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The Reopening of the London Foreign Exchange Market

Sterling's Window on the World

On 17 December 1951, the London foreign exchange market reopened. It had been closed since 1939. The reopening allowed sterling to test international waters. After the failed convertibility attempt of 1947, this was a step towards the reintegration of sterling into global finance. Capital controls remained and the Bank of England frequently intervened in the spot market. After the reopening of the market, the influence of the pound would grow. The newly reopened market gave investors a daily barometer reading of the state of the UK currency. Daily sterling quotes became available to any investors in New York who were concerned about the state of the international monetary system. The reopening of the market was smooth and did not trigger a crisis. The consequences were positive for market participants, who could trade currencies at a lower cost in London. It reinforced the position of the City in international foreign exchange markets. But sterling was still divided into different geographical convertibility areas and was far from a fully functioning international currency.

Looking back further in history, London emerged later than other financial centres as an international foreign exchange market. It was late to the game partly because international trade operated in sterling and this did not require London to have access to foreign currencies. Einzig shows that after the Napoleonic Wars, London and Paris were the two leading foreign exchange markets.[1] London lagged behind, in part because it did not offer a forward foreign exchange market. In 1870, London briefly overtook Paris when the franc came under stress, but at the beginning of the twentieth century, London was again lagging behind Paris, as well as

[1] Paul Einzig, *The History of Foreign Exchange*, 2nd ed. (London: Palgrave Macmillan, 1970), 182.

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Berlin and New York.[2] Since 'the overwhelming majority of foreign trade transactions in Britain were conducted in terms of sterling', most foreign exchange transactions were conducted abroad.[3] After the First World War, the London market rose in prominence.[4] When Britain withdrew from the Gold Standard in 1931, the importance of the Bank on the foreign exchange market increased.[5]

Reopening the market in 1951 was a natural step for the authorities. It restored sterling to the international scene. The *Manchester Guardian* called this 'the first essential step, although only a small step, towards the eventual goal of the restoration of full convertibility'.[6] The stability of sterling would become progressively more important within the Bretton Woods system, especially after convertibility in 1958. Thus the reopening of the market was successful in the early Bretton Woods system. It followed the failure of the 1947 convertibility and the 1949 devaluation. The devaluation did not solve Britain's long-run sterling problems, as we have seen.

NEGOTIATIONS

The negotiations leading to the reopening of the market were essentially a British matter. The United States was never involved. It was a negotiation between the Bank of England, the Treasury and the government. According to John Fforde, the Labour government was reluctant to reopen the market.[7] The victory in the October 1951 general election of the Conservatives, led by Winston Churchill, helped tip the balance.[8] The new government wanted the reopening to be communicated as a technical measure and not a political move.[9] The United States and the IMF were not consulted. It was a domestic policy decision for the United Kingdom,

2 Atkin, *The Foreign Exchange Market of London*, 1.
3 Einzig, *The History of Foreign Exchange*, 182–3.
4 Olivier Accominotti and David Chambers, 'If You're So Smart: John Maynard Keynes and Currency Speculation in the Interwar Years', *Journal of Economic History* 76, 2 (June 2016), 342–86.
5 Atkin, *The Foreign Exchange Market of London*, 58.
6 'Seen from the City', *Manchester Guardian*, 16 December 1951, 2.
7 This is described in John Fforde, *The Bank of England and Public Policy, 1941–1958* (Cambridge: Cambridge University Press, 1992), 412–17; and in a more succinct and intelligible way in Atkin, *The Foreign Exchange Market of London*, 102.
8 Atkin, *The Foreign Exchange Market of London*, 102.
9 Fforde, *The Bank of England and Public Policy*, 415.

unlike the opening of the gold market. The opening of the gold market prompted an international debate because of its obvious consequences for the stability of the Bretton Woods system as we will see.

The United States welcomed the reopening of the foreign exchange market. A press correspondent noted that it was 'regarded here [in Washington] as the most important move yet made by Mr Churchill's Government', and was 'applauded as a step towards greater economic and financial flexibility'.[10]

Treasury officials 'were sympathetic, but Ministers proved reluctant'.[11] Arguments for and against reopening were technical. While Labour was still in power in 1951, Douglas Jay, Financial Secretary to the Treasury, was concerned about wide forward premia or discounts on the new market. He thought they 'would simply encourage rumours and expectations that the sterling–dollar parity was going to be changed'.[12] The fear was that these markets helped speculation. They made speculative pressures measurable. We will use this measure of pressure in many charts in this book, but the forward market also helped protect companies trading abroad. These contracts could be used to hedge exchange risk. Before the opening of the market, the Bank of England was offering its own 'forward cover for genuine commercial exchange operations'.[13] The cost for these contracts was 1 per cent per annum over the official spot rate. A forward market would also offer a cover, but its price would change depending on expectations of the future price of sterling.

But as Einzig argued, leads and lags were a way to speculate. Leads and lags involved using 'genuine' commercial exchange operations for speculation.[14] And forward contracts funded this speculation. We have seen leads and lags at play during the 1949 devaluation, so the system of official forward rates at the Bank did not curb speculation. Worse, it even gave speculators funds from the Bank in the form of cheap forward contracts (remember they were fixed at 1 per cent). The *Economist* explained the issue: 'When sterling has been under suspicion, the authorities have been called upon to cover foreign exchange requirements on an abnormally large scale; when, conversely, rumours of re-valuation have been in the air, the authorities have had to be one-way buyers of forward dollars and other

[10] 'U.S. and Canadian Satisfaction', *Manchester Guardian*, 16 December 1951, 1.
[11] Fforde, *The Bank of England and Public Policy*, 413. [12] Ibid., 413.
[13] 'The Foreign Exchange Market', *Economist*, 22 December 1951, 1538.
[14] Einzig, *Leads and Lags*.

foreign currencies.'[15] The Bank of England was funding leads and lags speculators.

The Bank used this speculation argument to justify the opening of a free spot and forward market. By offering forward contracts at an official rate, the Bank was inviting speculation against sterling through leads and lags. The outcome was that the Bank was increasingly exposed to foreign exchange risks. It had high holdings of forward contracts with speculators. Atkin notes that since the war, 'monetary policy had been put into deep freeze with the government relying on fiscal policy and direct controls to manage the economy'.[16] He further argues that 'fixed forward exchange rates and flexible domestic interest rates are inappropriate bedfellows'. The Bank used the potential losses from increased speculation against sterling to make a case for a completely free forward market, and this was eventually successful.[17]

THE REOPENING

Before the reopening of the market in 1951, the Bank fixed the price of the currency and chose authorised traders, who dealt with the public. These dealers were 'clearing their balances daily' and did not hold any foreign exchange.[18] The *Economist* explained that the reopening meant that dealers no longer traded on behalf of the Bank of England. They had 'become genuine dealers again operating on their own account'.[19] The market moved from the Bank of England as a market-maker to 108 authorised banks and brokers setting their own prices.[20] In the view of the BIS, this was a bold move: 'it is interesting to find that while the strain on the reserves was still at its height the authorities decided that the London foreign exchange market … should be reopened'.[21] Figure 3.1 shows how the market reopening coincided with reserves in decline.

The increase in reserves in 1950 was a result of the 1949 devaluation, which strengthened the Bank's reserve position. Leland Yeager argues that the 'Korean War boom in the raw-material exports of Sterling-Area

15 'The Foreign Exchange Market', *Economist*, 22 December 1951, 1538.
16 Atkin, *The Foreign Exchange Market of London*, 102.
17 Free here means without official imposed limits and not free from central bank intervention.
18 'Control Eased – Slightly', *Manchester Guardian*, 17 December 1951, 5.
19 'The Foreign Exchange Market', *Economist*, 22 December 1951, 1538.
20 BIS, Annual Report 1953 (1 April 1952–31 March 1953), 8 June 1953, (Basel: BIS), 132.
21 Ibid., 138.

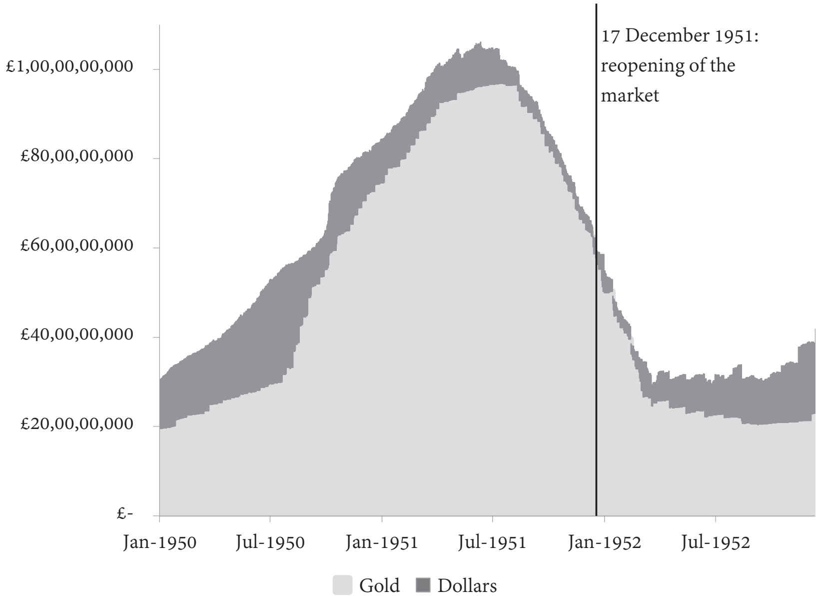

Figure 3.1. Exchange Equalisation Account gold and dollar reserves
Source: General Ledger of the EEA for 1949–52, London, Archives of the Bank of England, 2a141/7.

countries benefited the post-devaluation position of sterling'.[22] The position improved 'so much that rumours of its impending upward revaluation . . . circulated in the winter and spring of 1950–1951'. Leads and lags speculation had reversed. Yeager argues that 'merchants now tended speculatively to delay receipts and hasten payments due in sterling'. This honeymoon period of capital inflows came to an abrupt halt as the cost of more expensive imports due to the devaluation started to have an impact. Sterling area countries now needed more dollars and gold to pay for imports, which put a drain on the Exchange Equalisation Account (EEA).[23] Over the following two years, notably due to inflation resulting from the Korean War, the reserve position of sterling worsened.[24] Britain's rearmament also had a negative impact on reserves.[25]

[22] Leland B. Yeager, *International Monetary Relations: Theory, History and Policy*, 2nd ed. (New York: Joanna Cotler, 1976), 385.
[23] Ibid., 385. [24] Bordo, 'Bretton Woods', 45.
[25] William Allen, *Monetary Policy and Financial Repression in Britain, 1951–59* (New York: Palgrave Macmillan, 2014), 4–6.

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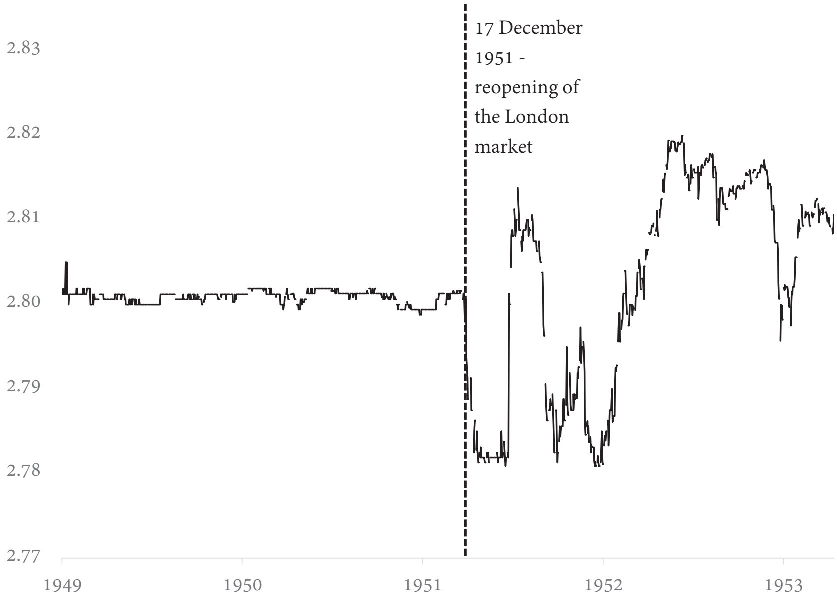

Figure 3.2. Spot exchange rate after the September 1949 devaluation until the end of 1953
Source: Global Financial Data.

The reopening of the market did not trigger a major foreign exchange crisis as could have been expected. It had two major consequences: it allowed the rate to float within a larger band; and it lowered bid–ask spreads. Market participants benefited from lower transaction costs. The City saw an opportunity to develop international leadership in the foreign exchange market, which it still retains today.[26]

Figure 3.2 illustrates the broadening of the band on the sterling/dollar market, the most important foreign exchange market in terms of volume. Sterling rates moved from \$2.78 7/8–2.80 1/8 per sterling to \$2.78–2.82 per sterling for spot rates. The Bank of England allowed the broadening of the trading band from \$0.0125 to \$0.04, a 220 per cent increase. The new band represents 0.71 per cent on either side of the \$2.80/£ official parity. As the BIS noted in its report, 'it is narrower than the swing permitted under the Articles of Agreement of the International Monetary Fund (one per cent

[26] Barry Eichengreen, Romain Lafarguette and Arnaud Mehl, 'Cables, Sharks and Servers: Technology and the Geography of the Foreign Exchange Market', working paper (National Bureau of Economic Research, January 2016), 1.

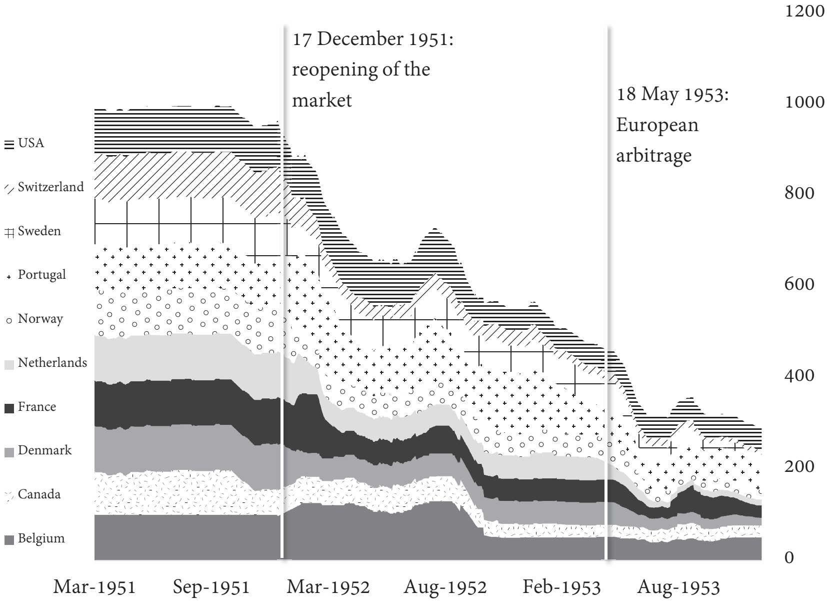

Figure 3.3. Bid-ask spreads, thirty-day moving average data for 1951–53
Source: Bid–ask data: Accominotti et al.; computation: the author.
Note: The index is based on spreads before the opening of the market (whole year 1950 = 100).

on each side of the official parity)'.[27] This increase allowed the authorised banks to make a market. The role of the Bank of England was reduced to interventions and was no longer market-making. Forward rates, unlike spot rates, benefited from 'full freedom of movement' and were not constrained to a band.[28]

The opening of the market was a success. Fforde quotes Bolton of the Bank of England, who wrote that authorised banks had done 'amazingly well in view of the short notice'.[29] The *Economist* noted approvingly that Canadian and US dollar spreads were 'no more than a quarter of a cent'.[30] Spreads are the difference between the buying and selling price (referred to as bid–ask spreads). Figure 3.3 illustrates for the first time the decline in the spreads of ten major currencies on the London market using data from

[27] BIS, Annual Report, 1952 (1 April 1951–31 March 1952), 9 June 1952, (Basel: BIS), 136.
[28] Ibid. [29] Fforde, *The Bank of England and Public Policy*, 416.
[30] Ibid., 416.; 'Revival in Foreign Exchanges', *Economist*, 29 December 1951, 1596.

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Accominotti et al. at a disaggregated level.[31] The cumulative index for the ten currencies fell from 1,000 in 1951 to just under 300 in 1953, representing an average decrease of more than 70 per cent in two years. Consequently, it became cheaper and more attractive to trade currencies in London. This advantage remained with the City for most of the twentieth century and into the twenty-first.[32]

Using a Bai–Perron break test on the data in Figure 3.3, two dates stand out.[33] As the figure shows, the first is the opening of the market in 1951 and the second arises in May 1953. This second shock is due to the liberalisation of arbitrage among European markets. The liberalisation simplified foreign exchange transactions after the introduction of the EPU.[34] The *Economist* describes the situation before liberalisation: 'A British bank in possession of French francs could sell them in Paris for sterling but not for guilders. A Belgian bank requiring guilders had to obtain them in Amsterdam, even though the cross-rates showed them to be cheaper in London.'[35] Liberalisation meant all European currencies could be traded throughout Europe. Dollars could still be traded only in the home centre of the currency in question (for example, the sterling–dollar pair in London).

This 1953 liberalisation applied to London, Paris, Amsterdam, Brussels, Frankfurt, Copenhagen, Stockholm and Zurich.[36] It led to 'very substantial' business on the first day of liberalisation according to a telephone conversation between the Federal Reserve and the Bank of England.[37] A few days after the liberalisation of arbitrage, Knoke of the New York Fed wrote to Menzies of the Bank of England to summarise the position: '[P]eople generally seem to feel that the new arrangement is not a major change but a step in the right direction.'[38]

[31] Olivier Accominotti et al., 'Currency Regimes and the Carry Trade', *Journal of Financial and Quantitative Analysis* 54, 5 (2019), 2233–60. https://doi.org/10.1017/S002210901900019X.

[32] BIS, 'Triennial Central Bank Survey of Foreign Exchange and OTC Derivatives Markets in 2016', BIS Triennial Report, 11 December 2016.

[33] Regressing a constant against both the sum and the mean of the indices presented in Figure 3.3 using a standard Bai–Perron structural break test (trimming 0.15, max. break 5, sig. 0.05) indicates 18 May 1953 (the first day of European arbitrage) as one of four break points. Using the median of the indices with the same specifications indicates 18 December 1951 (the day after the market reopening) as one of four break points.

[34] Bordo, 'Bretton Woods', 43.

[35] 'European Arbitrage Again', *Economist*, 23 May 1953, 531–3.

[36] BIS, Annual Report 1953 (1 April 1952–31 March 1953), 8 June 1953, (Basel: BIS), 132.

[37] Telephone conversation with Mr Roy Bridge of the Bank of England, memorandum, T. J. Roche, 18 May 1953, New York, Archives of the Federal Reserve, box 617031.

[38] Letter from Knoke to Menzies, 29 May 1953, New York, Archives of the Federal Reserve, box 617031.

The opening of the foreign market and the 1953 liberalisation made it easier to trade in currencies without making sterling fully convertible as numerous capital controls remained in place. This is in line with modern financial literature, which argues that foreign exchange market liquidity is largely driven by market-wide shocks; the reopening of the market is one such example.[39] The increase in turnover resonates with findings by Lyons, who argues that liquidity and market efficiency are closely related.[40] The reopening of the market and further liberalisation in 1953 increased the efficiency of the market and so reduced spreads.

ALTERNATIVE MARKETS

The reopening of the market and later liberalisation increased liquidity. What is unclear is whether it helped strengthen the credibility of sterling. The analysis in the BIS annual report reveals that although the pound started to present signs of weakness, after the March 1952 budget the position improved.[41] Unlike the 1947 convertibility, the reopening of the market did not trigger a serious currency crisis. And this despite it being a step towards greater openness in international markets.

To assess the impact of the reopening, I look at the valuation of sterling in the free offshore markets. The Swiss National Bank reported the situation of banknote markets in Switzerland every day. Figure 3.4 shows cross-rates for banknotes in Switzerland as used previously. Instead of plotting the actual exchange rate, the figures present the difference between the spot rate in London and the Swiss banknote cross-rate. When the premium is close to zero, there is no incentive to transport cash to Zurich for speculation.

During the period after the 1949 devaluation until the reopening of the market (819 days), the average black-market rate was \$2.49/£. This rate is a discount of 11 per cent against the official parity. In the same period after the market reopening, the average banknote rate was \$2.57/£, an average discount of 8 per cent. Looking at Figure 3.4, after the market reopened, the discount decreased. The data do not offer any statistically significant structural break on the date the market reopened. The market constantly fed on new information and it is unlikely that the reopening came as a

[39] Loriano Mancini, Angelo Ranaldo and Jan Wrampelmeyer, 'Liquidity in the Foreign Exchange Market: Measurement, Commonality, and Risk Premiums', *Journal of Finance* 68, 5 (2013), 1806.

[40] Richard K. Lyons, *The Microstructure Approach to Exchange Rates* (Cambridge, MA: MIT, 2006), 77.

[41] BIS, Annual Report,1952 (1 April 1951–31 March 1952), 9 June 1952 (Basel: BIS).

Figure 3.4. Discount on the sterling/dollar banknote cross-rate
Source: Swiss National Bank.

surprise. Restoration of convertibility in 1958 finally reduced the discount in this market almost to zero (far right in Figure 3.4). At this point, black, offshore and official markets were integrated.

Despite the relative success of the reopening of the market, officials at the Bank and the Treasury were worried about mounting pressure on reserves early in 1952 (see Figure 3.1). This led to debate about the introduction of floating in the form of the ROBOT scheme. The name of the scheme came from its main advocates: Leslie Rowan and Otto Clarke from the Treasury and George Bolton from the Bank. The scheme has received considerable attention in the literature despite never being adopted.[42] The idea was to float the pound immediately while still blocking some large sterling balances in the United Kingdom and abroad.[43]

[42] Peter Burnham, *Remaking the Postwar World Economy: Robot and British Policy in the 1950s* (London: Palgrave Macmillan, 2003); Cairncross, *Years of Recovery*, chapter 9; Capie, *The Bank of England*, 147–9; Fforde, *The Bank of England and Public Policy*, chapters 6b and 6c; Schenk, *The Decline of Sterling*, 102–15; Schenk, *Britain and the Sterling Area*, 114–19.

[43] Susan Howson, 'Money and Monetary Policy since 1945', in *The Cambridge Economic History of Modern Britain: Volume 2*, ed. Roderick Floud and Paul Johnson, 2nd ed. (New York: Cambridge University Press, 2014), 149.

The float would have been controlled within bands that were kept secret from the public.[44]

The ROBOT plan failed and was not implemented. It was followed by 'the collective approach' to convertibility at the end of 1952.[45] British officials discussed the 'collective approach' during several Commonwealth conferences at the end of 1952 and later with the American administration.[46] The idea was to make major currencies convertible simultaneously with financial support from the United States. Howson notes that the 'only short-term result was to feed rumours which weakened sterling in the foreign exchange markets and obliged successive chancellors to disclaim all intentions of letting sterling float'.[47] After the ROBOT plan and the 'collective approach' both failed, no new attempts to float were made until after the 1967 devaluation.

Floating was never put in place during the Bretton Woods period. Yet the reopening of the market remained an important step towards the liberalisation of sterling. American officials were optimistic about the move; IMF officials were more sceptical about completely freeing the forward market. Unlike previous liberalisation attempts such as 1947, the reopening of the foreign exchange market did not precipitate a crisis. It generally improved the situation for market participants. The international credibility of sterling improved, and for customers in London a freer market meant lower transaction costs.

[44] Capie, *The Bank of England*, 147. [45] Schenk, *Britain and the Sterling Area*, 119–24.
[46] Howson, 'Money and Monetary Policy since 1945', 149–50.
[47] Ibid., 149–50; and see also Fforde, *The Bank of England and Public Policy*, chapter 7.

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