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1958 Convertibility and Its Consequences

With convertibility, the Bretton Woods system was finally able to operate as intended. The 'real' Bretton Woods put to the test the ideas elaborated in 1944 at the Mount Washington Hotel, Bretton Woods. Theory was meeting practice. Convertibility was a seamless process. It did not trigger a crisis, but changed the structure of the whole international system. Convertibility put an end to parallel markets. It made arbitrage unnecessary and removed the different types of sterling presented in Chapter 2. Transferable sterling became redundant and was merged with official sterling. Swiss markets no longer offered opportunities for profitable arbitrage. Here, I analyse the direct effect of convertibility on the currency market. Using new data, I show how this important institutional change had little effect on the day-to-day functioning of the currency market. However, it did change how governments would manage their economies.

The trilemma of international finance forced policymakers to choose two of the following three policies: free capital flows; a fixed exchange rate; and monetary policy independence. Before convertibility, the United Kingdom had relative control of capital flows and fixed exchange rates. The government could set its monetary policy somewhat independently. Convertibility brought freer capital flows. The United Kingdom now had to choose between leaving the Bretton Woods fixed exchange rate system or relinquishing the right to set its own monetary policy.[1] They wanted neither. Leaving the Bretton Woods system and floating was only briefly considered in the ROBOT and collective approach schemes. These never saw the light of day. Prime Minister Harold Wilson (1964–70) explained what fixed exchange rates and free capital flows meant for the government.

[1] Many controls on capital flows remained, most of which survived until the 1980s. The trilemma simplifies reality.

He wrote that 'every action we took had to be considered against a background of the confidence factor, particularly against our assessment of what speculators might do'.[2] Wilson's speculators were overseas sterling holders pondering whether to sell their sterling before a possible devaluation. Convertibility put pressure on UK policymakers and reduced their freedom of action.

WHAT IS CONVERTIBILITY?

After restrictions from the war years were lifted, the Exchange Control Act formalised capital controls. The Act divided the world into four sterling regions, as we have seen. Many of the controls introduced in 1947 were lifted in 1958. The relevance of the different sterling regions diminished. The world would be divided only into the sterling area (the United Kingdom and its former colonies) and the non-sterling area (the rest of the world). Investors from Europe, the United States and many other non-sterling area countries could now freely move sterling in and out of the sterling area. Residents of the sterling area were not allowed to convert sterling into dollars or any other currency.

The timing of introducing convertibility was difficult. The United Kingdom had to coordinate the move with a French devaluation. Convertibility was finally agreed at the end of 1958.[3] The French devaluation was carried through on 26 December 1958. The United Kingdom was free to follow suit by unifying transferable and official sterling. Non-resident sterling was now transferable anywhere. There would no longer be two prices for sterling: one in London, the other in other trading places such as Zurich and New York. On Saturday, 27 December 1958, the UK Treasury issued the following statement: 'From 9 a.m. on Monday, December 29th, sterling held or acquired by non-residents of the sterling area will be freely transferable throughout the world. As a consequence, all non-resident sterling will be convertible into dollars at the official rate of exchange.'[4] Non-residents of the sterling area were now allowed to transfer sterling, say from New York to London. Sterling area residents were still not allowed to convert their sterling abroad without a valid reason

2 Harold Wilson, *Labour Government, 1964–70: A Personal Record* (London: Michael Joseph, 1971), 32–3.

3 Fforde, *The Bank of England*, 566–606.

4 Sterling was divided into different types, and resident sterling was the currency held by residents of the sterling area. See 'Exchange Control Retained', *Manchester Guardian*, 29 December 1958, 5.

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(for example, for import/export or for travel). Convertibility meant that businesses and individuals could buy goods abroad without limit. The aim was to facilitate trade within Europe and with the United States.

Convertibility was a European move. The BIS explained that the reason behind this new setting was 'to promote genuine economic integration'.[5] The new framework forced 'each country to keep its domestic monetary policy more closely in line with that of other countries, for no country can embark alone on an inflationary policy if it wishes to maintain convertibility'.[6] What sounded like a good thing to the BIS was a major concern to national governments. Wilson later complained about having to factor in 'what speculators might do'.[7] Overall the press was enthusiastic. The *Manchester Guardian* explained: 'The currency changes by the leading European countries were regarded yesterday in many parts of the world as a sign of complete economic recovery in the nations concerned.'[8] With this recovery came more pressure on European currencies. Pressure started on sterling first.

THE POLITICS OF CONVERTIBILITY IN EUROPE

Convertibility was a condition of Marshall Aid just after the war. In 1947 the United States wanted to establish European currency convertibility. The goal was not only to have an economically strong Europe opposing the Soviet Bloc. The United States also wanted to make Europe a strong trading partner. Negotiations for convertibility took place within the framework of the Organisation for European Economic Co-operation (OEEC).[9] The organisation was set up to implement the Marshall Plan. The *Manchester Guardian* explained: 'Negotiations about this week-end's changes in international currency relations began, in fact, at the O.E.E.C. meeting a fortnight ago, when the wreck of the plan for a Free Trade Area caused an ugly outburst of Anglo-French ill-feeling.'[10] The negotiations were mainly among three leading European countries. The *Guardian* noted: 'It ought to be made clear that the new policy was discussed between

[5] BIS, Annual Report 1959, 8 June 1959, 27. [6] Ibid.

[7] Wilson, *Labour Government, 1964–70*, 32–3.

[8] 'A Sign of Full Recovery: How the Changes Are Regarded', *Manchester Guardian*, 29 December 1958, 5.

[9] The predecessor of the Organisation for Economic Co-operation and Development (OECD), a rich country club as the *Economist* likes to call it.

[10] 'Europe in Concert', *Manchester Guardian*, 29 December 1958, 4.

the French, British and German Governments and then submitted to the other members of the O.E.E.C.'[11]

Once convertibility was established, European countries were divided into two groups. 'Weak-currency countries lobbied for more generous IMF quotas and increases in international reserves. Strong-currency countries objected that additional credits encouraged deficit countries to live beyond their means.'[12] Britain was in the weak-currency group. It was the most successful country in receiving international aid. This was because of the importance of sterling. Germany, on the other hand, would have lobbied for more rigour and smaller quotas, but after the war the country was under the control of the United States. It was the 'poster child' of US policy in Europe and one of its strongest allies. France, another strong-currency country in the early 1960s, was lobbying for more rigour. President de Gaulle's claims to go back to gold were made in this spirit. The French wanted a more rigorous international system.

The IMF was a strong proponent of convertibility. It was one of the reasons for the its existence. The IMF was bound by the Article of Agreements, Article I, section 4. The article stipulated that the IMF was to 'assist in the establishment of a multilateral system of payments in respect of current transactions between members'.[13] The article also mentions 'the elimination of foreign exchange restrictions which hamper the growth of world trade'. Convertibility was one of the reasons the IMF had been set up.

AN END TO PARALLEL MARKETS

Convertibility offers a unique example of capital controls being lifted suddenly. With this sudden shock, exchange rates were disrupted. I study the effect of this disruption using new exchange rate data. The data show that parallel and offshore markets became obsolete. Sterling became both fungible and transferable. There was no reason to have different prices in different places. Leland Yeager argues that convertibility 'unified and broadened the markets in spot and forward exchange, made competition in them more keen, narrowed the spreads between buying and selling quotations'.[14] On the market, the transition to convertibility was smooth.

[11] Ibid. [12] Eichengreen, *Globalizing Capital*, 112.

[13] Bretton Woods Conference, Final Act, Washington, Archive of the IMF (hereafter IMF), 22 July 1944, GD-48, 8329, 1944, 21.

[14] Yeager, *International Monetary Relations*, 376.

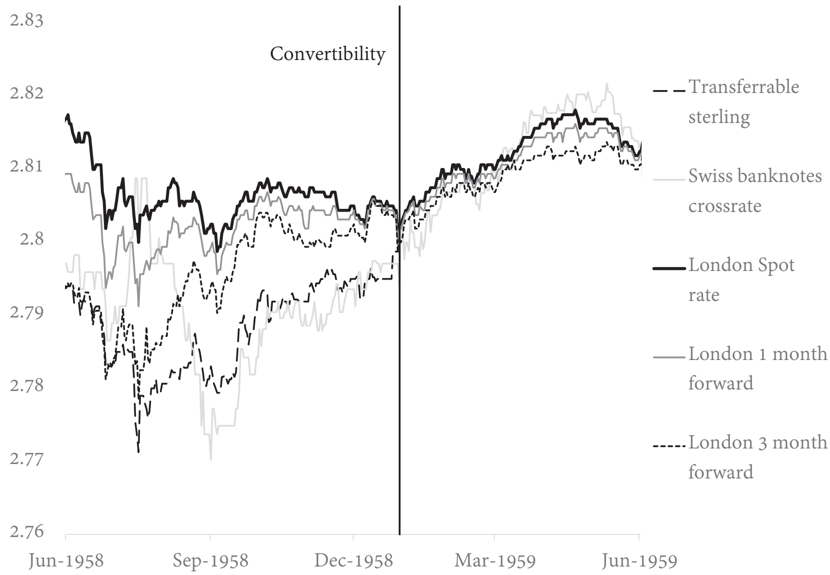

Figure 6.1. Parallel sterling/dollar exchange rates
Source: Accominotti et al., Swiss National Bank Archives and Bank of England dealers' reports (see text).

It did not trigger an immediate crisis as might have been expected with more capital flowing in and out of London. The Bank of England dealers' report of 29 December 1958 noted that the 'first day of convertibility found markets a little confused at the start but later there was considerable activity here [in London] especially in dollars, French Francs and Swiss Francs'.[15] There was no major crisis or speculation against a specific currency. Market participants saw convertibility as the harbinger of recovery in Europe.

Figure 6.1 highlights the effect of convertibility. Exchange rates were moving relatively independently before convertibility. After convertibility they moved closely together. They were now all part of the same global market. I present several different rates. The data for transferable rates and the Swiss cross-rate have been collected from manuscript ledgers in the archives of the Swiss National Bank and the Bank of England. Forward and spot data come from Accominotti et al.[16] Transferable sterling ceased to

[15] 'Dealers' report', 29 December 1958, London, archive of the Bank of England, C8.
[16] Accominotti et al., 'Currency Regimes'.

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exist with convertibility, which unified the different sterling rates, reducing the scope for arbitrage.

Convertibility lowered the forward premia. Here I measure the rate ninety days before and after convertibility as a comparison. Looking at the average daily forward rate, discounts decreased 63 per cent for the one-month forward (from –0.06 to –0.04 per cent). The decrease was similar for the three-month forward at 67 per cent (from –0.15 to –0.09 per cent). There is little evidence that the exchange risk diminished after convertibility. The risk of a sterling devaluation was just as high as before convertibility, if not higher. The lower discount came from the more liquid market with more arbitrage possibilities in Europe and New York. The Swiss banknote market no longer was the only arbitrage opportunity. Speculators no longer needed to travel to Zurich with a suitcase full of cash to convert their unwanted sterling. They could now place orders in London or New York, where the prices were the same.

Foreign exchange markets across the world became far more integrated. Convertibility also had an impact on the London foreign exchange market. Just as in 1951, it would be reasonable to expect buying and selling spreads to diminish. The market became more liquid and more integrated with global markets. But evidence of spread reduction is not as marked as in 1951. I use the same bid–ask spread index as I employed in Chapter 3. Bid–ask spreads in the two years leading up to convertibility were, on average, 9.5 per cent higher than after convertibility. It is unclear whether this was driven by convertibility alone. The decrease in spreads is not comparable with the spot market reopening in 1951. In 1951, spreads decreased by 70 per cent between December 1951 and December 1953. Convertibility, on the other hand, had a limited effect on spreads in a comparable timeframe. Dealers did not change their behaviour.

Why did spreads not decrease significantly? In theory, convertibility increased the turnover. A more liquid market should have led to lower spreads. However, this ignores the different forces at play. Lyons has shown that the foreign exchange market today is dominated by few players and a decentralised structure.[17] This applies also to the 1950s. Higher turnover did not increase competition as the main market participants did not change. A few large commercial and investment banks were still making the price. This explains the relatively stable spreads at this point.

[17] Lyons, *The Microstructure Approach to Exchange Rates.*

In summary, convertibility was quite a smooth process. It did not trigger a run on sterling, as might have been expected with capital flow liberalisation. Convertibility did not make spreads diminish significantly, as did the 1951 market reopening. However, it did reduce the discount of alternative markets when compared with the London spot market. If convertibility took place quite smoothly in terms of the market reaction, its consequences for the international monetary system were profound, as we will see.