Re-examining the removal of exchange control by the Thatcher government in 1979

Daisuke Ikemoto

The aim of the paper

This paper looks to explain the motivations behind the Thatcher government's decision to abolish the exchange controls in 1979; to trace the decision-making process; and to describe its (in many ways unforeseen) consequences. Before coming to these points, however, I will first explain what exchange control is, why its abolition was important, and how this analysis contributes to the study of the Thatcher government in particular and British politics in general.

What is exchange control?[1]

Exchange control prohibited the British residents, both individuals and corporate bodies, from holding foreign currencies. The regulation's purpose was to help the authorities conserve the gold and foreign currency reserves and maintain the UK's balance of payment positions. Before 1979, the Exchange Control Act of 1947 had tightly regulated capital transactions (both direct and portfolio investment) of British residents with foreign territories. The scheduled territories, including Ireland (and the sterling area before 1972), were exempted from the controls. International payments accompanying current transactions (trade in goods etc.) had already been liberalised during the era of the Bretton Woods regime. British banks and merchants were also prevented from lending sterling to non-residents in order to reduce its international role.

Why is the abolition of exchange control important?

(1) The abolition of exchange controls reduced the role of the state in economic management and increased competitive pressures for business. Its critics argued that exchange control required the government to put an extensive web of regulation of the British economy and distorted the allocation of resources. Approximately a quarter of the administrative staff at the Bank of England at the time were engaged in exchange controls. As such, the abolition of exchange controls was an essential part of the government's policy to reduce regulation and roll back the state.

(2) Exchange control's abolition also changed the balance of power between labour and capital. Due to the liberalisation of international capital movement, companies'

[1] The following account is based on Bank of England, *A Guide to United Kingdom Exchange Control* (February 1977).

management teams came under increasing pressure to make bigger profits and not to concede generous pay settlements to the trade unions. At the same time, they also obtained an option of moving their business out of the UK if the company's wage costs were judged as too high. In other words, the abolition of exchange controls was, alongside monetary and fiscal policy based on monetarism, an integral part of the Conservative strategy to reduce the negotiating power of the trade unions.

(3) The abolition of exchange controls made it difficult for a future government to implement Keynesian demand-management policy. The announcement of such a strategy would trigger a large-scale outflow of money and speculation against the currency in the foreign exchange market, forcing the government to change its course.

(4) The abolition of exchange controls on short-term international capital movement in developed countries such as the US, the UK and Japan also fostered the process of financial globalisation.[2] The so-called Big Bang of financial sector reform in 1986 was a logical conclusion of removing exchange control.[3] The lifting of controls on direct investment also freed up multinational companies' cross-border activities.

(5) The abolition of exchange controls and the resulting international capital mobility defined the terms of subsequent economic debate and decision-making within the Thatcher government. Mundell and Fleming's model of international macroeconomics suggests that national governments face a trilemma of a fixed exchange rate, national independence in setting monetary policy, and international capital mobility. It is only possible to pursue two of these goals simultaneously. Of these three options, Geoffrey Howe (Chancellor of the Exchequer 1979-83, Foreign Secretary 1983-89, the Leader of House of Commons 1989-90) and Nigel Lawson (Financial Secretary to the Treasury 1979-81, Employment Secretary 1981-83, Chancellor of the Exchequer 1983-89) chose a fixed exchange rate (the ERM) and the international movement of capital, while Margaret Thatcher and Alan Walters (economic advisor to the PM) preferred the autonomy of monetary policy and international capital mobility.[4]

In fact, once the international movement of capital was liberalised, national

---

[2] Eric Helleiner, *States and the Reemergence of Global Finance: From Bretton Woods to the 1990s* (Ithaca: Cornell University Press, 1994).

[3] As for the details of financial sector reform in the UK, see Michael Moran, *The Politics of the Financial Services Revolution: The USA, the UK and Japan* (Basingstoke: Macmillan, 1991).

[4] Margaret Thatcher, *The Downing Street Years* (London: HarperCollins, 1993), 689, 695. As for the political struggle within the government over British entry to the ERM, see Philip Stephens, *Politics and the Pound: The Tories, the Economy, and Europe* (London: Macmillan, 1996); Helen Thompson, *The British Conservative Government and the European Exchange Rate Mechanism, 1979-1994* (London: Pinter, 1996).

independence in setting monetary policy was constrained even with a floating currency.[5] The factor which most influenced the monetary policy of the Thatcher government was American interest rates, not the growth of domestic monetary supply, as would have been the case if the policy had been based on monetarism.[6] By contrast, if the UK had entered the ERM earlier than 1990, the government would have been required to accept the monetary leadership of the West German Bundesbank in order to keep the value of the pound sterling within a designated band of fluctuation. In other words, the choice for the UK came down to one between Europe and America.[7]

<u>This paper's contribution to the study of the Thatcher government and British politics</u>

There are numerous studies written on the economic and social policies of the Thatcher government[8], but few of them deal with the abolition of exchange controls.[9] At the same time, there is growing tendency in the recent literature to see the policies and legacies of the government from historical and comparative perspectives.[10] This tendency of contextualising the Thatcher government is desirable by itself, but this paper's analysis of the abolition of exchange controls will contest the conclusion of these works which tends to underestimate the importance of what the government achieved.

First of all, the abolition of all exchange controls by the Thatcher government in 1979 marked a clear break from the policy of its predecessors. Both political scientists and economists have been engaged in a long debate on whether there was any turning point in Britain's post-war economic management, and if there was, whether it was 1976 or 1979. If we pay attention to the control of monetary supply or the level of

---

5 Heather Gibson, *The Eurocurrency Markets, Domestic Financial Policy and International Instability* (Basingstoke: Macmillan, 1989).
6 Andrew Britton, *Macroeconomic Policy in Britain 1974-87* (Cambridge: Cambridge University Press, 1991).
7 Cf. Andrew Gamble, *Between Europe and America: The Future of British Politics* (Palgrave Macmillan, 2003).
8 For instance, Ben Jackson and Robert Saunders (eds.), *Making Thatcher's Britain* (Oxford: Oxford University Press, 2012); Stephen Farrall and Colin Hay (eds.), *The Legacy of Thatcherism: Assessing and Exploring Thatcherite Social and Economic Policies* (Oxford: Oxford University Press, 2014).
9 Few exceptions include Richard Vinen, *Thatcher's Britain: The Politics and Social Upheaval of the 1980s* (London: Simon & Schuster, 2009), though he did not use official papers.
10 For example, Helen Thompson, 'Thatcherite economic legacy', in Stephen Farrall and Colin Hay (eds.), *The Legacy of Thatcherism* ; Richard Vinen, 'Thatcherism and the Cold War', in Ben Jackson and Robert Saunders (eds.), *Making Thatcher's Britain*.

public expenditure, 1976 could be regarded as a pivotal moment.[11] From the viewpoint of exchange control, however, 1979 is of greater significance. In order to relieve huge pressure against the pound, the Callaghan government tightened exchange controls during the IMF crisis in 1976, including a ban on the use of sterling for international trade not including the UK.[12] Although exchange control was relaxed in 1977 and in 1978 – as a condition of the IMF loan – Dennis Healey, then Chancellor of the Exchequer resisted further relaxation. On the eve of the 1979 general election, the Treasury officials prepared a paper on the subject, presumably in the anticipation of a Conservative victory, yet it proposed only minor relaxations.[13] Therefore, without a Conservative government determined to depart from the orthodoxy of Britain's post-war economic management, it was highly unlikely that exchange controls would have been completely dismantled in October 1979.

From a comparative perspective, the abolition of exchange controls in 1979 changed the UK overnight. In terms of the freedom of international capital movement, among the developed countries it had been a laggard[14]; it was now among the frontrunners.[15]

This paper's analysis on the abolition of exchange controls will also shed a new light on the personal role of Margaret Thatcher within her government. The Prime Minister was more reluctant than any Cabinet ministers (at least those concerned with the issue) to dismantle controls completely. She was, however, swayed by colleagues such as Howe and John Nott, Minister for Trade. Inside the government, there were also discussions regarding the introduction of restrictions on capital inflow to the UK, which was attracted by the high interest rate policy introduced by the government. This damaged the international competitiveness of British industry by pushing up the sterling exchange rate. Thatcher was more inclined than her Cabinet ministers to introduce such a restriction in order to protect UK industry.[16] Again, she was dissuaded by her colleagues from doing so. All in all, Howe was the main architect of this policy. Lawson and Nott played a minor role, while Thatcher's influence was almost negligible. Many authors have recently pointed out a discrepancy between what Thatcher proclaimed as

---

11 Thompson, 'Thatcherite economic legacy'.
12 TNA, PREM 19/437, 'Exchange Controls', Howe to Thatcher, 23 May 1979.
13 The Bank of England's Archive, 8A243/1, Hancock to Barratt, 1 May 1979. The Conservative manifest of 1979 did not mention exchange controls, but before the election Howe, as the Shadow Chancellor, made a case for their relaxations.
14 The Bank of England's Archive, 8A243/1, Hancock to Barratt, 1 May 1979.
15 Helleiner, *States and the Reemergence of Global Finance*.
16 TNA, PREM 19/437, Lankester to Wiggins, 18 February 1980; Lankester to Wiggins, 18 September 1980; Lankester to Wiggins, 13 November 1980.

her political beliefs (most of which, according to her own account, were inherited from her father) and the policies her government actually implemented. Financial liberalisation is often cited as an example of such a gap.[17] My analysis suggests that this might be because her influence on the issue was more limited than previously thought.

The background to the abolition of exchange controls

There were three background factors which made it possible for the Thatcher government to dismantle exchange controls if they so wished: the collapse of the Bretton Woods regime; the production of North Sea oil; and the sound money policy that the government promised to pursue.

Exchange control was originally introduced in 1939 for wartime purposes, but it was maintained after the end of the conflict. This allowed successive British governments to reconcile the maintenance of a fixed exchange rate with their commitment to demand-management policy. However, due to the existence of the sterling balances, their management of the domestic economy was often disrupted by a run in the foreign exchange markets.[18] The collapse of the Bretton Woods regime in 1973 removed one of the main obstacles to the abolition of exchange controls. Nevertheless, it remained largely intact since the government could not afford a large depreciation of sterling, because of its inflationary consequences. In fact, exchange control was even strengthened at the time of the IMF crisis in 1976.

The increasing production of North Sea oil in the late 1970s, which turned the UK's current account into a surplus, changed the situation in favour of exchange control relaxation.[19] In addition, the newly elected Conservative government was committed to sound monetary policy, which would prevent uncontrollable outflow of capital from the UK even if exchange control was relaxed. Indeed, the combination of effective monetary policy and North Sea oil was expected to push up the exchange rate of sterling. If unchecked, this would damage the international competitiveness of British industry. Instead, if the government intervened in the foreign exchange market to keep the value of sterling down, this would add to domestic inflationary pressure and pile up the unwanted amount of the foreign reserves. Therefore, there might have been a good case for allowing private investment abroad by relaxing exchange control to some extent and

[17] John Campbell, *Margaret Thatcher: The Grocer's Daughter* (London: Pimlico, 2001), 29-30; Vinen, *Thatcher's Britain*, 180-81.
[18] Samuel Brittan, *Steering the Economy: The Role of the Treasury* (London: Secker & Warburg, 1969).
[19] The Bank of England's Archive, 8A243/1, Hancock to Barratt, 1 May 1979.

checking the appreciation of sterling.

A three-step approach to the dismantling of exchange control

It is important to note, however, that all of the above considerations did not make a complete abolition of exchange controls necessary or undisputed. Howe wrote in his memoirs that ‘this was the only economic decision of my life that caused me to lose a night’s sleep’.[20] Thus, we need to explore why this bold move was made in October 1979 and how.

The government took a three-step approach to dismantling exchange controls. In May 1979, in the Chancellor’s budget speech to the House of Commons, the government announced its first step in relaxing controls on direct investment. Then in July, the government abolished all remaining controls on direct investment, and lifted those on portfolio investment to the countries within the EEC. The government also began serious consideration of liberalising the latter completely in autumn. As the regulation of portfolio investment lay at the heart of exchange control, it became meaningless to retain the remaining controls in order to conserve the foreign reserves or to maintain the UK’s balance of payment positions. The government was now required to choose between the two options: dismantling exchange controls entirely, or keeping the remainder of the controls for other purposes, such as the prudential regulation of the banking sector.[21]

The debate inside the government

Geoffrey Howe, the main architect of the policy, was opposed to exchange control on philosophical grounds: his courtroom experience as a barrister convinced him of ‘the totalitarian nature of this regime’.[22] Both he and Nigel Lawson believed exchange control had to be abolished before the UK’s entry to the ERM, in order to lower the exchange rate of sterling to the level at which the government could maintain without incurring too much cost.[23] For Trade Minister John Nott, the dismantling of exchange control was an essential part of the Government’s economic strategy to reduce the state

[20] Geoffrey Howe, *Conflict of Loyalty* (London: Pan Books, 1995), 142.
[21] The Bank of England’s Archive, 8A243/1, ‘Exchange Control’, D.A.D to McMahon, 6 July 1979.
[22] Howe, *Conflict of Loyalty*, 140.
[23] The Bank of England’s Archive, 8A243/2, ‘Dismantling Exchange Control’, Lawson to Howe, 4 October 1979. Howe, however, omitted reference to the ERM from his paper to the Prime Minister.

intervention in the economy and break the power of the trade unions.[24] He also wanted to restore an international role for sterling.[25] Meanwhile, officials at the Treasury and the Bank of England contemplated only minor relaxations at first.[26] This cautious stance reflected their scepticism about the resolve of Conservative politicians to implement sound monetary and fiscal policy in the face of expected criticism.[27] However, their position changed in more positive direction after the July measures, as the possibility of complete liberalisation of portfolio investment towards countries outside the EEC (including the US) was mooted. The Bank of England, in particular, saw in the combination of North Sea oil and a Conservative government committed to sound money policy as a historic opportunity to dismantle exchange controls completely. One official noted that 'the lure of freedom is powerful. If we fail to dismantle the restrictive system under the present government, we risk having to live with exchange controls probably for another generation or more'.[28] A half-way option was quietly dropped from consideration.[29]

In this way, inside the government considerable momentum was building in support of the complete dismantling of exchange controls. However, several concerns were raised about this option. First of all, if exchange control was abolished, British banks could easily evade the direct control (known as the 'corset') on their activities by moving their business offshore. In turn, it was acknowledged that without direct control the government could not manage the growth of domestic monetary supply.[30] In other words, if exchange control was abolished, the government had to reconsider the central plank of its economic strategy – the implementation of monetarism. Secondly, the abolition of exchange controls was expected to trigger a large-scale capital movement across frontiers, which would in turn cause further disturbances in the foreign exchange market.[31] Third, if the government allowed non-residents to borrow from British banks

[24] TNA, PREM 19/437, 'Exchange Controls', Nott to Howe, 1 June 1979.
[25] TNA, PREM 19/437, Nott to Howe, 13 July 1979.
[26] The Bank of England's Archive, 8A243/1, 'Relaxation of Exchange Control', Hancock to Barratt, 1 May 1979.
[27] The Bank of England's Archive, 8A243/1, 'Relaxations of Exchange Controls – The Economic Arguments', Middleton to Hancock, 30 May 1979.
[28] The Bank of England's Archive, 8A243/1, 'Exchange Control', D.A.D to McMahon, 6 July 1979.
[29] The Bank of England's Archive, 8A243/2, 'Further Dismantling of Exchange Control', Hodges to Couzens, 7 September 1979.
[30] The Bank of England's Archive, 8A243/2, 'Exchange Controls and Offshore Banking', Middleton to Page, 30 August 1979.
[31] The Bank of England's Archive, 8A243/2, 'The Future of Exchange Control', Letter to McMahon, 29 August 1979.

in sterling or issue sterling-denominated securities in London, this would be good for the position of London as international financial centre.[32] Yet, it might also push up interest rates and cause the so-called crowding out of funding for industry. In other words, this was an issue where the interests of finance and industry collided with one another.[33] Last but not least, the abolition of exchange controls could increase the international use of sterling as trade and reserve currency. While people such as Nott welcomed this, the restoration of sterling's international status could not only cause well-known problems for domestic economic management, but might also have had serious international repercussions. For example, even as the UK agreed to phase out the international role of sterling as condition of its entry to the EEC, by changing its stance on sterling the government could be seen to have been moving away from the ERM.[34] These risks, however, were deemed worth taking in the debate within the government.

The crucial meeting for this historic decision was held on 17 October. The Prime Minister was given a very short notice, and received only a brief memorandum from Howe beforehand.[35] During the meeting, Howe, Nott and Gordon Richardson, Governor of Bank of England, argued for the complete removal of exchange control.[36] Although the Prime Minister was against exchange control in principle (in her public speech Thatcher denounced it as socialist measure), she wanted to tighten direct control on banking activities for more effective management of monetary growth[37], and therefore did not like to see its effects eroded by the abolition of exchange control. She had also previously expressed strong reservations about the timing: she was worried that

---

32 The Bank of England's Archive, 8A243/2, 'Relaxation of Exchange Control', EAJG to Walker, 13 September 1979.

33 The Bank of England's Archive, 8A243/2, 'Borrowing in the London Market', Walker to McMahon, 11 September 1979; 'Borrowing in the London Market', Walker to George, 14 September 1979.

34 The Bank of England's Archive, 8A243/2, 'Dismantling Exchange Control and the International Role of Sterling', Couzens to Howe, 17 September 1979. As for the international role of sterling and British entry to the EEC, see also Daisuke Ikemoto, *European Monetary Integration, 1970-79: British and French Experiences* (Basingstoke: Palgrave Macmillan, 2011).

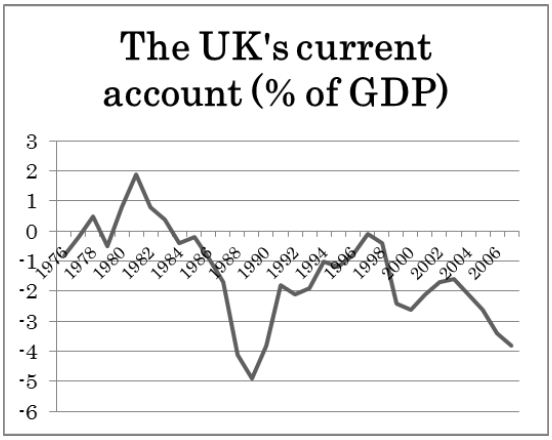
35 TNA, PREM 19/437, 'Exchange Control', Howe to Thatcher, 11 October 1979. One official at the Bank of England was concerned 'at the short notice the Prime Minister [was] being given to authorise a decision of this magnitude'. The Bank of England's Archive, 8A243/2, 'Exchange Control Relaxation', Letter to the Governors, 12 October 1979.

36 TNA, PREM 19/437, Lankester to Wiggins, 17 October 1979.

37 TNA, PREM 19/437, Lankester to Hall, 24 September 1979.

there was too much risk of uncontrollable capital outflow if the exchange control was abolished before the government demonstrated that its market philosophy was working.[38] In the end, however, her colleagues persuaded her. In this way, exchange control was completely removed on 23 October 1979, more than forty years after its introduction.

The (unforeseen) consequences of the decision



Retrospectively, the first Thatcher government made good use of a very small window of opportunity to abolish exchange controls. Despite the production of North Sea oil, the UK fell into a current account deficit again in 1983, and never recorded a surplus while Thatcher was the Prime Minister. International capital mobility made it easier for countries like the UK to offset their current deficits by attracting inward foreign investment from surplus countries. The market began to pay far more attention than had been the case to the relative tightness of monetary policy and far less to the state of the current account. Therefore, the government avoided having to deflate the economy so long as money was flowing in. All of this, however, was not foreseen when the government abolished exchange controls in October 1979.[39]

One consequence of the abolition of exchange controls was that, in making monetary policy, the government began to attach less importance to M3, which had been regarded as the main indicator of monetary supply. This was because M3, which included bank lending, moved in unexpected ways and expanded very rapidly without direct control on banking activities. The Thatcher government was increasingly divided into two camps. On the one hand, the Bank of England and Geoffrey Howe became reliant on exchange rates of sterling as a guide for monetary policy. This change made them more inclined to advocate Britain's entry to the ERM.[40] On the other hand,

38 TNA, PREM 19/437, Lankester to Hall, 24 September 1979.
39 One official at the Treasury's overseas finance division wrote: 'I have repeatedly been struck since we abolished exchange control in October by the extent of the implications of that decision for our thinking about the balance of payments'. The Bank of England's Archive, 8A243/4, 'Balance of Payments Policy after Exchange Control', Hancock to Barratt, 7 January 1980.
40 PREM 19/743, 'European Monetary System', Scholar to Kerr, 26 January 1982.

Margaret Thatcher and Alan Walters, her economic advisor, preferred to use a narrower definition of money like M1, which grew less rapidly than M3 and therefore allowed the authorities to justify lowering interest rates.[41]

Finally, the pound sterling did not recover its former strength as an international currency. This was partly because the British government, while dismantling exchange controls, continued to request that other countries did not hold sterling as a reserve currency.[42] More importantly, the world did not become a multi-reserve-currency system as the government had expected.[43] Rather, the US dollar re-established its dominance as the international currency in the 1980s. The City of London, through the abolition of exchange controls and the financial Big Bang, restored its status of international financial centre around the same time, but most of its business was then conducted in dollars not sterling.

References

Bank of England papers
Prime Minister's Office records (PREM)

Brittan, Samuel, *Steering the Economy: The Role of the Treasury* (London: Secker & Warburg, 1969).

Britton, Andrew, *Macroeconomic Policy in Britain 1974-87* (Cambridge: Cambridge University Press, 1991).

Campbell, John, *Margaret Thatcher: The Grocer's Daughter* (London: Pimlico, 2001).

Gamble, Andrew, *Between Europe and America: The Future of British Politics* (Palgrave Macmillan, 2003).

Gibson, Heather, *The Eurocurrency Markets, Domestic Financial Policy and International Instability* (Basingstoke: Macmillan, 1989).

Helleiner, Eric, *States and the Reemergence of Global Finance: From Bretton Woods to*

[41] PREM 19/696, 'New Financial Arrangements and Medium-Term Financial Strategy', Walters to Thatcher, 30 October 1981; PREM 19/998, 'Interest Rates and Monetary Policy', Walters to Thatcher, 14 September 1982.

[42] The Bank of England's Archive, 8A243/3, 'Official Sterling Balances', Letter to Payton, 30 October 1979.

[43] The Bank of England's Archive, 8A243/2, 'Dismantling Exchange Control and the International Role of Sterling', Couzens to Howe, 17 September 1979.

the 1990s (Ithaca: Cornell University Press, 1994).
Howe, Geoffrey, *Conflict of Loyalty* (London: Pan Books, 1995)
Ikemoto, Daisuke, *European Monetary Integration, 1970-79: British and French Experiences* (Basingstoke: Palgrave Macmillan, 2011).
Jackson, Ben and Robert Saunders (eds.), *Making Thatcher's Britain* (Oxford: Oxford University Press, 2012).
Moran, Michael, *The Politics of the Financial Services Revolution: The USA, the UK and Japan* (Basingstoke: Macmillan, 1991).
Stephens, Philip, *Politics and the Pound: The Tories, the Economy, and Europe* (London: Macmillan, 1996)
Thatcher, Margaret, *The Downing Street Years* (London: HarperCollins, 1993).
Thompson, Helen, *The British Conservative Government and the European Exchange Rate Mechanism, 1979-1994* (London: Pinter, 1996).
Thompson, Helen, 'Thatcherite economic legacy', in Stephen Farrall and Colin Hay (eds.), *The Legacy of Thatcherism: Assessing and Exploring Thatcherite Social and Economic Policies* (Oxford: Oxford University Press, 2014).
Vinen, Richard, *Thatcher's Britain: The Politics and Social Upheaval of the 1980s* (London: Simon & Schuster, 2009).
Vinen, Richard, 'Thatcherism and the Cold War', in Ben Jackson and Robert Saunders (eds.), *Making Thatcher's Britain* (Oxford: Oxford University Press, 2012).