

# Cardiff Historical Papers



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## The two sterling crises of 1964 and the decision not to devalue

### I

When Harold Wilson's Labour government took office after the October 1964 election it was greeted by dismal balance of payments figures. A current account deficit of £800 million was forecast, almost twice what had been expected (although the actual figure has since been revised down to £376 million).<sup>1</sup> Before long the new administration was confronted by a wave of speculation against sterling in the financial markets, much of it based on the assumption that a devaluation of the currency was unavoidable.

However Labour did not devalue. Instead, it negotiated a massive rescue package, worth \$3 billion, most of it from the central banks of the Group of Ten, made up of the wealthiest members of the OECD. Wilson ruled that the subject of devaluation was not to be mentioned in Cabinet. His aversion to a change in the rate has been attributed to political rather than economic calculations,<sup>2</sup> stemming from a determination to protect Britain's international reputation and an anxiety that Labour, which had presided over the last sterling devaluation in 1949 (from £1=\$4.03 to £1=\$2.80), should not be branded 'the Party of devaluation'. This robust attitude did not prevent further sterling crises in 1965 and 1966 however. There was more external assistance in return for which Labour introduced a wages' freeze and cut back its planned increases in public investment. The centrepiece of its strategy to modernise

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<sup>1</sup> Jim Tomlinson, *The Labour Governments 1964–70: Economic Policy* (Manchester: Manchester University Press, 2004), p. 14.

<sup>2</sup> Ed Balls, 'Why the Five Economic Tests?', Cairncross Lecture, St Peter's College, Oxford, 4 Dec. 2002; Tomlinson, *Labour Governments*, p. 50.

<sup>3</sup> Samuel Brittan, *Steering the Economy: the Role of the Treasury* (London: Secker and Warburg, 1969). Brittan worked briefly for the government at the Department of Economic Affairs in 1964–5.

the British economy, the National Plan, whereby the government was to co-operate with both sides of industry on measures designed to foster an annual economic growth rate of 3.8 per cent, was abandoned. Yet despite all these sacrifices sterling had to be devalued in the end: in November 1967 the rate was changed from £1=\$2.80 to £1=\$2.40 (14.3 per cent). When Labour left power in 1970 the average annual growth rate for its period in office was just under 2.5 per cent.

It all amounted to a severe anti-climax. On the whole economists and historians have not been very kind in their assessments of the years 1964–70, starting with Brittan's critical 1969 study.<sup>3</sup> The debate has been dominated by Labour's long battle with external financial difficulties. A conventional wisdom has developed that the government paid dearly for its failure to attempt an early resolution of these. Some have argued that there should have been an immediate devaluation, a view advocated at the time by Nicholas Kaldor and Robert Neild, both of whom were advisers to the government, and by Tony Crosland, the Minister of State at the new Department of Economic Affairs (DEA – responsible for implementation of the National Plan).<sup>4</sup> These arguments have been supported by informed commentators,<sup>5</sup> some of whom have argued firstly, that the exchange rate was uncompetitive given a comparison between British costs, prices, and productivity and those prevailing in the country's main trading partners, and secondly, that the chosen path of borrowing left economic policy at the mercy of central bankers with deflationary prejudices which were by

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<sup>4</sup> Susan Crosland, *Tony Crosland* (London: Jonathan Cape, 1982), pp. 120–1.

<sup>5</sup> These include Balls, 'Why the Five Economic Tests?'; Edmund Dell, *The Chancellors: a History of the Chancellors of the Exchequer 1945–90* (Glasgow: Harper Collins, 1996), pp. 310–20; Jacques Leruez, *Economic Planning and Politics in Britain* (London: Martin Robertson, 1975), p. 179; Michael Stewart, *The Jekyll and Hyde Years: Politics and Economic Policy since 1964* (London: Dent, 1977), pp. 25–30.

definition antagonistic to Labour's objectives. Others such as Fred Hirsch have maintained that devaluation could have provided an incentive to exporters by raising their profit margins, so that, given restraint in the home market, the resources needed for an improvement in the export performance would actually have materialised.<sup>6</sup> An alternative line has been taken by Roger Middleton,<sup>7</sup> who suggested that Labour's thirteen years of opposition since 1951 had left it poorly prepared 'to meet the challenge of a sterling crisis', and that its performance suffered partly as a result of a lack of self-confidence on the part of the new Chancellor, James Callaghan, and partly from time-consuming and draining bureaucratic battles involving Ministers and civil servants in the Treasury and the new DEA. Woodward goes further and argues that in 1964 Labour failed to respond to clear evidence of unsustainable demand in the economy. There were rising wage settlements, labour bottlenecks were starting to appear, and the external financial position was deteriorating.<sup>8</sup> Labour should have anticipated facing balance of payments problems if it won the election. If devaluation was impossible then the government should have introduced a deflationary package, an approach (Woodward says) supported by the Treasury. However, such action was rejected because it conflicted with the commitment to sustained expansion, although subsequent studies indicated that it might have led to a more satisfactory long-run result for growth than the one achieved.<sup>9</sup> In recent years this rather depressing picture has been reinforced by the eye-witness testimony of Sir Alec Cairncross, the government's Chief Economic Adviser, which shows an administration, and in

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<sup>6</sup> Fred Hirsch, *The Pound Sterling: a Polemic* (London: Gollancz, 1965), pp. 55–6.

<sup>7</sup> Roger Middleton, *Charlatans or Saviours? Economists and the British Economy from Marshall to Meade* (Cheltenham: Edward Elgar, 1998), p. 263.

<sup>8</sup> Nicholas Woodward, *The Management of the British Economy 1945–2001* (Manchester: Manchester University Press, 2004), p. 263.

<sup>9</sup> Woodward, *Management of the British Economy*, pp. 97 and 104.

particular a Prime Minister, without a strategy and therefore driven from one improvisation to another.<sup>10</sup>

## II

The picture which emerges is of a somewhat disorganised government, which was unwilling to take hard decisions about the economy, its policy in the end governed by a political rather than an economic rationale. The consensus has been challenged by Thirlwall and Gibson, and more recently by Tomlinson,<sup>11</sup> who have all pointed to a rather respectable economic record in comparison with subsequent administrations, and this article attempts to take the revisionist case a stage further by examining the evidence in the National Archives, notably in the Prime Ministerial and above all Treasury files, concerning the government's actions during the critical first two months during which sterling came under intense pressure. Does the record support the claims that the government was (a) unprepared (b) indecisive (c) should have foreseen a balance of payments crisis (d) allowed political rather than economic considerations to dominate its policy towards sterling (e) mistakenly avoided early deflationary action, and (f) lacked a strategy?

The first point to make is that there were in fact *two* sterling crises in the autumn of 1964, one which coincided with the election result and another which started some three weeks later. They were related but separate, and caused by two different sets of circumstances. The former was foreseen. It reflected both traditional City worries about the arrival of a new, Labour Government after thirteen years of dealing with the Conservatives and a predictable anxiety about the balance of payments deficit. The

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<sup>10</sup> Alec Cairncross, *The Wilson Years: a Treasury Diary 1964–69* (London: The Historians' Press, 1997), pp. 18–21.

<sup>11</sup> A.P. Thirlwall and Heather Gibson, *Balance-of-Payments Theory and the United Kingdom Experience* (Basingstoke: Macmillan, 1992), pp. 242–3; Tomlinson, *Labour Governments*, p. 50.

outgoing government had been committed to a 'dash for growth' and had allowed the deficit to expand during the course of the year rather than deflate the economy. It had justified what was on the surface a relaxed attitude with the argument that the external position reflected a high level of industrial investment and stockbuilding. Until the summer there had been confidence that the buoyant level of world trade and healthy order books would lead to a surge in British exports, and thus the imbalance would be eroded. In July such optimism was starting to wane and the Chancellor, Reginald Maudling, admitted that he was puzzled both by the refusal of exports to grow as forecast and by the obstinately high level of imports. But, wishing to avoid a return to the old 'Stop-Go' cycle, least of all in the approach to an election, he favoured borrowing abroad so that the expansion could continue. This could be followed if necessary by import surcharges, whose purpose would be to adjust 'the relationship between the profitability of the home market on the one hand and the export market on the other'.<sup>12</sup>

The external position did not improve before the election. In May the Treasury had forecast a £300 million balance of payments deficit for the year as a whole. By October this had been revised to £800 million, the figure which greeted the incoming Labour government. The deterioration was a particularly sensitive issue given sterling's international use as a trading and reserve currency and the presence of sterling balances in London. During the first nine months of 1964 overseas members of the sterling area (OSA: countries which traded in sterling and held the bulk of their reserves in the currency), most of them in the British Commonwealth, ran up payments surpluses and allowed their holdings of sterling in London to grow. The result was a substantial short-term capital inflow. This was augmented in turn by

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<sup>12</sup> TNA: PRO T171/755/1 (xxiii), record of a meeting between Chancellor, Chief Secretary, Financial Secretary, Economic Secretary, Sir W. Armstrong, Mr Governor, and others, 21 July 1964.



deposits of foreign currencies from private individuals, corporations, and governments not in the area (NSA) which London banks switched into sterling. At the end of September gross sterling balances held by OSA and NSA countries amounted to £3166 million and £1406 million respectively, a total of £4572 million. This figure represented an increase of £384 million since December 1963 and was over six times the published gold and foreign exchange reserve figures of £909 million. Set against these liabilities were UK claims worth £1032 million, made up of £631 million with the NSA and £432 million with the OSA – but many of these, especially with the NSA, were not very volatile: they tended to be composed of promissory notes and acceptances which could not be made liquid without upsetting the international trade and payments system.<sup>13</sup> It was the combination of the current account deficit with the large external liabilities which left the economy so exposed. Failure to reverse the position through a combination of more exports and less imports would put a question mark over the country's ability to continue bridging the gap in the balance of payments at the current exchange rate. As a result, holders of sterling, concerned about the value of their assets, would sell it in exchange for alternative currencies such as dollars or deutschmarks. Lord Cromer, Governor of the Bank of England, argued that spending cuts and increases in the Bank Rate would become necessary to 'impact on the outflow of money' and show the government's determination to 'deal with the deteriorating economic situation'.<sup>14</sup> In the absence of such measures there would be a crisis of confidence in sterling's ability to continue with its international role.

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<sup>13</sup> TNA: PREM 13/866, Lord Kahn's enquiry into the position of sterling, 1964–5, p. 11; statistical table A.

<sup>14</sup> TNA PRO T171/755/1 (xxx), meeting with Chancellor, Sir W. Armstrong, Mr Governor, and others, 28 Aug. 1964.

Maudling did not deviate from his commitment to borrowing in order to buy time for the economy before the long-anticipated export boom began. The Bank of England arranged short-term (three-month) swap facilities worth \$1 billion, half with the Federal Reserve Bank of New York and half with the central banks of Canada and leading European countries (Germany, France, Switzerland, Italy, Holland, Belgium).<sup>15</sup> There were standby facilities with the IMF which would allow the UK to draw \$1 billion rapidly. A further \$1.5 billion was available in drawing rights with the Fund. On top of this there were the gold and foreign exchange reserves and the dollar portfolio (worth \$1.3 billion, although only \$465 million of this was composed of short-term securities which could be cashed quickly). Finally, there was a sum of \$4.75 billion in non-sterling securities held by UK residents, although realisation of these would require emergency legislation, unprecedented in peacetime, allowing the government to requisition and purchase them first.<sup>16</sup> Up to the election Maudling had been able to point to this combination of reserves, credits, and assets and argue that, despite the deficit, the UK was not short of resources. The tactic worked and sterling performed well in the markets for most of the summer. All the same there was mounting anxiety within the Treasury about the widening deficit and the problems of financing it in the absence of measures to turn it around. Contingency plans revolved around an unspecified dose of deflation and immediate action to restrict imports whilst stimulating exports.<sup>17</sup>

Labour was no more reassured than the Treasury by the superficial calm in the markets. While still Shadow Chancellor, Callaghan had become increasingly concerned about the external position, fearing that a balance of payments crisis would

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<sup>15</sup> TNA: PRO T171/755/1 (xi), notes by Rickett of 18 and 21 Sept. 1964.

<sup>16</sup> TNA: PRO T171/758/GB(64)28, 'Immediate problems of reserve movements & financing the deficit', 15 Oct. 1964.

<sup>17</sup> TNA: PREM 13/032, minute by Armstrong on 'Economic affairs' and PRO T171/755/1 (xlix); Cairncross, 'Draft paper on the economic situation', 18 Oct. 1964.

encourage speculation against sterling. In May he had reached an understanding with Al Hayes, President of the Federal Reserve Bank of New York, that the latter would use the Bank's resources to support sterling in the event of speculative attacks upon it.<sup>18</sup> In June he had been warned by Maudling to expect 'troubles ahead for sterling'.<sup>19</sup> During the summer Callaghan concluded that it would be necessary for a new government to act promptly. He drew up a list of measures designed to reduce consumption of imports via levies and steps to restrain demand. It followed similar lines to other initiatives being considered by the Treasury at the same time and included a 'wages holiday' agreed with trade union leaders, an increase in Bank Rate, and tax reforms. Callaghan warned Shadow Cabinet colleagues that Labour would be unable to increase the global target for public spending set by the Conservatives.<sup>20</sup>

What surprised Labour was not the existence of a balance of payments problem, but the apparent scale of the deficit it had inherited. Wilson wrote later that he had expected a deficit of £400 million rather than the figure of £800 million with which the Treasury greeted him.<sup>21</sup> The change of government to Labour, not known for its friendliness towards the markets, created unease and a wave of selling.<sup>22</sup> However, the government's response to this was fast – the product, in its timing and nature, of the work done by both the Treasury and Labour itself in the last months of opposition. Within little more than a week a package was announced focusing in the short term on a 15 per cent import surcharge on manufactured goods and tax incentives for exporters; in the medium term there was to be a review of all government spending aimed at cutting back on defence and what was regarded as 'prestige' projects such as

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<sup>18</sup> James Callaghan, *Time and Chance* (London: Collins, 1987), p. 159; Kenneth Morgan, *Callaghan: a Life* (Oxford: Oxford University Press, 1997), p. 213.

<sup>19</sup> Callaghan, *Time and Chance*, p. 154.

<sup>20</sup> *Ibid.*, pp. 160–1.

<sup>21</sup> Harold Wilson, *The Labour Governments 1964–70: a Personal Record* (London: Weidenfeld & Nicolson and Michael Joseph, 1971), p. 5.

<sup>22</sup> TNA PREM 13/866, Lord Kahn's enquiry, p. 19.

the Anglo-French Concord; in the long-term export growth was to be promoted through agreement with both sides of industry, both on improvements in productivity and on restraint in wage and price rises.

When confidence in sterling collapsed during mid and late November, critics looked back at the October package and argued that it had been inadequate. The government's long struggle for credibility in the eyes of bankers, economists, and historians started here. Within its own ranks there were the enthusiasts for devaluation, who argued that an opportunity had been missed and that an early downward adjustment of sterling would have boosted exports, reduced imports, and could have been blamed on the Conservatives.<sup>23</sup> These were picked up by subsequent critics who argued that commitment to sustaining sterling's position as an international reserve currency was not confined to the Bank of England and the City, but was shared by Harold Wilson himself, and this played a great part in his rejection of devaluation.<sup>24</sup> Others, especially in the financial press and within OECD finance ministries and central banks, complained that Labour should have embraced a sharp deflation. This would have assured the markets that the government was determined to bring to an end the excess demand which had led to the deficit.<sup>25</sup>

These criticisms were misplaced. As far as the case for stringent deflation was concerned, there had to be evidence of overheating in the economy for it to be justified. In fact, material support for this was by no means conclusive, in two senses. First of all, the statistical information at the government's disposal was patchy and unreliable. Harold Macmillan had complained about it when Chancellor back in 1956. Contemporaries, among them Wilson himself, argued that there was still considerable

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<sup>23</sup> See Barbara Castle, *Fighting All the Way* (London: Macmillan, 1993), p. 350.

<sup>24</sup> Geoffrey Ingham, *Capitalism Divided? The City and Industry in British Social Development* (Basingstoke: Macmillan, 1984), p. 285; Susan Strange, *Sterling and British Policy: a Study of an International Currency in Decline* (London: Oxford University Press, 1971), pp. 303–4.

<sup>25</sup> 'World's lenders seek more information', *The Times*, 2 Nov. 1964.

room for improvement.<sup>26</sup> By October 1964 there was still no quarterly index of GDP (Output) and no seasonally adjusted index of average earnings.<sup>27</sup> In these circumstances it was hard to be confident about exactly what was happening to the economy. Secondly, the data did confirm that 'demand was high', but indicated that it was expanding 'much more slowly than had been anticipated earlier in the year'.<sup>28</sup> The growth of exports, stockbuilding, and consumption had paused during the summer. In the first two quarters of 1964 personal incomes had risen by 6 per cent, but prices and incomes had risen 'more slowly' since the middle of the year. The rise in consumer spending seemed to have been 'checked' and the index of industrial production, after peaking in the early part of 1964, hardly changed between May and July.<sup>29</sup> Fixed investment was still rising sharply, but it was anticipated that the cycle would flatten out during the second half of 1965.<sup>30</sup> Clearly there was no call for any further increase in demand. But how much should be taken out of the economy? Cairncross, looking at the worsening external position, did advocate a rise in the Bank Rate, tax increases, cuts in subsidies, and the holding back of some public investment projects (he suggested the electricity programme and council housing).<sup>31</sup> However, the consensus within the Treasury was that the situation did not justify deflation on its own (or devaluation), but that tax increases, a prices and incomes policy, measures to improve industrial competitiveness, and a review of public spending commitments were all necessary.<sup>32</sup> By the end of October Callaghan himself was planning an autumn budget which would start to remove between £300 million and £340 million

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<sup>26</sup> Jim Tomlinson, 'Managing the economy, managing the people: Britain c. 1931–70', *Economic History Review* LVIII (2005), pp. 570–1.

<sup>27</sup> Middleton, *Charlatans or Saviours*, p. 258.

<sup>28</sup> TNA: PRO T171/758/2 (xl), GB(64)46, briefing by Cairncross, 'The economic situation, 5 Oct. 1964.

<sup>29</sup> *Ibid.*

<sup>30</sup> TNA: PRO T171/776, minute by Hopkin, 'The economic situation to end of 1965', 8 Oct. 1964.

<sup>31</sup> TNA: PRO T171/755/1 (xlix), 'The economic situation: draft paper by Mr Cairncross', 12 Oct. 1964.

<sup>32</sup> TNA: PRO PREM 13/032, memorandum by Armstrong, 16 Nov. 1964.

in purchasing power from the economy in 1965–6 (1.3 per cent of the forecast GDP for 1965).<sup>33</sup>

As far as devaluation was concerned, whatever the political case against it there were also sound economic reasons for rejecting such action. In all likelihood these would have been decisive even if no political objections had existed. Treasury briefing papers argued that the 1964 situation of sterling could not be compared with prevailing conditions when the currency had been devalued previously during the century – in 1914, 1931, 1939, and 1949. Two of these devaluations had been at the outbreak of war, one at the bottom of the ‘greatest slump in history’, and the last had been part of an effort to engineer equilibrium between the dollar and non-dollar worlds. Now global trade in manufactured goods was rising at an annual rate of 7 per cent and British costs and prices were not ‘perceptibly out of line with costs and prices elsewhere’. Forecasts estimated that the underlying deficit, which reflected not the immediate current account position but the gap between imports and exports over the next five years, would reach £200 million per annum at a growth rate of 3 per cent and £260 million at one of 4 per cent.<sup>34</sup> In the meantime there were ample reserves and borrowing facilities available with which the short-term imbalance could be covered while the government attended to policies designed to shift resources into the export sector. All this tended to make devaluation ‘an act of desperation’. British foreign relations would become strained, since West European countries in particular would be unlikely to agree that the position was grave enough to justify an adjustment of the sterling rate and some might be tempted to retaliate with their own devaluations. There would be a serious danger that holders of sterling inside and

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<sup>33</sup> TNA: PRO T171/776, ‘The domestic economic outlook to the end of 1965’, table 1, 26 Oct. 1964; TNA: PRO T171/776, note of a conversation between the Prime Minister and the Chancellor of the Exchequer, 27 Oct. 1964.

<sup>34</sup> TNA: PRO T171/758/GB(64)47, ‘Longer term prospects for the economy’, 15 Oct. 1964.

outside the sterling area would shift their money out of London. Of course it is true that such an eventuality would have undermined sterling's status, and this is why the 'sterling-first party' led by Cromer and the Bank of England was so hostile to devaluation. But more persuasive than this objection was the risk of a financial crisis being provoked by the exodus of a large portion of the sterling balances: the deficit would be aggravated and there would be a danger that the new parity would not hold, with the result that sterling would have to go down further.

The case against devaluation was supported by leading economists such as Roy Harrod and Joan Robinson. Both were 'elasticity pessimists', believing that an alteration in the sterling rate would be unlikely to have much effect on demand for British goods. Robinson argued that given 'near full employment', demand for labour, not exports, would be stimulated, whilst more expensive imports would push up wage demands so that any advantage accrued from a change in the rate would disappear quickly.<sup>35</sup> Harrod, long a strong advocate of expansionist policies,<sup>36</sup> also argued that devaluation would stimulate a wage-price spiral which would damage competitiveness, and in addition questioned the rationality of altering the exchange rate given that all but 2.5 per cent of imports were now paid for by exports and net financial income.<sup>37</sup> This scepticism was to be supported over the next couple of years by economists from widely different political backgrounds such as John Hicks, Lionel Robbins, and Ralph Hawtrey<sup>38</sup> – the latter arguing that sterling was actually *undervalued*, with inflationary pressures resulting from this.<sup>39</sup> Ironically, the Treasury was not so gloomy, estimating that the price elasticity of demand for British exports

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<sup>35</sup> Quoted in A.P. Thirlwall, *Balance-of-Payments Theory and the United Kingdom Experience* (3<sup>rd</sup> edn Basingtoke: Macmillan, 1986), p. 156.

<sup>36</sup> T.W. Hutchinson, *Economists and Economic Policy in Britain, 1946–66* (London: Allen and Unwin, 1968), pp. 184–5.

<sup>37</sup> Sir R. Harrod, 'No Help to Devalue', *The Times*, 31 August 1966.

<sup>38</sup> Middleton, *Charlatans or Saviours*, p. 262.

<sup>39</sup> Hutchinson, *Economists and Economic Policy in Britain*, p. 222.

was unlikely to be less than 2, but it argued that improvements in the balance of trade caused by a 10 per cent devaluation would be offset by as much as 50 per cent by higher costs resulting from more expensive imports and competitive bidding for manpower and materials by domestic producers.<sup>40</sup> Wilson himself not only pointed to the risks of one devaluation leading to a collapse of confidence and further, forced, downward adjustments, but argued that altering the parity would not facilitate economic expansion since resources would have to be transferred from exports. Given full employment this would have involved holding down domestic consumption (to avert the danger of competitive bidding feared by the Treasury)<sup>41</sup> – and indeed this is what happened after November 1967.<sup>42</sup>

The balance of evidence favours the government's response to the deficit. A survey by Ray (1966) showed that total UK wage costs per unit of output rose between 1958 and 1964 by 11 per cent while they were going up by 12 per cent in Japan, 12 per cent in Italy, and 22 per cent in West Germany.<sup>43</sup> A review of the causes of Britain's balance of payments problem in 1964 published by Thirlwall and Gibson in the 1990s concluded that the trade deficit had not resulted from relative price deterioration. The culprit was a cyclical upswing whose impact on demand had been reinforced by Maudling's expansionism. Thirlwall and Gibson also estimate that the 15 per cent import surcharge, cut to 10 per cent in April 1965 and removed altogether in November 1966, reduced imports by between £380 million and £462 million over the period of its existence. The external position improved following the surcharge and the deflation of domestic demand which commenced with Callaghan's November 1964 budget. In 1965 and 1966, import growth fell whilst export volume grew by 7

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<sup>40</sup> TNA: PRO T171/758/2(xlix), papers on exchange rate policy, 15 Oct. 1964.

<sup>41</sup> Wilson, *Labour Governments*, p. 6.

<sup>42</sup> Thirlwall, *Balance-of-Payments Theory and the United Kingdom Experience*, pp. 162–3.

<sup>43</sup> Thirlwall and Gibson, *Balance-of-Payments Theory*, pp. 234–5.



per cent.<sup>44</sup> If the surcharge could act on the price level to discourage imports and encourage exports, the case for devaluation based on profitability made by Hirsch lost much of its strength: as Maudling had said in the summer, 'it would seem as if devaluation under any other name would smell as sweet'.<sup>45</sup>

Contemporary reports in *The Times* revealed that Labour's October package and its determination to protect the sterling rate had been well received by the markets, the favourable reaction being reflected in increased demand for sterling. On 16 October the pound had dropped on the spot market to \$2.7825, the level at which official support became unavoidable and its lowest point since 1957. Eleven days later, following the announcement of the measures, it recovered to \$2.7853, its highest position since August.<sup>46</sup> Thereafter sterling settled down at just under \$2.7850 while dealers awaited the budget on 11 November (see Figure 1). It appeared that the crisis was over. Both at the time and subsequently it was possible to maintain that the government had handled it responsibly and appropriately, even if Britain's partners in the European Free Trade Association were unhappy about the imposition of the import surcharge.

### III

The confidence was short-lived. By the middle of November sterling was under heavy pressure once again (Figure 1). There were heavy outflows from the reserves which reached a peak between 24 and 27 November (Figure 2). There were even indications that sterling balances were being run down.<sup>47</sup> Substantial Bank of England intervention was necessary to protect the rate. Talk of devaluation was widespread

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<sup>44</sup> Ibid., pp. 237–8.

<sup>45</sup> TNA PRO T171/755/1(xxiv), note by the Chancellor, 27 July 1964.

<sup>46</sup> 'Sterling has a good day', *The Times*, 27 Oct. 1964.

<sup>47</sup> TNA: PRO PREM 13/866, Lord Kahn's enquiry, p. 30.

and in the end the government was forced to negotiate a rescue package. What was behind this crisis?

Subsequent explanations stressing vacillation and inadequate measures going back to the October package echoed contemporary criticism in the City and in overseas capitals and central banks. A somewhat inconsistent narrative has emerged from this in which three fundamental reasons have generally been cited for condemning the government.

The first of these concerns the budget. Callaghan had announced increases in old age pensions, the abolition of prescription charges (two long-standing objectives in Labour's social policy), and an export rebate. Set against these new public spending commitments were an import surcharge, a 6d (2.5p) rise in the basic rate of income tax, an escalation in petrol duty, an increase in national insurance contributions, and an intention to introduce both a capital gains tax and a corporation tax in the April budget. The package was not well received in the financial markets. The priority given to welfare measures was seen as adding to inflationary pressures and stimulating the home market when the need was to reduce demand and divert resources into the export sector. The rise in petrol duties was attacked for raising costs in industry.<sup>48</sup> The proposed tax reforms created anxiety in the City, where the government was accused of wanting to add to the tax burden on business.<sup>49</sup> These arguments were repeated by OECD members. The Belgians were the most voluble, but there were also more restrained accusations from the French and German finance ministries and central banks. Common to them all was the assertion that Labour had

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<sup>48</sup> TNA: PRO T171/769/17(iv), meeting between Prime Minister and Mr Governor, 18 Nov. 1964.

<sup>49</sup> TNA: PRO T171/769/17(i), letter from Mr Governor to Chancellor, Nov. 18 1964; 'Corporation tax plan brings welcome relief', *The Times*, 26 Nov. 1964.

not done enough to convince either domestic business or overseas creditors that it was serious about turning around the external deficit.<sup>50</sup>

Labour's second mistake, according to the critical narrative, concerned the Bank Rate. By Monday 16 November, disappointment with the budget and failing overseas confidence had led sterling to fall back to \$2.7831, and the outflow from the reserves that day was over £30 million, the highest since Labour's arrival in office (Figure 2).<sup>51</sup> That evening Wilson addressed a City audience at the Lord Mayor's banquet and used the occasion to try to reassure the markets about the government's commitment to the defence of sterling. It was 'our determination to keep sterling strong and see it riding high', said the Prime Minister.<sup>52</sup> The tough line encouraged a widespread expectation that a Bank Rate increase would be announced on the coming Thursday, 19 November, but the day came and went with no such thing. The government seemed to be vacillating, and the result was the intensification of the exodus from sterling, which fell back to its support level.

Throughout the November crisis the Bank of England had been exchanging gold and dollars, drawn from the central bank credits and Federal Reserve swap arrangements which had been organised before Labour came to power, for unwanted sterling. But Cromer informed Callaghan on 20 November that these were now exhausted:

[...] and we have only \$220 million (£78 million) remaining under the \$500 million swap arrangement between the Bank of England and the Federal Reserve System. The total of these short-term credit lines was, as you will recall, arranged to coincide with the amount of the standby which was negotiated with the IMF for \$1,000 million, thus,

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<sup>50</sup> 'More support for sterling needed', *The Times*, 25 Nov. 1964; 'British policy under fire in OECD', *The Times*, 3 Dec. 1964.

<sup>51</sup> 'Thin Day for Sterling', *The Times*, 17 Nov. 1964.

<sup>52</sup> 'Prime Minister warns gamblers in sterling', *The Times*, 17 Nov. 1964.

as things stand at present the major part of our standby facility will be absorbed in repaying these short-term credit facilities.<sup>53</sup>

The UK did of course possess a further \$1.5 billion in drawing rights with the IMF, but access to these was dependent on negotiations and scrutiny by the Fund and therefore neither automatic nor immediate. It followed that the UK would have to rely on its own stock of gold and foreign exchange reserves, worth £907 million at the end of September,<sup>54</sup> to fund its deficit and the run on the pound caused by the breakdown of confidence. This was the position by 24 November.<sup>55</sup> Considering that the estimated current account deficit for the year was in the region of £800 million and that the reserves had been swollen by the inflow from the sterling area which now seemed to have reversed itself, this was a disturbing position. How long would Britain be able to afford its current volume of imports and maintain its obligations to the sterling area at £1 = \$2.80?

The situation was only stabilised after the successful negotiation of the \$3 billion rescue package was revealed late on 25 November. This might have been a sign that the international financial community was throwing its resources behind sterling, but it also represented a substantial increase in British dependence on overseas creditors. Cuts in public spending programmes – even if already announced and underway – and more decisive early action on the Bank Rate, both of which were urged repeatedly on a reluctant Prime Minister and Chancellor by Lord Cromer,<sup>56</sup> would have given sterling holders the signal they needed much sooner, so that speculation against the currency would not have reached fever pitch and the need for

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<sup>53</sup> TNA: PRO T171/769/17(viii), letter from Mr Governor to the Chancellor, 20 Nov. 1964.

<sup>54</sup> TNA: PRO T171/758/GB(64)28, 'Immediate problems of reserve movements & financing the deficit', 15 Oct. 1964.

<sup>55</sup> TNA: PRO T171/769/17(xi), note of a meeting, Chancellor, Sir W. Armstrong, Mr Governor, and others, 24 Nov. 1964.

<sup>56</sup> See for example TNA: PRO T171/769/17(iv), meeting, Prime Minister and Mr Governor, 18 Nov. 1964; TNA: PRO T171/769/17(iv), letter from Mr Governor to Chancellor, 20 Nov. 1964.

such spectacular external support would not have arisen.<sup>57</sup> Indeed if the government had moved faster a 1 per cent rise in Bank Rate would have been enough.<sup>58</sup>

The third accusation levelled at the government, not necessarily compatible with the second, is that it should have devalued the pound at this stage rather than borrowed; but the die had been cast after Wilson, Callaghan, and Brown rejected this course of action in October. After this the subject became the ‘unmentionable’ and did not surface again until July 1966, at the insistence of senior Cabinet Ministers.<sup>59</sup>

Wilson shows that the situation was not so clear-cut: on 24 November he threatened Cromer with a sterling float, a dissolution of Parliament, and a General Election on the issue of ‘dictation by overseas financiers’ unless the Governor made serious efforts to organise support for the pound from the international financial community.<sup>60</sup>

Cairncross varies the story slightly by pointing out that at the height of the crisis, on 25 November, the Economic Section to the Treasury and the government’s new advisers prepared papers ‘spelling out the alternatives of devaluation and drastic deflation’.<sup>61</sup> However, the Bank of England’s success in raising the \$3 billion credit allowed Ministers to argue that there was no need for either line of action, and all the relevant papers were destroyed.<sup>62</sup> Ponting argues that Wilson’s threats to Cromer on 24 November were really bluff. The Prime Minister knew that Cromer would regard a sterling float with horror; it would undermine Britain’s international financial standing and threaten the outbreak of global economic disorder. The Governor would realise that his opposite numbers in other central banks and, above all, in the Federal Reserve Bank of the USA, had a vested interest in averting this scenario. US deficits

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<sup>57</sup> Dell, *Chancellors*, pp. 324–6.

<sup>58</sup> TNA: PRO T171/769/17(i), letter from Mr Governor to the Chancellor, 13 Nov. 1964.

<sup>59</sup> Kevin Jeffreys, *Anthony Crosland* (London: Politico’s, 1999), pp. 97–8.

<sup>60</sup> Wilson, *Labour Governments*, pp. 37–8.

<sup>61</sup> Cairncross, *Wilson Years*, p. 17.

<sup>62</sup> Clive Ponting, *Breach of Promise: Labour in Power 1964–70* (London: Penguin, 1990), p. 71.

were generating a conviction that the dollar would come under attack if sterling were devalued.<sup>63</sup> This mutual aversion to the disruption of sterling and fear of its consequences allowed Cromer to mobilise the support of his colleagues for a rescue package. Leruez, Ponting, and Stewart all argue that the recourse to borrowing brought short-term gains but constituted a major long-term strategic error.<sup>64</sup> It meant that supervision of British economic policy had now been handed over to foreign central bankers and that the government would have to respect their criteria of what was 'responsible' policy. From this point onwards, management of the economy would revolve around orthodox deflationary measures designed to maintain confidence in sterling.

The accusations are all inappropriate if one examines the evidence available at the time. To begin with, the budget added no demand to the economy. The export rebate and increases in welfare benefits were more than offset by the rises in national insurance contributions and in direct and indirect taxation. In fact, Cairncross estimated that the effect on demand between November 1964 and April 1965 would be to withdraw purchasing power at an annual rate of £218 million.<sup>65</sup> This would have been the work of the import surcharge and the increase in petrol duty; the income tax rise along with the capital gains and corporation taxes would not make an impression until 1965–6. The judgement, shared by Maudling, now Shadow Chancellor, was that the budget had been mildly deflationary.<sup>66</sup> The first reaction of the City was favourable. Indeed, two aspects of the budget which were later singled out for criticism by the City and by the OECD were initially mentioned in favourable terms.

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<sup>63</sup> See for example *Foreign Relations of the United States 1964–68*, VIII, document 26, memorandum from Treasury Secretary Dillon to President, 5 Jan. 1965.

<sup>64</sup> Leruez, *Economic Planning*, p. 179; Ponting, *Breach of Promise*, p. 72; Stewart, *Jekyll and Hyde Years*, p. 35.

<sup>65</sup> TNA: PRO T171/761/3(xx), note from Cairncross to Chief Secretary, 16 Nov. 1964.

<sup>66</sup> Callaghan, *Time and Chance*, pp. 172–3.

Thus the government was actually commended for its decision to wait until the spring before implementing a capital gains tax instead of ‘rushing headlong into [...] major tax reforms’. Moreover, the avoidance of sharp deflation was welcomed and the Chancellor was congratulated for striking a ‘fairly reasonable balance’ given his ‘difficult task’ of avoiding measures which would restrict growth whilst encouraging exports and giving more to widows and pensioners. Indeed the redistributive measures in the package did not cause either surprise or dismay, and the initial verdict was encouraging, with share prices being ‘marked up over a broad front’ the day after its announcement.<sup>67</sup>

Secondly, the charge that the government acted too slowly when it came to approving a rise in the Bank Rate misses the point that prevailing economic conditions did not appear to warrant such action. On 13 November, Cromer argued, in support of his case for an increase (from 5 to 6 per cent), that ‘demand is beginning to accelerate so that the danger of some overheating is increasing’.<sup>68</sup> It is true that an easing of gilt-edged prices in the week ending 20 November reflected some expectation of a rate increase in the City, but this was much more a result of government assurances that there would be no devaluation than it was of undercurrents in the London money markets.<sup>69</sup> Overall the view that Bank Rate should be increased was a minority one. It was not only Ministers who challenged it: the Treasury failed to back the Governor, Armstrong noting on 16 November that the ‘consensus of our views is that an increase in Bank Rate to 6 per cent would not be

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<sup>67</sup> ‘Initial relief at budget measures’, *The Times*, 12 Nov. 1964. ‘Lex’ (*Financial Times*, 12 Nov.) wrote that ‘none of the feared frightfulness was in evidence’.

<sup>68</sup> TNA: PRO T171/769/17(i), letter from Mr Governor to Chancellor, 13 Nov. 1964.

<sup>69</sup> ‘Bank Rate talk bolsters sterling’, *The Times*, 19 Nov. 1964; ‘Gilt-Edged Easier’, *The Times*, 20 Nov. 1964.

justified in the present circumstances'.<sup>70</sup> Resistance to Cromer failed to crumble in the face of a further demarche, on 17 November, when he argued that the run on sterling was now so serious that only a 7 per cent Bank Rate would stop it.

The problem was the ambiguous evidence about the pressure of demand in the economy over the preceding ten months. This added 'an unusual degree of uncertainty to any interpretation of what action is needed'. Callaghan's adviser, Robert Neild, argued that the deflationary action taken in the budget seemed 'fairly adequate for the time being', but accepted that there was a case for tightening credit given the appearance of pressure on the engineering and construction industries and the high rate of stockbuilding. However, monetary measures to achieve this were not supported since they would indicate that the government had already lost faith in its own budget, damage business confidence, and risk a rapid adverse reaction on investment in stocks.<sup>71</sup> There was a danger of injecting excessive deflation – reminiscent of an old fashioned 'Stop' in the discredited 'Stop-Go' cycle from which Labour wished to escape as much as the Conservatives had when Maudling had been Chancellor. It made more sense to take direct action to curb Bank credit by requesting the banks to restrict personal and business advances as well as loans for property development and advances. If the authorities were not satisfied by the response they would have to consider Special Deposits (whereby the banks placed a prescribed percentage of their own liabilities in cash at the Bank of England), last used in July 1961. In short, the argument for increasing Bank Rate by 1 percentage point, let alone by 2, did not seem to be supported by objective economic circumstances. In so far as it might be

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<sup>70</sup> TNA: PRO T171/769/17(ii), submission by Armstrong covering papers by Goldman and Neild, 16 Nov. 1964.

<sup>71</sup> TNA: PRO T171/769/17(ii), minute by Neild, 16 Nov. 1964; TNA PRO T171/769/17(iii), note of meeting at 11 Downing Street, 17 Nov. 1964.



necessary to complement the deflationary steps taken in the budget, there were other, less disruptive methods, available.<sup>72</sup>

Thirdly, the government did consider altering the sterling-dollar rate in November 1964. Devaluation was not ‘unmentionable’ between 21 and 25 November. Wilson’s record of his confrontation with Cromer has been confirmed by documents released recently in the National Archives. On 24 November, with the Bank Rate at 7 per cent and the pound at support level, Cromer told Callaghan that the heavy sterling losses ‘stemmed from a basic lack of confidence overseas in the policies of the Government’.<sup>73</sup> Late that evening, at a meeting in no. 10 Downing Street, Wilson suggested that the Governor should mobilise international financial support for sterling. Cromer, who in fact possessed a ‘visceral dislike for what he saw as Labour’s objectives’,<sup>74</sup> replied that there was no guarantee such an approach would work unless the government deflated and abandoned its key welfare and public investment priorities. Nothing less would satisfy Britain’s creditors in the IMF and the OECD that Labour’s primary aim was to turn round the external deficit: they were far from convinced that the import surcharge and the budget were enough and believed the level of internal demand to be too high. At this point Wilson replied that he would have ‘no alternative but to go to the country’ if ‘central bankers and their governments’ were going to prevent ‘a democratically elected government’ from carrying out its mandate. He was confident that he would win ‘on that xenophobic issue’ and then he would ‘be free to do what he liked – devaluation included’. He added that a floating rate would be an option.<sup>75</sup>

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<sup>72</sup> TNA: PRO T171/769/17(ii), Armstrong note of 17 Nov.

<sup>73</sup> TNA: PREM 13/261, note of a meeting held in Treasury Chambers, Great George Street, 5.30 p.m. 24 Nov. 1964.

<sup>74</sup> David Kynaston, *The City of London, vol. IV: A Club No More 1945–2000* (London: Pimlico, 2002), p. 307.

<sup>75</sup> TNA: PREM 13/261, note of a meeting at no. 10 Downing Street at 10.30 p.m., 24 Nov. 1964.

Of course, Wilson was aware that talk of a sterling devaluation or float was the last thing Cromer wanted to hear and that these comments could hardly fail to galvanise him into consultations with other central bankers about a large support package for sterling. As Brandon wrote shortly afterwards, Cromer 'could not afford to assume the blame for a collapse of sterling'.<sup>76</sup> The Governor had been avoiding such discussions, claiming that they would not work in the absence of confidence-building (in other words strongly deflationary) measures at home.<sup>77</sup> However, there is evidence to support the argument that the Prime Minister's remarks about devaluation and floating were not empty threats: his case had been prepared in advance. On 21 November there had been an emergency meeting at Chequers involving Wilson, Brown, Callaghan, Gordon-Walker (Foreign Secretary), Healey (Defence Secretary), and Bottomley (Commonwealth Relations Secretary). The Ministers had agreed on the 2 per cent rise in the Bank Rate and had also concluded that, should this not quell speculation, it would be necessary to 'go to the country' and then take action on sterling. The document did not use the term 'devaluation' but records that Ministers specifically asked for studies 'of the possibility of widening of exchange parities (including a floating rate)'.<sup>78</sup> Donald MacDougall, then Director General of the DEA, later recalled that on 24 November he had been summoned with other economic advisers to Downing Street where Wilson was having his showdown with Cromer. The Prime Minister told them that 'he was thinking of floating the pound and refusing to slash public expenditure'. MacDougall and Neild were asked to prepare papers on the relative merits of devaluation or floating.<sup>79</sup> Cromer's success in raising the \$3

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<sup>76</sup> Henry Brandon, *In the Red: the Struggle for Sterling 1964–66* (London: Andre Deutsch, 1966), p. 68.

<sup>77</sup> TNA: PREM 13/261, note of a meeting at no. 10 Downing Street at 10.30 p.m., 24 Nov. 1964.

<sup>78</sup> TNA: PREM 13/261, 'Top Secret Annex' to minutes of a Ministerial meeting at Chequers, 21 Nov. 1964.

<sup>79</sup> Donald MacDougall, *Don and Mandarin: Memoirs of an Economist* (London: John Murray, 1987), pp. 155–6.

billion meant that there was no change in the exchange rate – but the evidence suggests that Wilson would have approved one if the Governor had failed.<sup>80</sup> Of course Ponting was right to point out that a change in the sterling-dollar rate was regarded as a most undesirable prospect in Washington, but given the pressure on its balance of payments at this time, the US was not in a position to develop, alone, a financial package large enough to protect the pound against the speculation. Support from other members of the Group of Ten would be needed. Attitudes in the OECD had shown that this could not be taken for granted: by threatening to let sterling go, Wilson forced the central bankers to choose between their scepticism about Britain's prospects under Labour and their fear that a sterling float or devaluation would set off a wave of international currency instability. They chose fear. Even if the odds strongly favoured such a choice, it was a gamble on Wilson's part.

The government was prepared to contemplate devaluation or floating rather than pursue the stringent deflation advocated by Cromer. However, the arguments in favour of a downward adjustment of sterling were no more persuasive now than they had been five weeks earlier; they were only attractive because the alternative was so unappealing. It was therefore unsurprising that the raising of the support package should have been greeted with relief, especially since there were no conditions. The credit was short-term (of three months' duration), but it was (correctly) anticipated that renewal beyond this limit would be possible. Far from compromising British sovereignty and giving decisive power over macroeconomic policy to foreign central bankers, the \$3 billion allowed the government to continue with its long-term plans for turning round the external deficit and creating the conditions for sustained expansion. The import surcharge and the budget were two foundations of the strategy.

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<sup>80</sup> See also Cairncross, *Wilson Years*, p. 17 (entry for 25 Nov. 1964).

The third was to be the *Joint Statement on Prices, Incomes and Productivity*, negotiated by the DEA with both sides of industry and announced in December. In approving this document the TUC committed itself to restraining wage and salary increases so that they did not exceed the growth of national output. The *Joint Statement* was the prelude to the establishment the following year of the Price and Incomes Board (PIB), which was to decide whether pay or price increases referred to it by the government were 'in the national interest'. The government intended that the *Joint Statement* and the PIB should institutionalise tripartite co-operation designed to ensure that British costs remained internationally competitive and growth non-inflationary. With hindsight the optimism with which these reforms were greeted may seem somewhat overcooked, but they were part of a coherent design for the economy.<sup>81</sup>

#### IV

Given the weakness of the case for either devaluation or sharp deflation it is hard to see what Labour could have done differently in response to sterling's problems. After all, before Labour took office Maudling and his advisers discussed key measures, including an import surcharge and external support, as contingency plans in case of severe pressure on sterling. In addition, the turn to mild deflation and the preference for using credit restrictions rather than monetary policy was the approach regarded in the Treasury as 'right to adopt in a "normal" situation in which the policies adopted were working'.<sup>82</sup> What made the second crisis so severe despite the apparent text-

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<sup>81</sup> Scott Newton and Dilwyn Porter, *Modernization Frustrated: the Politics of Industrial Decline in Britain since 1900* (London: Unwin Hyman, 1988), p. 149; Woodward, *Management of the British Economy*, pp. 97–8.

<sup>82</sup> TNA: PRO T171/769/17(ii), submission by Armstrong, 'Monetary Policy', 16 Nov. 1964.

book reaction to it was its abnormality, and this was why the standard policies failed to resolve it even when they were reinforced by a 2 per cent Bank Rate increase.

The abnormality of the November crisis derived from the extent of the speculation against sterling, which was beyond anything experienced since the convertibility crisis of 1947. This new turn was the product of international economic liberalisation since the late 1950s. The removal of exchange controls and barriers to trade had been supported by national governments as well as by international organisations such as the IMF and the OECD (after 1961) with the aim of promoting trade, which economists and politicians identified as one of the principal engines of rapid growth.<sup>83</sup> The British had played a leading role. Strongly supported by commercial interests rooted in the City of London, the Conservative governments of the 1950s sought to rehabilitate sterling as a worldwide trading and reserve currency after the era of war and reconstruction when its use had been governed by regulations. This endeavour was backed strongly by the Bank of England and the Overseas Finance Section of the Treasury, where its success was identified with the prosperity of the financial sector and gains to the national welfare<sup>84</sup> (the international use of sterling had contributed 10 per cent of all earnings in 1951).<sup>85</sup> Sterling convertibility for current transactions had finally been reintroduced at the end of 1958. Exchange controls for capital transactions remained – but so keen had the Bank of England and the Treasury been to attract funds to London that they allowed the mechanisms to fall into neglect. By 1964 evasion was easy. Bank of England approval for transactions was required far less frequently than in the past. Treasury enforcement staff

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<sup>83</sup> Scott Newton, *The Global Economy 1944–2000. The Limits of Ideology* (London: Arnold, 2004), pp. 62–3 and 74–6.

<sup>84</sup> Scott Newton, 'Keynesianism, sterling convertibility, and British reconstruction, 1940–52', in R. Michie and P. Williamson (eds), *The British Government and the City of London in the Twentieth Century* (Cambridge: Cambridge University Press, 2004), pp. 268–75.

<sup>85</sup> Alan S. Milward, *The European Rescue of the Nation-State* (London: Routledge, 2000), p. 389.

comprised one part-timer. Customs, responsible for checking from exchange control forms that the proceeds of exports were banked within six months, operated by scrutinising a small sample known as 'black sheep'.<sup>86</sup> This was the liberal background which had encouraged the growth of the sterling balances to over £4 billion in the years up to 1964.

This trend towards the removal of controls was not only a function of policy decisions by national governments. It was reinforced by two developments in the international economy. The first of these was the rise of the multinational corporation. Most of the leading multinationals at this time were based in the USA where they accounted for over 75 per cent of the country's exports and nearly 50 per cent of its imports.<sup>87</sup> Initially the most popular location for investment by the multinationals was Western Europe, due to rapid post-war growth, expanding trade, and relatively cheap labour costs. Investment flows were stimulated further by the existence of the EEC tariff wall, and by 1964 high-technology sales of US subsidiaries in Europe were four times the value of American exports to Europe.<sup>88</sup> The resulting income was more often banked locally than repatriated. In part this was because it could be drawn on for reinvestment, but there was also a speculative motive: Shonfield estimated that by the mid 1960s, 50 per cent of the foreign assets of multinational corporations were 'relatively liquid', and tended to move from one financial centre to another according to interest rate variations or expectations of alterations in exchange rates.<sup>89</sup>

The shift towards increasing mobility of international capital fed into a second major development in the global economy from the late 1950s onwards: the rise of the

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<sup>86</sup> TNA: PREM13/866, Lord Kahn's enquiry, p. 4.

<sup>87</sup> Eric Hobsbawm, *Age of Extremes: the Short Twentieth Century 1914–* (London: Michael Joseph, 1994), p. 279.

<sup>88</sup> Newton, *Global Economy*, p. 85.

<sup>89</sup> Andrew Shonfield, *International Economic Relations of the Western World, 1959–71, I: Politics and Trade* (London: Oxford University Press, 1976), p. 114.

'Eurodollar' market. Eurodollars were foreign currency balances, mostly dollars held outside the USA in foreign banks or overseas branches of US banks. They could be lent as short-term credit instruments to buyers approved by another bank operating in the market.<sup>90</sup> Banks outside the USA (most of them in London) had held dollar balances prior to 1939, but this had been a small part of their business. The position changed with the advent of convertibility. British and European banks could now trade freely in dollars. London banks in particular benefited: not only did they have long experience of international banking, but they were not subject to regulations introduced in the USA to curtail the outflow of capital. The new opportunities were exploited not only by British-owned banks, but also by concerns in the USA, Canada, Australia, and on the continent which all established subsidiaries in the City during the 1960s. Schenk states that the number of foreign banks in the City rose from 51 to 129 between 1962 and 1970.<sup>91</sup> The overall figure concealed a tripling of US banks with London branches.<sup>92</sup> The expansion of banking in London facilitated the development of an international short-term money market fed by oil corporations, multinationals, insurance companies, other banks, and private individuals. This 'Euro-dollar market', as it was dubbed by contemporaries, had expanded from very little in the late 1950s to \$9 billion by the middle of 1964.<sup>93</sup> In London alone foreign currency liabilities and claims of banks had grown from £100 million (\$280 million) in 1958 to over £1300 million (\$3.6 billion) in 1964<sup>94</sup> and £2 billion (\$5.6 billion) by mid 1965.<sup>95</sup>

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<sup>90</sup> Strange, *Sterling*, p. 207.

<sup>91</sup> Catherine Schenk, 'The new City and the State in the 1960s', in R. Michie and P. Williamson (eds), *The British Government and the City of London in the Twentieth Century* (Cambridge: Cambridge University Press, 2004), p. 325.

<sup>92</sup> Susan Strange, *International Economic Relations of the Western World, 1959–71, II: International Monetary Relations* (London: Oxford University Press, 1976), p. 234.

<sup>93</sup> *Ibid.*, p. 182.

<sup>94</sup> *Bank of England Quarterly Bulletin*, vol. 4, June 1964.

<sup>95</sup> TNA: PREM 13/866, Lord Kahn's enquiry, p. 35.

There were further reasons for the especial attractiveness of London to these foreign funds. To begin with, sterling's international role made it a local currency which provided an alternative to the dollar. Secondly, there were financial incentives for switching out of dollars (or any other foreign currency) into sterling: a higher Bank Rate in the UK than in comparable European states; the ability of domestic credit consumers, in the form of hire purchase companies and local authorities, to outbid the Treasury for foreign funds and short-term credit by between ½ and 1 per cent; the existence of forward cover. The last of these usually involved holders of dollars swapping their currency for sterling by selling them in the spot market. Hirsch quotes the example of an American oil corporation undertaking this transaction to enable its liquid assets to earn more from a higher short-term interest rate in London than in New York.<sup>96</sup> To ensure that it would avert exchange risk, when buying sterling the corporation would arrange that it could sell it against dollars three months forward at the original rate or something very close to it. A premium would be involved for this cover, generally in the form of a discount on the spot sterling-dollar rate. If this amounted to the equivalent of an annual rate of 1 per cent whilst the interest rate in London yielded 1½ per cent more than the rate in New York, the result would be a 'covered interest margin of ½ per cent' in London's favour, a clear incentive to pursue the arrangement.

Labour's problem was that there were circumstances in which the factors responsible for encouraging an inflow of short-term capital – a deregulated financial market, a sophisticated banking system, and significant balances of mobile foreign currency in search of profitable opportunities – could all produce the opposite effect. These factors had been present in 1961 when the last sterling crisis was provoked, but

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<sup>96</sup> See Fred Hirsch, *Money International* (London: Penguin, 1969), p. 211.



the growth of the Eurodollar market and the increasingly exposed position of sterling as liabilities accumulated ensured that when they reappeared late in 1964 they did so in much more threatening style.

The danger took two forms. First of all, by mid November the size of the current account deficit and the illiquidity of sterling were undoubtedly fuelling anxiety on the part of Britain's international creditors about Labour's ability to protect the sterling-dollar exchange rate. It is of course true that the exposed position of sterling, in terms of the imbalance between short-term assets and liabilities, had grown throughout the year without provoking a crisis; but confidence began to wane after the budget, with the appearance of scepticism within the OECD and especially within the Group of Ten. The Group, which met in Paris, had a central responsibility in the provision of credit to nations labouring under balance of payments difficulties. Its role stemmed from the IMF's establishment of the General Arrangements to Borrow (GAB) in 1961. Under the GAB the members of the Group had agreed to transfer \$6 billion from their reserves to the Fund so that it could expand the resources available to support significant British and American withdrawals made to protect sterling and the dollar respectively.<sup>97</sup> However, support was conditional on surveillance: the Group of Ten (also known as the Paris Club) would have to approve the supplementary drawings by the UK. It would then be required to establish an ongoing review of the British balance of payments position, a task which would be conducted by Working Party Number Three of the OECD. At the start of November, the Paris Club agreed to contribute \$400 million to the total if the UK sought to use its standby credit of \$1 billion with the IMF, but not before there had been a 'searching examination' of Labour's economic policy. The possibility was mooted that further borrowing would

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<sup>97</sup> Newton, *Global Economy*, p. 91.

be required if the external balance failed to improve.<sup>98</sup> OECD misgivings, based on hostility to the import surcharge and doubts whether the budget was sufficiently deflationary, were allayed if not removed after the British stressed the temporary nature of the surcharge, the new government's difficult inheritance, and its determination to enhance productivity.<sup>99</sup> Yet, given the rather cool reception of Labour's measures already seen in the OECD, there was a risk that Working Party Number Three might not support extra funding except on terms which the government would find hard to accept. What foreign bankers regarded as insouciance on Labour's part ate away at confidence in sterling; selling began to gather momentum, initially in overseas markets.<sup>100</sup>

Secondly, the selling of sterling was fuelled by fears (or expectations) of devaluation. These surfaced after the failure to raise the Bank Rate in the wake of Wilson's speech to the Lord Mayor's Banquet. Labour's failure to invoke monetary measures led to a belief that either it had no serious idea what to do, or that rather than deflate, it was prepared to let the exchange rate go if pressure on the reserves continued. Such views became particularly common in the City and were repeated to foreign bankers and dealers when they spoke to their counterparts in London.<sup>101</sup> There was, finally, the 2 percentage point increase in Bank Rate, from 5 per cent to 7 per cent, on 23 November; but the rise failed to make the impact expected, partly because it was seen as a last-minute panic measure to save the pound. The situation facing sterling now fell into the category later identified as 'second generation currency

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<sup>98</sup> 'Paris Club to lend Britain \$143m', *The Times*, 9 Nov. 1964.

<sup>99</sup> See TNA: T312/812, Hankey (UK delegation to OECD) to Foreign Office, 22 Nov. 1964.

<sup>100</sup> 'Widespread selling of sterling', *The Times*, 7 Nov. 1964.

<sup>101</sup> TNA: PREM 13/866, Lord Kahn's enquiry, p. 50.

crisis',<sup>102</sup> whereby although the fundamentals of the British economic position had not changed substantially between October and November 1964, there was a change in the markets' and in central bankers' perceptions of them, and it was this shift which provoked the fierce attack on sterling.

The failure of confidence extended to the sterling area, an unprecedented development.<sup>103</sup> Yet it was unsurprising that holders of sterling might wish to switch to other currencies out of anxiety about whether their assets would lose value, and in fact the Bank of England estimated that OSA members ran down their balances between October 1964 and August 1965 by around £80 million beyond what was needed to cover their own deficits, the bulk of these withdrawals occurring in the fourth quarter of 1964. November to December also witnessed a major shift out of sterling on the part of the NSA, particularly by private holders in Western Europe (whose balances were regarded as 'among the most volatile elements in the balance of payments'). It was later estimated that NSA balances fell by £201 million between November 1964 and January 1965.<sup>104</sup>

This crisis of confidence was reinforced by interest rate movements: initially the Bank Rate increase pushed the covered interest margin up to ½ per cent in London's favour, but the effect was undercut by a sharp rise in the cost of forward cover. The Wall Street premium on the dollar at three months rose from just under 0.25 per cent to 0.71 per cent between 23 and 26 November as forward selling of sterling gathered pace.<sup>105</sup> By 25 November the covered interest rate comparison had turned against London by ¼ per cent. There was a swing back to London's advantage in December,

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<sup>102</sup> See M. Obstfeld, 'The logic of currency crises', *Cahiers Economiques et Monétaires*, 43 (1994), pp. 189–213, and Massimo Sbracia and Andrea Zhagini, 'Expectations and Information', *Economic Modelling*, 18, 2 (2001), pp. 203–22.

<sup>103</sup> TNA: PREM 13/866, Lord Kahn's enquiry, p. 33.

<sup>104</sup> *Ibid.*, pp. 34 and 37.

<sup>105</sup> 'Sterling sold forward', *The Times*, 26 Nov. 1964.

but the brief period during which this had been lost coincided with the heaviest pressure on sterling. On 24 November £87 million were lost and the following day £91 million (see Figures 1 and 2). These losses were intensified by a small rise in Eurodollar deposit rates so that the covered local authority rate comparison turned against London, leading to a movement out of local authority deposits.<sup>106</sup> Indeed, net local authority borrowing from overseas fell by £26 million between the third and fourth quarters of 1964.<sup>107</sup> At the same time UK banks taking and on-lending foreign currency deposits (mainly Eurodollars) switched them out of sterling, their liabilities falling by between £167 million and £107 million between November and December.<sup>108</sup>

The government suspected that the exodus from sterling had more to do with speculative motives than commercial ones, although in reality it was hard to distinguish between the two. However, Wilson and Callaghan were convinced that sterling was being sold short ('oversold', in the jargon) by speculators. In other words dealers were betting on a devaluation by arranging to borrow sterling and then sell it for dollars with the objective of buying it back at a discount following a change in the rate. Wilson pointed out that extortionate rates of interest might apply to the borrowed funds, but the profits dealers would expect to make as a result of a change in the sterling-dollar rate would more than compensate.<sup>109</sup> It is hard to quantify the losses created by such action but there does appear to have been some justification for these suspicions, with much of the heavy selling of sterling in New York on 24 and 25 November being of the short variety.<sup>110</sup> Dealers built up a significant oversold position and suffered badly when the Bank intervened on the spot market on 30

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<sup>106</sup> TNA: PREM 13/866, Lord Kahn's enquiry: memorandum by R.J. Painter, 20 Aug. 1965.

<sup>107</sup> Strange, *Sterling*, p. 241.

<sup>108</sup> TNA: PREM 13/866, Lord Kahn's enquiry, pp. 35–6 and Statistical Table A.

<sup>109</sup> Wilson, *Labour Governments*, p. 32.

<sup>110</sup> TNA: PREM 13/866, Lord Kahn's enquiry, p. 36.

December to drive the rate up to \$2.7916, over half a cent higher than it had been five weeks earlier. Many who had gone short of sterling were forced into the market to buy it at this higher rate rather than the lower one they had anticipated, in order to cover their year end obligations.<sup>111</sup>

## V

Between November 1964 and January 1965 spot financing requirements amounted to £596 million. Just under half of this (£257 million) was attributed to the current account deficit, and £91 million was accountable to payments deficits in the rest of the sterling area. The rest was down to ‘confidence’, which provoked the respective falls of £80 million in OSA and £201 million in NSA sterling balances. The severity of the move out of sterling did come as a shock to a government which had good reason to believe that it had taken all the appropriate measures by the standards of conventional macroeconomic wisdom. Indeed, the measures taken by the government to manage the crisis do not suggest that it was clueless either about the causes or the available cures.

The government was clear that much of the pressure on sterling was speculative and that it followed on from the increasing volatility of the international financial markets. In these circumstances it seemed clear that ‘confidence’ had as much to do with the pressure on sterling as the fundamentals of the British economic position.<sup>112</sup> Given the nature of the November crisis in particular, it was reasonable for Wilson to worry that a sterling devaluation would mean capitulation to the markets and leave them confident that in the absence of a rapid improvement in Britain’s external deficit they would be able to repeat the coup in the near future. It followed that there was

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<sup>111</sup> ‘Bank alters tactics for sterling defence’, *The Times*, 30 Dec. 1964. The tactic was known as a ‘bear squeeze’ (see Hirsch, *Money International*, pp. 224–5 and 229–30).

<sup>112</sup> TNA: PREM 13/866, Lord Kahn’s enquiry, pp. 108 and 110.

some rationality in delivering a counterblast to the markets which would make a powerful impact on market sentiment. The \$3 billion support operation of November 1964 not only averted devaluation but was intended to demonstrate to the markets that they would never be able to mobilise enough resources to undermine a national government when it was backed by the world's leading central banks.<sup>113</sup>

From 25 November onwards this demonstration was reinforced by intervention in the forward market for sterling whereby the Bank of England employed the Exchange Equalisation Account (EEA) to offset the selling of sterling at a discount by guaranteeing to honour the currency's parity three months down the line. Initially the Bank had not been happy about making this commitment when Wilson asked for it on 24 November. Cromer argued that the spot and forward positions had not been out of line and that forward support could be expensive. Yet there was pressure on the forward rate and support would only be costly if devaluation left the Bank committed to a series of settlements at the old exchange rate. Moreover, the guarantee of exchange rate stability received by sterling holders as a result of forward market intervention would be likely to reduce both pressure on the spot market and the premium for forward cover, as indeed occurred from the last week of November. Along with the 7 per cent Bank Rate, this enabled the covered interest rate margin to move in favour of London, where it remained for most of the time from December 1964 (up to June 1965, when the Bank Rate was cut to 6 per cent), while spot sterling remained above \$2.79. Cromer's reply was in fact rather strange in the circumstances and indicative both of his lack of confidence in the government and his view that it should resort to old-fashioned deflation. Wilson, however, pressed the Governor on

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<sup>113</sup> TNA: T171/769/16(v), statement by the Chancellor, 26 Nov. 1964; John Cooper, *A Suitable Case for Treatment: What To Do About the British Balance of Payments* (London: Penguin, 1968), p. 61. Cooper was well-informed. He was Manager of the Foreign Exchange Department of Schroder Wagg and had good Treasury contacts. See for example Cairncross, *Wilson Years*, pp. 319–20, entry for 19 Aug. 1968.

the issue,<sup>114</sup> and thereafter forward market intervention became almost routine,<sup>115</sup> with £580 million being made available for support by the EEA in December, and the net figure for the period October 1964 to August 1965 reaching £838 million.<sup>116</sup> At the same time, the insistence that devaluation itself be ‘unmentionable’ within the government made sense given the sensitivity of the markets to rumour.<sup>117</sup>

It could be argued that these actions were improvised, piecemeal measures to cope with an emergency, but they were informed by two working assumptions which characterised the government’s external economic policy throughout its period in power. First, from the perspective of the national interest it was reasonable to attempt to restore some stability to the external economic environment. There was a history of distrust of speculators within the Labour party, reaching at least as far back as 1931. It found expression in a populist left wing assumption that the 1929–31 Labour government had been undermined by international finance acting in conjunction with powerful forces in the City, led by Montagu Norman, Governor of the Bank of England at the time.<sup>118</sup> In 1964 Ministers favoured both reversing the trend away from tight controls on the outflow of capital and intervention in the forward market to reassert the power of the government over unaccountable and remote financiers. There were suspicions, shared by Harold Wilson and George Brown, that Cromer might be playing the same game with the same unpatriotic forces as Norman had over thirty years before; this was one factor in the bitter clashes between the Prime Minister and the Governor.<sup>119</sup> The assault on sterling was seen by the government as a hostile act: Wilson said ‘we are fighting a war and we don’t know who the enemy

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<sup>114</sup> TNA: PREM 13/261, meeting between the Prime Minister and Mr Governor, 24 Nov. 1964.

<sup>115</sup> Cooper, *Suitable Case*, p. 54.

<sup>116</sup> TNA: PREM 13/866, Lord Kahn’s enquiry, pp. 29 and 38.

<sup>117</sup> Wilson, *Labour Governments*, pp. 32–3.

<sup>118</sup> Jacques Attali, *A Man of Influence: Sir Siegmund Warburg 1902–82* (London: Weidenfeld & Nicolson, 1986), p. 242.

<sup>119</sup> Brandon, *In the Red*, p. 66.

is',<sup>120</sup> while British businessmen and Conservative politicians who briefed foreign bankers and governments against Labour were engaging in 'treasonable talk'.<sup>121</sup>

Such sentiments were no doubt one source of Labour's dedication during 1964–70 to working for an international economic order supportive of a modernising social-democratic government. But Wilson and Callaghan understood what was happening in the markets even if they could not identify the actors;<sup>122</sup> the determination to resist speculative pressure and the commitment to international financial co-operation in the cause of exchange rate stability had much more to it than Labour's folk memory. It reflected an effort to reconcile the trend to internationalisation of finance and production with the post-1945 search of the nation-state for growth, full employment, and price stability. Anxiety about the damage speculative activity could inflict on national governments was shared by Washington and the Group of Ten.<sup>123</sup> The government supported and built on the efforts of the previous, Conservative administration to reform the international monetary order and, in co-operation with the USA, to secure an increase in international liquidity. This would be available through the IMF to assist members suffering from serious balance of payments fluctuations; it would be particularly useful to countries like the UK or the USA where there was an imbalance between short-term assets and liabilities.<sup>124</sup> The talks progressed slowly, largely because of enthusiasm on the part of French, with support from Belgian, West German, and Dutch central bankers, for a harder system of international payments based on an expansion of the use of gold (the upshot was the Special Drawing Right [SDR], unveiled in 1968). In addition the government strengthened capital controls and commenced efforts to multilateralise the sterling

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<sup>120</sup> Ibid., p. 67.

<sup>121</sup> TNA: PREM 13/039, Prime Minister to Chancellor, 20 Nov. 1964.

<sup>122</sup> Wilson, *Labour Governments*, pp. 31–3.

<sup>123</sup> Newton, *Global Economy*, pp. 90–1.

<sup>124</sup> TNA: FO371/178909/W2/198, 'International Liquidity': brief for Washington talks, 27 Nov. 1964.



burden so that vulnerability to destabilising movements of money would be reduced, although these did not reach fruition until the Basle Agreement of September 1968 whereby Britain received a \$2 billion standby credit to offset fluctuations in the overall level of the sterling balances.<sup>125</sup> The measures taken in response to the 1964 sterling crises were informed by the same commitment to the management of global monetary disturbances.

Secondly, whilst the government was aware that it needed international support for sterling, it was also clear that macroeconomic policy had to be directed to measures designed to transform the external balance. Lord Kahn's 1966 enquiry into the position of sterling in 1964–5, commissioned by Wilson himself, pointed to the way the confidence factor interacted with the existence of large short-term liabilities, especially to the NSA.<sup>126</sup> Even though the \$3 billion credit had calmed the markets in the winter of 1964–5, speculation was renewed the following summer and another rescue package became necessary. It was evident that repeated demonstrations of international confidence in the currency, led by the USA, were not enough to stabilise sterling for long periods of time. The only escape lay in the reduction of short-term liabilities, which in turn required a trade surplus large enough for resources to be devoted to the reduction of debt. The government followed the recommendation of Neild and Kaldor that it should aim to accumulate a balance of payments surplus of £500 million up to 1970, a figure endorsed by Kahn,<sup>127</sup> although Cairncross considered it too high.<sup>128</sup> This explains why the need to drive up exports whilst holding down domestic consumption replaced the National Plan of 1965 as the centrepiece of the government's economic strategy. The point was made by Kahn:

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<sup>125</sup> Catherine Schenk, 'The Empire strikes back: Hong Kong and the decline of sterling in the 1960s', *Economic History Review*, LVII (2004), p. 551; Wilson, *Labour Governments*, p. 546.

<sup>126</sup> TNA: PREM 13/866, Lord Kahn's enquiry, sections 2 and 3.

<sup>127</sup> *Ibid.*, pp. 123–4.

<sup>128</sup> Cairncross, *Wilson Years*, p. 123.

[...] if economic policy is to be developed on its merits, and not under pressure of international monetary disturbances, then it is essential that the development and maintenance of a really substantial balance of payments surplus, taking one year with another, shall be accepted as an important element of economic policy, to be pursued with vigour in good times as well as bad.<sup>129</sup>

Given the problems involved with devaluation there was no other course of action available to Labour except to improve the balance of payments whilst holding speculative pressures at bay through a mixture of external support and intervention in the markets.

Despite the good reasons for preferring an import surcharge, external support, and intervention to action on the sterling rate or stringent deflation in the autumn of 1964, the fact that sterling was devalued three years later has generally been taken as strong evidence for the case that the government should have done it before. Did Britain devalue in 1967 because it had failed to do so earlier? The evidence does not support such a *post hoc ergo propter hoc* argument. Thirlwall and Gibson point out that after 1964 the balance of payments on current account diminished and by 1966 was in surplus. In 1967 demand appeared to be falling and the indications were that the country would end the year in the black on current and long-term capital account. This promising situation was transformed by a series of events beyond the government's control. Export growth was checked by a global slowdown. All the same by midsummer the external position was still healthy. At this point two factors destabilised it. The first was the Six Day War and the closure of the Suez Canal, which stimulated heavy selling of sterling. The bear market in sterling was intensified by an increase in short term interest rates in the USA and in the Eurodollar market. A set of disappointing trade figures for June did not help, and in the third quarter the

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<sup>129</sup> TNA: PREM 13/866, Lord Kahn's enquiry, p. 110.

balance of payments went back into the red. Confidence began to evaporate once more, reinforced by dock strikes in London and Liverpool which hit shipments of exports. By November the speculation was out of control.<sup>130</sup> Almost \$2 billion in short-term credits had been exhausted and this had mortgaged ‘nearly all [...] total reserves’. By 12 November only \$600–\$800 million was left in short-term credits and it was feared that this would disappear completely if an attempt was made to hold the rate for another few weeks.<sup>131</sup> Given this growing anxiety about the reserves Wilson and Callaghan now favoured devaluation unless a rescue package with acceptable terms could be agreed on with the IMF. One did emerge – but with intrusive and deflationary conditions. It all meant that there were compelling reasons in favour of devaluation, and the government acted appropriately.<sup>132</sup> Yet the crisis itself, as in 1964, was ultimately a speculative one. There was no insurmountable problem with Britain’s trading position – indeed in 1969 it was found that this had been substantially better than appreciated at the time, thanks to the discovery of a mistake in the recording of the export statistics.<sup>133</sup>

The historical record suggests there are good grounds for questioning the view that on coming to power in 1964 Labour demonstrated economic incompetence and lacked any strategy for dealing with external financial problems. Rather, it seems that the real story concerns the difficulties created for the postwar nation-state by the progressive internationalisation of production and finance. Labour was elected at a time when what civil servants and politicians regarded as an abnormal situation was to become increasingly common. No doubt Britain’s relatively open economy and

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<sup>130</sup> Thirlwall and Gibson, *Balance-of-Payments Theory*, p. 240.

<sup>131</sup> Declassified Documents Reference System, CK3100135999, memorandum for the President regarding a meeting between Secretary of the Treasury Henry H. Fowler, British Chancellor of the Exchequer James Callaghan, Sir Denis Rickett, and a Bank of England official, 12 Nov. 1967.

<sup>132</sup> Wilson, *Labour Governments*, pp. 452–4.

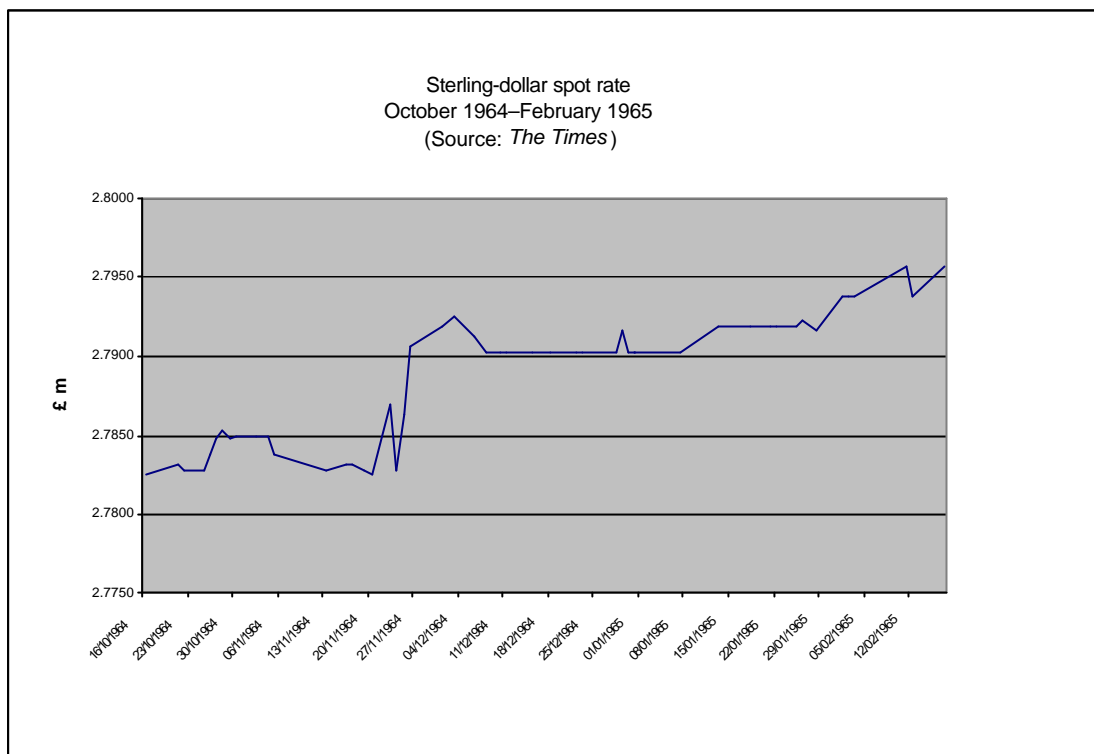
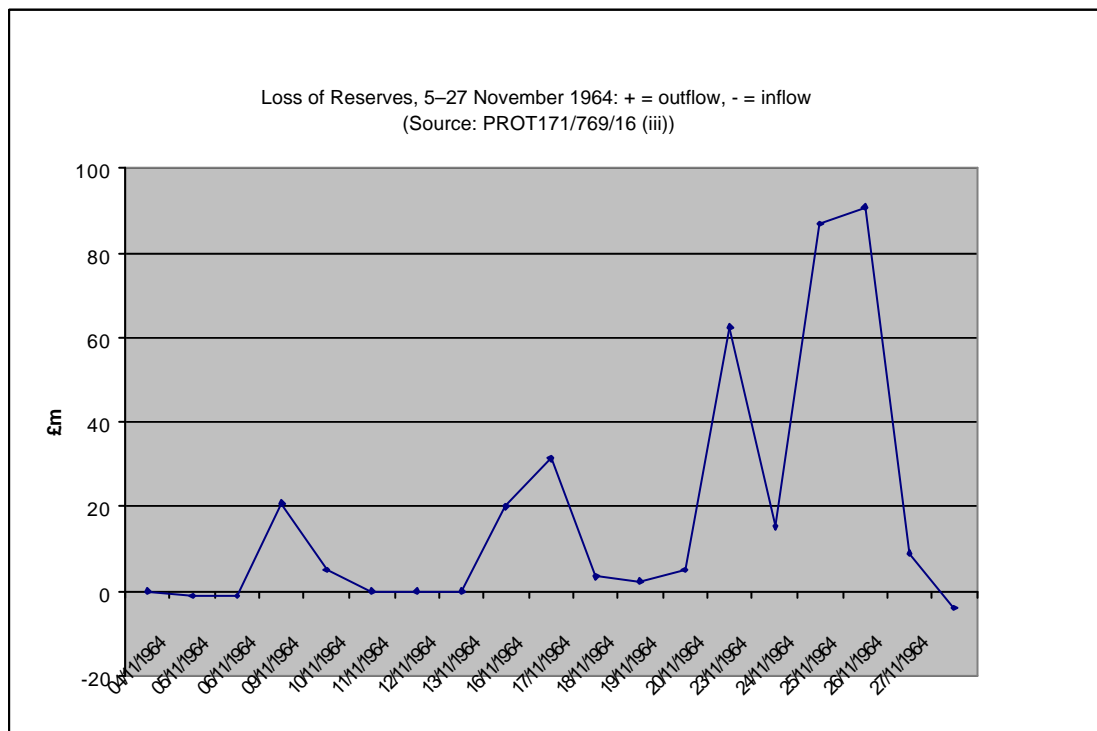
<sup>133</sup> Roy Jenkins, *Life at the Centre* (London: Macmillan, 1992), pp. 278–9.

position as banker to the sterling area enhanced its vulnerability to the powerful forces of global capitalism.<sup>134</sup> Yet over the next decades the impact of speculative crises would be felt by other members of the OECD. Here, as with industrialisation, Britain was a pioneer, forced to face problems that would in time confront most advanced industrial countries: *de te fabula narratur*, as Marx, quoting Horace, liked to say.<sup>135</sup>

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<sup>134</sup> See Paul Hirst and Graham Thompson, 'Globalization in one country? The peculiarities of the British', *Economy and Society* 29, 3 (2000), pp. 335–6.

<sup>135</sup> For example, Karl Marx, *Capital Volume I* (London: Penguin, 1976), pp. 90 and 378. The full quotation is, 'mutato nomine, de te fabula narratur' – change the name and the story's about you (Horace, *Satires*, I, i, vv. 69–70).

**Figure 1****Figure 2**

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