une notion que Jacques Rueff condamne expressément dans la 'note' ... qu'il remet personnellement six ans plus tard le 10 juin 1958 au ministre des Finances Antoine Pinay. Si Jacques Rueff s'en prend à la politique de la confiance, c'est dans la mesure où cette dernière vise, par des mesures destinées à produire un effet purement psychologique - une baisse autoritaire des prix par exemple - à masquer l'absence de toutes dispositions propres à atténuer ou supprimer les causes objectives de l'inflation (déficit budgétaire dépassant les possibilités d'emprunt sur le marché, interventions massives de la Banque de France sur le marché monétaire, etc).[103]

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[102] D. Bévant, "De l'opération de décembre 1958 au 'discours sur le crédit' (décembre 1961), de Jacques Rueff", in Comité pour l'histoire économique et financière de la France (ed.), *Du franc Poincaré*, p.474.
[103] P. Fabra "Le plan de 1958 dans l'histoire économique contemporaine, une voie alternative aux politiques d'austérité", in Institut Charles de Gaulle (ed.), *1958*, p.139.

> 'One was ... placing one's trust in a 'policy of trust', a notion which Jacques Rueff condemned expressly in the 'note' ... which he submitted personnally six years later on June 10, 1958 to the Minister of Finance Antoine Pinay. If Jacques Rueff denigrates the policy of trus, it is insofar as the latter aims, through measures geared to produce a purely psychological effect - an resolute lowering of prices, for example - to conceal the absence of any true measures to weaken or eliminate the objective causes of the inflation (the budget deficit which exceeds the credits available in the market, massive interventions by the Banque de France in the monetary market,

While some observers claim that Pinay persuaded de Gaulle to call in Rueff and a team of experts to restore economic stability, it seems more likely that it was de Gaulle who decided to create a committee under the leadership of Rueff against the opposition of Pinay.[104] Pinay was one of the strongest opponents of the Rueff plan, within the government, when the plan was presented to the cabinet in early December. [105] It is unlikely, therefore, that it was his idea to call in Rueff in the first place. De Gaulle's economic advisor, Roger Goetze, asserts, that "[c]'est ... sur intervention direct du général de Gaulle et malgré les réticences du ministre des Finances ... qu'il fut possible à cette commission [Rueff] de voir le jour en temps utile même si les délais limités fixés pour son travail allaient se révéler très prègnants".[106] An appeal by de Gaulle to the French people to accept the economic sacrifices necessary for the restoration of budgetary balance, monetary stability and French competitiveness in August 1958 shows that de Gaulle actively supported the redressement.[107] This support was crucial to the success of the plan. De Gaulle had two reasons for lending his active support to the economic reforms. First, he had greater international ambitions for the franc than his predecessors.[108] A strong and international currency was a characteristic of international power. To be able to contend with the United States and Britain as great power, France needed a currency that could

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etc.)'

[104] For a discussion, see S. Guillaume, *Antoine Pinay ou la Confiance en Politique*, Presses de la Fondation Nationale des Sciences Politiques, 1984, pp.169-171.

[105] see Guillaume, *Antoine Pinay*, pp.169-179.

[106] Comment by Roger Goetze, technical advisor to De Gaulle, in Institut Charles de Gaulle, *1958*, chapter II p.50. See also comment by Meo who claims that de Gaulle "s'est engagé personnellement dans la réussite de ce plan qui est, avant tout, le sien parce que c'est lui qui l'a rendu possible", in ibid., p.57. 'it was on direct intervention of the General de Gaulle an against the resistance of the finance ministry ... that the Rueff committee was created at the opportune moment even if the time constraint under which the committee had to operate would turn out to be very significant'.

[107] *Le Monde*, "Le General de Gaulle: je demande à tous de prendre une part des sacrifices grâce auxquels s'ouvrira largement la porte de l'espérance", August 3-4, 1958, p.5.

[108] E. A. Kolodziej, *French International Policy under De Gaulle and Pompido; The Politics of Grandeur*, Cornell University Press, 1974, pp.176-210.

stand its ground against the dollar and the pound. Contrary to previous governments, de Gaulle saw a strong franc as an important tool in the pursuit of France's international power ambitions. The first prerequisite for a strong franc was its domestic stabilization. The establishment of convertibility was an important step towards increasing the international currency status of the franc. The second factor conducive to de Gaulle's support of the Rueff Plan was the imminent coming into force of the Common Market. Having decided that the European Economic Community (EEC) was the best channel through which to pursue France's national interests and international aspirations, economic reforms were necessary to prepare the economy for the tariff and quota provisions of the Rome Treaty that were to come into effect on January 1, 1959.[109]

"As soon as M. Rueff was called to organize and lead a committee of experts it was clear that there would be something altogether different from mild adjustment."[110] Rueff was known to regard inflation as "*le* mal des finances françaises" ('*the* evil of French finances').[111] He had participated in the successful stabilization of the franc in 1926.[112] He had a reputation for being obsessed with financial stability, having claimed that "[s]ans régulation monétaire, la liberté ne peut engendrer que le désordre".[113] By

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109 Discussions of De Gaulle's policy on Europe can be found in E. Barnavie and S. Friedländer (eds.), *La politique étrangère du général de Gaulle*, Camps, *Britain and the European Community*, and Kolodziej, *French International Policy*, Presses Universitaires de France, Genève, 1985, pp.235-292.

110 de Jouvenel, "France", p.92.

111 J. Rueff, *Combat pour l'ordre financier*, Plon, 1972, p.176.

112 Accounts of the stabilization of the franc in 1926 are provided in B. Eichengreen, "The Bank of France and the Sterilization of Gold, 1926-1932" and B. Eichengreen and C. Wyplosz, "The Economic Consequences of the Franc Poincaré", both in Eichengreen, *Elusive Stability*, pp.57-82 and 153-179. See also J. Rueff, "Sur un point d'histoire: Le niveau de la stabilisation Poincaré", in *Revue d'économie politique*, March-April, 1959, pp.168-178.

113 quoted in J. Guyot, "Les travaux du comité Rueff", in Institut Charles de Gaulle (ed.), *1958*, p.34.
'without monetary regulation liberty can only breed disorder'
According to Jean Guyot, a member of the Rueff Committee, Rueff's economic philosophy was formed by two historical experiences in particular: "L'expérience allemande de l'entre-deux guerres a démontré de manière implacable l'enchainement qui mène du désordre financier à la généralisation des contrôles, puis à la mise au pas des comportements individuels. L'autre souvenir concerne une recette que Lénine enseignait aux forces de la révolution: 'Pour détruire le régime bourgeois, vous devez dégrader sa monnaie." Guyot, "Les travaux", p.33.

appointing Rueff, the government sent out the signal that it was ready to take tough, and, if necessary, unpopular, measures to combat France's economic problems. Thus, Rueff's image played an important role in his appointment as head of the Committee. Couve de Murville acknowledges that the restoration of confidence was an important element of the Rueff Plan. However, he correctly distinguishes between Pinay's policy of relying on largely symbolical acts to restore confidence and Rueff's economic philosophy:

> La philosophie même du projet était de ne pas compter sur une confiance a priori, mais de créer par des mesures courageuses, pratiques et efficaces une confiance a posteriori véritable et durable parce que fondée sur une situation réellement assainie, ce qui, d'ailleurs, a été le cas au moins jusqu'en 1963.[114]

For Rueff, convertibility was a vital component of the stabilization of the French economy. Devaluation, anti-inflationary measures and the consolidation of public finance, were the prerequisites for the restoration of a stable franc. With a currency protected by exchange control, policymakers might be tempted to revert to their old habits of inflationary monetary policy and budget deficits, periodically offset by devaluation: "Seule une très large convertibilité permettra de tester la réalité et la durabilité de la nouvelle donne monétaire ainsi réalisée".[115] He saw the exchange guarantee, both for residents and non-residents and into gold as well as into other currencies, as a way of keeping governments honest.

> Depuis la libération, j'avais utilisé toutes les occasions d'attirer l'attention des divers Ministres des Finances sur la nécessité d'un effort d'ensemble, propre à résoudre, une fois pour toutes, le problème financier français. Inlassablement, je leur soumettais les grandes lignes de la politique que pareil effort me semblait exiger. En même temps et malgré les sarcasmes des «experts», je marquais la nécessité d'un prompt retour à la convertibilité monétaire et la certitude qu'il

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[114] Couve de Murville comment in Institut Charles de Gaulle (ed.), *1958*, chapter II, p.62.

'The philosophy itself of the project was not to rely on confidence ex ante, but to create, through courageous, practical and efficient mesures, ex post a confidence which was veritable and lasting because it was founded on a truly healthy situation, which, incidentally, was the case at least up until 1963.'

[115] Guyot, "Les travaux", p.30.

'Only extensive convertibility will test the reality and the durability of the new monetary situation thus realized'.

serait, en fait, rapidement accompli.[116]

The existence of the Rueff Committee, which was created on September 30, 1958, was kept secret until December, largely to prevent destabilizing speculation.

The aims of the Rueff plan were threefold, namely the restoration of, first, external equilibrium, second, price stability, and, third, stable economic growth.[117] The principal means with which these objectives were to be achieved were budgetary consolidation, monetary and legal measures aimed at ensuring price stability, the liberalization of trade and payments, and a devaluation of the franc. One of the key insights driving the reforms, and learned from the experience with the franc devaluations since 1948, was that a devaluation could only succeed in restoring exchange rate stability if it was combined with disinflationary measures. The Rueff Committee identified budget deficits as the primary cause of France's inflationary problem. Budget deficits had hovered around five per cent of GNP between 1950 and 1957 which was significantly higher than in Germany or Britain. The Rueff Plan was therefore aimed at restoring budgetary balance. This was to be accomplished through expenditure reductions and tax raises.[118] In total, compared to the initial 1959 budget proposal, government expenditure was reduced by some fr300 billion, largely through the elimination of subsidies and cuts in welfare spending, while government revenue was increased by roughly the same amount, largely through raises in

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[116] J. Rueff, "La restauration du franc", in *Revue d'économie politique*, November-December 1960, No.6, p.172.

> 'Since the liberation, I have used all opportunities to attrace the attention of various finance ministers to the need for a common effort, to solve, once and for all, France's financial problem. Time and time again I presented the grand design of the policy which I believe such an effort requires. At the same time and in spite of the sarcasm of the 'experts', I emphasized the necessity of a rapid return to monetary convertibility and the conviction that it would, in fact, be established rapidly.'

[117] For a detailed analysis of the redressement see P. Arnaud-Ameller, *Mesures économiques et financières de décembre 1958*, Librairie Armand Colin, 1968, and M. Byé, "L'opération des 27-28 décembre 1958", in *Revue économique*, No.2, March 1959, pp.11-200.

[118] Byé, "L'opération", pp.166-177.

value added and income taxes.[119] With these measures the projected budget deficit for 1959 could be brought down from fr1,082 billion to fr587 billion. In contrast the 1956 and 1957 budget deficits had been fr1,011 billion and fr1,041 billion, respectively. The elimination or downsizing of state subsidies to companies and of price subsidies for consumption reduced government expenditure and forced French businesses to become more competitive. It was anticipated that the immediate result of the removal of price subsidies on consumption would be a rise in the prices of these goods, which in itself would push up inflation. The willingness to accept an initial increase in inflation in return for a more deregulated and competitive economy revealed the longer term commitment to price stability and economic growth. In addition, by abolishing the indexation of salaries and prices on certain goods, the government removed an important cause of inflationary pressure.[120] The Rueff committee rejected the infant industry argument for trade protectionism, according to which it is necessary to shelter nascent industries from international competition through protectionism or subsidies until they have become competitive. The Rueff Plan abolished at one stroke many export subsidies and liberalized a large percentage of French import trade from quotas. Thus, trade liberalization which had been suspended in 1957 was increased to 90 per cent for OEEC imports, on the basis of 1948 imports, and 50 per cent of dollar imports (see table 1 in chapter II). The reversal of trade policy and the establishment of convertibility were the most dramatic policy changes implemented by the Rueff Plan.

The return to convertibility in France distinguishes itself from the moves in Germany and Britain in that the establishment of non-resident franc convertibility was combined with a sweeping reform aimed, among other things, at ensuring a stable franc,

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[119] Koch, *Histoire de la Banque de France*, p.333.
[120] The minimum wage remained indexed.

both internally and externally. According to Paule Armand-Ameller,

> [e]n optant pour la convertibilité monétaire, la libération des échanges et une forte dévaluation, les auteurs du plan se sont fixés de nouveaux objectifs: à l'expansion à tout prix, on a substitué l'expansion dans la stabilité, à un régime de contrôle, celui de liberté, au recours à des ajustements périodiques des changes, la volonté de s'arrêter à un taux définitif.[121]

The determination to establish monetary stability is accentuated by the fact that the government reduced public demand at a time when private demand was faltering and most economic indicators were indicating that France was experiencing a recession. Private consumption showed signs of weakening, with consumption of durables and of clothing in 1958 falling by 2.8 per cent and 4.6 per cent in real terms, respectively.[122] Agricultural production remained the same in 1958 as in 1957, and manufacturing production was 1.9 per cent lower in the fourth quarter of 1958 compared to the year-on earlier period.[123] Unemployment rose by 19 per cent in 1958. Real GDP growth dropped from six per cent in 1957 to 1.9 per cent in 1958.[124] The sluggish economic activity combined with the ongoing US recession, which was feared to spill over into Europe led French observers to anticipate a serious recession for the second half of 1958 and continuing into 1959.[125] In these conditions, Keynesian demand management theory would have advocated an expansionary fiscal or monetary policy, or both, to stimulate aggregate demand. However, instead of increasing government spending to offset the stagnation of private demand, the government cut public expenditure and devalued the franc, both of which could be

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[121] Arnaud-Ameller, *Mesures économiques*, p.9.

'In opting for monetary convertibiltiy, trade liberalization and a large devaluation, the authors of the plan have set themselves new objectives: they have substituted stable expansion for expansion at all costs, liberalization for a regime of controls, the will to maintain an exchange rate to the resort to periodic exchange rate adjustments.'

[122] *OECD Statistical Bulletins, General Statistics 1962.*

[123] *OEEC Statistical Bulletins, General Statistics 1960.*

[124] *OECD Statistical Bulletins, General Statistics 1962.*

[125] *Le Monde*, "Le choix entre les restrictions de consommation et le chomage ne peut plus être éludé", May 7, 1958, p.3.

expected to reduce domestic demand by raising the prices for imported goods.[126] The willingness of the government to implement contractionary fiscal and monetary policies at a time when economic activity was already faltering, and when things were expected to deteriorate further in the near future indicated the determination to restore monetary stability and create a solid foundation for an improvement in France's balance of payments.

Any economic reform aimed at increasing budgetary discipline and removing protectionism is likely to encounter criticism from some economic and political factions and the French redressement in 1958 was no exception to this rule. Within the French government many ministers opposed the Rueff Plan. In addition to Pinay, who criticized in particular the proposed devaluation and tax increases, the head of the Socialist party and member of the cabinet, Guy Mollet, offered his resignation in protest against the economic reforms. In particular, he opposed the unpopular cuts in government expenditure and the abolition of wage indexation. Not surprisingly, the French public did not welcome the spending cuts and tax raises with open arms.[127] Workers' and farmers' organizations were the harshest critics of the reforms. The reduction in family allowances combined with the discontinuation of government price subsidies for agricultural and consumer products and the de-indexation of wages, - with the exception of the minimum wage (SMIG) -, were expected to reduce the purchasing power and thus the living standard of low-income families disproportionately compared to other income groups. Consequently, the reforms were attacked as being socially unjust. Farmers, in turn, were outraged over the massive

[126] An excellent analysis of the effects of devaluation on domestic absorption is provided in Corden, *Inflation*.
[127] An analysis of the national reactions to the reforms can be found in Arnaud-Ameller, *Mesures économiques*, pp.91-112.

cuts in agricultural subsidies. Overall, however, the reforms provoked much less of a public outcry than might have been expected. There were no major strikes or incitations to boycott or revolt against the new government nor its economic measures.[128] The striking feature of the redressement in France in 1958 was, therefore, the general consensus that a far-reaching, even painful, reform was necessary: "Aucun commentateur, théoricien, politique, syndicaliste, ne contest[ait] la nécessité d'une réforme".[129] This consensus was critical to the success of the reforms.

While the public was aware of the economic crisis France that was facing domestically, contemporary observers claim that few realized the severity of France's external economic problems.[130] Antoine Fleury remarked on the "extraordinaire décalage qui existe entre la crise des paiements, dont la gravité est perçue par tous les experts, aussi bien français qu'étrangers, et son ignorance par l'opinion publique française, y compris dans les milieux politiques".[131] If the French public failed to grasp the severity of the external problems, a claim which is difficult to verify 40 years after the fact, then the general acceptance of the measures further accentuates the importance of the personal support by a leader with the clout of de Gaulle for the viability and the success of the Rueff Plan. The "immense prestige" of the general and his personal backing of the reforms was crucial in securing popular support for the redressement.[132] Starting in

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[128] The significance of the relative calm response to the reforms is illustrated by the current wave of massive strikes and labor unrest in response to the tightening of fiscal and monetary policies in France today.

[129] Arnaud-Ameller, *Mesures économiques*, p.100.

[130] Arnaud-Ameller, *Mesures économiques*, p.110, and A. Fleury, "La position des autorités suisses face à la crise économique et financière de la France 1956-1958", in Comité pour l'histoire économique et financière de la France (ed.), *Du franc Poincaré*, p.444.

[131] Fleury, "La position", p.444.

'the extraordinary discrepancy which exists between the balance of payments crisis, the severity of which is recognized both by foreign and by French experts, and its unawareness by the French public opinion, including political circles.'

[132] Arnaud-Ameller, *Mesures économiques*, p.109.

'No commentator, theoretician, politician, union official, questioned the necessity of reform'.

August 1958, the government was given emergency powers for a six-month period, which enabled it to implement policies necessary for the financial and economic recovery without the consent of Parliament. The popularity of de Gaulle and the severity of the economic crisis created a unique situation which gave government a free hand to implement far-reaching reforms.

The precarious external financial situation in 1957 and 1958 forced France to seek special credits from the EPU, the IMF and the US, to ease balance of payments problems and counteract the depletion of foreign exchange reserves. The EPU granted France a conditional special credit of $150 million which was to be paid in two installments, with the payment of the second installment being made dependent on whether the Managing Board was satisfied with French stabilization policies. The IMF granted a similar conditional credit under its standby arrangements.

> Having come to the Fund hat in hand and then undergoing what they regarded as a humiliating experience, French financial officials were psychologically receptive to President de Gaulle's expressed determination to make France economically strong and to combat what he regarded as Anglo-Saxon domination of international monetary affairs. [133]

The elimination of automatic credit facilities upon the termination of the EPU provided a further incentive to get the economy into shape as quickly as possible. Under the European Monetary Agreement (EMA), which was to replace the EPU upon the establishment of convertibility, credits would be granted at much tougher conditions than under the EPU.

Kaplan and Schleiminger claimed that the advice of the EPU Managing Board and the consistent pressure exerted by the Board on France persuaded the French government to implement anti-inflationary policies.[134] The importance attributed to the EPU by

[133] R. Solomon, *The International Monetary System 1945-1981*, Harper and Row, 1982, p.21.
[134] Kaplan and Schleiminger, *The European Payments Union*, p.284.

Kaplan and Schleiminger in the redressement is exaggerated. While, the humiliation and exasperation felt by French policymakers at France's dependence on conditional credits provided an additional motivation to restore France's finances in order to prevent future French dependence on foreign aid, the actual advice or the attempts by the Managing Board to exert pressure are unlikely to have influenced French policymaking. As has been shown in this chapter, France exhibited a particularly strong resentment to foreign interference with, what it considered, its domestic affairs. It is, therefore, unlikely that French ministers would have been open to advice or pressure from the EPU Managing Board. The redressement was undertaken because France considered it in its best interest to do so not because it had suddenly become receptive to outside counseling.

CONCLUSION

In the first decade after World War II, trade balance problems, the fear of opening up the economy to international competition, autarky plans, and the reluctance to remove controls over trade and payments in general all combined to create a strong national opposition to the establishment of currency convertibility. However, in 1958, there was a shift in French policy on trade and payments. The continued problems of the balance of payments, the weakness of the franc, growing budget deficits, the deterioration of French competitiveness, and an inflation that was rising faster than the European average, all led to the realization of a need for drastic change in French economic policy away from dirigisme and excessive reliance on controls and protectionism and towards economic openness and market mechanisms.

According to Saint-Paul, in the Fourth Republic, that is, from 1945 to 1958, trade restrictions, capital and exchange controls and repeated devaluations weakened the external constraint of a fixed exchange rate on monetary expansion. By reducing the costs of inflation, these policy tools allowed governments to pursue a more inflationary monetary policy than they would have been able to otherwise.[135] However, over time, repeated recourse to devaluation and the persistence of inflationary pressures, increased the costs of inflation, as rising inflationary expectations expressed themselves through high wage demands, price rises and adverse currency speculation. Contrary to Britain, France never considered the establishment of convertibility as a policy response to adverse speculation.[136] Rather, convertibility was considered to be a condition which could only be established after France's external situation had stabilized or jointly with measures which would ensure its stabilization.

By 1958, it was clear to policymakers that only a drastic and visible change in fiscal and monetary policy could ensure the return to a stable exchange rate for the franc. The success of such policy changes depended both on their real effects on the economy, - for example, reductions in the budget deficit, changes in interest rates, devaluations, etc. -, but also on their ability to restore credibility in the government's ability and willingness to control inflation.

> By their boldness in the international realm and their toughness in the domestic realm, these measures are clearly meant to contrast with the makeshifts that had characterized the policies that preceded them, and to challenge at one blow all the criticisms that French economic policy had incurred abroad.[137]

Contrary to Britain and Germany, in France the move to convertibility was

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[135] Saint-Paul, "France", p.312.

[136] Britain repeatedly considered establishing convertibility at a floating rate as a way to stop speculative pressures. One of the occasions on which this policy was considered was in February 1952 when foreign exchange reserves were dwindling and trade deficits rising. Kaplan and Schleiminger, *The European Payments Union*, p.140.

[137] de Jouvenel, "France", p.89.

accompanied by a sweeping economic reform. One of the principal aims of the economic measures introduced jointly with convertibility, was to re-establish exchange rate stability. The balance of payments crisis made necessary, but also provided the opportunity, for undertaking the economic adjustment which allowed France to create the conditions necessary for stable economic growth. Though not as drastic, the redressement in 1958 is comparable to the economic and currency reform which Germany underwent in 1948 and which Rueff thought should have taken place in France much sooner. In Britain, which had also experienced severe currency instability and adverse speculation, no similar economic adjustment was undertaken when convertibility was established. Similarly, Germany failed to accompany the official return to convertibility with any far-reaching measures which might have tackled the roots of the growing upward pressure on the DM.

V: MONETARY COOPERATION AND CONVERTIBILITY: 1958

INTRODUCTION

This chapter examines why and how France, Britain and Germany cooperated in the return to convertibility. The first section assesses to what extent changes in economic conditions or in economic policies in 1958 explain the decision to establish convertibility. British policymakers decided in mid-1958 that the conditions were opportune for a move to convertibility. The considerations which determined the British choice of timing and of cooperation, before the free trade area negotiations came to play an increasing role, differ considerably from those which persuaded France and Germany that the moment was right for a collective move.

The second section of this chapter looks in particular at the change in British attitude towards cooperation in convertibility. Among other things it focuses on European integration as an explanation for both the choice of timing and the decision to cooperate in the move. So far, few attempts have been made to analyze, firstly, why European countries chose late December 1958 to establish convertibility, and, secondly, why they chose to move jointly to convertibility. Moreover, the connection between the concurrence of the coming into force of the Customs Union of the Six and the OEEC-wide return to convertibility has not been examined.[1]

In the second half of 1958, rumors spread that a British move to convertibility was imminent. This was not the first time, however, that convertibility seemed likely to happen in the imminent future. Between 1952 and 1958, government statements and policies constantly fed rumors of imminent convertibility. This chapter seeks to understand what

[1] This can be explained partially by the relatively recent opening of the archival material, which is crucial to understanding national policy priorities and decisions in the policy on convertibility.

factors convinced Britain to move this time. In particular it establishes an important connection between the coming into force of the quota and treaty provisions of the Rome Treaty, the negotiations for a European free trade area, and the collective establishment of convertibility.

THE 'RIGHT'CONDITIONS

The IMF explained the timing of the move to convertibility with a concurrence of several favorable economic conditions, which corresponded roughly to the conditions necessary for a return to convertibility established by the British Treasury.[2] Thus, according to the IMF's tenth annual report on exchange restrictions, 1958 witnessed both the first UK trade surplus in the postwar period and a current account surplus. In addition, 1958 marked a year of improved terms of trade for Western Europe and of increases in gold and convertible currency reserves, largely due to the first US trade deficit with Europe since World War II which in turn led to a dollar outflow. Furthermore, the US recession had been halted in the spring of 1958, allaying fears of reduced European exports to the US in the near future. In the course of 1958, Western European countries had succeeded in eliminating inflationary pressures, indicating sound internal policies. The report argued that all the above developments had led to an increase in confidence in the strength of the Western European currencies. Finally, the decision to raise IMF quotas announced in New Delhi in October 1958 increased international confidence due to the anticipated increase in liquidity. The report concluded that, "[f]or these various reasons, the European countries felt more able at the end of 1958 than at any previous time since the end of World War II to make a major

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[2] IMF, *Tenth Annual Report on Exchange Restrictions*, 1959.

monetary move toward the elimination of the distinction between dollar and non-dollar currencies in their foreign exchange arrangements".[3] Similarly, the Bank for International Settlements explained the timing of the move by the strengthening of European reserve positions during the year, caused partially by an improvement in Europe's terms of trade.[4]

[3] ibid., p.2.
[4] BIS, *29th Annual Report April, 1 1958 to March 31, 1959*, p.185.

Table V.1: Net reserves (end of year; million US dollars; percentage increase in brackets)

	1955	1956	1957	1958
Austria	337	392 (16.3)	489 (24.7)	655 (33.9)
Belgium-Luxembourg	949	951 (0.2)	1,003 (5.5)	1,325 (32.1)
Denmark	104	90 (-13.5)	136 (51.1)	205 (50.7)
Finland	99	55 (-44.4)	63 (14.5)	143 (127.0)
France	2,082	1,142 (-45.1)	364 (-68.1)	687 (88.7)
Germany	2,518	3,566 (41.6)	4,464 (25.2)	5,138 (15.1)
Greece	187	193 (3.2)	188 (-2.6)	166 (-11.7)
Italy	1,178	1,264 (7.3)	1,496 (18.4)	2,215 (48.1)
Netherlands	1,048	904 (-13.7)	953 (5.4)	1,335 (40.1)
Norway	136	157 (15.4)	155 (-1.3)	210 (35.5)
Portugal	670	693 (3.4)	685 (-1.2)	708 (3.4)
Sweden	456	463 (1.5)	445 (-3.9)	471 (5.8)
Switzerland	1,706	1,785 (4.6)	1,885 (5.6)	2,053 (8.9)
Turkey	-99	-5 (95.0)	-13 (-160.0)	14 (208.0)
United Kingdom	2,120	2,172 (2.5)	2,374 (9.3)	3,105 (30.8)
Total	13,491	13,822 (2.5)	14,687 (6.3)	18,430 (25.5)

Source: BIS, annual reports.

In 1958, the net reserves of all Western European countries, with the exception of Greece, were larger than in 1957 (see table V.1).[5] Total European reserves increased by 26 per cent, compared to six per cent in 1957 and three per cent in 1956. Germany's reserves increased less quickly than most other countries' reserves (15 per cent) Moreover, Germany was the only country, besides Denmark, where reserves increased

[5] BIS, *29th Annual Report April 1, 1958 to March 31, 1959*, p.175. For development of French, British and German reserves between 1952 and 1959, see figure 1 in chapter I.

less than the had in 1957. The increase in German reserves only accounted for one fifth of the total improvement in European reserves, as compared to 1957 and 1956 where the increases in German reserves alone accounted for the total rise in European reserves. As a result, the share of Germany's reserves as a percentage of total European reserves fell from 30.4 per cent in 1957 to 27.9 per cent in 1958. Simultaneously, UK reserves as a percentage of total reserves increased slightly from 16.2 per cent to 16.8 per cent, as UK reserves increased by 31 per cent over 1957. Thus, there seemed to be a general improvement in reserves at the same time as German reserves increased less than average, indicating a redistribution of reserves away from the largest reserve holder to the rest of Europe. According to *Die Weltwirtschaft*, the redistribution of reserves from Germany to the UK and other European countries was due largely to official capital exports.[6] Particularly, the improvement in France's reserves, which increased by 89 per cent, can be explained entirely by international credits, of which $100 million came from Germany in the form of a special EPU credit. British reserves were bolstered by a £89 million credit from the Export/Import Bank ($250 million), the deferment of service payments, worth £63 million (approximately $176 million) on the US and Canadian loans, and the IMF drawing of $562 million, made in December 1956. The Treasury admitted, unofficially, that net of these special borrowings, the UK reserves would only amount to £844 million or roughly $2363 million.[7]

[6] *Die Weltwirtschaft; Halbjahresschrift für Weltwirtschaft an der Universität Kiel*, 1959, Heft 1, p.16.
[7] PRO T236-4820, "Unicorn: U.K. External Assets and Liabilities", November 10, 1958.

Table V.2: Terms of trade, 1953=100

	UK	Germany	France
1950	100	86	94
1951	88	83	85
1952	95	94	92
1953	100	100	100
1954	100	100	95
1955	99	97	97
1956	101	99	98
1957	104	100	96
1958	111	108	100

Source: *OEEC Statistical Bulletins General Statistics, 1960.*

The improvement in Britain's trade balance contributed to the increase in UK reserves in 1958. Whereas throughout most of the 1950s Britain's trade balance had been in deficit, in 1958 it swung into a small surplus ($132 million).[8] The improvement in Britain's trade balance can be attributed solely to the overall improvement in Europe's terms of trade, which was the result of a fall in prices for primary products (see table V.2).[9] Whereas the volume of British imports remained unchanged, the value of imports fell by nearly $500 million compared to 1957 or five per cent. At the same time, the volume of exports fell by 3.5 per cent in 1958, corresponding to a fall in the value of exports of $280 million or 2.9 per cent.[10] Thus, the improvement in Britain's trade balance was explained entirely by the fall in the cost of imports, since there was no increase in export volume.

In addition to the favorable developments of Britain's reserves and its trade surplus, in 1958 prices and wages increased more slowly than they had in most of the post-war period. The greater price stability can also largely be attributed to the fall in import prices.[11] Relatively low price and wage inflation, compared to previous years,

[8] See figure 2 in chapter I.
[9] BIS, *29th Annual Report April 1, 1958 to March 3, 1959*, p.150.
[10] ibid.
[11] OEEC, *Economic Conditions in Member and Associated Countries of the OEEC: United Kingdom*

rapidly growing reserves, a trade and current account surplus, and the strengthening of sterling on foreign exchange markets, seemed the ideal conditions under which to finally take the official step towards sterling convertibility. The Treasury and the Bank of England used this line of argumentation to convince the British government to establish convertibility. Thus, the Chancellor of the Exchequer wrote to the Prime Minister in September: "I feel that we are unlikely to find a better conjuncture to unify the sterling rates."[12] It is true that the economic conditions were favorable for a largely symbolical move. However, the question that presents itself is whether the economic conditions would remain favorable in the future for the maintenance of a stable convertible currency.

A closer inspection of the economic situation reveals that the circumstances attributable to the improvement in Britain's financial and commercial conditions were ephemeral. Moreover, it was foreseeable in 1958 that, unless policy was changed, continued financial and exchange rate stability could not be assured in the near and medium-term future. The international recession in 1958 had led to a fall in raw material prices. The resulting large drop in import prices was the determining factor in the slowdown in British wage and price inflation, the improvement in the trade balance and the increase in reserves. The improved confidence in sterling was a by-product of these developments. Since lower import prices, rather than advances in productivity or in Britain's competitiveness, explain the improvement in Britain's monetary stability and trade balance, the situation could be expected to be reversed once the global economy came out of the recession. Britain's exports declined by 2.9 per cent in 1958 while

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1958, p.13.

[12] PRO PREM11-2671, "Exchange rate policy and related matters", memo by the Chancellor of the Exchequer to the Prime Minister, September 8, 1958.

German exports grew by 2.7 per cent in value terms (see table V.3). When the international economy recovered in 1959, German exports increased by 10.9 per cent while British exports only rose by 3.4 per cent. After the devaluation and the accompanying stabilization measures, French exports increased dramatically by 22.6 per cent in 1959, while in 1958, before the reform, they had fallen by 7.4 per cent. These figures confirm that there was no improvement in Britain's competitiveness relative to Germany or France after 1958. Correspondingly, the Bank for International Settlements observed in mid-1959: "It is unlikely that the very favorable balance on current and capital account in 1958 will be repeated in 1959, since imports are expected to rise, both in value and in volume, as the United Kingdom moves out of the recession".[13]

Table V.3: Export development, 1957-1961 (percentage increases)

	UK		Germany		France	
	value[a]	volume	value[a]	volume	value[a]	volume
1957	3.9	1.7	16.5	13.9	8.9	10.0
1958	-2.9	-4.1	2.7	3.7	-7.4	4.5
1959	3.4	4.3	10.9	13.8	22.6	19.6
1960	5.8	5.8	17.7	14.9	27.5	17.0
1961	4.2	2.3	11.2	5.5	9.9	5.2

[a] based on figures expressed in US dollars.
Source: values: *OECD Statistics of the Balance of Payments 1950-1961*;
volumes: *IMF International Financial Statistics.*

The Economist voiced similar concerns about the fragility of the improvement of British economic conditions and criticized the government's interpretation of the situation. It described the conditions in 1958 as owing to "quite unusual good luck" in the form of "the convenient turn in the terms of overseas trade and this past year's unexpected flight from the dollar". As a result of the coincidence of several special circumstances, *The Economist* warned, "Sterling ... [set] sail on a long voyage in a fair weather ship at a moment when the weather forecast is favourable."[14] The article cautioned:

[13] BIS, *29th Annual Report April 1, 1958 to March 31, 1959*, p.152.
[14] *The Economist*, "An Act of Bravery?", January 3, 1959, pp.11-13.

> There is no doubt that sterling is at present, and for the short time into the future that it is possible to see, strong enough to sustain the burdens of this sort of convertibility... There is equally no doubt that the proclamation of strength is itself a strengthening factor, just as any confession of weakness (for example by contracting out of the emerging European monetary accord) would have undermined such strength as there is. But the new currency system, with convertibility at fixed rates of exchange, is not designed for a few months. It is only prudent to ask how it is likely to work out in circumstances other than the present; it is in the middle distance that the doubts lurk.

John Fforde claimed that, when convertibility was established, "[a]ll that had happened, give or take the local difficulty with the French, was that the UK had taken advantage of a favourable and probably fleeting opportunity to remove the anomaly of the two rates for convertible sterling into dollars. The underlying problem of sterling remained".[15]

The unusually large inflow of reserves, unusually stable prices and wages and the unusually stable sterling presented the government with the unique opportunity to establish convertibility without making any changes to its general economic policy orientation. This was precisely the problem and the reason for the doubts expressed by *The Economist*. To persuade the government that the moment to act was right, the advocates of convertibility, in particular Bank officials, pointed to ephemeral conditions as the fact that the dollar was temporarily somewhat under strain, - something which nobody expected to last -, and that since Britain had recently weathered a severe sterling crisis, in 1957, speculators were laying low. In addition, they argued that another reason for acting was that the public was expecting a move. If Britain disappointed these expectations by failing to act, then this would hurt confidence in the pound.[16] By September, the Chancellor of the Exchequer agreed that the time was right since, "[o]n balance, ..., he felt that the present conjunction of circumstances was as favourable as

[15] Fforde, *The Bank of England*, p.603.

[16] See, for example, PRO T236-3946, Report by the Bank of England: "'Pros' for early amalgamation of official and transferable sterling", March 18, 1958 and "The Arguments in Favour of an Early Amalgamation of Official and Transferable Sterling -Views of the Bank of England", April 2, 1958.

was ever likely to occur".[17] The criteria defining the right time to establish convertibility focused solely on whether the short term conditions could ensure that the move would not trigger a run on the pound. Government policy was not concerned with whether the underlying state of the economy was conducive to the maintenance of a stable exchange rate.[18] The currency and balance of payments crises that had regularly afflicted Britain since World War II, were not interpreted as indicating the need to change economic policy to assure price and exchange rate stability. Moreover, no connection was made between convertibility and the need to assure monetary stability in the future. In 1958, there was no indication that price and wage stability would continue, and that British exports would increase, once the global economy came out of its recession. What could be anticipated was that imports would increase. In 1958, when unemployment reached its highest level since World War II, hourly wages in manufacturing increased by 3.1 per cent while manufacturing output fell by 0.8 per cent. The wage development showed that "[t]he opportunity of making this most favourably-placed of all years the one in which to break the wage-price spiral has therefore not been resolutely seized".[19] Moreover, starting in mid-1958, the government began to implement policies which were aimed at reflating the economy. Bank Rate was lowered four times between March and November 1958, from seven per cent to four per cent. The ceiling on bank advances was removed in July and hire-purchase restrictions were reduced in September and removed in October. The public investment limit imposed by the former Chancellor of the Exchequer, Peter Thorneycroft, was removed.[20] In response to these measures,

[17] T236-4820, "Exchange Rate Policy: Note of a Meeting held at 10 Downing Street, S.W. 1 on Wednesday, 5th November, 1958, at 10.15 a.m.", November 11, 1958.
[18] As an important exception, W. M. Scammell warned of the need to adjust the British economy. See chapter II.
[19] *The Economist*, "Peace Through Some Inflation?", May 17, 1958, p.570.
[20] Dow, *Management*, pp.105-106.

private consumption and industrial output increased rapidly in the second half of 1958. In contrast to Germany and France, where private consumption growth was slower in 1958 than it had been in 1956 and 1957, in Britain private consumption in real terms grew by 2.4 per cent in 1958 compared to 2.1 per cent and one per cent in 1957 and 1956. The nominal figures were 5.2 per cent for 1958 and 5.6 per cent and 5.4 per cent for 1957 and 1956, respectively.[21] The 12.8 per cent real increase in purchases of consumer durables in 1958 indicated that consumer confidence had not suffered from the ongoing international recession. In 1957 the increase had been 12.6 per cent, while in 1956 purchases of consumer durables fell by 11.5 per cent in comparison. In spite of the rapid improvement of domestic demand and output which was already apparent in the third and fourth quarter of 1958, the Chancellor Derrick Heathcoat Amory presented a strongly expansionary budget in April 1959. Taxes were reduced by approximately £360 million and public expenditure was increased. The upcoming elections most likely played an important role in the decision to reflate the economy at a time when it was already obvious that economic activity was in an upswing.[22]

The move to convertibility was undertaken at a time when sterling and the British economy were benefiting from the disinflationary effects of an international recession. When the government reflated the economy through strongly expansionary fiscal and monetary policy, there was no indication that the structural problems of the British economy had been removed. Wages continued to rise more rapidly than productivity, and prices continued to increase faster than in the competing economies. At the same time, British productivity growth, particularly in manufacturing, continued

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[21] *OECD Statistical Bulletins General Statistics 1962.*

[22] Macmillan's inclination to woo voters with expansionary economic policy, and his willingness to sacrifice price stability to that aim, was discussed in chapter II.

to lag behind when compared to France and Germany.[23]

Whereas in 1958, Britain's trade performance was better than before and after, Germany's trade performance was slightly worse than before and after (see figure 2 in chapter I). German exports grew much more slowly in 1958, 3.6 per cent, than in 1957, 15 per cent, as a result of the international recession which depressed demand for German goods in the European and US markets. Imports fell by 1.8 per cent in value terms, although they grew in volume terms by seven per cent, with Germany also benefiting from the fall in world prices of primary commodities. However, from 1959 onwards exports growth was back at above 10 per cent in value terms and in 1960, at 16 per cent, export growth was the highest since World War II. Similarly, real GDP growth in 1958 was the lowest in the 1950s, at 3.1 per cent, compared to an average growth rate of 7.5 per cent between 1951 and 1961 (see table 2 in chapter III). However, in 1959, growth was back up to 6.8 per cent. The significantly lower increase in reserve inflow in 1958 and in 1959 could be attributed to the temporary slowdown in export growth, but also to official capital exports, a large share of which was of a non-recurrent nature designed to reduce the large inflow of reserves.[24] The return to rapid export growth, rising trade surpluses and large reserve inflows after 1959 indicate that the slight deterioration of German balance of payments surpluses was only a limited deviation from the trend rather than a structural break. Moreover, like in Britain, German policy was no different after convertibility than it was before. Thus, after convertibility, Germany continued to sterilize the expansionary impact of its balance of payments surpluses. According to Scammell,

> the existence within any payments system, world-wide or regional, of a chronic

[23] See Crafts, "'You've never had it so good?'" and Millward, "Industrial and commercial performance".
[24] See chapter III.

> surplus country is a maladjustment. If allowed to continue it leads to the piling up of reserves by the surplus country, to measures of self-defence by neighbours which may have deleterious effects on the volume of trade, and perhaps to frictions due to anticipated or actual movements or exchange rates. Given that a chronic surplus by a single country is a maladjustment in the payments system, there is a case for removing it.[25]

Germany lowered the official discount rate to stimulate internal demand in 1958, from four per cent in 1957 to 3.5 per cent in January 1958, to three per cent in June 1958, and finally to 2.75 per cent in January 1959. However, in September 1959 the rate was increased to three per cent and again to four per cent in October even though, according to the OEEC, "there were no actual inflationary symptoms".[26] In addition, reserve requirements were raised. The decision to tighten monetary policy even before inflationary pressures had developed, confirmed that the Bundesbank uncompromising commitment to price stability had not changed after convertibility. The rigorous commitment to price stability in turn further increased confidence in the current and future strength of the DM, especially when Germany's firm anti-inflationary stance was compared with the economic policy orientations of most other European countries, and the United States.

Germany and Britain shared the fact that the move to convertibility was facilitated by special circumstances which temporarily reduced pressure on sterling to devalue on the DM to revalue. 1958 was not the beginning of a new trend towards balance of payments equilibrium or greater exchange rate stability in either of the two countries. Rather, the economic situation in 1958 represented a temporary aberration from the trend towards a weaker sterling in Britain and a stronger DM in Germany. Moreover, the favorable circumstances cannot be ascribed to a change in economic policy orientations in either of the two countries. Thus, in the case of Germany and

[25] Scammell, *International Monetary Policy*, p.356.
[26] OEEC, *Economic Conditions in Member and Associated Countries in the OEEC; Federal Republic of Germany 1960*, p.5.

Britain, the move to convertibility was undertaken at a time when the pressures for economic adjustment had momentarily weakened.

In contrast, in France the move to convertibility was undertaken at a time when the problems which had been troubling the French economy throughout the 1950s had reached their peak. Consequently, and contrary to Britain and Germany, the establishment of convertibility was combined with a sweeping economic adjustment which changed the course of the French economy from 1958 onwards. After 1958, and, more importantly, after the economic and financial reforms of that year, the French trade deficits turned into consistent surpluses. Government budget deficits as a percentage of GDP were significantly lower in the decade after convertibility than before. After 14 years of continuous erosion of the franc, the exchange rate was not readjusted until 1968, when domestic political instability forced a devaluation. Although inflationary pressures were not removed, monetary stability in the decade after convertibility was much greater than in the pre-convertible period.[27]

This section has shown that the improvement in Britain's economic and monetary conditions in 1958 was only of a fleeting nature and that it could be, and was, foreseen that the improvement was only temporary. Similarly, the slackening of the buildup of German reserves and the abatement of pressure on the DM to revalue was only momentary lull, and in 1959 the upward trend in Germany's external surpluses and its foreign reserve earnings returned with greater vigor than ever. Britain and Germany took advantage of the brief respite from pressures to undertake the necessary economic adjustment to establish convertibility without taking any accompanying measures to

[27] Sautter, "France".

address the causes of the persistent balance of payments disequilibria and currency speculation that had been troubling both countries and that could be expected to continue to trouble them after convertibility. In contrast to Britain and Germany, France established convertibility at a time when economic and monetary conditions were at a nadir. France took the opportunity of the critical economic and financial situation to implement far-reaching reforms together with the establishment of convertibility. In doing so, France laid the foundations for a decade of prosperity and currency stability.

EUROPEAN COOPERATION AND CONVERTIBILITY

EUROPEAN COOPERATION ON CONVERTIBILITY BEFORE 1958

Whereas the previous section looked at the economic and monetary conditions that explain why, from mid-1958 onwards, the UK was finally ready to establish convertibility after years of hesitation, this section examines the national policy considerations that ensured a collective return to convertibility. Chapter III explained why for Germany establishment of official convertibility was only envisaged as part of a collective move. This section examines why Britain and France cooperated in a OEEC-wide establishment of convertibility. It focuses particularly on the connection between British policy towards Europe and the British attitude towards cooperation in convertibility, since the analysis reveals a significant, interrelated, policy shift in both in 1958, whereas German and French policy was fairly consistent in this regard.

Before 1958, several examples show that neither Britain nor France found it necessary to consult or cooperate with other countries on their external monetary policies. Britain's decision to devalue its currency by 30 per cent in 1949 was taken without prior consultation with the rest of Europe even though continental Europe was strongly affected by the step. The unilateral British decision to devalue, without consulting with or informing beforehand its European partners, met with strong criticism in France. Britain's apparently dismissive attitude towards continental Europe was regarded as an act of betrayal of European cooperation.[28] Similarly, France's neighbors and traditional allies only found out about France's decisions to devalue the franc by 20 per cent effectively, through a general import tax and export subsidy, when the French government announced the step in the IMF in August 1957.

The British approaches to convertibility up until 1955 are well documented in recent literature.[29] Britain's first convertibility proposal, called Robot, was devised by the high-ranking Treasury and Bank of England officials in 1951/2 and envisaged neither consultation on nor coordination of policy actions with continental Europe. Robot would have inevitably meant the end of the EPU. The principal country to be consulted before the move to sterling convertibility, which was to be established jointly with a floating exchange rate, was the United States, since their financial support was considered a prerequisite for the execution of the plan.[30] Cooperation with Europe was not part of the plan. Indeed it was incompatible with the aims pursued by Britain, which was to set Britain and sterling apart from other European countries and currencies and prove that it was an international financial power on par with the US. Robot was motivated by the pursuit of foreign policy objectives, namely power, prestige and a close relationship, based on equal partnership, with the US.[31]

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[28] Koch, *Histoire de la Banque de France*, p.118.
[29] See Fforde, *The Bank of* England, pp.426-503, Kaplan and Schleiminger, *The European Payments Union*, pp.157-183, Milward, *The European Rescue*, pp.347-396.
[30] For an account and analysis of Robot, see Milward, *The European Rescue*, pp.351-9.
[31] ibid., p.354.

When Britain was denied US support for the operation, policymakers designed the Collective Approach in 1952:

> Its title implied that other EPU members would also be involved; in reality the plans were to be discussed first with the Commonwealth, then in a meeting in Washington with the US Administration, and only lastly - when all, it was hoped, would have been decided - with the European countries.[32]

In general, the ability to move to convertibility without having to consult or coordinate with continental Europe was an important element of British policy on convertibility. To British policymakers cooperation with Europe on convertibility was equivalent to an admission of weakness both of Britain's international clout and of its currency. However, the experience with sterling instability in the 1950s and the US refusal to help Britain go convertible ahead of the rest of Europe, brought the painful realization that Britain needed continental Europe, at least Germany and probably France, to be able to establish sterling convertibility.

In 1954, British policymakers slowly began to realize that they could not simply ignore continental Europe in their convertibility plans. They put forward proposals for a European Fund which would provide financial assistance both for countries who decided to join the UK in making their currencies convertible, and for countries whose currencies remained inconvertible.[33] On August 5, 1955, the members of the OEEC members the European Monetary Agreement (EMA), according to which the EPU would be terminated when countries who jointly accounted for at least 50 per cent of the total EPU quotas agreed to establish currency convertibility. At the same time the European Fund would come into existence.

The British initiative on the EMA should not be interpreted as an indication that

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[32] ibid., p.358.

[33] for a discussion of negotiations on the European Fund see Milward, *The European Rescue*, pp.383-389. See also Kaplan and Schleiminger, *The European Payments Union*, ch.12.

Britain intended to cooperate closely with the rest of Europe on a move to convertibility. British plans envisaged a unilateral decision to establish convertibility after which the continental European countries would be informed of the British decision. The latter was to take place approximately one week before the actual move, the date of which would have been set by Britain alone. British policymakers assumed that at least Germany, Switzerland and the Benelux countries would simply follow a British initiative towards convertibility.

Ever since Britain's unilateral decision to devalue in 1949, the French were very skeptical about Britain's willingness to cooperate with the rest of Europe on monetary issues. They were suspicious when the British put forward proposals for OEEC consultations on convertibility, arguing that Britain only consulted with the others because it had decided that it was not ready for convertibility, and it expected other countries to advise against a move.

> Peut-être, dans ces conditions, après s'être donné une fois de plus le beau rôle, ne seront-ils pas fâchés de voir les autres pays accumuler les objections, et les éclairer sur une série de considérations dont ils sont, au fond d'eux-mêmes, parfaitement conscients. Peut-être avons-nous là l'explication de cette étrange procédure de consultation collective et publique, qui est si peu conforme aux habitudes britanniques lorsque le Gouvernement anglais est véritablement résolu à prendre une décision d'intérêt national, et qui semble si peu susceptible d'aboutir à des résultats clairs et positifs, dans la discussion de problèmes aussi complexes, entre plus de dix nations dont les conceptions, les intérêts et les politiques ne coïncident que très partiellement.[34]

Similarly, "[t]he German central bank suspected that the proposals for a European Fund

[34] AEF B44744, "Le handicap de la France dans la course à la convertibilité", June 10, 1954.

'Maybe, in these conditions, after having made themselves look good [by making themselves champions of convertibility], they are not annoyed to see other countries accumulate and express their objections on a number of points, of which they themselves are perfectly aware. Maybe this is the explanation of this peculiar procedure of collective and public consultation, which is so at odds with the way the British government normally proceeds when it is really determined to make a decision of national interest, and which seems so unlikely to result in a clear and positive decision, given the discussion of a problem as complex as this one, between more than ten nations whose conceptions, interests and policies only overlap marginally.'

were not even honestly intended, but only a diplomatic smoke-screen, behind which Whitehall was still preparing a unilateral declaration of convertibility as soon as the government had won a general election".[35] In 1954, when the government and the Bank of England were hinting that they might be getting ready to move, the French Finance and Economics Ministry maintained that the proclaimed British intentions of establishing sterling convertibility in the near future were motivated primarily by the desire to indicate to Germany that Britain was ready to act and thus hopefully prevent Germany from storming ahead, and, in addition, "pour rompre avec le Continent une solidarité qui depuis des années irrite l'orgueil britannique".[36]

As early as 1953, German central bankers assured Britain that Germany would move to convertibility "five minutes after Britain". With this commitment, Britain was assured that Germany would not move before Britain, but also that Britain would not be isolated in the move to convertibility when it decided to take the step. In 1953 and 1954, officials from the Bank of England and from the Bank deutscher Länder met to discuss convertibility. In these meetings, the German delegation repeatedly assured Britain that Germany would not act before Britain. However, Germany's rapid dismantling of exchange control aroused concerns that Germany was preparing to establish official convertibility.[37] In addition, in spite of these assurances, British fears of a German initiative, were stirred further by repeated public statements by Erhard in which he indicated Germany's interest in rapid convertibility.[38] As a result, in 1953 and 1954, British Treasury and Bank officials worried that Germany might establish convertibility

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[35] Milward, *The European Rescue*, p.385.
[36] AEF B44744, "Le handicap de la France dans la course à la convertibilité", June 10, 1954.
'to end a solidarity with the continent which has been piquing Britain's pride for years'
[37] See chapter III.
[38] BoE OV34/39, "Germany and Convertibility", L.A. Martin to Tansley, October 7, 1953, and "Erhard's statement", handwritten note by Rootham to the Governors, September 30, 1954.

before Britain.[39] To reinforce its claim to an international currency status of sterling Britain wanted to lead Europe into convertibility. As the German economy and the DM strengthened in the course of the 1950s, British ministers became concerned that the DM might compete with or even take over sterling's international key currency status.[40] This, Treasury and Bank officials agreed, "would certainly not be a desirable development, politically or economically".[41] For these reasons they wanted to avoid Germany beating Britain to convertibility.

But the German government was not planning to act unilaterally. Contrary to Britain, Germany's national interests were best served by cooperation in a collective move to convertibility. Even Erhard, the most ardent supporter of convertibility, had reasons for preferring a collective move under British leadership to a German initiative. The purpose of Erhard's statements is therefore more likely to have been to keep the British on their toes and prevent them from dragging their feet too much on convertibility rather than revealing actual plans. Uncertainty about German intentions was a good way of making sure that Britain kept moving forward.

From the early 1950s onward, France advocated a collective return to convertibility by the European currencies. For France, a collective move offered several advantages. Among other things, policymakers believed that it would facilitate public acceptance of the unpopular monetary adjustments, which would be necessary for the franc to become convertible. More importantly, however, by advocating a collective

[39] BoE OV34/39, "Germany and Convertibility", L.A. Martin to Tansley, October 10, 1953, and "Germany: Convertibility" D. H. Macdonald to Watson, February 18, 1954.
[40] BoE OV34/41, "Germany's progress towards multilateralism", D.A.H. Byatt to Stone, March 23, 1956.
[41] PRO T236-3940, R. Hall, suggested redraft of Rowan's memo "Why Convertibility" from May 18, 1956, June 8, 1956.

move, France hoped to prevent its European partners, particularly Britain and Germany, from moving to convertibility before the franc was ready to follow. Up until 1958, France was not ready to establish convertibility. By declaring itself in favor of a collective move, France sought to influence both the timing and form of convertibility that would be established. Between 1953 and 1955, French governments worried that a British move to convertibility was imminent.[42] In 1954, the French Ambassador in the UK, E. de Crouy wrote to Mendès France, Minister of Foreign Affairs at the time, that France had two options when dealing with apparent British plans for imminent convertibility of sterling. France could either openly oppose the British plans and force the British government to abandon them by rallying for support from other European countries, or it could accept the objectives of the plan and then negotiate modifications on important points to suit France's interests. The Ambassador strongly recommended the more diplomatic latter course over open confrontation.[43] The Finance and Economics Ministry advocated a similar strategy: "En nous déclarant prêts à participer à la convertibilité, nous pourrions essayer d'influencer sa date et ses modalités de la façon la moins désavantageuse pour nous..."[44] In this manner, France hoped, ideally, to delay a British move to convertibility. Moreover, France sought to ensure that, when convertibility was adopted, it would be as limited as possible.[45]

[42] For reasons discussed in the previous chapter, France wanted to prevent such a move.
[43] AEF B44744, E. de Crouy (Fr. Ambassador in UK) to Mendès France (Foreign Minister) re. "la convertibilité de la Livre", July 2, 1954.
'By declaring ourselves ready to participate in convertibility, we could try to influence the date and the conditions of its establishment to assure that it would be least disadvantageous for us...'
[44] AEF B44744, "Les conséquences de la convertibilité", May, 24, 1954.
[45] ibid.
"Quant au type de convertibilité le plus désirable pour nous, nous avons intérêt à ce que les pays européens adoptent, au moins à titre de première étape, une convertibilité aussi limitée que possible et compatible avec une organisation européenne."
'As far as the type of convertibility the most desirable to us, we wish that the European countries adopt, at least in the first stage, a convertibility which is as restricted as possible and compatible with a European organization.'

While working to keep the negotiating channels open with Britain, France actively campaigned in the US against American financial support for a British move to convertibility. France argued that a unilateral move would hurt European cooperation and integration, something which many important factions considered a top priority of America's Europe policy. Thus, according to Frances Lynch,

> La France béneficia d'un avantage dans la mesure où la Grande-Bretagne ne put rétablir la convertibilité de la livre faute de pouvoir obtenir de crédits des Etats-Unis. De plus, dans un premier temps, l'Administration Eisenhower accueillit avec autant de bienveillance que ses prédécesseurs les arguments de la France en faveur de la création d'institutions européennes capables de stabiliser les situations politiques et économiques européennes. Non seulement la Grande-Bretagne se vit refuser toute aide américaine susceptible de faciliter la convertibilité de la livre mais c'est la France qui reçut un soutien significatif, ostensiblement destiné à subvenir aux dépenses militaires en Indochine, à assurer sa contribution à l'OTAN, et à permettre également de combler ses déficits vis-à-vis de l'UEP.[46]

In May 1954, Vanoni the head of the Italian OEEC delegation and Budget Minister wrote to France to express his concern that Germany and Britain would soon establish convertibility and that their lead would be followed by the Belgians and the Dutch. This would leave France and Italy relegated to a second rate group of inconvertible currency countries, with all the political and economic disadvantages that would entail. According to Vanoni the only way to prevent such a situation from occurring was for France and Italy to engage in

> un progrès dans la voie de l'intégration économique de l'Europe qui permettra de faire jouer le mécanisme de la solidarité européenne vis-à-vis des Allemands et des

[46] Lynch, "Le franc", p.395. For an analysis of the US policy on convertibility and European integration, see also, F. Romero, "Interdependence and Integration in American eyes: from the Marshall Plan to Currency Convertibility", in Milward et. al., *The Frontier*, in particular pp.162-163 and A. Milward, "La livre sterling, le franc et le deutsche Mark 1950-1955", in Comité pour l'Histoire Économique et Financière (ed.), *Du Franc Poincaré à l'ÉCU*, 1993.

> 'France benefited from an advantage in the sense that Britain could not re-establish sterling convertibility due to the US's denial of financial assistance. Moreover, initially, the Eisenhower Administration was as receptive as its predecessors to France's arguments in favor of the creation of European institutions capable of stabilizing European political and economic conditions. Great Britain was not only refused any US aid to facilitate sterling convertibility, but France received considerable aid, manifestly to subsidize military expenditure in Indochina, to secure its contribution to NATO, and to allow it to offset its deficits vis-à-vis the EPU.'

Anglais, en les convaincant de différer le retour à la convertibilité de leur monnaie jusqu'à ce que tous les partenaires européens soient en état d'y procéder pour leur part".[47]

This statement from 1955 foreshadowed the close link between the return to convertibility and European integration that was to emerge in 1958.

By 1955, some French observers thought that the deterioration of Britain's reserves, the weakening of sterling, and domestic inflationary pressures would deter Britain from moving to convertibility. Since Britain was unlikely to establish convertibility in the near future, the wisest thing for the French government not to voice any resistance to British convertibility plans, so as not to risk confrontation.[48]

Intergovernmental communication on convertibility between France and Britain seems to have been very poor on this topic. This impression is confirmed by the concerns expressed by British Treasury officials to the financial attaché at the French embassy in London, Paul Leroy-Beaulieu, in 1954, regarding the lack of mutual consultation. Thus Leroy-Beaulieu reported to the French Finance Ministry that Copleston and Rowan from the UK Treasury

> m'ont dit tous deux qu'il leur paraissait quelque peu anormal que des conversations à un niveau aussi élevé aient eu lieu depuis un an, à deux reprises, entre Allemands et Anglais (Erhard et Blücher étaient venus à Londres au mois de Juillet dernier), alors qu'il n'y avait pas eu de conversations du même ordre depuis longtemps entre Français et Anglais; celles que Rowan a eues avec Guindy n'étaient pas du même genre, elles se situaient plutôt sur le plan personnel. Etant donné les liens beaucoup plus étroits qui existaient entre l'Angleterre et la France - 'alliée traditionelle de l'Angleterre' -, il serait, à leur avis, souhaitable que les Ministres compétents des deux pays et leurs Hauts Fonctionnaires examinent ensemble et complètement les questions économiques et finançières qui se posent

[47] AEF B44744, telegram by the French embassy in the UK: communiqué from Rome from May 26, Nrs.420/428, May, 30, 1954.

'a progress in the direction of the economic integration of Europe which would make it possible to use the mechanism of European solidarity vis-à-vis the Germans and the English, and convince them to delay the return to convertibility of their currencies until all the European partners are in a position to proceed'.

[48] MAE DE CE 488, memo by Chauvel, no title, April 5, 1955.

actuellement.[49]

Anglo-German consultation on convertibility was much fuller than Anglo-French or Franco-German intergovernmental communication. The lack of intergovernmental coordination or even consultation between France, on the one hand, and Britain and Germany, on the other, can be explained by French reluctance to let any foreign players have a say in what they considered a national concern. In a public speech in 1955, Baumgartner emphasized that

> [a]lthough convertibility is an international problem, for each country the decision is a national issue, based on the degree to which the country will be able to face outside competition. France is still a protectionist country, although she has liberalised to 75 per cent within E.P.U. French industries would have to accustom themselves to international competitions but there could be no question of reducing any section to a state of unemployment.[50]

The need for national reassertion and independence after World War II played a particularly important role in French economic and monetary policymaking in the 1950s.[51] During the French balance of payments crisis in 1957, France sought a special EPU credit. In spite of French dependence on the EPU, and other foreign aid, to alleviate its shortage of gold and foreign exchange reserves, France categorically refused to place its economic reforms under the supervision or even the advice of international experts. This attitude explains the French reluctance to communicate with other countries on convertibility.[52]

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[49] AEF B44744, Leroy-Beaulieu à Sadrin, Directeur des Finances Extérieures (Ministère des Finances): "Conversations sur la Convertibilité, May 28, 1954.

> 'have both told me that they found it slightly anomalous that such high-level talks had been going on, on two occasions, between the Germans and the English (Erhard and Blücher had come to London last July), while there had been no similar talks in a long time between the French and the English; the talks between Rowan and Guindey had not been of the same type, they were of a more personal nature. Given the much closer ties between England and France - 'traditional ally of England' -, they thought it would be desirable that competent ministers of both countries and their civil servants examine together thoroughly the economic and financial questions that currently present themselves'.

[50] BoE OV45/42, "France" by B. W. Gunn, Overseas Dept, June 2, 1955. The quote is from Gunn's summary of the speech.

[51] See chapter IV.

[52] A. Fleury, "La position", p.444.

The communication between the French and British central banks worked better than between the respective governments and economics ministries, due to a traditionally good, and often very personal, relationship between the Banque de France and the Bank of England.[53] However, the potential for cooperation, or even information was limited by the nature of the fact that in both countries, the independence and power of the central bank had been severely curtailed after World War II and, in both countries, it was the government that held the power of decision making regarding convertibility. In early November 1958, when the British government was in the dark, and very concerned, about a French reaction to sterling convertibility, the governor of the Bank of France, Baumgartner, could only speak for himself and the Banque de France, when he conveyed to the Bank of England that he supported a move to convertibility before the end of the year. He could not vouch for what the French government would decide to do.[54]

One of the formal channels of international consultation was the meetings of the EPU Managing Board. However, even there, the British members were extremely reluctant to inform their foreign counterparts of government intentions regarding convertibility. Thus, at the EPU meeting in late March 1953, British officials refused to confirm nor deny rumors about an imminent move to sterling convertibility, leading the vice governor of theBanque de France, in his report of the meeting, to conclude wryly that "les déclarations des experts anglais n'ont pas été très précises".[55]

Aside from central bank communication, France and Britain relied on the information and observations of their respective embassies about what was going on in the

[53] Fforde, *The Bank of England*, p.603.
[54] Fforde, *The Bank of England*, p.596.
[55] AEF B48886, report by the vice-governor of the Banque de France to the Finance Ministry, "Objet: 35ième Session du Comité de Direction de l'Union Européenne de Paiements", no date, late March 1953. 'the declarations of the English experts were not very precise'.

other country.[56] France and Britain shared a reluctance to disclose information about their convertibility plans to other countries. In the case of Britain, the reticence or secretiveness of policymakers vis-à-vis their foreign counterparts can be explained partially by the fact that few, if any officials, knew what would happen with regard to sterling convertibility in the near future. Foreign observers were kept on their toes by the fact that Britain's policy on convertibility fluctuated between the contemplation of a 'dash to convertibility' and the indefinite delay of sterling unification. In addition to the uncertainty and wavering in British convertibility policy, however, it was part of Britain's policy to keep the other Europeans in the dark. This strategy was shared by France. Both countries viewed cooperation as a renouncement of monetary sovereignty.

Up until 1958, the strongest external influences on British policy on convertibility seem to have been US unwillingness to finance a British move and fear that Germany would take the initiative away from Britain. French policy was characterized by the effort to delay a British or German move until France was ready to participate. In 1956, the Director of External Finance in the Foreign Affairs Ministry observed with satisfaction that, "[l]'attitude réservée de la France à l'égard de la politique de la convertibilité a sûrement contribué à retarder et, par conséquent, à faire échouer la mise en œuvre du plan britannique primitif."[57] However, as chapter II has shown, domestic doubts about the desirability of convertibility played a greater role than French efforts, or considerations of European cooperation, in delaying a British move to convertibility, at least up until 1958.

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[56] See, for example, MAE DE CE 761.

[57] AEF B44242, Memo by the director of external finance, "Note pour le Ministre - Objet: Évolution du régime des paiements internationaux - convertibilité et 'transférabilité' des monnaies européennes." February 20, 1956.
'France's reserved policy stance on convertibility has surely contributed to delaying the execution of the original British plan and, consequently, causing it to fail'.

Thus, the French ambassador to Britain seems to have been more accurate when he wrote in June 1955:

> Quant aux répercussions politiques de la convertibilité de la £ivre sur la coopération européenne, ...il ne semble pas que l'on y ait ici très sérieusement songé. Le souci du prestige de la £ivre et des profit que la Grande-Bretagne peut tirer de la convertibilité parait avoir dominé, jusqu'à présent, exclusivement.[58]

Before 1958, both French and British governments were very reluctant to reveal their intentions to other countries.

1958: Currency convertibility and European integration

In the second half of 1958, the economic conditions appeared increasingly favorable for the UK. Reserves had been rising rapidly since the speculative crisis in September 1957, Britain was recording a trade surplus for the first time since 1951, inflation was moderate, and sterling was continuously strengthening in the parallel markets. UK Treasury officials started to discuss the possibility of a unification of the sterling rates and the establishment of non-resident convertibility in the coming months. By September, the Chancellor of the Exchequer, Derrick Heathcoat Amory, was convinced that convertibility should be established before the end of the year.[59] Although some Treasury officials remained skeptical whether convertibility should be established in the near future, the government had finally been persuaded that financial and economic conditions were conducive to taking the step, and timetables were prepared which planned

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[58] MAE DE CE 198, French ambassador to the UK to Antoine Pinay, "a.s. Convertibilité de la £ivre", June 7, 1955.

> 'As far as the political repercussions of sterling convertibility on European cooperation are concerned, ...they do not appear to have been of great concern here. The concern with the prestige of sterling and the profit that Great Britain can gain from convertibility seem to have dominated, so far.'

[59] PRO PREM11-2671, "Exchange rate policy and related matter", memo by the Chancellor of the Exchequer, September 8, 1958.

for a move in November. It was at this point that the deterioration of the European free trade area negotiations rose as another obstacle to convertibility.

In the early 1950s, British economic policymakers had cared little about the potentially damaging consequences of a move to convertibility for trade with Europe and European cooperation and integration.[60] However, after 1955, Europe came to play an increasingly determining role in British policy on the timing of convertibility, and, by late 1958, the European question had become a crucial factor in the decision of when to move to convertibility. In particular, Britain had begun to worry about German and French reactions to a British move to convertibility. The British went from an attitude of dismissal of any considerations for European cohesion in their discussions on the pros and cons of convertibility to one in which concern for European cooperation seemed the only consideration preventing them from establishing convertibility. This section analyzes the reasons for the British change of attitude.

Sterling and European integration: British dilemmas

In the first half of the 1950s, Britain showed little interest in participating in the nascent European organizations.[61] The lack of enthusiasm towards European integration in the UK was strengthened by the belief that the attempts at European integration by the Six were a non-starter anyway and that the Common Market would never materialize.[62] In addition, Britain remained confident of its ability to persuade Europe to form a free trade

[60] for a discussion of the British attitude in the negotiations for EPU renewal in 1954 and 1955, see Milward, *European rescue*, pp.383-9.

[61] for a discussion of the UK view of European integration in the 1950s, see, for example, Milward, *European rescue*, pp.345-395 and pp.425-433, and Camps, *Britain and the European Community 1955-1963*.

[62] Horne, *Macmillan: 1894-1956, Volume I*, pp.362-3.

area instead of, or in addition to, the EEC.[63] After the Messina Conference, however, many in the UK began to realize that they had underestimated the vigor of the European integration movement. Harold Macmillan was among those who became increasingly concerned by late 1956 that the EEC might actually take off while the free trade area would not materialize, the combination of which would leave Britain isolated from the largest economies in Europe.[64] In the course of 1958, it became clear that particularly the French were not interested in a European free trade area.[65]

By late autumn 1958, the prospects of a successful outcome of the free trade area negotiations were very dim. However, the British government had not yet given up hope. As French opposition to the British proposals grew, the British government became very careful to avoid any action that might allow France to accuse Britain of being anti-European and thus precipitate a final breakdown of the negotiations.[66] The UK press increasingly warned of the damaging consequences of a breakdown of the free trade area

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[63] The free trade negotiations had been initiated by Britain in late 1956 as an alternative or supplement to the European Community which the Messina Six were planning to establish. The British did not want to join the EEC - for reasons of national sovereignty and because of the trading relations with the Commonwealth - but at the same time they did not want to be excluded from a Continental trading bloc. Consequently, they had presented the proposal for a European free trade area which would ensure that their goods would not be discriminated against in intra-European trade, without forcing them to sacrifice their preferential trading arrangements with the Commonwealth and the sterling area, or to devolve sovereignty to a supranational body, which the European Community was set to become. In addition to economic considerations, Britain feared a loss of influence over Europe, which it considered one of its three 'spheres of influence', next to the United States and the Commonwealth. The British attitude towards European integration is analyzed thoroughly in Camps, *Britain and the European Community*. See also D. Robertson, "United Kingdom", in Graduate Institute of International Studies Geneva (eds.), *The European Free Trade Association and the Crisis of European Integration: An aspect of the Atlantic Crisis?*, Michael Joseph Ltd., London, 1968, pp.163-214, Federation of British Industries, *European Free Trade Area; A survey for industrialists*, April, 1957, and *A European Free Trade Area, United Kingdom Memorandum to the Organisation for European Economic Co-operation*, Cmnd. 72 February 1957, HMSO.

[64] Horne, *Macmillan*, p.386.

[65] Analyses and accounts of French policy on European integration are provided in Barnavie and Friedländer (eds.), *La politique étrangère*, Camps, *Britain and the European Community*, Grosser, *La politique* extérieure, Hanrieder, *The foreign policies*, and Kolodziej, *French International Policy*.

[66] The Soustelle affair in November 1958 demonstrated France's inclination, almost eagerness, to walk out of the free trade area negotiations at the slightest British provocation which would allowed them to blame the British for the breakdown of negotiations. The French Information Minister, Jacques Soustelle, had bluntly stated that France rejected the UK proposal for a free trade area. Jacob J. Kaplan and Günther Schleiminger, *The European Payments Union*, p.310.

negotiations for Britain and of the need to avoid a rift between Britain and continental Europe. In December 1958, in light of the rumors of an imminent UK move to sterling convertibility, *The Economist* cautioned against any British action which might be viewed as hostile to the French, since that would only increase solidarity among the Six, thus undermining OEEC-wide economic cooperation and further alienating Britain from some of its most important commercial partners.[67] There was thus a growing realization in Britain of the danger of its isolation and a rift with Europe. In December 1958, Treasury Third Secretary Denis Rickett wrote that "Ministers are very anxious not to put themselves in a position where the French Government could accuse them of having broken up the EPU as some kind of retaliation for the attitude of the Six on the Free Trade Area".[68] He warned that there were already signs "that the French are putting it about that we want to break up the EPU in order to make the Common Market impossible".[69]

Why could a British move to convertibility have been viewed as anti-French and anti-European? The British view was that the establishment of non-resident current account convertibility necessarily implied the end of the EPU and the beginning of the EMA, as agreed in 1955. In 1958, France was a huge debtor to the EPU (see table 2 in chapter II) and the government was constantly struggling to defend the franc against adverse speculation. By October 1958, there were growing expectations of a further devaluation of the franc. Upon liquidation of the EPU, France would have to settle its considerable EPU debt bilaterally, that is, through bilateral agreements with each of its EPU creditor countries. Failing agreement, repayment would have to be over three years, a

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[67] *The Economist*, "Partition of Europe", December 20, 1958, p.1053. see also *The Banker*, "Convertibility - at what risk?", February 1959, pp.80-1.
[68] PRO T236-4822, Rickett to Thorold, December 15, 1958.
[69] ibid.

relatively short period for paying back such a sizable debt. Understandably, France was hoping to reduce its debt to a more manageable size, or eliminate it altogether, before the EPU was liquidated. Since the British maintained that convertibility inevitably ended the EPU, France was not likely to endorse British convertibility plans in the near future.

The EPU was created to facilitate intra-European payments under conditions of currency inconvertibility, and to pave the way for the establishment of convertibility. Consequently, the British argued, the introduction of current account convertibility for non-residents ended the usefulness of the existence of the EPU.[70] For some countries, however, the EPU had gradually come to represent European monetary cooperation and trade liberalization, thus extending its function and importance beyond its original technical purpose. In light of the strong British opposition to the EPU in the past, British proposals to end the EPU were viewed by some as attempts to eradicate an important forum for European cooperation.[71] In the 1955 negotiations for the EMA, the British had successfully lobbied for a post-EPU Europe in which, in matters of intra-European trade and payments relations and internal fiscal and monetary policies, the IMF and the GATT would replace the EPU Managing Board and the Steering Board for Trade, both OEEC-run bodies. Largely due to British pressure, the end of EPU would therefore usher in an era in which, "[t]he OEEC as an institution for European integration would be diminished for want of effective authority over its members' trade, payments relations, or internal fiscal and monetary policies".[72]

[70] Thus the Federation of British Industries wrote in 1957: "If complete currency convertibility is achieved the E.P.U. will no longer be necessary." Federation of British Industries, *European Free Trade Area*, p.13.
[71] see, for example, Kaplan and Schleiminger, *European Payments Union*, pp. 205-8, for an account of the discussion between the British and the Continentals on the transition from EPU to EMA.
[72] According to Kaplan and Schleiminger, Britain's successful lobbying, in 1955, for a less integrative European Monetary Agreement than the one originally sought by most Continentals, was partially responsible for pushing those countries that "attached great importance to the economic integration of

By late 1958, the situation and British thinking had changed. Britain faced the dilemma of not wanting to belong to a highly integrated Europe, which would curtail its economic sovereignty and threaten its Commonwealth trading system, while, at the same time, fearing exclusion from an EEC trading bloc and political association. For countries outside the group of Six, the OEEC, through the EMA and its European Fund, offered a more moderate form of European cooperation, compared to the EEC, and one, more importantly, from which they were not excluded. In 1955, Britain had worried about being drawn into a too integrative OEEC-governed Europe. In 1958, British officials began to realize that the OEEC was the only forum that might prevent the Six from building a trading bloc that would discriminate against Britain, and instead attract them into a wider commercial framework with less political implications.[73]

In July 1955 the EPU countries agreed that when a group of countries that combined at least 50 per cent of the EPU quotas declared their intention to end the EPU and to make their currencies convertible, the EMA would replace the EPU. The EMA introduced the following changes to intra-European payments. First, countries declared fluctuation bands for their currencies vis-à-vis the US dollar. The fluctuation were generally around 0.75 per cent on either side of parity, with only Sweden committing itself

Europe", to "pursue it [economic integration] thereafter through the Common Market negotiations". Thus they argue that, partially as a result of trying to contain European integration in the OEEC, Britain found itself confronted with an even more integrative smaller forum for European integration in which it had no say since it had chosen not to participate. Faced with the exclusion of what looked set to become the new core institution for European cooperation and integration, the British began to revise their policy of trying to weaken OEEC as a forum for European cooperation. This point remains to be proven, however. Kaplan and Schleiminger, *European Payments Union*, p. 227. see also p. 217.
The EMA and the European Fund were a much less cohesive and integrative bodies than the EPU had been; they had less powers, less funds, and less institutionalized forms of cooperation. According to Guillaume Guindey, "In fact the sole function of the European Monetary Agreement turned out to be the granting of small credits to those OEEC members regarded as developing countries." G. Guindey, *The International Monetary Triangle - Myths and Realities*, transl. by Michael Hoffman, Basil Blackwell, 1977, p.24.
[73] Starting on January 1, 1959, the Six would implement the mutual tariff cuts and quota increases agreed in the Rome Treaty. January 1, 1959 thus marked the beginning of trade discrimination on the part of the Six against the rest of the OEEC countries.

to a much narrower fluctuation band, ±0.03 per cent and Switzerland, which was not a member of the IMF, declaring a significantly wider fluctuation band of roughly ±1.8% around parity. Second, compared to the EPU, where intra-European payments were settled at parity rates and debtors could resort to automatic credits for a share of their debts, intra-European payments were now settled 100 per cent in US dollars and at the least favorable exchange rate for the country that sought settlement through the EMA. The aim was to ensure that most exchange clearings would take place in the foreign exchange markets, reducing drastically the scale of inter-central bank clearings.[74] Third, the European Fund replaced the automatic credit facilities of the EPU, was characterized by "non-automatic and much more limited credit facilities" than had existed under the EPU.[75] Thus, ad hoc credits, which could be coupled with stipulations for economic policy changes, replaced the automatic credit facilities of the EPU. The European Fund, whose resources were to amount to $600 million was to be financed through member contributions and through the remaining EPU capital which would be carried over.

The EMA offered a degree of cooperation loose enough for the British to be willing to accept it. Consequently, they began to lobby for the EMA, something, which they probably would not have thought likely when the EMA was created. For Britain, the ideal was a Europe loosely bound together, via the provisions of the EMA, with the OEEC as an advisory body without executive power. The problem was that, given its balance of payments problems and its chronic shortage of reserves, France was not keen on the EMA

[74] Deutsche Bundesbank, *Monatsbericht für Dezember 1958*, pp.4-5.
[75] Federal Reserve Bank of New York, *Monthly Review, January 1959*, p.7.
Members of the EMA had to "make available limited amounts of very short term interim finance, and credit may be granted to assist in meeting temporary balance of payments difficulties, the approval of each application being subject to examination of the merits of the case". IMF, *Tenth Annual Report on Exchange Restrictions*, 1959, p.7.

- particularly not on the European Fund - which was an integral part of the EMA - since it would have required it to contribute to the European Fund, where credits would no longer be automatic and as easily available as in the EPU, and would have to be repaid quicker.

While the fear of the breakdown of the free trade area negotiations and of French hostility deterred the British from unilaterally establishing convertibility in late 1958, the impending beginning of the Customs Union put pressure on Britain to act. Britain's aim to terminate the EPU required Germany, and some of the other continental countries, such as Belgium and the Netherlands, to join the British in the move to convertibility. Since 1954, the UK had been assured that Germany would follow a British lead into convertibility.[76] Treasury officials feared that once the customs union came into effect in January 1959, Germany might no longer be free or willing to move with Britain. Instead, Germany might coordinate its policy on convertibility with its EEC partners, whose plans for convertibility were unlikely to coincide with the British plans.[77] If it wanted to be certain of German cooperation, the UK was under pressure to act before the common external tariff and the Treaty of Rome's separate rules for quota removal came into effect. Again, it was particularly the French the British were worried about. They knew that Germany, in particular the Economics Ministry, wanted convertibility as soon as Britain was ready. But they also knew that, if forced to chose between the UK and France on convertibility, the Germans would side with the French. The close relationship between Konrad Adenauer and Charles de Gaulle that blossomed in the fall of 1958, strengthened German ties with France, making it increasingly unlikely that Germany would follow Britain into convertibility if France would be damaged in the process.[78] Moreover, German loyalty

[76] *The Economist*, "Five minutes after Britain", June 19, 1954, p.962.
[77] PRO T236-4371, A. France to Rickett, "The Rome Treaty and Convertibility", May 17, 1957.
[78] One indication of the closer relationship between Germany and France than between Germany and the UK is the official visits of Adenauer in France compared to Britain. During his period as Chancellor,

towards France was only likely to grow stronger as European integration progressed. As the free trade area negotiations deteriorated and Anglo-French relations on the issue become more and more frosty, British fears grew that "[t]he French Government might also seek to persuade the German Government to refrain from following our lead in spite of their explicit undertakings to us to do so; and a unification of the sterling rates, without matching action by Germany, would leave us in a very embarrassing position".[79]

If convertibility was contingent upon the transition from EPU to EMA, the French were likely to be opposed. But the British saw it as vital that convertibility coincided with the beginning of the EMA and the European Fund. The Chancellor of the Exchequer argued: "The replacement of automatic credit by the European Fund will put us in a position to control assistance from the European Fund to others, including the Six, who will therefore be disposed to take more account of our point of view."[80] The authority to grant credits increased the power of the European Fund compared to the EPU with its automatic credit facilities. As a result, the Fund was hoped to provide an effective counterweight to the Common Market. Treasury officials emphasized the importance of ensuring that the OEEC remained "the chief forum for economic co-operation in Europe".[81] In order to achieve this it was crucial that the European Fund was established as a source of credit together with convertibility. If not, Hubback from the Treasury warned, the OEEC would lose a lot of its influence, and, in that case, he asked, "[m]ight

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between 1949 and 1963, Adenauer visited France 22 times, more than twice as often as any other country, whereas he only visited the UK 6 times. *Außenpolitik der Bundesrepublik Deutschland: Dokumente von 1949-1994; herausgegeben aus Anlaß des 125. Jubiläums des Auswärtigen Amtes*, Auswärtiges Amt, 1995, p.1127.

[79] PRO T236-4820, "Exchange Rate Policy: Note of Meeting held at 10 Downing Street, S.W.1 on Thursday, 27th November, 1958, at 12.15 p.m.", November 27, 1958.

[80] PRO T236-4818, draft memo by the Chancellor of the Exchequer on exchange rate policy, October 16, 1958.

[81] PRO T236-4822, memo from Hubback to France on "A Truncated E.M.A.", December 16, 1958.

we not then have left the field clear for the Six to operate through their own Fund which, in the last resort, I suspect the Germans would be ready to finance?".[82] "If this happened", he worried, "would we not find ourselves shut out of the major policy discussions?".[83] Similarly, as late as December 23, 1958, a telegram from the Foreign Office to UK embassies in Europe and the US and the UK delegation of the OEEC, reiterated that, when establishing convertibility and terminating the EPU, "it is of great importance that the European Fund should be in existence so as to preserve the possibility that E.M.A. should be a source of credit. This will be evidence of the general desire to maintain financial and monetary cooperation among the 17 O.E.E.C. countries".[84]

Based on its past dependence on foreign aid, France was expected to require financial assistance in future. German or EEC credits to France would only increase the cohesion of the Six, thus reducing Britain's influence. As a Treasury document argued,

> it is a major United Kingdom interest to keep O.E.E.C. as the main forum for all major matters of economic co-operation, since otherwise we cannot influence decisions important to us. If France looked to the Six for aid we should have no say about the conditions on which aid was granted. The likelihood of discrimination by the Six would increase and the influence of O.E.E.C. would be bound to decline.
>
> On balance therefore, we should try to ensure that France continues to look to O.E.E.C. for aid, even though this means that we should at any rate have to take on a contingent liability for 25 percent of the aid granted.[85]

Britain was faced with the problem of how to establish convertibility while at the same time convincing the French to agree to the adoption of the EMA. At a meeting of the smaller circle of Ministers in late October 1958, discussions centered on how to gain French support for a move to convertibility and for the transition from EPU to EMA.[86]

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[82] ibid.

[83] ibid.

[84] PRO T236-4823, telegram from Foreign Office to UK embassies in Europe and the US and to the UK delegation at the OEEC, December 23, 1958.

[85] BoE OV 45/48, "Sir Denis Rickett's Working Party Aid for France: Note by the Treasury", June 2, 1958.

[86] PRO PREM11-2671, "Meeting on Exchange Rate Policy"- Record of Discussions, October 28, 1958.

The British hoped to persuade the French to acquiesce to the transition from EPU to EMA by assuring them that the UK would accept repayment periods of longer than three years for their EPU debt, and that it would do everything to influence other creditor countries to do the same vis-à vis France.[87] Finally, the UK government proposed a compromise on the EMA that was palatable to France: only the settlements system of the EMA was to begin with the establishment of non-resident convertibility; the European Fund would be suspended for six months thereafter, on condition, however, of firm French commitment to activate it on June 30, 1959.[88] This compromise would allow the French some breathing space before their contribution would be called up. Also, it would provide time for a revision of the structure of the contributions of the European Fund to accommodate for the changed conditions since the drafting of the EMA in 1955, something the British also considered necessary.[89]

The more intransigent the French became with regard to the free trade area negotiations, the more anxious the British became to appease them and not to give them any occasion for accusing the UK government of being anti-European or of wanting to harm the French. The fear was justified. The French press was ready to jump at the slightest opportunity to blame the UK for a breakdown in European cooperation.[90] On October 31, von Mangoldt, German member of the EPU Managing Board said something to Ellis-Rees, the head of the British delegation to the OEEC, which the latter "interpreted as a warning that we should not break up E.P.U. until the Free Trade Area negotiations

[87] PRO PREM11-2671, paper on France, joint paper by the Treasury and the Bank of England, October 27, 1958.
[88] PRO T236-4822, memo from Rickett to Makins, December 19, 1958.
[89] in particular, the British felt that the Germans should contribute more than they were originally asked to. PRO PREM11-2671, paper on "Transition from E.P.U to E.M.A", prepared by the Treasury and the Bank of England, October 27, 1958.
[90] see, for example, *Le Monde*, "Qui souhaite la fin de l'U.E.P.?", November 23-24, 1958, p.I (Section *Le Monde économique et financier*), and, *Le Monde*, "Après l'enterrement de la zone de libre-échange: où mène le virage de Bad-Kreuznach?", November 30-December 1, 1958, p.7.

were completed or we should have a further accusation from the French, which the Six might have to support, that we were taking action without regard to the interests of our European partners".[91]

On November 5, 1958, in a meeting with the smaller circle of ministers, including the Prime Minister, the only point on the agenda was the decision on whether convertibility should be publicly announced on November 17.[92] The general consensus of the meeting was that both technical and political advantages would be secured from immediate sterling rate unification.[93] Nonetheless, the Prime Minister concluded that two factors - the imminence of the French elections on November 23 and November 30, and the state of the free trade area negotiations - made it inadvisable to take immediate steps to unify the rates. In other words, what stopped the British from taking steps to establish convertibility on November 17, was the concern that the French might use the opportunity to accuse the UK of trying to embarrass the French and divide Europe. The ministers concluded that "[w]hile, therefore, any hope remained of salvaging the Free Trade Area negotiations, it would be unwise to present the French with an excuse for breaking them off" and that, instead of acting immediately, it was better to wait and see what happened to the free trade area negotiations.[94]

The British were ready to establish convertibility in mid-November, if not earlier. Fears of a resulting rift with France and the fear that Germany would side with France played a significant role in the final phase leading up to convertibility. An interesting question is how long this standstill would have continued, had the free trade area

[91] PRO T236-4819, Sir Hugh Ellis-Rees to A.W. France, October 31, 1958.
[92] PRO PREM11-2671, Macmillan to Heathcoat Amory, October 31, 1958.
[93] ibid.
[94] PRO PREM11-2671, "Meeting on Exchange Rate Policy" - Record of Discussions, November 5, 1958.

negotiations been dragged on for months. But on December 10, 1958 Heathcoat Amory, the Chancellor of the Exchequer, sent an almost panicked memo to the Prime Minister: "We are informed that the French are urgently considering a change in their exchange policy before the end of the year", which "may take the form of devaluation or of making the franc convertible or both".[95] Heathcoat Amory believed that a French decision to make the franc convertible would be followed by the Germans, Belgians, Swiss and Dutch. He wrote that,

> In these circumstances I am emphatically of the opinion that we must now decide to bring the sterling rates together so as to move as nearly as possible at the same time as the French. If we do not do this the recent weakness of sterling, which has been due mainly to the appearance of our having lost the initiative, both in regard to the Free Trade Area and unification of sterling rates, will be intensified. This would obviously be very damaging to our position.
> I propose therefore that, when I am in Paris on Monday, I should inform my French and German colleagues (and simultaneously the main Commonwealth countries should be informed) that we have now decided to unify the rates and intend to move not later than the end of the year. I shall take care not to become involved in a negotiation with the French or the Germans on this issue, and so restrict our freedom of action in a matter which must remain entirely under our own control.[96]

If the British government had not expected and feared that the French would pre-empt them in the establishment of convertibility, then, given the state of the free trade area negotiations, it is unlikely for political reasons that the UK would have made a move before 1959.[97] The free trade area negotiations, specifically the lack of progress in the negotiations, and the growing fear of being excluded from Europe had put Britain in a difficult dilemma, which Rickett accurately presented as the following:

What Ministers have to weigh, therefore, is the danger on the one hand of taking a

[95] PRO PREM11-2671, minute from Heathcoat Amory to Prime Minister, December 10, 1958.
[96] ibid.
[97] Speedy progress was not helped by the fact that, as has been shown in chapter II, the Prime Minister had never been an enthusiastic supporter of convertibility. He knew that the Board of Trade, the Trade Union Council (TUC) and the Labour Party remained opposed and, particularly in view of the upcoming elections, he feared that the government would be attacked on the grounds that the move indicated that it was prepared to sacrifice economic expansion and full employment to financial interests. PRO PREM11-2671, "Meeting on Exchange Rate Policy - record of discussions", September 11, 1958.

> step which might still further exacerbate the political atmosphere in Europe and on the other hand the danger of allowing the French to have what amounts to a veto over any forward move by us, with the result that we might give the impression in the foreign exchange markets of having no firm policy.[98]

As late as December 12, 1958, the British government was still uncertain about the French reaction to a UK move to convertibility. Fearing a trap, that is, that the French might take the opportunity of a British move towards convertibility to blame British policy for the imminent Franc devaluation, Macmillan decided to wait with convertibility until the UK could be certain that France would participate in the move.[99] The British government only acted when it had obtained a written confirmation of French willingness to cooperate on this move, to ensure that the French would not back out and then accuse the British of bullying or trying to embarrass them. On December 22, 1958 the UK sought a written statement by France that the date for convertibility had been "chosen to suit the convenience of the two Governments".[100]

In the final days before the joint decision to establish convertibility, on December 15, 1958, Erhard offered de Gaulle a $300 million credit if France devalued and made its currency convertible together with Germany and Britain, and, on the following day, de Gaulle reached his decisions about the French budget and about devaluation and trade liberalization on December 16.[101] On December 17 Amory wrote to Macmillan that in a meeting with the German and French Finance Ministers in Paris the three countries had agreed to "a concerted move on the exchange front between Christmas and the New Year".[102] Amory reported that Pinay had told him: "He thought it would help the discussions on European co-operation in January if we had this piece of co-operation

[98] PRO T236-4822, Rickett to Thorold, December 15, 1958.
[99] PRO PREM11-2671, Record of Cabinet Meeting on exchange rate policy, December 12, 1958.
[100] PRO PREM11-2671, no title, December 22, 1958.
[101] Kaplan and Schleiminger, *The European Payments Union*, p.283.
[102] PRO PREM11-2671, letter from Amory to Macmillan, December 17, 1958.

behind us". With this assurance, the British were finally ready to prepare for the move.

In his account of the return to convertibility, Fforde attributed a central role to central bank cooperation between France, the UK and Germany in assuring agreement on a joint move.[103] According to Fforde, the British, French and German governments communicated largely through the central banks on this issue. The importance attributed to the central banks, and, in particular, to the close relations between the French and the British governors, Baumgartner and Cobbold, as key negotiators and actors, is exaggerated. It is true that the central banks had agreed much earlier than their governments that a concerted move would be desirable. However, central bank negotiations on the issue were restricted to mutual declarations of goodwill and speculation, particularly, on the part of the Banque de France, as to what their respective governments would do. Thus, as late as December 15, 1958, the French governor, Baumgartner, told his British colleagues that while he personally welcomed devaluation, and convertibility, he did not consider it very probable.[104] On December 10, the head of the British OEEC delegation, Sir Hugh Ellis-Rees warned Rickett at the Treasury, that "it would be unwise to assume that what Baumgartner might say about French concurrence to any proposal was necessarily the view of the French Government".[105] Communication between the French and the British central bank was very good, the only problem was that their power to negotiate on the behalf of their respective governments was limited.

The British Prime Minister personally insisted that the announcements of the move to press and parliament were changed to emphasize the cooperative element of the move.

[103] Fforde, *The Bank of England*, pp.595-600.
[104] PRO T236-4822, record of conversation with Baumgartner, December 15, 1958.
[105] PRO T236-4821, Sir Hugh Ellis-Rees to Denis Rickett, December 10, 1958.

Thus, the following paragraph was added to the announcements: "This is part of a co-ordinated European move. The date has been chosen after consultation in the first instance between H.M.G. and the French and German Governments".[106] The British government wanted to make sure that the British would not be seen as following a continental lead while at the same time, however, conveying the willingness of Britain to cooperate with the rest of Europe.

Conclusion

According to Robert Triffin, "the restoration of an international system of trade and payments after the end of the war was ... recognized at an early stage as a problem whose solution would require international negotiation and agreement rather than be left to unilateral uncoordinated decision by several scores of sovereign countries".[107] Similarly, Strange argued that between 1952 and 1954, the European countries, including the UK, agreed to cooperate in the return to convertibility and to synchronize and co-ordinate national policies to achieve a "major change of gear in the international monetary system".[108] These statements does not apply to British policy on convertibility. Whereas Germany and France had been interested in a collective move throughout the 1950s, - although for different reasons -, in the UK, up until 1958, consultation and cooperation with other European countries conflicted with the national policy goals attached to convertibility. Therefore, it was not a foregone conclusion that the three countries would cooperate in the return to convertibility. The decision to cooperate with the rest of Europe in a joint move to convertibility was the result of a gradual realization, a process which was far from finished in 1955 when the EMA was signed, that the UK needed

[106] see, for example, PRO PREM11-2671, "UNICORN - Draft Press Announcement", December 24, 1958.
[107] Triffin, *Europe and the Money Muddle*, p.92.
[108] Strange, "International Monetary Relations", pp.36-37.

Europe, both for the move to convertibility and to pursue its international economic and political ambitions. The development of the free trade area negotiations opened British eyes to the the force of the European integration movement and to the limits of Britain's ability to influence the course of events in continental Europe. The pound weakness and the increasing fear of exclusion from a European trading bloc led to the realization that Britain needed Europe for the fulfilment of its national interests, whereas Europe was not dependent on the UK to integrate. As a result of this gradual realization British ministers decided to negotiate with continental Europe to ensure a collective return to convertibility. This decision constituted a significant departure from previous British policy on convertibility, which had paid little attention to the considerations and reactions of, or the consequences for, the other European countries of a British move.

The decision to seek a collective move to convertibility thus marks a fundamental shift in the UK's policy towards Europe. Far from being a mere technicality, the return to currency convertibility in 1958 was an integral part of a new British attitude towards European integration. British policy on convertibility in the second half of 1958 is the first manifestation of the change in British policy towards Europe which culminated in the application for membership in the EEC in 1961. Previous accounts of the return to convertibility fail to place the event in the context of this structural break in British policy towards Europe. While acknowledging that the free trade area negotiations affected the British choice of timing of the move, they do not establish the connection between the change in the UK's policy on convertibility and the shift in its policy towards Europe.[109]

Britain's dismissive attitude towards the integration efforts by the Six in the first

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[109] Fforde, *The Bank of England,* pp.595-600 and Kaplan and Schleiminger, *The European Payments Union,* chapter 17.

half of the 1950s can only be explained by a belief that the plans would not materialize.[110] This indicates an error of judgment on the part of the British, due in part to an overestimation of the importance of British membership in any forum for European cooperation. According to Milward,

> British policy was not only based on a complete misunderstanding of the strength of the common interest that bound the continental EPU members together, it was also a serious misjudgement of the United Kingdom's own economic strength.[111]

After 1955, the British, particularly Macmillan, began to realize that a Common Market of the Six was becoming increasingly likely and that the Continentals could advance towards European integration without British consent or participation. The increasing concern with the effects of a move to convertibility on European cooperation reflect this realization.

While the temporary strengthening of sterling, and other advantageous economic conditions discussed in the previous section, explain why the Treasury was generally favorably inclined towards establishing convertibility in the second half of 1958, the final decision on when to act was determined by foreign policy considerations. Macmillan was not prepared to jeopardize the free trade negotiations and to be accused of being anti-European by establishing convertibility. Only when it transpired that the French might be getting ready to establish convertibility did the UK Treasury begin its own concrete preparations for a move. Even then, however, Macmillan refused to give his consent until he had received a written assurance from France that the latter would not use the move to entrap the UK. Thus, in the final instance, the desire to prevent a rift with continental

[110] Fforde spoke of a 'Euro-blindness', which afflicted the Bank of England and accounts for its proposals for convertibility, such as Operation ROBOT, which completely ignored the importance of Europe. Fforde, *The Bank of England*, p.453.

[111] Milward, *The European Rescue*, p.386. See also the article by Sir Nicholas Henderson in *The Economist*, "Mad John Bull disease", November 23, 1996, pp.49-52.

Europe took priority over the international ambitions for sterling. Previous literature on the topic has failed to recognize the importance of Britain's policy towards Europe, and, in particular, the shift in the policy, for the timing of the move towards convertibility and the decision to cooperate. However, it was foreign policy considerations, rather than economic or monetary conditions, which explain why convertibility was established in late December 1958 and why it was established jointly with the rest of Europe.

In 1959 Per Jacobsson, the Executive Director of the IMF wrote:

> External convertibility does not in itself imply greater freedom of trade, but the very fact that so many countries in Europe could agree on these currency steps at a time when discussions on the future of their trade relations were distinctly acrimonious may be expected to have a very useful psychological impact.[112]

As chapter III has shown this psychological impact was very important for German opponents to the EEC, led by Ludwig Erhard. The timing of the move coincided with the coming into force of the tariff and quota provisions of the Rome Treaty. It conveyed the impression that OEEC-wide cooperation could continue in spite of the potentially divisive effects of the beginning customs union of the EEC. The remarkable thing is that, contrary to its previous European policy, by 1958, the UK was also very anxious to communicate such a message. Moreover, by emphasizing the cooperative aspect of the move, in the public announcements, the government was willing to forgo the benefits for sterling and for its international financial ambitions which it associated with clear leadership in the establishment of convertibility in favor of promoting European cooperation.

According to Sir Alec Cairncross, in the 1940s and 1950s, "[a]part from the dwindling competitiveness of British exports, the main concerns of external economic policy were to re-establish convertibility and to find some alternative to joining the

[112] Jacobsson, "Toward More Stable Money", p.379.

European Economic Community".[113] In 1958, the realization of the former policy objective, especially a unilateral British initiative, seemed to diminish the chances of achieving the latter, revealing a close connection between the two which had not been obvious before. Cooperation with France and Germany allowed the UK to establish convertibility without jeopardizing the possibility of finding an alternative to joining the EEC.

National policy on convertibility in the 1950s reveals discrepancies between the UK, France and Germany in the role assigned to monetary policy and the national currency, but also in the national political interests that motivate European monetary cooperation. The study of the return to convertibility thus provides important insights into national decisionmaking and national priorities that determine European integration, and, moreover, it provides new evidence of the close links between monetary and political cooperation. In the 1970s, Miriam Camps and Fred Hirsch, Michael Doyle and Edward L. Morse analyzed the growing role of politics in international monetary relations.[114] The German and the British policies on convertibility have showed the importance of political considerations in monetary decisionmaking. One of Hirsch and Doyle's characteristics of the increased politicization of international economic issues is the greater involvement of higher political levels.[115] Prime Minister Macmillan's active involvement in decisionmaking on convertibility is a prime example of the politicization of monetary issues.

[113] Cairncross, "Economic policy", p.64.
[114] M. Camps, *The Management of Interdependence*, Council on Foreign Relations, 1974, p.55, and F. Hirsch, M. W. Doyle and E. L. Morse, *Alternatives to Monetary Disorder*, Council on Foreign Relations, McGraw-Hill, 1977.
[115] F. Hirsch and M. W. Doyle, "Politicization in the World Economy: Necessary Conditions for an International Economic Order", in Hirsch, Doyle and Morse, *Alternatives*, pp.12-13

CONCLUSION: MONETARY COOPERATION AND EXCHANGE RATE STABILITY

> It is inevitable that individual nations in their approach to international monetary planning should be influenced by their own economic aspirations. It is best to be realistic and to admit that unless a satisfactory answer can be given to the question 'what is there in this for us?' co-operation will be, at best, ephemeral.[116]

The previous chapters have analyzed the domestic issues that shaped the national policies of France, Britain and Germany on convertibility. The country chapters showed that convertibility meant different things and was associated with different issues and policy aims of each of the three countries. The main focus of this chapter has been to determine why countries cooperated in the return to currency convertibility and why they chose December 1958 as the date for the event. It has examined what economic circumstances and policy objectives ensured that France, Britain and Germany agreed to cooperate in the move to convertibility. It analyzed the national goals that were pursued in the coordination of the return to currency convertibility. This section assesses whether the type of cooperation which took place in the return to currency convertibility in 1958 between France, Britain and Germany enhanced the stability of the international monetary regime.

Ralph C. Bryant identified three different degrees of international economic cooperation. The lowest degree of cooperation, which he called "traffic regulations", refers to a set of rules or regulations which governments agree upon to "ensure against the worst excesses of unconstrained noncooperative behaviour".[117] Examples of such traffic regulations are GATT and the IMF Articles of Agreement. The next level of cooperation,

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[116] Scammell, *International Monetary Policy*, p.8.

[117] R. C. Bryant, "Intergovernmental Coordination of Economic Policies: An Interim Stocktaking", in *International Monetary Cooperation: Essays in Honor of Henry C. Wallich*, Princeton Essays in International Finance, no.169, December 1987, p.5.

"consultation", implies some intergovernmental exchange of information the purpose of which is an enhancement of governments' ability to make decisions "likely to promote national interests".[118] Finally, "coordination", which Bryant identified as the most ambitious type of cooperation, involves some degree of "centralization of decisionmaking". In the case of coordination, "explicit bargaining occurs and the governments agree to behave differently than they would have behaved without the agreement".[119] In general, according to Bryant, economic cooperation is always motivated by self interest, and thus should not be taken to imply "amity, harmony, or altruism".

> It [coordination] certainly does not imply that national governments have common goals, that their goals are compatible, or that some governments must give up their own goals in deference to the goals of others.[120]

If monetary coordination can be motivated by the pursuit of incompatible goals, then, to extend Bryant's hypothesis, international monetary cooperation can be detrimental to international monetary stability. Thus, if monetary cooperation serves to promote conflicting national interests, then, particularly, in a fixed exchange rate system, cooperation can actually be destabilizing for the international monetary regime. The pursuit of consistently different national inflation rates in a fixed exchange rate system could be one of the conflicting national interests which might undermine the international monetary system.

British economic policy in the 1950s was determined by the conflicting objectives of full employment and a strong pound. The former objective deterred British governments from maintaining price stability at the level necessary for exchange rate stability. The benefit of convertibility was assessed according to its compatibility with

[118] ibid.
[119] ibid.
[120] Bryant, "Intergovernmental Coordination", p.7.

these two objectives. Whereas convertibility, at a fixed exchange rate, was considered necessary to secure confidence in sterling, it was perceived to be incompatible with the pursuit of full employment policies. Similarly, German economic policy after World War II was characterized by the desire to avoid DM revaluation while at the same time continuing to maintain a level of inflation which was lower than that of its trading partners. However, in 1958, the temporary convergence of trade and monetary conditions in Britain and Germany, presented a unique opportunity to establish convertibility without sacrificing either of the two policy objectives. The establishment of convertibility could be expected to increase confidence in the pound, at least in the short run, whereas the favorable economic circumstances relieved the British government of the need to implement disinflationary policies to ensure the success of the move. At the same time, the move was unlikely to strengthen the DM, thus easing pressures, on German policymakers, for revaluation and monetary expansion. Cooperation and the choice of timing on convertibility allowed Germany and Britain to continue to pursue national policy objectives which were incompatible with the maintenance of balance of payments equilibrium and thus with the stability of the international monetary system.

Germany left the choice of the timing of the move to convertibility up to the British, secure in the knowledge that the British would pick a moment when the pound appeared relatively strong which implied a time when the DM would appear weaker than normal. The British press[121] as well as the British Treasury and the Bank of England watched very closely the development of the DM and the dollar in the exchange markets. Assessments of the strength of the dollar frequently appeared in the memos discussing the

[121] See, for example, *The Economist*, "Convertibility at Work", p.55, and "An Act of Bravery?", p.12, both January 3, 1959.

appropriate moment for sterling convertibility.[122] In the second half of 1958, several circumstances and events seemed to moderate the strength of both the DM and the dollar, making sterling look relatively stronger than in the years before. The Berlin Crisis initiated by Khrushchev in the fall of 1958, and culminating in the ultimatum he presented to the Allies on November 27, 1958, raised temporary doubts among the Zürich foreign exchange dealers, "whether Germany really is the safest place for their money", and as a consequence, but again only temporarily, bolstered confidence in the pound.[123] At the same time, in 1958 the US dollar emerged, according to *The Economist*, as "this year's suspect currency", benefiting the pound through correspondingly increased trust.[124] These circumstances were favorable to Britain's desire to dispel pressure for a devaluation of the pound and December 1958 presented a particularly opportune moment for Britain to 'lead' Europe in the collective convertibility move with the aim of convincing the world that sterling deserved confidence.[125]

By cooperating and deliberately taking the backseat in the collective establishment of convertibility, Germany found an, albeit short-lived, valve to reduce the pressure for economic adjustment. The temporary abating of the speculative capital inflows into Germany weakened the case of Germany's trading partners who urged, and even tried to intimidate, it into appreciating its currency or implementing other changes to correct the

[122] See, for example, PRO T236-3946, Report by the Bank of England sent to the Treasury: "'Pros' for early amalgamation of official and transferable sterling", March 18, 1958, and PRO T236-3946, Views of the Bank of England on "The Arguments in Favour of an Early Amalgamation of Official and Transferable Sterling", April 2, 1958.
[123] *The Economist*, "Assessment for Sterling", November 29, 1958, p.812. For a discussion of the Berlin Crisis, see Schwarz, *Die Ära Adenauer: Epochenwechsel.*
[124] *The Economist*, "Assessment for Sterling", November 29, 1958, p.811.
[125] Of course, leadership in the move to convertibility in itself was not a sufficient sign of strength of the British currency. A relatively high level of foreign exchange and gold holdings is one measure of the 'strength' of a currency, indicating an opportune moment for action. The issue of timing, and its importance for the British, will be discussed in the British chapter of this thesis.

'structural' imbalance. The recorded strengthening of the pound, also vis-à-vis the DM and the increase in the flow of short-term funds into Britain in the months immediately following the collective establishment of convertibility indicate that the policy worked, at least temporarily.[126]

Renouncing leadership in favor of the British in the collective convertibility move suited Germany's monetary, and indirectly its economic, policy goals. Most economic factions in Germany, led by the Bundesbank, wanted to avoid a revaluation of the DM. Throughout the 1950s, as the DM gained confidence concurrently with rising trade surpluses, the Economics Ministry took numerous unilateral steps towards import liberalization in a continued attempt to reduce the buildup of foreign exchange reserves and thus the pressure to revalue.[127] However, reserves continued to swell and with it, speculative upwards pressure rose. A unilateral move to convertibility or leadership in a collective move, which would have made sense given the outstanding strength of the DM, would have surely intensified speculation even further, increasing pressure for a revaluation. Letting the British 'lead' and taking the backseat in the OEEC-wide move dispersed, temporarily, the upward pressure, which unilateral import liberalization failed to do. Already in 1957, Germany and Britain had cooperated in a joint effort to prevent either a DM revaluation or a pound devaluation. Instead of tackling the underlying real causes for the exchange rate pressures, they resorted to a joint statement confirming both countries' commitment in the existing exchange rate. The effect of the statement was to reduce temporarily currency speculation, thus merely postponing the economic adjustment

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[126] See *The Economist*, "Convertibility Markets", January 3, 1959, pp.60-2, "Foreign Exchange: Convertible Pounds in Demand", January 10, 1959, pp.151-2, "Sterling's Strength", January 17, 1959, pp.244-6, "Foreign Exchange: Foreign Funds to London", January 24, 1959, pp.340-3, "Convertibility Debate: The Next Move", January 31, 1959, p.431, "Convertibility: Sterling Pulls in the Gold", February 7, 1959, pp.513-4.
[127] Giersch, Paqué and Schmieding, *The Fading Miracle*, pp.110-111.

necessary to return the two currencies to their purchasing power parities.

The temporary reduction in the pressure to revalue also momentarily took the steam out of the pressure exerted by Germany's trading partners to implement policies to correct the structural imbalance which continuing surpluses seemed to reflect. The artificial dampening of the confidence in the DM corresponding to the artificial boost to the strength of the pound as a result of the collective move under British leadership allowed Germany to continue to sterilize the expansionary effect of the balance of payments surpluses on the domestic economy. In this way, Germany's cooperation in the collective move actually undermined the Bretton Woods system by preventing the adjustment mechanism of a fixed exchange rate system from establishing equilibrium. While, on the surface, the Bretton Woods system appears to have been a period of exchange rate stability and economic cooperation aimed at assuring this stability, a closer look at some of the examples of monetary cooperation reveals that often countries were joined by a common desire to prevent the adjustments necessary for maintenance of balance of payments equilibrium, and thus for the viability of the international monetary system.

> When both monetary and fiscal coordination are considered, we find potentially important gains to cooperation. When only monetary policy is considered, we find the gains are relatively small.
> One implication of these results is that it is likely to be easier to achieve coordination of monetary policies rather than coordination of both fiscal and monetary policies.[128]

In the case of the coordinated move to convertibility, monetary cooperation was a way of reducing the pressure for fiscal policy coordination. By cooperating on this external monetary policy, German and Britain avoided fiscal policy coordination. Britain and

[128] W. J. McKibbin and J. D. Sachs. *Global Linkages: Macroeconomic Interdependence and Cooperation in the World Economy*, The Brookings Institution, 1991, p.187. See also K. Dam, *The Rules of the Game: Reform and Evolution in the International Monetary System*, University of Chicago Press, 1982, p.12.

Germany's preference of monetary coordination over fiscal coordination is rational since,

> monetary coordination alone implies policy settings that are close to ones that a government would follow in its own self-interest. Coordinating both fiscal and monetary policies, in contrast, implies policy adjustments that are quite different from ones that a country acting alone would pursue.[129]

Whereas it is true, as Eichengreen claimed, that "[i]nternational monetary stability has always required international cooperation and collaboration", international cooperation and collaboration, at least when it is limited to monetary cooperation, is not necessarily conducive to international monetary stability.[130] In the return to official convertibility, monetary cooperation preserved present exchange rate stability in the very short term at the expense future stability.

In contrast to Germany and Britain, French policymakers viewed cooperation in convertibility as an opportunity to introduce unpopular economic adjustment measures. By combining the economic reform with a collective move to convertibility, the government found it easier to convince the French public that economic adjustment was necessary if the French economy was to keep up with the rest of Europe. France coupled a fundamental change in its external policy direction, from a very closed to a relatively open economy, with an equally big change in its domestic economic policy orientation, from a strongly state-controlled, wage-and price indexed and inflationary economy to deregulation, de-indexation, and price stability. In Germany and Britain, the move was not accompanied by a change in economic policy. On the contrary, the moment for convertibility was chosen to ensure that a policy change would not be necessary when undertaking the move. Since in the French case, monetary cooperation was sought to

[129] McKibbin and Sachs, *Global Linkages*, p.190.
[130] Eichengreen, *Elusive Stability*, p.12.

facilitate public acceptance of economic adjustment, French cooperation, as opposed to British and German cooperation was conducive to longer term exchange rate stability.

In contrast to Germany and France, Britain decided very late that cooperation in the return to currency convertibility was in its best interest. The change in British policy on convertibility can be ascribed to two realizations. The first was the realization that European integration was a more powerful force than Britain had reckoned with, and, that it could prosper without, and even against the wishes of, Britain. The development of the free trade area negotiations made this painfully clear. As a result, policymakers in the UK gradually understood that they could not ignore European concerns if they wanted to have a say in Europe. The second realization relates to the fragility of sterling. As again the free trade area negotiations had shown, British policymakers realized that they could not take for granted that the rest of Europe would obediently follow a British lead into convertibility. However, after having lived through a decade of recurring sterling crises, British ministers became increasingly apprehensive of a bold unilateral move towards convertibility and they were increasingly anxious to assure themselves that above all Germany would follow a British move.

Favorable economic circumstances in 1958 offered the opportunity to establish convertibility without triggering a run on the pound. Thus, as the Treasury had wished, the move to sterling convertibility was undertaken from a position of strength. However, the causes for the improvement in British economic conditions, were exogenous and ephemeral. Consequently, the problems of sterling could be expected to return once the international economy came out of its recession. The momentary monetary stability allowed the government to move to convertibility at a time when it was implementing economic policies aimed at stimulating domestic economic activity. A move to convertibility combined with a tightening of fiscal and monetary policy, as undertaken in France, would have been politically unacceptable in Britain. It would have been attacked by the opposition parties as indicating the government's willingness to sacrifice full employment and expansion to external monetary objectives.

Similar to Britain, the establishment of DM convertibility made no lasting impact on the conduct of monetary and fiscal policy in Germany. There was no reason to assume that, after convertibility, Germany would change its policy of sterilizing the expansionary effect of balance of payments surpluses and of trying to get away with higher than average price stability while avoiding revaluation.

The French move to convertibility marked a clear change in economic policy orientation. Before convertibility was established, France had been one of the most closed and protected economies in Europe. For France, convertibility and trade liberalization presented a much larger step than for Germany and Britain, where the move was largely symbolic. France's decision to take this plunge, at a time when economic and financial conditions were worse than they had been in a decade, indicated that France was willing to make a change. By combining the step with far-reaching economic reforms, the government made a clear break with the past. French cooperation in convertibility was motivated by the desire to make the new economic policy orientation more palatable to the public. German and British cooperation in convertibility was motivated by the desire to preserve policies and structures which had already proven to be inconducive to exchange rate stability and thus to international monetary stability.

CONCLUSIONS

This thesis has shown that the assumption that countries were united by a common desire to establish convertibility because of its benefits for multilateral trade is simplistic and erroneous. Chapter I argued that existing explanations fail to provide a satisfactory answer to why Western Europe moved jointly to convertibility in 1958. The most widespread explanation is that the later than expected fulfilment of certain preconditions for convertibility, in particular, the insufficiency of reserves, forced Western Europe to postpone convertibility longer than originally planned. Taking a different approach, the Eichengreen hypothesis argued that the preconditions for a move to convertibility were fulfilled by the early 1950s, and, that the delay in convertibility can be attributed to a collective desire to protect the post-war settlement by maintaining the European Payments Union. Both explanations assume that countries agreed from the beginning that convertibility would only established collectively and that they shared a commitment to convertibility and to the stability of the international monetary system. This thesis refutes these assumptions, arguing instead that there was no widespread consensus on convertibility nor on the need to cooperate in a collective move. The comparison of the key countries' policies on convertibility reveals fundamental differences in national economic policy objectives.[1]

Chapters II, III, and IV, analyzed the British, German and French national policies on convertibility, respectively. The country chapters show that, depending on their diverging economic policy orientations, the three key countries associated very different benefits and costs with currency convertibility. The reasons for delaying convertibility

[1] A light-hearted but revealing essay written in the 1950s which mocked the differences in national views on convertibility is reproduced in Appendix B.

until 1958 varied according to the national objectives pursued with the move. Moreover, the motivations for monetary cooperation in convertibility differed significantly from country to country. The analysis of national policy goals shows that the only interest that bound France, Britain and Germany together in the move to convertibility was the attraction offered to each country by a cooperative move.

The international currency role of sterling and the traditional trade dependence should have made Britain one of Europe's most fervent advocates of convertibility. The Conservative Party declared convertibility one of its top economic goals in 1952. Contrary to public statements, however, in Britain convertibility was a much more controversial issue than in France or Germany. British policy on convertibility was torn between international ambitions for sterling and the rejection of an external constraint on expansionary domestic economic policy. Moreover, trade considerations mitigated against, rather than in favor of, a speedy return to convertibility. From its inception, British governments questioned the desirability of two of the foundation stones of the Bretton Woods system, namely convertibility and a pegged exchange rate. Sterling's weakness cannot be explained by an irrational lack of confidence in the pound. Rather, monetary policy which failed to stabilize prices and wages weakened the pound and in addition undermined confidence in the pound, which in turn further increased spculation against the pound. The lack of consensus on convertibility and the frequent turnarounds in British policy contributed to the erosion of confidence in sterling. Policymakers' attraction to a floating exchange rate combined with a commitment to full employment policies, at a time when employment was already at historically low levels, undermined the stability of sterling and thus of the entire international monetary system. British policy dilemmas and the conflicted view on convertibility are illustrated by the fact that, when the government finally took the step in 1958, it made a deliberate decision to avoid the term 'convertibility' in the announcement of the event of the move to the public:

> It would be easy to compare convertibility with the return to the gold standard in 1925, since both operations were based on the principle of a fixed parity; and both the Parliamentary Opposition and organised labour would undoubtedly take advantage of this fact to maintain that the Government were abandoning the protection which the economy derived from the flexibility of dual rates and were sacrificing employment and production to the interests of the international bankers. Moreover, this criticism would not be wholly without foundation in-as-much as convertibility necessarily entailed the maintenance of a disinflationary internal policy and might therefore make it more difficult for the Government to embark on the expansionary measures which they had under consideration at the moment. For these reasons it would be desirable that, if the rates were unified in the near future, the Government should seek to minimise the psychological impact of the operation by representing it not as constituting the full convertibility of sterling but as representing only a further step towards the ultimate goal of convertibility.[2]

The official establishment of convertibility which was intended to be one of the showpieces of the Conservative Party's policy successes, was thus downplayed for fear of domestic opposition to the move.

In Germany, trade considerations were much more conducive to the rapid return to convertibility than in Britain. In addition, and in total contrast to Britain, the unique combination of historical experience, economic conditions and political circumstances laid the foundation for a widespread, even grassroots, consensus on the desirability of convertibility. However, whereas sterling's special role and Britain's international power aspirations were best served by a unilateral British move to convertibility before the rest of Europe, German economic and political interests were best served by a collective move to convertibility. The priority attributed to cooperation in convertibility explains why Germany waited for Britain and the rest of Europe, when its economic and financial

[2] T236-4819, "Exchange Rate Policy: Note of a Meeting held at 10, Downing Street, S.W.1, on Tuesday, 28th October, 1958, at 12.15 p.m.".

conditions would have allowed it to establish DM convertibility as early as 1954. In contrast to Britain, the consistency of German policy on convertibility reinforced the strength of its currency.

French policy on convertibility can be divided into a pre-1958 and a post-1958 period. Before 1958, the reality of trade deficits, currency instability and higher than average inflation combined with the politically motivated quest for self-sufficiency made convertibility a secondary priority. Convertibility was relegated to a distant and utopian future in which France was prosperous, competitive and financially stable. The generous and frequent resort to multiple exchange rates and high import barriers indicated that the statutes of Bretton Woods were did not play an important role in economic policy making. However, the deterioration of the external balance and internal price stability led to a growing realization that current policies were not working. Policymakers began to look to other policy options to cure the French economy of its ills. Prominent economists, led by Jacques Rueff, who had been preaching the virtues of monetary stability and convertibility for years, were no longer ignored. In 1958, political instability, exacerbated by the Algerian war, joined with financial instability to create a general atmosphere of national crisis. The circumstances demanded a strong leader who was willing to implement drastic policies to get France back on its feet. General Charles de Gaulle fit the role perfectly. The economic reformers were called in to clean up the mess left by more than a decade of lax fiscal and monetary policy, inflation, and price-distorting government intervention. Convertibility was an intricate part of the package of measures adopted in the 'redressement' of the French economy.

The extraordinary popular support and respect which de Gaulle enjoyed were the ideal prerequisite for the implementation of far-reaching and painful economic measures. The similarities and differences between 1958 and the situation in France in 1996 are striking. Then as now, France had to cut public spending and deregulate to renew to create favorable conditions for economic growth and to prepare the economy for the next phase in European economic integration. In 1958 it was the Common Market and the commitment to trade liberalization while today it is the European Monetary Union (EMU) and the necessity to meet the three convergence criteria, relating to the budget deficit, inflation and interest rates. Then as now, economic conditions demanded unpopular economic policies. However, whereas in 1958 the public responded favorably to the measures, even though large segments of the population experienced real income losses, in 1996, the reforms have met with massive protests which in turn are undermining the political stability of an already vulnerable government. Considering the current difficulties in pushing through reforms aimed at economic and monetary stabilization, the turnaround in French policy and the success of the widespread economic reform is all the more remarkable. The combination of extreme political and economic crisis and a strong and popular leader created a favorable setting for the imposition of far-reaching economic reforms which, in turn paved the way for a decade of rapid growth with relative monetary stability. In contrast, Britain lacked the consensus and the political mandate to make possible a similar change in policy.

Contrary to France, both Britain and Germany resisted economic adjustment throughout the 1950s. The bi-annual sterling crises indicated that the state of the British economy was unconducive to the stability of sterling. Higher than average inflation combined with lower than average unemployment confirmed a policy orientation which placed economic expansion above monetary stability. Conversely, the strength of the DM on foreign exchange markets and the repeated bouts of speculative capital inflow, reflected a structural surplus problem in the German balance of payments. Germany sterilized its balance of payments surpluses and thus prevented the automatic adjustment mechanism from restoring balance of payments equilibrium. Consequently, inflation rates remained lower than average while trade surpluses continued to grow. Neither Britain nor Germany were inclined to letting their economic policies be dictated by external pressures on the exchange rate. In 1958, the exceptional economic and financial conditions temporarily removed the pressure on both Germany and Britain to adjust their economies and thus to change their economic policy orientation (see chapter V). 1958 was therefore the opportune moment to establish convertibility. However, as a result of the failure to remove the origins of the structural external imbalances, once international economic conditions had returned to normal, and the international economy had come out of the recession, the problems, and with them currency speculation, returned. By 1959, the trade balance was back in deficit, wages and prices were rising and sterling was back in hot water.[3] Similarly, rapidly growing trade surpluses and speculative capital inflows returned in Germany in 1959/1960, and, in 1961 the DM was revalued. Cooperation in the move to convertibility and the choice of the timing of the move only allowed Germany and Britain to postpone further the economic adjustment measures which would have been necessary to ensure lasting balance of payments equilibrium and exchange rate stability. Whereas

[3] "Between 1959 and 1964 the vital currency was sterling. Had the pound been capable of assuming the role of key currency to which the British Government aspired, had it been backed by a stronger balance of payments, more skilful monetary policy and had it not been subject to repeated speculative attacks by lagged payments and hot money movements, then the suspicion which clouded it would probably not have been extended to the dollar later in the decade. As it was the period from 1959 to 1964 was punctuated by recurrent sterling crises which marked the end of its career as a key currency." Scammell, *The International Economy*, p.120.

Germany wanted to avoid both revaluation and inflation, Britain sought to fend off devaluation and disinflation. The resistance of both countries against the convergence of inflation rates revealed an unwillingness to subscribe to the rules of game, of a fixed exchange rate system.

Up until 1958, European cooperation on convertibility was obstructed by British and French reluctance to share their intentions with other countries. Mutual consultation was viewed as an infringement of each country's right to self-determination and a threat to both Britain's and France's aspirations for leadership in Europe. The maintenance of sterling's international currency role, in particular, demanded unilateral and assertive British decision-making. Policy cooperation was considered to be an admission of insecurity, on the part of British policymakers, regarding sterling's strength. However, after 1958, there was a gradual change of British policy on cooperation. British ministers paid increasing attention to the development of European integration on the continent. A growing fear of losing influence over continental Europe was exacerbated by the unsuccessful negotiations for a European free trade area. At the same time, sterling's unsatisfactory track record heightened British awareness that a successful move to convertibility depended Germany and as many other countries as possible following a British lead. The two factors led Britain to adopt a cooperative stance on convertibility in the second half of 1958. The decision to consult and cooperate with France and Germany in the move to convertibility marked a significant change in Britain's policy on convertibility.

Whereas Britain only discovered the advantages of cooperation at a very late stage, in Germany, cooperation had always been a pre-condition for a German move to convertibility. Due to Germany's unique situation after World War II, cooperation presented no threat to its self-determination. On the contrary, it was the only way for Germany to regain sovereignty. Germany's economic and political orientation generated an early consensus on the desirability of both convertibility and cooperation.

Articles IV and VIII of the Articles of Agreement committed countries to establishing and maintaining currency convertibility for current transactions at a fixed exchange rate, with a permitted fluctuation of 1 per cent on either side of the par value, and to "collaborate with the Fund to promote exchange stability" (Art. IV, Sec. 4(a)). In addition, by signing the Articles of Agreement, member countries subscribed to the principles of the International Monetary Fund (IMF) which included the purpose "To promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems" (Art. I (i)). Throughout the 1950s, policymakers in the UK hesitated to commit to a fixed exchange rate, currency convertibility and international monetary cooperation. Governments' deep-rooted scepticism of the tenets of the Bretton Woods system and particularly public awareness of policymakers' reluctance to espouse the principles of the Bretton Woods constitution significantly contributed to the weakness of sterling in the 1950s and 1960s. Similarly, Germany's policy of sterilizing balance of payments surpluses and maintaining German inflation below the European average meant that the DM was consistently judged to be undervalued. While, on the surface, the Bretton Woods system appears to have been a period of exchange rate stability and economic cooperation aimed at ensuring this stability, a closer look at some cases of monetary cooperation reveals that often countries were brought together by a shared intention to prevent the adjustments necessary for the smooth functioning of a fixed exchange rate system.

Martin Feldstein claimed that "[a]lthough the Bretton Woods Agreement was accepted by the United States and all the other major nations of the non-Soviet world, the system never worked the way that it was designed to do".[4] Feldstein listed as the three reasons why the Bretton Woods rules were never followed, firstly, changing economic conditions, secondly, changing views on the most suitable international monetary system, and thirdly, "an unwillingness of major countries to accept the constraints imposed by the Bretton Woods Agreement when it conflicted with national interests".[5] This thesis has shown that the national policies towards convertibility of some of the key countries of the international monetary system revealed a lack of commitment to the tenets of a fixed exchange rate system with convertible currencies, and a refusal to follow the rules of the game. If countries never played by the rules of the game established in the Bretton Woods Agreement, then the it can be argued that the conference at Bretton Woods created "[a] system that never was".[6]

Axel Leijonhufvud attributed a crucial role to expectations in the definition of a monetary regime. Thus he defined a monetary regime as

> first, a system of expectations governing the behavior of the public. Second, it is a consistent pattern of behavior on the part of the monetary authorities such as will sustain these expectations.[7]

Public awareness of governments' doubts about the Bretton Woods principles undermined the stability of the fixed exchange rate regime and consequently eroded the

[4] M. Feldstein, "Lessons of the Bretton Woods Experience", in Bordo and Eichengreen (eds.), *A Retrospective*, p.613.
[5] ibid.
[6] ibid.
[7] Leijonhufvud's definition of monetary regimes differed from previous ones which defined a monetary standard by the institutions and arrangements regulating the money supply. See A. Leijonhufvud, "Constitutional constraints on the monetary powers of government", in R. B. McKenzie (ed.), *Constitutional Economics*, Lexington Books, 1984, p.95 and Bordo and Jonung, *Monetary Regimes*, p.2.

very foundation that Bretton Woods was built on. This thesis has shown that the exchange rate imbalances which racked the Bretton Woods system in the 1960s were already foreseeable in the 1950s. From its inception, a lack of commitment on the part of some of its most important members eroded the Bretton Woods system and led to its collapse in the early 1970s.

APPENDIX A: The Institutional Setting: Ludwig Erhard And The Struggle For Power

Germany's loss of sovereignty after World War II included the loss of sovereignty over its exchange policy ('Devisenhoheit'). When the Federal Republic regained that sovereignty in 1952, the authority over Germany's exchange policy was not clearly assigned. The economic bodies had undergone a restructuring process in which authorities over policy domains had been newly assigned, leaving, however, uncertainty on the authority over exchange policy and convertibility.[1] A parliamentary working committee was formed to examine where the decision-making power over the exchange liberalization process lay or should lie. In the report on its first meeting in January 1954, the committee established that:

> Das Gesetz wird den Waren- und Dienstleistungsverkehr grundsätzlich freistellen, jedoch bestimmte umrissene Gebiete genehmigungspflichtig machen, um es dann auf Grund einer Ermächtigung dem BMW zu überlassen, den jeweiligen Grad der Auflockerung zu bestimmen. Die Fragen der Zuständigkeit, insbesondere bei der Devisenüberwachung sind nocht nicht entschieden.[2]

As long as Germany monetary sovereignty rested in the hands of the Allies, the assignment problem did not present itself, but as Germany gained greater degrees of independence over its exchange policy, the issue of who would be allowed to decide what became a pressing and contentious one. Exchange policy presented an unchartered territory, a no man's land waiting to be claimed. The undefined situation pitted the three bodies responsible for economic and monetary matters in Germany, - the Bank deutscher

[1] for an account of the restructuring of the German banking system by the military government see Horstmann, "Die Entstehung der Bank deutscher Länder".

[2]BA B102-55740, "Bericht über die erste Sitzung des Devisen-Arbeitskreises in Bonn am 18.1.1954 unter Leitung von Herrn Dr. Frentzel", January 22, 1954.

> 'The law will permit the free trade of goods and service in general, excepting, however, certain specified areas which will require permission from the BMW, leaving it up to the BMW to determine the degree of liberalization. The questions regarding responsibility, in particular regarding exchange control, have not yet been decided upon.'

Länder (BdL), later to become the Deutsche Bundesbank (DBB), the Ministry of Finance and the Ministry of Economics -, in an acrimonious struggle for power over Germany's exchange policy. These three economic policymaking bodies were already engaged in a fight for power in general. Thus, Finance Minister Schäffer tried to gain control of the monetary policy of the BdL and to reduce the decisionmaking powers of the Economics Ministry in his favor.[3] The fight for authority over German exchange policy continued throughout the 1950s and played a considerable role in the relations between the three rival institutions as late as the time of the passing of the Außenwirtschaftsgesetz, the law regulating Germany's external economic relations, in 1957. The struggle for the power over exchange policy probably contributed to the delay of the passing of the law which had been under discussion since 1953.

Germany regained sovereignty over its external monetary policy in 1953 as a result of the London Debt Agreement, - which is also the year the FRG became a member of the IMF and the World Bank and when the DM was recognized as an international currency -, making the question of who would manage that sovereignty a very topical one.[4] The debate flared up in 1953 in the discussions following the proposal for a currency law ('Devisengesetz') put forward by the Economics Ministry. The official aim of the currency law was to supersede the laws passed by the military government which generally prohibited any transactions between residents and non-residents of Germany, except where explicitly permitted. The law proposed by Erhard turned the general prohibition on international transactions between Germans and non-Germans into a general permission.

[3] *Der Spiegel*, "In Schäffers Kompetenzsack", No.5, Jan.30, 1952, pp.7-10.
[4] Gutmann, Hochstrate and Schlüter, *Die Wirtschaftsverfassung*, pp.245, 247 & 256.

In a letter written in September 1953, the BdL strongly protested in a letter to Erhard against a draft of the law drawn up in the Economics Ministry which reduced the decisionmaking power of the BdL on currency matters to the area of the obligation to hand in foreign exchange ('Devisenablieferungspflicht'). The BdL letter pointed to the London Debt Agreement in which the BdL and the central banks of the Länder were assigned the task of carrying out the Debt Agreement.[5] Dr. Schulz from the Economics Ministry accused the BdL of resisting a currency law because it refused to give up its power to pass decrees ('Rechtsvorschriften'), which it had been given by the Allied forces.[6] According to official from the Economics Ministry, this decree-passing power violated constitutional law, by which only the government was permitted to pass decrees.

In the same month, Erhard wrote to Schäffer, the Finance Minister, obviously in response to some claim staked by the latter on the finance ministry's say in currency matters, to remind him that parliament had decided that exchange control and payments restrictions should be supervised by the 'Oberfinanzdirektion' which, however, as Erhard pointed out gleefully, had to act on the instructions of the Minister of Economics.[7] The Justice Minister confirmed Erhard's interpretation of the law.[8] Moreover, already in October 1951, the German parliament had voted in favor of officially assigning the responsibility for money and credit to the Economics Ministry, and not to the Finance Ministry.[9] The Finance Ministry was eliminated from the competition for power over Germany's exchange policy early on, leaving the Economics Ministry and the BdL to fight it out.[10] In a letter written to the Economics Minister in 1954 the Minister of Justice

[5]BA B102-55740, BdL to Erhard re."Deutsches Devisengesetz", September 8, 1953.
[6]BA B102-55740, Note by Dr. Schulz (VD2), February 17, 1954.
[7] BA B102-55740, Erhard to Schäffer re. "Neues Devisengesetz", September 1953.
[8] BA B102-55740, Justice Minister to Economics Minister re. "Neues Devisengesetz", March 8, 1954.
[9] *Der Spiegel*, "In Schäffers Kompetenzsack", No.5, January 30, 1952, p.9.
[10] In 1955, the Finance Ministry received a request for information on the establishment of convertibility in Canada in 1951 by a Ph.D. student. An official of the Finance Ministry wrote back to the Ph.D. student,

declared that the Economics Minister could restrict the import or export of goods or payments without requiring the explicit agreement by the BdL.[11] That left open the question, however, of who retained the power to decide on removing restrictions on payments.

The written exchanges between the Economics Ministry and the BdL on convertibility indicate that, in practice, the two bodies negotiated agreements on each of the significant steps towards the lifting of exchange restrictions and the establishment of convertibility, but that the Economics Ministry had the greater and final say. Each institution published its own announcement of the individual steps taken to liberalize payments. But while the decrees ('Runderlässe Außenwirtschaft') by the Economics Ministry were published 'with the agreement of' the Finance Ministry and the BdL - "im Einvernehmen mit" -, the general permissions ('Allgemeine Genehmigungen') produced by the BdL were published after having been approved by the Economics Ministry and Finance Ministry.[12] More importantly, when the British initiated talks between them and Germany on the issue of the pace of the establishment of convertibility in 1953, they invited Erhard and Schäffer and not Vocke or any other representative of the BdL.[13] Indirectly, the Economics Ministry benefitted from the strength of the UK Treasury relative to the Bank of England, since if the latter had had the greater say over convertibility in Britain, then it is possible that the BdL and not the Economics Ministry

regretting that the Finance Ministry possessed no such material, and suggesting instead that the student turn to the Economics Ministry or the BdL who would be more likely to be able to provide the information requested. BA B126-7746, Bernard (Finance Ministry) to Jungmann re. "Konvertibilität bei festen oder schwankenden Wechselkursen, hier: Einführung der Konvertierbarkeit in Kanada im Jahre 1951, Unterlagen und Erfahrungsmaterial", January 23, 1955.

[11] BA B102-55470, Minister of Justice to Minister of Economics, "Entwurf eines Gesetzes zur Verinfachung des Außenwirtschaftsrechts - Außenwirtschaftsgesetz - (Fassung vom 4. September 1954)", September 22, 1954.

[12] BA B102-57658, Westrick (Economics Ministry) to Vocke (President of the BdL), April 5, 1954, and, BA B102-57708 "Entwurf betr: Rechtsgeschäfte und Zahlungen ausserhalb des Waren-, Dienstleistungs- und Kapitalverkehrs", November 1955.

[13] *Der Spiegel*, "Goldwährung: In einer andern Welt wieder", No.24, June 10, 1953, p.20.

would have been approached in Germany. The power relations between the UK Treasury and the Bank of England further consolidated the Economics Ministry's hold over convertibility policy. Domestically, the Economics Ministry had already managed to wrestle a significant amount of control over currency policy away from the BdL, which traditionally held the scepter in monetary matters.[14]

Several factors explain Erhard's successful assertion of power in this matter. First, the repercussions of the liberalization of payments extended beyond the monetary domain into the larger economic, political and diplomatic sphere. The effects of liberalization, or restriction, of payments, spilled over into trade and capital flows. The intertwined nature of payments and trade and capital liberalization allowed Erhard, as the minister responsible for Germany's external economic relations, to stake his claim on authority over policy regarding exchange and convertibility. Moreover, the coordination of the collective convertibility move depended on and influenced Germany's plans for European integration.[15] Erhard's power within the government had already allowed him to gain control over Germany's European policy in a power struggle with the foreign ministry.[16] His clout within the government, combined with his grip on Germany's Europe policy and the importance of convertibility for European cooperation gave Erhard, and thus the Economics Ministry, a way to squeeze himself into the driver's seat of the convertibility truck.

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14 According to Owen Smith, the post-war history has witnessed increasing government involvement in the central bank's traditional policy domain, exchange rate control. He claimed that while "an independent central bank has dictated the course of monetary policy", "exchange-rate considerations have involved the Federal government in monetary policy matters". E. Owen Smith, *The German Economy*, Routledge, 1994, pp.13 &140.

15 Dickhaus, *Zwischen Europa und der Welt*, p.168.

16 H. J. Küsters, "Der Streit um Kompetenzen und Konzeptionen deutscher Europapolitik", in Herbst, Bührer and Sowade (eds.), *Vom Marshallplan*, p.369. See also Koerfer, "Wirtschaftspolitische Kontroversen", pp.33-45.

The marginalization of the Finance Ministry in the policymaking process regarding the move to convertibility eliminated the body which, out of the three, consistently exhibited the most skepticism and hesitation vis-à-vis the rapid removal of exchange restrictions and establishment of convertibility. In 1952, Hartmann from the Finance Ministry expressed his strong disapproval to Erhard about the latter's efforts towards reducing exchange control before Germany's external debts, as decided in the London Debt Agreement, had been repaid and the London Debt Agreement had expired. The London Debt Agreement was set to expire in 1980. Hartmann claimed that

> Der Artikel 10 [des Londoner Schuldenabkommens] macht es der Bundesrepublik zur Pflicht, die Devisenbewirtschaftung bis zur Erledigung aller Verpflichtungen aus dem Londoner Schuldenabkommen aufrecht zu erhalten.[17]

The official from the Finance Ministry declared that Germany's external debts and the duration of the London Debt Agreement "stehen den Bestrebungen zur Einführung einer auch nur begrenzten Konvertibilität der D-Mark als absolutes Hindernis entgegen".[18] In a letter to the Bank deutscher Länder, Hartmann expressed the same strong opposition to any lifting of exchange restrictions on the use of Sperrmark.[19] Erhard rejected the Finance Ministry's interpretation of Article 10 of the London Debt Agreement as "vollkommen abwegig".[20]

Germany's progress towards convertibility took place within an environment of fluid lines in the assignment of exchange policy authority and, moreover, in an

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[17]BA B102-56894, Hartmann (finance ministry) to Erhard re., "Gutachten des Wissenschaftlichen Beirats beim Bundeswirtschaftsministeriums zur Frage der Konvertibilität", December 16, 1952.

> 'Article 10 [of the London Debt Agreement] makes it the obligation of the Federal Republic to maintain exchange control until the all liabilities from the London Debt Agreement have been repaid.'

[18] ibid.
'present an insurmountable obstacle to efforts to establish even a limited DM convertibility'

[19] BA B102-57705, Finance Ministry to BdL (signed by Hartmann) re., "Verwendung von gesperrter D-Mark", December 16, 1952.

[20] BA B102-56894, Erhard to Schäffer re., "Gutachten des Wissenschaftlichen Beirats zur Frage der Konvertibilität", January 8, 1953.
'completely off the mark'

environment in which the power struggle between the BdL or DBB, the Economics Ministry and the Finance Ministry could have easily hampered or even paralyzed the process. Instead, Germany pressed ahead with payments liberalization at a much faster pace than other countries - such as Britain and France -, where responsibilities for exchange policy were much more clearly defined, which were not tied down by outstanding settlements of war debts, which enjoyed full sovereignty over exchange policy, and where, consequently, progress might not have been obstructed by an ambiguous institutional setting. Erhard's position within the German government and the economy and the stronger general consensus, than in Britain or France on the desirability of convertibility sooner rather than later explain Germany's ability to set the pace in Europe's progress towards de facto convertibility.

It is frequently suggested that the independence of the German central bank is the secret to Germany's price stability and its economic success.[21] While the independence of the German central bank and its clear commitment to price stability provided an anchor for inflationary expectations, this factor was not instrumental in assuring rapid liberalization of payments. The fast pace at which the Federal removed exchange restrictions cannot be explained by the independent central bank pursuing the establishment of currency convertibility, as the Bank of England did in the case of sterling. Rather, Germany's policy on convertibility can be attributed to the combination of a widespread consensus on the desirability of currency convertibility and Ludwig Erhard's personal crusade for DM convertibility. Similarly, the decision to wait with the official establishment for the rest of Europe is explained by a consensus on the disadvantages associated with a unilateral move.

[21] See, for example, Bordo and Eschweiler, *Rules*, pp.22-3.

APPENDIX B: La convertibilité racontée à Juliette[1]

L'intellettuale di destra: Mi pare che ne parlasse anche il Manzoni nel famoso capitolo sull'Innominato.

L'intellettuale di sinistrà: Nel processo di progressiva disintegrazione del mondo capitalistico, la convertibilià appare, deterministicamente, come il tentativo della classe sociale dominante di appropriasri con manovre monetarie di un'ulteriore frazione del plusvalore.

Il prof. Erhard: Konvertibilität über alles.

Le fonctionnaire de l'Office des Changes: La convertibilité devrait être subordonnée à une condition essentielle préalable, celle d'un reclassement équitable du personnel de l'Office des Changes dans le cadre de l'Institut d'Emission.

Il grande oratore italiano: Mentre nella lontana tormentata giungla, si spengono i bagliori di un conflitto che avrebbe forse potuto segnare la fine di una meravigliosa evoluzione biologica, palpitano sulle rive de Tamigi, fra le sofferenze di una laborica creazione, i primi fremiti di una fragile creatura destinata a recare alle nostre invecchiate monete il messaggio di una nuova gioventù.

Il grande oratore inglese: Gentlemen, ...ehm... convertibility...euhm...well...wider system...ehm...financial stability...ehm.. I daresay....

L'industriale milanese: Sa cosa ci dico? La convertibilità l'é una bella cosa e bisogna farla. Ma le tasse; dove Le mette Lei le tasse? Ma lo sa, caro Lei, che io non so più come fare a andare avanti? Il Vanoni la faccia pure la convertibilità, ma tenga conto dell nostre aspirassioni.

L'Uomo di Stato: Sur le plan socioligique et moral, la convertibilité est la pièce maitresse de l'intégration économique de l'Europe.

L'Uomo politico: In assenza delle necessarie precauzioni, la convertibilità é suscettibile di arrestare nettamente il processo di integrazione economica dell'Europa.

Le Résident: Ah. les salauds! Ils m'ont recalé. J'espère d'y réussir à la rentrée, si le professeur Ehrard [sic] le veut bien.

Il Non Residente: Dopo tutte le fregature che ha preso in questi ultimi vent'anni, era giusto che una riparazione mi fosse dovuta.

Juliette: Elle fait beaucoup de manière, cette fille. J'ai entendu dire qu'il faut y aller doucement. En tout cas, il y a en a de ceux qui n'en veulent pas.

[1] AEF, B44744, undated extract from an Italian publication. The likely date of publication is August 1954.

L'Appassionato di cinematografo: Anche se é piena, alla convertibilità io preferisco la Lollobrigida.

L'Expert de l'OECE (à la conference de Presse): Après des recherches approfondies et une longue discussion, le Comité est arrivé à la conclusion que la convertibilité monétaire suppose le rétablissement et le maintien de la stabilité financière intérieure.

Il Giornalistà (al suo giornale, prima della conferenza stampa): Flash Si apprende da insicrezioni che il Comitato, prima di ripristinare la convertibilità, deciderà il mantenimento della stabilità interna.

Il lettore assiduo di giornali: Ho letto nei giornali del 1o giugno di una medicina molto energica che non può essere somministrata senza pericoli a tutti malati. Deve essere certamente lo Stalinon.

L'Amico di Juliette (à Juliette): Tu sais mon chou, il y a trois espèces de convertibilité: la convertibilité anglaise ("convertibility without tears"), la convertibilté allemande ("Konvertibilität Durch Freude") et la convertibilité latine ("convertibilitas et dollares americanos).

Il giovane Segretario di Ambasciata: La convertibilità? Mi porti i precedenti.
Le Chargé de Mission d'un petit Pays: La convertibilité produira certainement un écrasement du cours parallèle du dollar sur le cours officiel. Elle aura donc une incidence directe sur le montant mensuel des indemnités de mission.

L'Economista classico: Si la convertibilité signifie autre chose que le retablissement de l'étalon-or, elle est une plaisanterie.

L'Economista neo-classico: Il vertice dell'evoluzione monetaria internazionale è costituito da un sistema eve il rigido mantenimento dei controlli valutari è unicamente destinato ad impedire i movimenti di capitali.

L'Uomo della Strada: Sarà una buona cosa? Converrà vendere i Buoni del Tesoro? Ribasserà l'oro?

Il portavoce de Patronat: La convertibilité doit être réalisée dans le cadre du maintien d'une protection suffisante des branches moins compétitives de l'économie nationale.

L'Alto Funzionario dell'OECE: La convertibilità non deve in alcun modo mettere in periocolo la struttura dei Comitati orizzontali e verticali dell'organisazione. Ove ciò devesse invece avvenire, bisognerebbe rinunciare, sia pure a malinciore, ad iscrivere la convertibilità fra gli scopi della politica economica internazionale postbellica.

Il Funzionario dell'Alta Autorità: Le marché commun de la monnaie est une initiative susceptible de favoriser le developpement de la CECA et les efforts vers la création du po"em <sic> vert.

Il militante del P.G.: La convertibilità permetterà finalmente un grande sviluppo del lavoro del nostro ufficion cambio, che per tanti anni è stato passivo. L'introduzione dei cambi mobili, poi, si ripercuoterà in maggiori utili dell'ufficio arbitraggi.

Il poratvoce della C.G.T.: La convertibilità sera acceptèe par les travailleurs à la seule condition qu'elle soit accompagnée d'une augmentation substantielle du salaire minimum interprofessionnel garanti.

L'Amico di Juliette (à Juliette): Insomma, per riassumere, ti pagheranno in dollari e tu potrai cambiarli in lire senza riempire i moduli alla banca.

Juliette: Je fais ça depuis dix ans à Piazza Colonna sans la convertibilité.

Le concierge: Qu'est ce que vous en penser? Vous croyez qu'il y aura la guerre?

Lo scattico moralista (non esperto di questioni monetarie): La convertibilità è il diritto di esercitare quella libertà che, se fosse da tutti esercitata, provocherebbe immediatamente l'abolizione del diritto di esercitarla ed il ripristino della primitiva felice situazione di rifare con rinnovato piacere le stesse cose divenute nuovamente proibite. Edonisticamente, la convertibilità è in sostanza una provisoria diminuzione del piacere.

Il Prate Protestante: .....And the eigth Day, Butler created a convertible currency (The new Bible).

Il Poeta: Di franchi, dollari, sterline e marchi,
Le cortesie e le adaci imprese io canto,
l'aspre guerre di cui menaron vanto
Gli aller, gli onori di cui furen carchi.
Di conversion dirò L'audace parto,
Che in allegria iniziò e finì in pianto.

........: E la provvigione del 0,60 per cento dove la mettiamo?

Mendès-France: "Gouverner c'est choisir". Le choix de la convertibilité est le choix du sacrifice et de l'austerité monétaire. Nous sommes aujourd'hui le 3 Août; si aucune solution satisfaisante du problème de la convertibilité n'aura pu aboutir avant la minuit du 20 Avril 1955, mon Gouvernment remettra sa demission au Président de la République.

Scelba: Il Governo Italiano non subordina la propria adesione alla convertibilità alla soluzione del problema di Treste.

Foster Dulles: Convertibility is the missing link in our common system of defense against Communist tide ni Western Europe.

Butler: Wait and see.

Adenauer: Heil Konvertibilität

De Gaulle: Le jour suivant celui du rétablissement de la convertibilité monétaire, je me rendrai seul à l'Arc de Triomphe. Seul. Le peuple de Paris sera là.....ecc.

Sir Winston: Her Majesty's convertibility will be declared tomorrow at 12 noon.

Molotof: La proposta sovietica di un sistema di sicurezza collettiva in Europa costituisce un contributo alla Pace del mondo di gran lunga più efficace di quanto lo siano i piani di convertibilità delle cricche guerrafondaie americane.

Ivar Rooth: We shall stand by.

Le BIRD: Sorry gentleman, we can't help. Convertibility is not a definite project within the meaning of the Bank's articles of agreement.

La F.O.A.: Questo Fondo Europeo ci ha l'aria di essere un pozzo senza fondo.

L'Amministrazione Doganale Americana: We shall... Watch.

Il filosofo: Il controllo dei cambi? Tutto ciò che non è proibito è obbligatorio. La convertibilità? Tutto è libero, fiorché l'obbligaotio e il proibito.

The U.S. Republican Party: I like convertibility.

(continua) NB. Prossima puntata:
Le huron au Pays des Convertibles.

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