

# ***The Sterling Area in the 1930s: A Unique Monetary Arrangement?***<sup>1</sup>

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## **Introduction**

Attempts to reconstruct the prewar liberal international economic order in the interwar years ended in failure with the result that there was a vast increase in the barriers to international intercourse and cooperation, especially in the 1930s. However, there were a few signs of constructive effort, most notably in the field of currency management. The purpose of this essay is to look more closely at one aspect of the stabilisation and currency management process which has been relatively neglected, namely the formation of the sterling area and its role in currency stabilisation in the 1930s.

The 1930s have often been seen as a period of unrelieved currency disorder. It is well-known that the almost universal disintegration of the international gold standard in the early 1930s ushered in a period of currency chaos not dissimilar to that of the first half of the 1920s.<sup>2</sup> Exchange rates were extremely volatile and there were fears at the time that exchange rate instability would hamper the recovery of international trade and lead to a renewed burst of inflation. As the League of Nations commented in its second *World Economic Survey*, 'The most destructive development during 1932 was exchange instability'.<sup>3</sup> The devaluation of the dollar early in 1933 and the failure to establish even a modicum

<sup>1</sup> I should like to thank Professor George Zis of the Department of Economics, Manchester Metropolitan University, for his many helpful comments on this article.

<sup>2</sup> For the background to the 1920s see D. H. Aldcroft, 'Currency stabilisation in the 1920s: success or failure?', *Economic Issues*, 7(2001).

<sup>3</sup> League of Nations, *World Economic Survey 1932-33*, (Geneva 1933), p. 15.

of international cooperation on monetary and currency matters at the World Economic Conference in the summer of that year appeared to bode ill for the future.

However, the year 1933 probably marked the nadir of exchange rate turbulence. From thereon foreign exchange markets began to settle down, though not through a restoration of the gold standard, much as some nations might have wished for such an outcome, nor could it be attributed to the resumption of hegemonic leadership by one nation. In fact, asymmetric managed currency systems became the order of the day, and although this still left scope for haphazard and unpredictable changes in exchange rates in a world beset by nationalistic forces, they did ensure a more orderly pattern of exchange rates in the latter half of the 1930s.<sup>4</sup> Three factors were largely responsible for the rescue from continued currency chaos. First, a determination on the part of many countries to avoid undue instability in the exchanges even if this meant resorting to controls or administrative management; secondly, the emergence of fairly distinct, though loosely-drawn, currency areas or blocs following the general collapse of gold, which provided a fragmented form of asymmetric leadership; and thirdly, despite the fiasco of the World Economic Conference in the summer of 1933, a gradual resumption of international monetary cooperation during the course of the 1930s.

It is a mistake, therefore, to regard the 1930s as a period of unrelieved currency turmoil. Indeed, by the middle of the decade the degree of currency volatility was remarkably small and the pattern of exchange relationships among the chief currencies not practising exchange control was very similar to that prevailing in 1930.<sup>5</sup> Moreover, for many countries the abandonment of gold followed by currency depreciation was a blessing in disguise since it relieved the external constraint on domestic economic management and eased the path of recovery from the depression.

<sup>4</sup> L. B. Yeager, *International Monetary Relations: Theory, History, and Policy*, (New York 1976), p. 374.

<sup>5</sup> D. H. Aldcroft and M. J. Oliver, *Exchange Rate Regimes in the Twentieth Century*, (Cheltenham 1998), pp. 66-8.

## Formation and Structure of the Sterling Area

Out of the wreckage of the currency turmoil of the 1930s there emerged several distinct currency areas or blocs. The three most important were the sterling area, the gold bloc, and the exchange control or Reichsmark bloc. One can also identify a dollar zone associated primarily with Latin American countries and possibly a yen bloc covering a significant part of East Asia. Most of them were loosely drawn and none of them had any formal organisation with executive power over currency activities. Classification of countries is also sometimes difficult because of changes in regime structure over time. As *The Economist* noted, it was often very difficult to determine whether countries did or did not belong to the sterling area.<sup>6</sup> Greece provides a good example. It introduced exchange control in September 1931 and suspended convertibility in April 1932 which was followed by a large depreciation of the drachma (nearly 60 per cent by the end of that year). In June 1933 Greece joined the gold bloc and pegged its currency to the Swiss franc, but when the gold bloc finally disintegrated (September 1936) it joined the sterling area and pegged the drachma to sterling.<sup>7</sup> The League of Nations also classed Greece as belonging to the German economic bloc by the later 1930s, presumably because of its trading links and the fact that exchange control remained in force.<sup>8</sup> Nevertheless, there was undoubtedly a measure of informal leadership exercised by the dominant country which encouraged the members to link their currencies to and track the currency of the leader of the group. Einzig reckoned that as a result of these arrangements there was *de facto* stability practically all over the civilised world by the end of 1936.<sup>9</sup>

The largest and most influential of these exchange arrangements was the sterling area, or the sterling bloc as it was known in the 1930s. It began to emerge in embryonic form soon after Britain's departure from the gold

<sup>6</sup> *The Economist*, 6 August 1938, pp. 280-1.

<sup>7</sup> S. Lazaretou, 'Macroeconomic policies and nominal exchange rate regimes: Greece in the interwar period', *Journal of European Economic History*, 25(1996), pp. 664-7.

<sup>8</sup> League of Nations, *World Economic Survey 1938-39*, (Geneva 1939), p. 186.

<sup>9</sup> P. Einzig, *World Finance 1935-1937*, (London 1937), p. 309.

standard and by the first half of 1932 a sterling bloc was in *de facto* existence covering the greater part of the British Empire, Portugal, Egypt, Iraq and Argentina.<sup>10</sup> A number of other non-imperial countries subsequently attached themselves to the sterling group so that by the end of the decade it included not only all of the British Empire including colonies and mandates, but also the Irish Free State, Argentina, Denmark, Egypt, Finland, Estonia, Iran, Latvia, Lithuania, Norway, Portugal, Siam and Sweden.<sup>11</sup> By the mid-1930s the sterling area comprised more than one-fifth of the world's population and accounted for up to a third of the world's foreign trade.<sup>12</sup> Several other countries, including Brazil, Bolivia, Greece, Japan, Yugoslavia and the Straits Settlements, also maintained a stable link with sterling for several years, though they were never regarded strictly as formal members of the area since from time to time they practised exchange control or used multiple exchange rates.<sup>13</sup>

The emergence of the sterling area was a logical outcome of Britain's departure from gold; it brought 'cohesion and recognisable shape' to what had existed in embryonic form for some time.<sup>14</sup> Many members of the group had strong commercial links with Britain, especially the imperial countries, and these were to become even stronger during the course of the decade. Effectively British Empire countries formed the original nucleus of the sterling area and they were eventually joined by several independent countries. In the past they had relied heavily on Britain for people and capital, much of their trade had been financed through the City and they had held their reserves in the London money market. Their trade links with Britain were such that they had an obvious incentive to safeguard their competitive position by allowing their currencies to

<sup>10</sup> D. Kynaston, *The City of London: Vol. III, Illusions of Gold 1914-1945*, (London 1999), p. 363.

<sup>11</sup> I. de Vegh, *The Pound Sterling*, (New York 1939), p. 8-9.

<sup>12</sup> Bank for International Settlements, *Fifth Annual Report. 1 April 1934-31 March 1935*, (Basle 1935), p. 8.

<sup>13</sup> A. Cairncross and B. Eichengreen, *Sterling in Decline: The Devaluations of 1931, 1949 and 1967*, (Oxford 1983), pp.23-4; I. de Vegh, *The Pound Sterling*, (New York 1939), p. 8-10.

<sup>14</sup> P. Bateau, 'The sterling area: what it is and how it works', *British Commonwealth Affairs*, 3(1960), p. 14.

depreciate with sterling and then pegging them to that currency. Their export trade was especially dependent on the British market, for one half or more of exports in some cases, a dependence generally greater than Britain's in their own domestic markets. Moreover, since many of the countries had long-term debts with the UK, payable in sterling, the liquidity of sterling reserves facilitated the discharge of such liabilities.<sup>15</sup> Countries which had traditionally maintained large sterling balances, such as Portugal, were trapped into aligning with sterling since any other policy would have entailed a hefty capital loss.<sup>16</sup> The pressure to align was difficult to resist even for those countries of the Empire who wished to pursue an independent line: the ties of trade and capital proved too much for the South African nationalists who were forced to capitulate, much to the relief of the British authorities since gold flows from the Cape helped to bolster the pre-eminence of the London financial market.<sup>17</sup> Thus they were bound together by 'interests and historical habits as much as by formal rules and obligations.'<sup>18</sup> According to Sayers the Dominions also had somewhat vague notions of establishing an 'imperial currency' or 'sterling standard' as a way of insulating themselves from the monetary disturbances of the outside world.<sup>19</sup> This was one reason why they were keen to see monetary issues on the agenda of the Imperial Conference in Ottawa in July 1932, though neither the Bank of England nor Neville Chamberlain, Chancellor of the Exchequer, were in favour and the latter did his best to scotch any serious discussion of currency issues.<sup>20</sup> At that particular point in time the authorities still retained the hope that it would be possible to establish some form of reformed gold standard.

<sup>15</sup> League of Nations, *International Currency Experience: Lessons of the Interwar Period*, (Geneva 1944), p. 49.

<sup>16</sup> I. M. Drummond, *The Floating Pound and the Sterling Area*, (Cambridge 1981), pp. 7-8.

<sup>17</sup> P. J. Henshaw, 'Britain, South Africa and the Sterling Area: gold production, capital investment and agricultural markets, 1931-1961', *Historical Journal*, 39(1996), pp. 199-206.

<sup>18</sup> D. T. Llewellyn and J. R. Presley, 'The role of hegemonic arrangements in the evolution of the international monetary system', in J. Reis (ed), *International Monetary Systems in Historical Perspective*, (Basingstoke 1995), p. 268.

<sup>19</sup> R. S. Sayers, *The Bank of England 1891-1944*, Vol. 2, (Cambridge 1976), p. 450.

<sup>20</sup> R. Skidelsky, *John Maynard Keynes, Vol. 2: The Economist as Saviour 1920-1937*, (London 1992), p. 434.

There was, moreover, considerable support both within Treasury circles and outside for a closer relationship among sterling countries. This was strongly motivated by self-interest. Early notions favoured an imperial sterling standard which foreign countries would be free to join if they so wished; this gained the approval of the Federation of British Industries (FBI), the Empire Economic Union and of course the Dominions themselves. Retaining the supremacy of the City of London and the sterling currency appears to have been one of the main aims of the Treasury. As early as October 1931 a senior Treasury official wrote that:

“The countries that have been driven off the gold standard with us may become the nucleus of a new block. If we can manage our devaluation in an orderly fashion - and only on that condition - then leadership of the block will be ours and we may be able to maintain to a large extent the prestige of sterling and the vital commercial business which it carries with it.”<sup>21</sup>

Two months later a memorandum from Sir Richard Hopkins to Neville Chamberlain of 8 December 1931 expressed similar sentiments:

“One of the leading objectives that we ought to have in mind as soon as we can keep sterling steady at a reasonable level, is to make it easy for as many as possible of the unstable currencies to base themselves on sterling so that we may become the leaders of a sterling bloc which, pending our restabilisation on gold, would have the best opportunities of mutual trade and would give sterling a new force in the world.”<sup>22</sup>

Though initially it was emphasised both by the Treasury and the Bank of England that there should be no attempt to put pressure on countries to attach themselves to the sterling bloc, the British authorities later employed subtle commercial and financial leverage, mainly through bilateral commercial treaties, loan negotiations and credit lines, to induce other, non-imperial countries to move onto a sterling standard.

Similar sentiments were expressed by the Economic Advisory Council's Committee on Financial Questions in its report on Sterling Policy of March 1932 (The Committee was chaired by the Prime Minister and included R.

<sup>21</sup> I. M. Drummond, *The Floating Pound and the Sterling Area*, (Cambridge 1981), p.15.

<sup>22</sup> K. A. Oye, 'The sterling-dollar-franc triangle: monetary diplomacy 1929-1937', in K. A. Oye (ed), *Cooperation Under Anarchy*, (Princeton, NJ 1986), p. 188.

H. Brand, W. Layton, R. McKenna, Sir Josiah Stamp, Sir Arthur Salter and J. M. Keynes). The Committee were against any immediate commitment to return to the gold standard, but were anxious to foster the consolidation of the existing sterling area by encouraging countries not on gold to join. They also stressed the importance of maintaining stability in exchange relations and that countries should so regulate their monetary systems as to maintain their exchanges at constant fixed parity with sterling. Though they favoured price stability they did recognise the need for an initial boost to prices to restore profitability and the importance of cheap credit in this regard.<sup>23</sup> The sterling bloc acquired a more definitive form when, on 27 July 1933, delegates from Britain, Australia, New Zealand, South Africa and India issued a joint statement, the British Empire Currency Declaration. This statement was partly prompted by the dismal failure of the World Economic Conference of 66 nations which met in London in June-July of that year. But it was also the upshot of the disillusionment among Dominion countries with the limited reference to currency and monetary issues at the Ottawa Conference in the previous year; additionally, the Dominions were displeased with the subsequent management of sterling where it was suspected that too much attention was being given to maintaining stable exchanges with gold currencies and that the recently established Exchange Equalisation Account was being used to peg the pound and franc rate.<sup>24</sup>

The Declaration therefore reaffirmed the Ottawa commitment to avoid undue fluctuations in the purchasing power of gold and stressed the importance of raising prices and orderly monetary policy (low interest rates and ample credit) to assist the revival of enterprise and trade.<sup>25</sup> Non-imperial countries should be encouraged to join the sterling 'club', which 'would make possible the attainment and maintenance of exchange stability over a wide area.'<sup>26</sup> Several countries, notably Sweden and

<sup>23</sup> S. Howson and D. Winch, *The Economic Advisory Council 1930-1939: A Study in Economic Advice during Depression and Recovery*. (London 1977), pp. 254-63.

<sup>24</sup> G. Cassel, *The Downfall of the Gold Standard*, (Oxford 1936), p. 156.

<sup>25</sup> Bank for International Settlements, *Fourth Annual Report, 1 April 1933- 31 March 1934*. (Basle 1934), pp. 13-14.

<sup>26</sup> League of Nations, *World Economic Survey 1932-33*, (Geneva 1933), p.227; P. Clavin, *The Failure of Economic Diplomacy: Britain, Germany, France and the United States, 1931-36*, (Basingstoke 1996), pp.136-7.

Denmark, were attracted by the prospect of exchange stability and promptly joined the scheme. It is important to note that the statement avoided any specific reference to the rate between sterling and the franc.<sup>27</sup> It should also be noted that the authorities had not abandoned the hope of eventually resurrecting the gold standard in some form. In this regard the Declaration stated that the ultimate aim of monetary policy was 'the restoration of a satisfactory gold standard under which international co-operation would be secured and maintained with a view to avoiding, so far as may be found practicable, undue fluctuations in the purchasing power of gold'.<sup>28</sup> The prospect of a new gold standard was possibly the reason why Montagu Norman and the Bank of England were somewhat lukewarm towards the sterling area and never explicitly endorsed the sterling bloc programme. Yet this attitude does seem somewhat at odds with Norman's imperial endeavours in trying to equip Commonwealth countries with the requisite financial machinery and organisation to protect and strengthen the sterling system.<sup>29</sup> True the policy misfired in the case of Canada, whose divergent commercial interests led her to gravitate to the dollar zone, but that should not be construed as a failure of the overall strategy.<sup>30</sup>

The sterling system was a very loose and informal arrangement. It has been described as 'little more than an international club of nations pursuing similar monetary policies and bound by similar interests'.<sup>31</sup> Rowland was even less complimentary: 'Britain's sterling bloc was a hodge-podge of countries, based on but not limited to the empire, tied to the mother country in diverse ways for reasons of sentiment and economic expediency'.<sup>32</sup> It had no formal constitution, nor any specific

<sup>27</sup> W. A. Brown, *The International Gold Standard Reinterpreted, 1914-1934*, (New York 1940), p. 1288.

<sup>28</sup> League of Nations, *World Economic Survey 1932-33*, (Geneva 1933), p. 227.

<sup>29</sup> S. Strange, *Sterling and British Policy*, (London 1971), p. 55; G. Cassel, *The Downfall of the Gold Standard*, (Oxford 1936), p. 205.

<sup>30</sup> P. J. Cain, 'Gentlemanly imperialism at work: the Bank of England, Canada and the sterling area, 1932-1936', *Economic History Review*, 49(1996), p. 338.

<sup>31</sup> W. M. Scammell, *International Monetary Policy*, (London 1961), p. 247.

<sup>32</sup> B. M. Rowland, 'Preparing the American ascendancy: the transfer of economic power from Britain to the United States, 1933-1944', in B. M. Rowland (ed), *Balance of Power or Hegemony: The Interwar Monetary System*, (New York 1976), p. 200.

terms of agreement, and there was no single country with centralised monetary control, though the Bank of England did attempt to foster some degree of monetary cooperation with Dominion countries.<sup>33</sup> In fact it was not until 1940 that membership of the system was formally defined, that is shortly after it had begun to operate as a single unit for exchange control purposes during wartime.<sup>34</sup> Members could join or leave at will, they could alter the valuation of their currencies without prior formal notification or sanction, and all sterling assets were convertible into other currencies or gold. The members did not meet regularly to discuss their mutual interests or to coordinate monetary and fiscal policies, and the British Treasury was anything but keen to divulge on policy formation to its imperial members.<sup>35</sup> The only exception to this general statement was the attempt by the Bank of England, in its assistance with imperial financial structures, to foster some degree of monetary cooperation with the Dominion central banks.<sup>36</sup> Probably the chief factor binding them together was the belief that it was in their best interests to maintain their currencies at a fixed rate with sterling.<sup>37</sup> Compared with the alternatives available at the time, the sterling option seemed the most attractive and this is one of the major reasons why non-imperial countries, especially the Scandinavian, gravitated towards the group.<sup>38</sup> 'Even when the pound was at its most unstable, as in the winter of 1931-2, many foreigners found that there was still no substitute for London.'<sup>39</sup> However, during the course of the 1930s Britain did, in a number of different ways, try to forge closer links with sterling area countries; for example, through the imperial preference system devised at Ottawa, by reciprocal trade pacts with non-

<sup>33</sup> S. E. Lobell, 'Second image reversed politics: Britain's choice of free trade or imperial preferences, 1903-1906, 1917-1923, 1930-1932', *International Studies Quarterly*, 43(1999), p. 688.

<sup>34</sup> A. R. Conan, *The Sterling Area*, (London 1952), p. 2.

<sup>35</sup> C. R. Schenk, *Britain and the Sterling Area: From Devaluation to Convertibility in the 1950s*, (London 1994), p. 8.

<sup>36</sup> S. E. Lobell, 'Second image reversed politics: Britain's choice of free trade or imperial preferences. 1903-1906, 1917-1923, 1930-1932', *International Studies Quarterly*, 43(1999), p. 688.

<sup>37</sup> W. M. Scammell, *International Monetary Policy*, (London 1961), p. 246.

<sup>38</sup> P. Bareau, 'The sterling area - its use and abuse', *The Banker*, 73(1945), pp. 131-36.

<sup>39</sup> I. M. Drummond, *The Floating Pound and the Sterling Area*, (Cambridge 1981), p. 20.

Empire countries, preferential treatment in loans especially to Dominion countries, and advice and assistance in the development of financial institutions in the latter countries.<sup>40</sup>

Despite its informality the sterling area has been seen as much more than a holding operation in response to the crisis of the early 1930s. The French, and to a lesser extent the Americans, suspected that it was a new version of imperialism designed to bolster Britain's waning pre-eminence in international affairs, and specifically in international finance. The French in particular had long been distrustful of what they saw as Norman's financial imperialism.<sup>41</sup> There is some substance in this view which Cain has recently forcibly emphasised.<sup>42</sup> He argues that the main objective of British international economic policy (under the aegis of the Treasury and the Bank of England) was to safeguard the sterling area and to foster its extension in an effort to salvage as much as possible from the wreckage of 1931 and with the aim of restoring Britain's former international financial supremacy when sterling at its peak had financed 60 per cent of world trade.<sup>43</sup>

In essence, therefore, the sterling area was tantamount to a fixed exchange rate system similar to that of the gold exchange standard, the main difference being that it was sterling not gold that was the medium of account for settling imbalances among members. For the most part exchange rates of the members remained remarkably stable and changes in sterling parities were something of a rarity despite the fact that they

<sup>40</sup> R. B. Stewart, 'Instruments of British policy in the sterling area', *Political Science Quarterly*, 52(1937), pp.174-5; I. M. Drummond, *British Economic Policy and the Empire 1919-1939*, (London 1972), pp. 119-20.

<sup>41</sup> S. Strange, *Sterling and British Policy*, (London 1971), pp. 50-3.

<sup>42</sup> P. J. Cain, 'Gentlemanly imperialism at work: the Bank of England, Canada and the sterling area, 1932-1936', *Economic History Review*, 49(1996), pp. 337-8.

<sup>43</sup> P. J. Cain and A. G. Hopkins, *British Imperialism: Crisis and Deconstruction 1914-1990*, (London 1993), pp. 81, 93; D. Williams, 'The evolution of the sterling system', in C. R. Whittlesey and J. S. G. Wilson, (eds), *Essays in Money and Banking in Honour of R. S. Sayers*, (Oxford 1968), p. 268; A. Redish, 'British financial imperialism after the first world war', in R. E. Dumett, (ed), *Gentlemanly Capitalism and British Imperialism: The New Debate on Empire*, (London 1999), pp. 133-35; P. Williamson, *National Crisis and National Government: British Politics, the Economy and Empire 1926-1932*, (Cambridge 1992), p. 499.

could be made at will. The success of the system owed much to the fact that sterling still retained much of its former status as an international currency in this period and, as in the nineteenth century, its stability in value and wide acceptability as a means of payment made it the most sought after currency. Though it lost some 40 per cent of its former value relative to gold countries, most of the depreciation had taken place by the end of 1931. Thereafter, it retained a fairly stable value relative to other currencies which had followed it and so members of the sterling bloc were happy to keep a large part of their reserves in sterling.<sup>44</sup> Drummond notes that a large part of the trading world enjoyed reasonably stable exchange rates in the 1930s and this he attributes to the management of the sterling system, though it was probably less successful in restoring equilibrium between costs and prices.<sup>45</sup> Only in the early 1930s and again late on in the decade was there really serious disorder in the foreign exchanges.

### **Stabilization**

The abandonment of gold was accompanied by a wave of exchange depreciations except in countries which chose to maintain official parities by means of exchange control (mainly those in central and eastern Europe, though many countries instituted temporary exchange control in the early 1930s). The extent of the currency depreciation varied considerably, but many devaluations fell within the range of 40-50 per cent by the mid-1930s. The move to the new values was accompanied initially by severe currency instability as exchange rates adjusted to the new conditions. Fluctuations were widest at the initial stage of depreciation of each currency, whereafter they tended to subside significantly.<sup>46</sup> The most intense phase of currency upheaval occurred between the latter half of 1931 and the end of 1933, that is the period when many countries broke the link with gold and allowed their currencies to decline.

<sup>44</sup> W. M. Scammell, *International Monetary Policy*, (London 1961), p. 248.

<sup>45</sup> I. M. Drummond, *The Floating Pound and the Sterling Area*, (Cambridge 1981), pp.19-20, 253-4; G. Cassel, *The Downfall of the Gold Standard*, (Oxford 1936), p. 204.

<sup>46</sup> League of Nations, *Money and Banking 1936/37*, (Geneva 1937), p. 32.

In its fifth annual report published in May 1935 the Bank for International Settlements (BIS) deplored the continued uncertainty caused by 'moving currencies' which it saw as the main impediment to the recovery of trade and economic activity. Even sterling came in for some opprobrium whose fluctuations were seen to be disturbing to trade given the importance of this currency in international transactions. However, one gets the impression that the Bank was anxious to make out a case that no durable recovery was possible until the leading currencies were properly established, that is restabilised on the basis of gold.<sup>47</sup>

In point of fact much had been accomplished by the time the BIS issued its fifth report. What is most remarkable given the very unsettled conditions of the period, is the speed with which currencies stabilised once the main devaluations had taken place and the way in which traditional currency relationships were restored. From 1933 there was a steady move towards greater exchange stability as the majority of the important trading currencies moved into a stable relationship with sterling, the dollar and the franc.<sup>48</sup> As early as March 1934 *The Economist* was able to comment on the comparative stability of the major currencies of the world other than the dollar,<sup>49</sup> and by the latter half of that year the volatility of currencies in general had become quite modest and it continued to decline in subsequent years. Comparative data on monthly and daily currency fluctuations in Tables 1 and 2 show the steady progress towards stabilisation. By the middle of the decade the daily or weekly fluctuations of the key currencies were almost back to the range of the old gold parity points, with significant movements occurring only at times of major policy changes, as for example the devaluation of the French franc in September 1936 following the final collapse of the gold bloc.<sup>50</sup>

The sterling area was a model of stability almost from its inception. Though members were free to alter their sterling rates without formal notice, this freedom of action was rarely utilised. One or two countries,

<sup>47</sup> Bank for International Settlements, *Fifth Annual Report, 1 April 1934 - 31 March 1935*, (Basle 1935), pp. 5, 8, 70.

<sup>48</sup> League of Nations, *World Economic Survey 1936/37*, (Geneva 1937), pp. 9, 15-16.

<sup>49</sup> *The Economist*, 31 March 1934, pp. 685-86.

<sup>50</sup> R. S. Sayers, *The Bank of England 1891-1944*, Vol. 2, (Cambridge 1976), pp.475-83; League of Nations, *Money and Banking 1935/36*, (Geneva 1936), pp. 267-8.

**TABLE 1 - Range of Fluctuation of Gold Value of Selected Currencies, 1931-1937**

(PERCENTAGE BY WHICH THE HIGHEST MONTHLY AVERAGE EXCEEDED THE LOWEST DURING EACH HALF YEAR PERIOD SHOWN)

	1931b	1932a	1932b	1933a	1933b	1934a	1934b	1935a	1935b	1936a	1936b	1937a
USA	-	-	-	22.5	16.6	6.6	1.4	0.6	0.6	1.4	0.8	-
Mexico	63.3	46.1	16.2	33.6	17.8	6.7	1.2	1.1	0.7	1.4	0.7	-
Austria	18.5	5.5	1.9	9.9	1.9	1.6	0.8	1.8	0.5	0.3	1.5	0.1
Yugoslavia	-	-	24.3	1.2	1.3	2.3	0.6	0.6	0.2	0.1	0.8	0.2
Canada	20.6	5.6	5.3	19.4	8.5	5.9	1.3	1.8	0.7	1.1	0.7	0.2
China	14.6	9.7	10.9	6.6	7.0	11.5	5.4	17.3	30.8	1.3	3.2	0.4
Japan	13.6	18.8	33.1	3.9	12.2	7.0	4.4	3.8	1.8	2.2	3.9	0.4
UK	44.0	9.4	8.3	2.3	6.2	6.3	2.7	3.5	0.7	1.7	3.6	0.6
Portugal	36.8	6.9	6.9	3.4	1.8	6.8	3.0	3.5	0.4	1.3	3.4	0.4
New Zealand	44.0	9.3	8.3	9.1	6.0	6.3	2.9	3.5	0.7	1.8	3.5	0.6
Siam	-	34.0	6.9	2.3	6.1	6.3	2.6	3.5	1.3	1.7	3.6	0.6
Denmark	43.5	8.6	12.8	13.1	6.1	6.4	2.6	3.5	0.7	1.7	3.6	0.6
Sweden	43.3	6.2	4.6	6.1	6.1	6.4	2.5	3.5	0.7	1.7	3.6	0.6
Norway	44.3	8.5	5.4	3.1	6.3	6.2	2.5	3.4	0.6	1.7	3.6	0.6
Finland	49.1	14.8	8.0	4.0	5.8	6.8	2.5	3.4	0.6	1.5	3.5	0.6
South Africa	-	-	-	4.1	6.1	6.2	2.5	3.5	0.8	1.7	3.6	0.6
Greece	-	103.3	17.9	5.0	0.5	0.7	1.0	0.6	0.3	0.9	5.9	0.6
Australia	38.9	9.2	8.4	2.2	6.0	6.7	3.2	3.5	0.7	1.9	3.5	0.7
Peru	2.2	31.0	26.5	21.7	10.5	4.0	2.2	3.9	5.0	0.7	2.5	0.7
Estonia	-	-	-	6.3	4.6	6.5	2.5	3.4	0.7	2.2	3.5	0.8
Chile	-	-	-	15.7	6.9	8.2	6.9	1.5	6.6	4.5	0.8	-
Unweighted average	34.1	20.4	12.1	9.3	6.9	6.0	2.6	3.4	2.6	1.6	2.9	0.5

Source: League of Nations, *Money and Banking 1936/37*, (Geneva 1937), p.32.

<b>(DAILY FIGURES: MAXIMUM AS PERCENTAGE OF MINIMUM)</b>						
	<b>1931</b>	<b>1932</b>	<b>1933</b>	<b>1934</b>	<b>1935</b>	<b>1936 *</b>
USA	1.6	2.0	70.4	9.8	3.4	2.6
Sweden	51.3	19.1	17.2	13.1	6.5	3.3
UK	51.2	19.5	14.9	13.1	6.7	3.4
Norway	43.0	26.3	16.1	13.0	6.6	3.4
Denmark	53.4	26.3	28.0	12.8	7.0	3.4
Austria	21.8	18.2	14.8	2.8	5.1	3.8
Japan	42.7	84.8	24.4	17.0	6.5	4.4
* nine months						
Source: League of Nations, <i>Money and Banking 1936/37</i> , (Geneva 1937), p.33.						

it is true, did make some adjustments to the initial sterling rates early on in the period, notably Denmark and New Zealand at the beginning of 1933, while the Argentine maintained an official buying rate but at the same time allowing the peso to fluctuate independently of sterling in the free exchange market.<sup>51</sup> These apart, the exchange rates of virtually all the member countries kept their stable relationship with sterling. Central bankers maintained fixed buying and selling rates on sterling with only a very small range between them. Though some countries did contemplate adjustments in their original parities no major change was made until the outbreak of war. Thus the rates originally set from the date of the link with sterling were still in force in 1939, as shown in Table 3.

While the extent of currency depreciation in the 1930s (1932-39), averaging some 5.6 per year, was on par with that of the years 1923-26, exchange volatility in the later period was very much lower, about one third that of the early 1920s.<sup>52</sup> The speed with which the leading currencies stabilised, especially sterling, meant that exchange rates the world over were soon brought to heel. The great majority of important

<sup>51</sup> League of Nations, *International Currency Experience: Lessons of the Interwar Period*, (Geneva 1944), pp. 50-2.

<sup>52</sup> B. A. Simmons, *Who Adjust? Domestic Sources of Foreign Economic Policy during the Interwar Years*, (Princeton 1994), p.109.

**TABLE 3 - Sterling Bloc Currencies: Dates and Values**

	July 1939 as a percentage of 1929 sterling parity	Date from which the £rate was maintained
Egypt	100	September 1931
Estonia	100	September 1933
India	100	September 1931
Iraq	100	September 1931
Latvia	100	September 1936
Portugal	100	September 1931
South Africa	99	December 1932
Sweden	94	July 1933
Norway	91	June 1933
Finland	85	March 1933
Denmark	81	February 1933
New Zealand	80	January 1933
Australia	80	December 1931
Argentina*	77	January 1934
Greece	69	September 1936
Iran	68	March 1936

\* Official buying rate  
Source: League of Nations, *International Currency Experience: Lessons of the Interwar Period*, (Geneva 1944), p.51.

trading currencies moved into a stable relationship with sterling, the dollar and the franc. The major exceptions were the free rates in some of the South America republics and the fluctuations of the unofficial rates of countries maintaining nominal parities through exchange control.<sup>53</sup>

While it would be misleading to imply that currency fluctuations were of minor importance in the 1930s, or that all exchange rates were in equilibrium after 1933, which in fact was far from being the case,<sup>54</sup> it is possible to argue that currency movements became far more modest than many contemporary accounts would suggest, once the dust had settled from the wholesale abandonment of gold. Though many currencies were overvalued in terms of sterling at the end of 1931, by the autumn of 1936 exchange adjustments and price movements had ironed out much

<sup>53</sup> League of Nations, *World Economic Survey 1936/37*, (Geneva 1937), pp.15, 18.

<sup>54</sup> J. Foreman-Peck, *A History of the World Economy: International Economic Relations since 1850*, (Brighton 1983), pp. 249-50.

of the discrepancy and had brought many rates closer to their 1929 relationship with the pound sterling. The major exceptions were the undervalued rates of Japan and India and free rates of some of the South American Republics, while the official rates of Germany and most East European countries remained seriously overvalued.<sup>55</sup> Nor would it be correct to argue that competitive depreciations were a special feature of the period. In fact the majority of devaluations were once-and-for-all events, most of which followed the leaders: Britain in 1931, the United States in 1933 and France in 1936. Hawtrey thought the competitive depreciation view was ill-founded<sup>56</sup> and, as Simmons has noted more recently, none of the three major powers devalued simultaneously.<sup>57</sup>

Given the inauspicious times, it may seem surprising that currency stability was restored with such ease, especially after the experience of the 1920s. But perhaps the latter served as a useful lesson since for most countries the experiment with free floating had been more than enough. As the League of Nations noted in one of its later reports '... one of the facts that stands out from this experience [currency instability of the early 1930s] is that monetary authorities in most countries had little or no desire for freely floating exchanges.'<sup>58</sup> Most countries were in fact anxious to restore exchange stability as soon as possible, even via a return to the gold standard if possible, though this option was never really on the cards.

### Costs to the Centre

While the exchange rate stability established after 1933 between empire currencies and other members of the sterling bloc was no doubt mutually beneficial, as Clay argued, it has been suggested that members other than Britain gained more benefit from the sterling system.<sup>59</sup> The

<sup>55</sup> League of Nations, *Money and Banking 1936/37*, (Geneva 1937), pp. 37-9.

<sup>56</sup> R. G. Hawtrey, *The Gold Standard in Theory and Practice*. 4th edition, (London 1939), p. 240.

<sup>57</sup> B. A. Simmons, *Who Adjust? Domestic Sources of Foreign Economic Policy during the Interwar Years*, (Princeton 1994), p. 110.

<sup>58</sup> League of Nations, *International Currency Experience: Lessons of the Interwar Period*, (Geneva 1944), p. 122.

<sup>59</sup> H. Clay, *Lord Norman*, (London 1957), p. 416.

majority of sterling members pegged their currencies to the pound at a discount from the former exchange rates with sterling, with only the Indian rupee, the Egyptian pound, the South African pound and the Baltic currencies retaining their original par values.<sup>60</sup> *The Economist* reckoned that by the end of 1934 the British pound was on average about 10 per cent too high throughout the sterling area.<sup>61</sup> In some cases the discounts were quite large; by 1939 as a percentage of the 1929 sterling parities they were as follows: 20 per cent in the case of Australia and New Zealand, 19 per cent for Denmark, 15 per cent for Finland, 9 per cent for Norway and 6 per cent for Sweden (see Table 3). Given this comparative advantage, together with the concessions to imperial countries under the Ottawa tariff arrangements, it can be argued that Britain, the centre country, made the greater sacrifice.<sup>62</sup> Even Cain and Hopkins acknowledge that there was a price to pay for maintaining the prestige of sterling: 'Generous provision for the empire in British markets, and an adverse movement in the balance of trade with the empire, were the price Britain had to pay for a smoothly functioning sterling bloc.'<sup>63</sup>

The second major disadvantage for the centre, and one that became much more pronounced after the second world war, was its exchange reserve role. In theory a fully cooperative system should produce benefits for all members providing that they all abide by the rules of the game. Thus the centre country should not be disadvantaged by a deterioration in its own trade balance with other members since this should lead to an increase in the London balances of the central banks of the overseas members and thereby strengthen the sterling exchange, in the same way as would be the case if overseas members improved their trade balances with third countries.<sup>64</sup> However, this depended of course on the willingness

<sup>60</sup> W. A. Brown, *The International Gold Standard Reinterpreted, 1914-1934*. (New York 1940), p. 1165.

<sup>61</sup> *The Economist*, 24 November 1934, pp. 985-86.

<sup>62</sup> A. Redish, 'British financial imperialism after the first world war', in R. E. Dumett, (ed.), *Gentlemanly Capitalism and British Imperialism: The New Debate on Empire*. (London 1999), pp. 133-35.

<sup>63</sup> P. J. Cain and A. G. Hopkins, *British Imperialism: Crisis and Deconstruction 1914-1990*. (London 1993), p. 87.

<sup>64</sup> H. D. Henderson, *The Interwar Years and Other Essays*, (Oxford 1955), p. 87.

of the non-centre countries to keep most of their reserves in London. It is true that the reserve balances of the overseas members held in London did increase during the course of the 1930s, but the prospects of full cooperation throughout the area proved something of a disappointment. According to Palyi overseas members took every opportunity to draw upon Britain's credit reserves yet refused to surrender as much as one half their gold holdings.<sup>65</sup> The overseas members of the sterling area reduced the ratio of sterling holdings to their total reserves from 61 per cent in 1929 to 46 per cent in 1938. Thus throughout the decade their gold holdings tended to be greater than their exchange reserves, whereas in 1929 gold only amounted to two-thirds of the exchange holdings.<sup>66</sup>

As the main reserve centre Britain was also exposed to pressures on the sterling currency. While the increase in the exchange reserves of the overseas sterling group enabled its members, more especially the imperial countries, to repatriate bonded debt, it left Britain vulnerable in times of weakness in sterling currency. As long as the current account of the sterling area was in credit balance the adherence of other members of the group was a source of strength for sterling. However, once there was any weakness in the current account due to adverse fluctuations in commodity prices reducing the income of overseas members, or, alternatively, pressure on Britain's own external account, as for example in the 18 months prior to the war when sterling came under heavy pressure and declined by nearly 20 per cent against the dollar on account of the US government forcing the British Treasury to reduce its 'war chest', thereby occasioning the loss of a large part of its foreign exchange reserves, then sterling as a currency began to lose credibility.<sup>67</sup> At this point in time there was a distinct danger that the overseas members of the sterling area would, for their own self-protection, be inclined to convert their sterling assets into gold or into other non-sterling assets, thus putting further pressure on sterling. This they were at perfect liberty to do.

<sup>65</sup> M. Palyi, *The Twilight of Gold 1914-1936: Myths and Realities*, (Chicago 1972), p.140.

<sup>66</sup> League of Nations, *International Currency Experience: Lessons of the Interwar Period*, (Geneva 1941), p. 55.

<sup>67</sup> R. A. C. Parker, 'The pound sterling, the American Treasury and British preparation for war, 1938-1939', *English Historical Review*, 98(1983), pp. 261-2.

Speculative activities on the London market by overseas members also put pressure on sterling from time to time, since the speculative operations of traders in sterling bloc countries tended to be concentrated in London. This was an inevitable consequence of the much better organised currency market in Britain. In the autumn of 1938 for example, speculation in dollar currency by Scandinavian traders was a notable feature of the market. The Scandinavian countries did not possess a very good dollar market of their own, apart from which it was advantageous for them to buy and sell dollars in London because of the narrower margins prevailing there. Such operations enhanced the burden of the British monetary authorities, especially the Exchange Equalisation Account (EEA), which had to meet the Scandinavian demand for dollars on account of their exchange reserves being kept in London.<sup>68</sup>

### **The Sterling Area and Recovery**

A large sterling area was seen by many imperialists as being a good thing for Britain. It helped to restore the country's prestige in international finance and consolidated imperial unity. Clay waxed lyrical about the mutual benefits of the imperial connection:

The stability established after 1933 in the exchange rates between Empire currencies and sterling was the best evidence of success. It implied confidence of the Dominions in sterling, which made them ready to hold sterling though it was no longer tied to gold, and confidence of London in the Empire, for which it continued to act as banker and capitalist. For Norman it meant continuous attention to Empire business. No class of appointments figured more frequently in his diary than visits of issuing brokers and bankers to discuss the needs of Empire territories for loans, and the means of making them.<sup>69</sup>

More recent writers have also discerned economic benefits for Britain. Cain and Hopkins, while recognising some of the drawbacks, felt that the sterling area helped Britain over the worst effects of the depression

<sup>68</sup> *The Economist*, 29 October 1938, pp. 226-27.

<sup>69</sup> H. Clay, *Lord Norman*, (London 1957), p. 416.

and stabilised her share of world trade after decades of relative decline.<sup>70</sup> Routh even argues that 'Britain in effect climbed out of the depression on the backs of the primary producers'.<sup>71</sup>

Yet it would be fair to say that it was the overseas members of the sterling area that secured the best economic bargain. The fact that most of them pegged to sterling at a discount to the original parity meant that they gained an additional competitive advantage in world markets including the British.<sup>72</sup> For Empire countries the imperial preference system devised at Ottawa also worked in their favour. Moreover, members found, along with Britain, that the principal advantage of currency depreciation was the freedom to pursue more liberal monetary and fiscal policies without having to be concerned with the threat to their gold reserves. New Zealand's strong economic recovery from the depression, for example, can be attributed to the abandonment of the traditional parity link with sterling which paved the way for the introduction of an expansionary monetarist regime.<sup>73</sup> It is a well-known fact that sterling countries in general experienced a far more dynamic recovery from the depression than gold bloc or exchange control countries. These factors, together with firmer commodity prices, led to an appreciable measure of recovery in sterling area countries during the 1930s.<sup>74</sup>

During the 1930s trade became more concentrated within the trade and currency groupings and in this respect the sterling bloc was no exception. The big difference was that sterling countries also traded proportionately more with the rest of the world than did the countries in other blocs.<sup>75</sup> As far as trade and external transactions are concerned,

<sup>70</sup> P. J. Cain and A. G. Hopkins, *British Imperialism: Crisis and Deconstruction 1914-1990*, (London 1993), p. 93.

<sup>71</sup> T. Routh, *British Protection and the International Economy: Overseas Commercial Policy in the 1930s*, (Cambridge 1993), p. 316.

<sup>72</sup> *The Economist*, 18 May 1935, pp. 9-10.

<sup>73</sup> D. Greasley and L. Oxley, 'Regime shift and fast recovery on the periphery: New Zealand in the 1930s', *Economic History Review*, 55 (2002), pp. 697-720.

<sup>74</sup> H. V. Hodson, *Shump and Recovery 1929-1937: A Survey of World Economic Affairs*, (London 1938), pp. 274, 277.

<sup>75</sup> League of Nations, *World Economic Survey 1938-39*, (Geneva 1939), p. 186; B. Eichengreen and D. A. Irwin, 'Trade blocs, currency blocs and the reorientation of world trade in the 1930s', *Journal of International Economics*, 38(1995).

**TABLE 4 - Balance of Payments of the Sterling Area 1932-1938 (£mn)**

	UK	Sterling Empire	Subtotal	Twelve countries	Total
Merchandise	-2269	-195	-2464	+90	-2374
Services	+2114	-881	+1233	+23	+1256
Balance					
on Current Account	-155	-1076	-1231	+113	-1118
Gold production	-	+677	+677	+9	+686
Gold dishoarding	-	+212	+212	+13	+225
Balance on Current					
account and gold	-155	-187	-342	+135	-207
Increase (-) or decrease					
(+) in official gold					
holdings	-384	-8	-392	-59	-451
Net capital movements,					
errors and omissions	+539	+195	+734	-76	+658

*Source: I. de Vegh, The Pound Sterling, (New York 1939), p. 25.*

it seems that the overseas sterling countries had more to gain from the sterling connection than did Britain. Exports to the UK, though well down on the 1929 level during the depression years, held up better than imports from the centre country, while in the subsequent cyclical upswing they recovered nearly to their former peak, whereas imports from the UK were still some 20 per cent down.<sup>76</sup> This would seem to confirm the advantages derived from linking to sterling at a discount on the rates prevailing before the break-up of the gold standard, and the benefits from the non-currency trading preferences accorded to empire countries.

Data for external transactions as a whole are somewhat fragile for this period, but taking account of all transactions including gold movements, many sterling area countries, and especially the non-empire members, had a positive balance of payments position for much of the decade (see Table 4).<sup>77</sup> Thus, for much of the time the sterling bloc was building up its reserves in London. Using sterling for this purpose instead

<sup>76</sup> League of Nations, *International Currency Experience: Lessons of the Interwar Period*, (Geneva 1944), pp. 50-2.

<sup>77</sup> League of Nations, *International Currency Experience: Lessons of the Interwar Period*, (Geneva 1944), p. 59, Table 4.

of buying British goods is estimated to have reduced Britain's exports by between 6-10 per cent through 1932-38.<sup>78</sup> Furthermore, the demand for sterling reserves' also made the task of monetary and currency management more difficult for the British authorities, especially the Exchange Equalisation Account's efforts to keep sterling down. But, as noted previously, this was not the only burden for the centre country.

## Conclusion

A remarkable experiment, all the more so in the light of the many attempts to cobble together monetary arrangements in the twentieth century. It emerged almost naturally from the ruins of the currency crisis of the early 1930s and gathered members along the way. In an era of increasing regulation and restrictions on trade and economic activity its informality was reminiscent of the heyday of *laissez-faire*. The sterling area currency system had no formal constitution, executive body, nor general administrative structure and yet it worked. For most of the decade exchange rates among members countries remained fixed and stable and there were few pressures to make major adjustments in the original pegs to sterling. The chief fluctuations that did occur were those between member countries' currencies and those outside the group, that is greater inter-bloc exchange variability, which was the reverse of nineteenth century experience.<sup>79</sup> Floating nominal exchange rates between the different blocs or currency zones were the main source of real exchange rate movements in the 1930s.<sup>80</sup>

The sterling area experiment undoubtedly helped to maintain more orderly exchange rate behaviour after the troubles of the early 1930s. It was assisted by the fact that, despite the relative weakness of the British

<sup>78</sup> P. J. Cain and A. G. Hopkins, *British Imperialism: Crisis and Deconstruction 1914-1990*, (London 1993), p. 83.

<sup>79</sup> B. Eichengreen and M. Flandreau, 'Blocs, zones and bands: international monetary history in the light of recent theoretical developments', *Scottish Journal of Political Economy*, 43(1996), pp. 412-13.

<sup>80</sup> C. Kool and K. G. Koedijk, 'Real exchange rates between the wars', *Journal of International Money and Finance*, 16(1997), pp. 229-30.

economy after the first world war, sterling was still regarded as a key currency, and a safe one at that. After all, British financial institutions and the City of London had weathered the financial crisis of 1931 far better than their counterparts in most other countries, and the City was seen as a safe haven for funds. What better, therefore, than to peg to sterling and reap the benefits of safety and devaluation at the same time.

The greater stability in exchange rates world-wide in the period after 1933 was not, of course, due solely to the sterling area. The stability of the sterling-dollar exchange rate after the devaluation of the dollar through to 1938 was also very important in imparting greater order to the exchanges in general. The other main currency blocs - the gold bloc until its demise in 1936 and the Reichsmark bloc - for all their faults, also contributed to the process. What really characterised the 1930s was the fluctuations in rates between the member blocs rather than instability within the blocs themselves. Not perfect maybe, but far better than the chaotic volatility of the early 1920s, the early 1930s, and for that matter the 1970s.

The gains were somewhat unevenly distributed. While the formation of the currency area no doubt helped to bolster Britain's international financial position, it was the overseas members who benefited the most in concrete terms from the sterling bloc arrangement. The sterling system also increased the difficulties of monetary management in the centre country, especially with the build-up of sterling reserves which made it more difficult to cap sterling, while at the same time leaving the centre country vulnerable to erratic movement of funds should confidence in sterling begin to wane. The sterling balance problem was but a foretaste of what was to come in the postwar years.

The beauty of the sterling area currency system lay in its informality and its flexibility. Unlike other international monetary mechanisms, for example the gold standard and the more recent eurozone monetary arrangement, it was not weighted down by bureaucratic structures and regulatory procedures which were likely to constrain the policy actions of member countries. This was due to the fact that it was not dominated by political motives as has been the case with most other monetary unions. In consequence it could be described as the most flexible and smooth-working currency system of modern times.

Nostalgia for the gold standard still of course remained quite strong for much of the period in question, especially among official institutions such as the Bank for International Settlements. But experience with managed currencies suggests that there was an alternative to metallic systems which could work reasonably well. The exchange rate experience of the 1930s has been much criticised in the literature. It is perhaps time that it was accorded a greater degree of credit especially in view of the very difficult circumstances of the period.