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AMM

Chapter II

Vols 1 & 2 (overseas file)

APPROACH TO U.S.A. ON POST-WAR FINANCIAL, MONETARY AND TRADE POLICY: 1941/42

See also SEC 23 - Post War Policy etc Sir C. Bolton's PPS

In the Spring of 1941 unofficial discussions took place in Washington on a supplementary Trade Agreement with the U.S.A. Proposals were:

(1) that the U.S.A. should approach the Dominions with an offer of reduction of tariff on wool, butter and meat in exchange for reduction of margin of Imperial Preference on dried and canned fruits in U.K.market; and

(2) that the U.S.A., in return for a reduction in the U.K.tobacco preference in 1942 for a period of 5 years, should reduce by 50% certain duties calculated to increase our exports by about £2 million a year and give us freedom to continue to restrict certain imports to meet post-war exchange difficulties.

Mr.Cobbold thought it absurd to enter into post-war negotiations at that early stage (7.5.41), as did the Treasury rather more mildly: they could only lead to "argument which we should prefer to avoid and later to misunderstanding and accusations of bad faith" (Mr.Cobbold). But the Chancellor considered it too late to draw back, and Lord Halifax was instructed to write to Mr.Cordell Hull pointing out that we might have to maintain restriction of imports of tobacco (and other goods) after the war. If Imperial Preference on tobacco were reduced in 1942 we still might not be able to take any more. H.M.Government were thus even then committed to giving serious thought to probable (and possible) post-war trade and financial conditions.

In view of the 4th and 5th Articles of the Atlantic Charter (14th August 1941) and (draft) Article 7 of the U.S.A.-U.K.Mutual Aid Agreement*, the Treasury and the Board of Trade were asked to make recommendations to the Government in regard to post-war

financial

*A draft of Article 7 was in existence in the Autumn of 1941, though the Agreement was not signed until 23rd February 1942.

financial, monetary and trade policy, with special reference to the Anglo-American discussions contemplated.* The following extracts from the preamble to the document as eventually drawn up† to guide our representatives will sufficiently indicate their scope:-

> "The primary objective .... is the attainment of the greatest possible expansion of trade and especially of international trade. No country can have a greater interest than this country in such an objective. Lack of employment was for long before the war a continuing anxiety. This country also, with its dependence on overseas trade, has a vital interest in the prosperity of other nations, which is the most important single factor in the flow of international trade.
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> It is in the subsidiary points .... especially in regard to questions concerned with the elimination of so-called discriminatory practices and arrangements (including in particular Imperial Preference), that divergences of view may be expected to be found ....
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> The attitude of the United States Administration is likely to be much influenced by our general approach to these discussions. If we start by accepting the desirability of restoring multilateral exchange and trade to the fullest possible extent, but explain the very serious practical difficulties which confront not only the United Kingdom but other countries before these objectives can be realised .... it may be hoped that the United States Administration will be prepared to give full consideration both to the difficulties and to any solutions which we may have to propound."

The trade aspects were left to the Board of Trade, while on financial and monetary aspects the Treasury (16th September 1941) proposed consultation with the Bank, and sent them memoranda by Lord Keynes and Sir Hubert Henderson∅ as a basis. Of the two memoranda that by Lord Keynes, "Post-war Currency Policy" (8.9.41), was of wider scope, and embodied some of Sir Hubert's views.

The <u>currency</u> proposals of Lord Keynes, and subsequently of the American Treasury, are dealt with in a separate chapter.x This chapter is concerned with the remaining aspects.

The Keynes and Henderson memoranda both emphasised the responsibility of creditor nations for the maintenance of equilibrium

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*"The necessity to attempt a decision now on general policy arises primarily from the insistence of the U.S.Administration upon early discussions about Anglo-American co-operation, following on Article 7 of the Mutual Aid Agreement signed on 23rd February 1942." (Treasury memorandum as finally drafted)

†Apparently in the Spring or Summer of 1942.

∅Submitted to the International Committee on Reconstruction (24.3.42). The Bank's copy is undated, but obviously the memorandum was written before that of Lord Keynes, and therefore before September 1941.

x"Bretton Woods".

in international payments. As regards the post-war position, they felt that the bargaining power of the United Kingdom as a large importer might have to be used to secure the volume of exports necessary to balance its international accounts - that bi-lateral bargaining might therefore be necessary; and that disturbances due to movements of refugee capital must be eliminated. Lord Keynes thought that his Currency Union plan might appeal to the Americans; that its discussion would make clear the nature of the United Kingdom's difficulties, and that if the Americans did not favour such solutions as were put forward, they could then be asked to produce their alternatives.

After the Keynes memorandum had been studied at the Bank the Deputy Governor wrote, on 29th September, to say that the Bank were in complete agreement with what they took to be the fundamental conclusions of both this memorandum and the paper by Henderson:

"(a) that exchange control and trade control (which we regard as inseparable) will have to be maintained for an indefinite period after the war;

(b) that with the very uncertain prospects of our balance of payments it would be madness to forswear the use of bilateral trade negotiations;

(c) that the problem before us is to make the Americans realise these limitations and acquiesce in accepting them as the framework within which our policy must be devised for a number of years after the war.

....

On the tactics of presentation to the Americans you will get better advice elsewhere than from us, but I offer certain suggestions -

(a) It is scarcely possible that we can obtain formal American blessing for any joint statement of policy for the immediate post-war period within the framework outlined above. We therefore agree in principle with Keynes' view that we shall do better to state the facts and the limitations which are imposed upon us by these facts, and then seek American comment and co-operation in working out a scheme of longer range and wider scope.

(b) It might be well to attempt some early education of informed American opinion on the facts of our position ....

(c) Emphasis should be laid on the world-wide nature of these problems: they tend to be seen too much in an Anglo-American light. It is inconceivable that the Continent of Europe can return immediately after the war to a system of free exchanges: it is equally inconceivable that we could return to a free exchange system independently of the Continent of Europe. Any real plan for Anglo-American co-operation must take account of the needs of all the important trading communities.

(d) Emphasis

(d) Emphasis should be laid on "services" as well as on trade .... for instance, any attempt by America to dominate merchant shipping would make equilibrium much more difficult.

I should like to refer to one other aspect of the problem .... From our point of view there are two distinct facets - the relation of the U.K.with the rest of the world, including the sterling area, and the relation of the sterling area as a whole with the rest of the world. Even if we maintain the structure of the sterling area, we in the U.K.shall not be able to disregard our balance of payments with the rest of the area; whilst the alignment of exchange and import controls throughout the area, which has proved comparatively easy in war-time, would be a very different matter in peace conditions."

These views were amplified in a two-page note, which was enclosed.

Before receiving the Bank's communication the Treasury had produced a memorandum of its own, and after some revision in the light of Bank of England suggestions, gave it to the Board of Trade on 2nd October. The Treasury memorandum was designed rather to ask questions than to answer them, and this chapter will not suffer from the omission of its ten pages or so. The Bank's views were also set out at some length, and had more the character of an Exchange Control "creed".

On 17th October the Bank sent them to the Treasury, as a further memorandum on post-war trade and financial policy, intended to supplement the Treasury's paper of 2nd October and to afford with that note a basis -

(a) for reaching decisions as to the general line of policy to be pursued; and

(b) for preparing a case for presentation to the U.S.Administration.

The Bank also indicated that they were working on the problem of "whether and how the sterling area can be kept together", which Sir Richard Hopkins had asked them to consider.

The Bank's memorandum follows. Apart from the "Skeleton Draft of Memorandum for presentation to U.S.Administration", summarised on pages 18 - 19 below, it seems to have been the only considerable document emanating from the Bank relating to these discussions.

POST-WAR TRADE AND FINANCIAL POLICY

It is suggested that the Treasury Memorandum might be usefully supplemented under two heads -

I. by bringing out the underlying conditions governing and limiting United Kingdom economic policy: and

II. by indicating the type of exchange control which these conditions call for and permit.

I. (1) The draft "Consideration Agreement" provides -

"for joint and agreed action by the United States and United Kingdom, each working within the limits of their governing economic conditions, directed to securing as part of a general plan the progressive attainment of balanced international economies, the avoidance of harmful discriminations and generally the economic objectives set forth in the Joint Declaration ...."

It is necessary to set out these governing economic conditions.

(2) From the point of view of Exchange Control they may be summarised as follows:-

(a) The U.K. is dependent in a unique degree on imports of food and raw materials, its own population being predominantly industrial and commercial.

(b) The U.K. provides the sole or chief available market for the exports of surplus production in other countries of meat, wheat, dairy produce, pig products, tea, maize, sugar, cotton.

(c) For geographical and historical reasons the U.K. is an indispensable economic link between the Continent of Europe and the rest of the world, and must accept the responsibilities of that position.

(d) London is the monetary centre and capital market in which a large number of countries (the sterling area) keep their reserves and through which they clear their payments with the rest of the world.

(3) Before 1914 the U.K.'s payments were balanced by the export of manufactures and coal, financial and tourist services, earnings of foreign investments, and shipping - with normally a large surplus which was re-lent abroad. All these sources of

payment were adversely affected by the last war and by the conditions which obtained between the two wars, so that in the years immediately preceding the present outbreak, the U.K. had become a net importer on capital account. The present war is further worsening our competitive position on all these heads. Moreover, domestic reconstruction and reorganisation have a prior claim on our productive resources and therefore on the resources available for exports. The war and immediately pre-war drain on our exchange resources and foreign assets will have left us with an exchange reserve so small that it will hardly suffice to do much more than cover temporary divergences between current payments and receipts. The U.K., therefore, unlike the U.S.A. cannot face the risk of incurring uncontrolled and involuntary deficits on current account.

(4) The prevention of unlicensed capital movements and the retention (both for this purpose and in order to be in a position to intervene if the current payments balance became seriously adverse) of the machinery of exchange control are the irreducible minimum of U.K. post-war requirements. But, assuming this irreducible minimum, American attention should be drawn to the consequences of leaving the adjustment of supplies to demand to be effected by the unimpeded operation of market forces with only such interference as is involved in tariffs. Agricultural production has been stimulated by the war, and the dependence of agricultural exporters on the United Kingdom market is likely to be even greater than after the last war. In the absence of quantitative regulation of commercial exchanges the necessary adjustment can take place only through prices, and agricultural prices will collapse as they did in 1920 and 1930. Such a collapse is likely (as after 1930) to force the agricultural countries to let the external value of their currency fall, endangering our remaining income from invisibles and initiating another period of competitive exchange depreciation.

(5) Some discrimination in U.K. relations with other countries is inherent in any action which seeks to relate our commercial policy to the "governing economic conditions" of the U.K. To the method of bilateral quantitative agreements, the American method of tariff agreement is a possible alternative. Agreements would be made with

each of the agricultural countries by which some commodity or commodities in which each had a predominant interest would be given favourable treatment, while duties on all other goods would be raised, to the height necessary to restrict imports as a whole to the amount which United Kingdom exports would pay for. The objections to this method are that it would add the United Kingdom to the list of high tariff countries and reverse the movement towards lower tariffs initiated by Mr.Hull, and that it would involve frequent changes of particular duties in order to check unwanted imports. No less discrimination is involved in the American method of selecting commodities for special treatment than in the English method of selecting countries.

(6) As the focal point at which (a) European relations with the extra-European world and (b) sterling area relations with the rest of the world tend to be balanced and cleared, the United Kingdom is exposed to strains which it would not have the resources (especially the exchange resources) to meet if it permitted freedom of foreign payments. Our responsibilities are increased by the practice of other countries maintaining and constantly replenishing by their exports large holdings of sterling balances and securities on which they draw to make payments all over the world. The case for Exchange Control as a means of anticipating and meeting the strains and responsibilities of our position would be decisive, even if the needs of the U.K. balance of payments did not call for it. To the extent that the U.K. can maintain confidence in the value of sterling and preserve existing monetary relations with the other countries of the sterling area, it contributes to world stability, maintains an area of free exchange, and lessens the area of uncertainty and instability to be dealt with. The U.K. Government is forced, therefore, to reserve the right to use any instrument of trade control which may prove to be necessary to discharge our responsibilities to ourselves, to Europe and to the Empire.

II. Conditions of Exchange Control

(1) The present Control is not, like the Control of the last war, an avowedly temporary interruption in the workings of an established system (the Gold Standard). It is a natural development,

accelerated and facilitated by war conditions, of a rudimentary regulation of the exchanges with which the country had been experimenting since 1931. A restoration of the status quo is not an alternative open to us. The stability and automatism which characterised the status quo ante 1914 were never recovered after 1919, and the arrangements under which exchange business took place between 1931 and 1939 were only a temporary and experimental adjustment to conditions produced by the mass movement of capital under the influence of panic. The alternatives that are open are either to go right back to the pre-1914 system which, however desirable, is hardly practicable, or to adapt the present Control to peace-time needs and conditions.

(2) The characteristic features of this Control are related to and arise from the special conditions of United Kingdom external relations and the special conditions of the London market. Owing to the special relation of the U.K. with (a) the Continent and (b) the sterling area, the value of sterling is influenced by the actions of traders, bankers and Governments in countries over which H.M.G. can exercise no legal control. As an offset to this the London Market, through which most of the transactions take place, is concentrated in a high degree and accustomed to act co-operatively without the friction involved in legal coercion.

(3) It follows that our Control cannot be modelled on the German precedent of centralising all external payments under legal compulsion. To do so would be to run the risk of driving the European and Empire countries which normally clear their payments through London to deal direct with America and the rest of the world. It would theoretically be possible to apply the centralised method to U.K. residents only, but it would mean sacrificing the large area of exchange freedom represented by the sterling area. There is every reason to suppose, as is indeed the experience of our war-time control, that a decentralised control which involves as little interference as possible with legitimate business is the form best suited to the needs of the sterling area as a whole. In practice this means employing as agents of the control under general directions the commercial banks, and reserving the central

institution for decisions on doubtful and new cases.

(4) A Control of this type, dependent on the active co-operation of the controlled and of the authorities in other countries of the sterling area, can easily enter into reciprocal agreements for a good deal of freedom with other Controls of the same type; i.e., with countries in which banking institutions are similarly unified and standards of commercial and financial conduct are high enough to dispense with regimentation on the German model. Relations with other countries will be much more difficult; they can make no attempt at a common system but must leave each authority to follow its own methods of control.

(5) The objects of Exchange Control cannot be secured by Exchange Control alone. Control, in the narrow sense of authorising (or refusing to authorise) all external payments is only an instrument for executing a policy which defines what payments shall be permitted. In addition to the control of capital movements, which is naturally entrusted to the Exchange Control, there is needed a deliberate policy of keeping the country's payments (and in association with the other authorities, the sterling area's payments) in balance by regulating imports, fostering exports by trade agreements, etc., and requisitioning the proceeds of exports.

(6) The details of the country's trade policy are outside the scope of Exchange Control; but the Control will be involved:-

(a) in any attempts to balance total imports and exports by bilateral agreements country by country;

(b) in the use of bulk purchases through commodity controls as a means of controlling imports or stimulating exports;

(c) in defining the area if any within which trade and/or capital movements are to be subject to no Exchange Control.

<u>NOTE</u>

Provisional decisions require to be taken on a number of points, not only in order to be prepared for the post-war situation, but in order that H.M.G.'s representatives in the discussions with America may be able to elaborate and support the case for retaining Exchange Control and reserving the right to make any agreements necessary to secure a balance in the U.K.'s external payments.

(1) The content of the legislation which will replace the D.F.R. as the legal authority for Exchange Control.

(2) The rate of exchange in terms of the dollar and/or the price of gold which we expect by Exchange Control to maintain. Any choice will be arbitrary since the volume of payments will be adjusted by direct quantitative regulation.

(3) The place we contemplate for gold in post-war exchange policy. Gold is the largest single export of the sterling area, and we have always been buyers without limit.

(4) The relation to exchange policy of the actions of Government Departments and purchasing commissions which have large foreign transactions.

(5) The form of relations with the sterling area. Will capital transfers within the area be free or subject to the same regulation as outside? Will import licensing be applied?

(6) Relations with Allied European Governments, especially Russia.

(7) The extent and conditions of permitted capital transfers.

This brought comments from Lord Keynes (22nd October) which seemed to the Bank to be due to a slight misunderstanding of the Bank's position.

BANK OF ENGLAND MEMORANDUM ON
POST-WAR TRADE AND FINANCIAL POLICY

I am in general agreement with this paper, so far as it goes. But there are certain matters where my perplexities are not answered or where I should like to carry the argument a stage further.

1. The rate of Sterling Exchange

The Bank of England attach importance to the maintenance of the sterling area. Is it agreed as a corollary of this that a stable, as distinct from a fluctuating, value of the sterling exchange is essential? If so, the method of attempting to reach equilibrium by allowing the exchange to find its own level is excluded.

Apart from the question of allowing fluctuations, whilst obviously we shall be prudent to start with a figure for the exchange at which sterling is not obviously over-valued, we cannot expect the rest of the sterling area to accommodate themselves to a level adapted to suit our own domestic exigencies, if the latter should be widely discrepant from the de facto position.

My own feeling is strongly in favour of aiming at exchange stability, and I see no present reason for expecting that a rate of $4 to the £ is likely to over-value sterling materially at the end of the war. Indeed, in a search for the optimum level, I should think it as likely to find that level at a slightly higher value of sterling as at a slightly lower. But if, e.g., the Board of Trade were to hold that $3.50 or $3 would be helpful to our balance of trade position, it might nevertheless be inadvisable to accept this view unless the advantage to be gained was very clear and definite, since we can scarcely expect to hold the sterling area together on the basis of large changes in the value of sterling to suit our own internal difficulties, when they might have an inflationary influence in other parts of the area.

The above shoud not be taken to mean that we should necessarily accept $4 to the £ when the time comes without careful thought and examination of the circumstances. But it does mean that we shall have to consider the position of the sterling area as a whole and not merely the position of this country, before we can establish a case for any important change. And, having once fixed a figure, we should not depart from it except for grave reason. If the Bank is in general agreement with the above line of thought, namely that the maintenance of the sterling area as a separate currency unit involves the objective of a stable exchange value for sterling, several alternative proposals are ruled out. I emphasise this because the favourite alternative line of approach, as it has emerged from recent discussions, seems to point to a policy of fluid exchanges whereby we seek to reach equilibrium by trial and error, allowing sterling to reach its alleged "natural" or "equilibrium" level. I am not sure that the authors of these proposals have given thought to the position of the sterling area as a whole. Nevertheless the rest of us might do well to recognise that this is pro tanto an objection and a difficulty in the way of any plan which aims at the maintenance of the sterling area as an independent currency unit.

2. The Convertibility of Sterling into Dollars

At present an American who obtains possession of sterling through permitted imports into any part of the sterling area is credited with "registered" sterling, which he is at liberty to convert into dollars, whenever he chooses, at the official rate. Do the Bank of England contemplate maintaining this arrangement after the war, or would they convert "registered" sterling into "special" sterling, which would be available for use anywhere in the sterling area but could not be converted into dollars or any non-sterling currency?

This seems to me to be the crux of the immediate post-war problem.

At present we depend on the efficacy of import regulations throughout the sterling area, and on shipping difficulties, to prevent the potential of "registered" sterling from reaching a figure higher than we can support. The situation is already precarious. During the early part of the war our resources were eaten up by inadequate import restrictions in other parts of the sterling area; more recently we have obtained relief partly through the Dominions being allowed to lend-lease and partly through the stiffening up of import restrictions in South Africa, Australia and India. Even so, it is doubtful whether we could hold the position if it were not for shipping difficulties and the growing restrictions of the priority system in U.S.A.

After the war we cannot expect the continuance of any of these forms of relief except possibly import control. But is there much hope of adequate import control elsewhere in the sterling area or of control which is equal in the different countries concerned? Is it to be supposed that South Africa, with the ability to pay in gold, will restrict her imports at all? Can we expect Australia to maintain, for example, as strict an import control after the war on the importation of American automobiles as we are likely to maintain ourselves? Whether, in such circumstances, we can afford to undertake this liability must depend on whether the <u>rest</u> of the sterling area is likely, in conditions of comparative freedom, to have a favourable or unfavourable balance with U.S.A. The prospect here may be favourable, but it would be advisable to calculate it exclusive of the South African gold beyond what is required to provide for South Africa's own requirements.

What about the control of capital movements in the rest of the sterling area?

But there is also a further question. If the Dominions remove or greatly mitigate their existing import restrictions, can we afford to allow them to use their existing balances in London to pay for imports from U.S.A.? If not, how do we propose to prevent them?

Generally speaking, I am not clear how the maintenance of the sterling area on the present lines is compatible with the maintenance after the war of any exchange control on our part which is worth having. A domestic exchange control presents serious difficulties, but capable, one hopes, of being overcome. Are we satisfied that the same is possible in relation to the sterling area taken as a whole?

3. Overseas Balances in London

The Bank of England memorandum proposes to retain restrictions on the movement of capital outside the sterling area by British nationals. No final conclusion is reached as to whether there should be freedom of capital movements within the sterling area. As proposed, this does not apparently apply to existing balances in London in overseas ownership. What is the view of the Bank of England as to what we can afford in this respect?

This is a big question which I should like to discuss in a separate paper. But *prima facie* it will be impossible for us to allow any important part of these balances to be used for current purposes. Either they must be written off, or they must be funded or repatriated, or they must be blocked. Has the Bank arrived at any conclusion on this matter? If they are blocked, that would be compatible with their being gradually released in payment for British exports as and when we can afford to allow this to happen. Meanwhile, the blocking would be not merely blocking within the sterling area, but blocking within this country; and even within this country they would not be available except by a process of gradual release.

The Bank seems to have sent no written reply to these comments.

Meanwhile there had been two developments in the U.S.A. of which account had to be taken.

The word "discrimination" had occurred in the first United States draft of Article 7 of the Mutual Aid Agreement; but whereas the phrase as quoted in the Treasury memorandum of 2nd October 1941 was "the avoidance of harmful discriminations" and the sentence on co-operation contained the qualification "each working within the limits of their governing economic conditions", this qualification disappeared in the final text (23.2.42) and "the elimination of all forms of discriminatory treatment in international commerce" was substituted as an objective of the declaration*. The wording of Article 7 had given rise to much discussion between the Americans and H.M.Treasury in the Summer and Autumn of 1941, and on 7th October Mr.Sumner Welles, the Under-Secretary of State, brought the matter into prominence in a public speech. After condemning the tariff policy of the U.S.A. prior to the Reciprocal Trade Agreements Act of 1934 he declared that the U.S.Government was determined that restrictive tariff preferentials and "discriminations" should become things of the past. The State Department was evidently anxious that there should be no discriminations against the U.S.A. export trade, which consisted largely of wheat, cotton, tobacco and fruit: U.S.farmers were a formidable political force. Preferences and "narrow bi-lateral practices" were also criticised and our Ambassador thought the reference was clearly to the United Kingdom and Dominions.

About

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*The United Kingdom, however, was safeguarded in some respects in the 4th Clause of the Atlantic Charter by the proviso "with due respect to their existing obligations." But see later (7.1.42) for the Bank of England's views on Article 7.

About the same time two American Professors, Messrs.Hansen and Gulick, produced plans for attaining the objectives of full employment, etc., and the control of international investment (schemes possibly to be associated with that for a Clearing Union).

First, they proposed an International Economic Board, with research staffs in various centres, to advise collaborating Governments in regard to internal policy to promote full employment, a rising standard of living and the world-wide use of productive resources, together with an International Resources Survey for exploring opportunities for internal and regional development projects throughout the world.

The second was a more ambitious and difficult proposal for the revival of international lending under international control through a corporation with capital stock subscribed by the United States Government, the British Government, the Dominion Governments and other participating Governments, and bonds privately subscribed under guarantee by the several Governments "in appropriate proportions".

The next edition of the Treasury memorandum contained references to both Sumner Welles' speech and to these proposals, and bore traces of having been influenced by the Bank's memorandum of 17th October. Much of the ground had, of course, already been covered, but the memorandum was an important step towards agreement and its essentials are worth recording:-

Sumner Welles

Sumner Welles had declared the United States' determination to relegate "unconscientious tariff preferences to the past and to move towards conditions" ... "under which no nation should seek to benefit itself at the expense of another". The Treasury memorandum began by expressing the U.K.Government's agreement with this objective, since this country (and the British Commonwealth) had a greater interest than any other country in international trade being maintained at the greatest possible level.

But our desire to obtain the greatest possible measure of amenities, including goods and services from overseas, had to be reconciled with our immediate interest, on the cessation of hostilities, to attain equilibrium in our balance of payments with the rest of the world.

The deterioration of our international position after the First World War would have been intensified by the Second; which would, moreover, have seriously depleted our reserves of gold and foreign exchange. We could not perhaps, unlike the United States, contemplate "large and uncontrolled deficits on current account" - without, indeed, incurring the risk of disastrous exchange depreciation.

We could not, therefore, undertake for an indefinite period to avoid the continuance of tariffs and preferences. Internal deflation (which might be regarded as appropriate to our situation) would be disastrous; and currency depreciation, as indicated by recent history, also disastrous if it became competitive. Retention of our war-time production mechanism, at least in part, seemed preferable to either; and it would be rash to forgo the right to make bilateral trade arrangements.

Regulation of irresponsible movements of capital would probably be necessary for a long time. No repetition of the monetary chaos of the 1930's was thinkable (it was unlikely that the U.S.A. would raise any objection here).

The Balance of Payments issue was brought to a head by the draft prepared in the United States for a "Consideration Agreement" for lease-lend assistance. Clause 7 of this draft took the following form:-

"The terms and conditions upon which the United Kingdom received defence aid from the United States of America, and the benefits to be received by the United States of America in return therefor, as finally determined, shall be such as not to burden commerce between the two countries but to promote mutually advantageous economic relations between them and the betterment of world-wide economic relations; they shall provide against discrimination in either the United States of America or the United Kingdom against the importation of any produce originating in the other country; and they shall provide for the formulation of measures for the achievement of these ends."

It was clearly necessary to convince the U.S.A. of the probable gravity of our post-war difficulties and of our sincere desire to co-operate with them in promoting the expansion of international trade.

Lessons of the period between the two wars must not be lost sight of, particularly that any attempt to restore free commercial arrangements under conditions of grave disequilibrium could not
cannot be left to ordinary market forces.

The U.K. was an indispensable economic link between the Continent of Europe and the rest of the world: a position which exposed the monetary system of the U.K.to special strains.

Much responsibility for the solution of these difficulties was understandably thrown upon the U.S.A., e.g., tariff reductions to increase U.S.imports, and avoidance of accentuating disequilibrium by curbing rises in the price of wheat, cotton, etc.

The last paragraphs referred to possible redistribution of gold and to the appearance of various forms of Exchange Control after 1931 as expedients to avoid disaster.

The Deputy

The Deputy Governor's reply (4.11.41), with a revision of the Treasury's latest draft, was probably the Bank's most important contribution to the discussions. The Bank showed apprehension as to the line of approach to the Americans hitherto envisaged, which they felt to be somewhat insincere in respect to final objectives. They again expressed themselves strongly on exchange control - its inevitability and positive advantages. But the memorandum did not contain any extensive review of the sterling area*, such as had been promised. Nor was this forthcoming at any stage prior to the production of the final Treasury draft (which appears to have been issued to Ministers in the Spring of 1942).

"Post-war Policy

.... Subject to one or two small points which we have noted in the margin, we are in general agreement with this draft, though as a result of its perusal and of consideration of the various discussions and papers on this subject we are led to make two general observations:-

1. The discussions throughout have tended to assume two entirely different phases -

(i) a transitional period, and

(ii) the final post-war period ("when things have settled down") when it may or may not be possible to introduce a completely new economic plan.

This is, it seems to us, a somewhat misleading picture both for our own working and for presentation to others. The cardinal mistake and the greatest admission of defeat which we can make is to put up as a final objective something which we do not believe has a reasonable chance of coming about. We must set ourselves aims in which we believe and our policy must from the start be directed towards bringing them about. Progress can only be by trial and error but we must consciously strive to form and adapt our controls and our international economic relations with the ultimate goal always in view. We must never allow ourselves to contemplate a static transitional period and hope that on a given date one, two or three years after the war the heavens will open and our problems be solved.

2. It has come to be assumed that exchange controls and trade controls are inevitably destructive and restrictive. On the contrary we believe that their intelligent use in co-operation with other countries is the only possible alternative to a regime of fluctuating exchange rates and speculative movements of funds, far more destructive of trade, and that if properly used they can be constructive and expansive: in fact, that without them the post-war world would inevitably fall back into the chaos of the 'Thirties.

We

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*There are many memoranda concerning the sterling area in the files, but they hardly cover the question raised by Sir Richard Hopkins, nor is there evidence that any of them reached the Treasury, though in conversations prior to April 1943 no doubt various considerations were put forward by the Bank's representatives.

"We have been thinking further about these problems and, mainly with a view to clearing our own minds and to showing you the direction in which they are working, we have attempted a first skeleton draft, which I enclose, of the sort of Memorandum we should favour presenting to the U.S.Administration (in which, as you will see, we have borrowed largely from your documents).

I also enclose, to carry the basis of discussions a stage further, an outline of post-war exchange control policy as we see it. This outline is at present rudimentary, but if we could secure your agreement to the general principles we could then set to work to fill in the details.

We are at your disposal to discuss these and other related documents."

The main points stressed by the Bank in the Skeleton Draft were:-

H.M.G., after studying the economic history of the period between the wars and also having regard to the circumstances in which they and other members of the British Commonwealth were likely to find themselves after the end of the war, concluded that "an early return to complete freedom of trade and exchanges would inevitably lead the world back to the disturbances and depressions of the period between the wars" .... "a considerable degree of control, supervision and planning in the industrial sphere .... would be necessary."

H.M.G. had "always in mind the peculiar responsibilities imposed on the U.K. as the focal point at which

(a) European relations with the extra-European world, and

(b) sterling area relations with the rest of the world,

tend to be balanced and cleared. The international economic situation is likely to suffer serious damage if the stability of that "(i.e., the U.K.)" monetary system is impaired."

H.M.G. therefore believed that the first objective was "to achieve approximate equilibrium in the current balance of payments both between the U.K.and the rest of the world, and between the sterling area and the rest of the world".

It would prove essential to retain -

(a) import control, to keep the volume of external expenditure within the limits of internal income;

(b) exchange control, to prevent unjustified capital movements; and

(c) the

(c) the method of inter-Governmental negotiation to equilibrate the volume of current income to that of current expenditure.

Finally, H.M.G. would welcome the views of the U.S.Government on certain basic principles of concerted long-term policy:-

Protective duties - sudden or large changes without prior consultation with other affected countries.

The even harsher principle of quotas.

Exchange depreciation, as a self-defeating policy.

The discarding of tariff preferences and bilateral quota agreements since the expansion of world trade offered alternative outlets.

The special obligation of creditor countries to lower obstacles to imports and not to force up the external prices of their exports unreasonably.

No further toleration of mass movements of capital (as destroyers of exchange stability).

International lending on private account for productive purposes should be permitted, subject to supervision by Governments.

International lending by Governments of creditor countries might be necessary.

Stable exchange rates ".... as an adjunct to endeavours in other fields to achieve equilibrium and as a basis for the development of international trade".

Such monetary mechanism "postulates an exchange control to prevent exceptional capital movements and an import control at least in countries whose resources are limited". Its basis should be a "co-ordinated series of bilateral agreements between .... the principal currency areas".

Appended to the Skeleton Draft was a memorandum outlining Post-war Exchange Control policy, based on the foregoing precepts and principles, which it is not necessary to introduce here but which assumed the retention of control of imports and of the proceeds of exports.

The Treasury accepted a number of the alterations proposed in the Skeleton Draft, but stated that they were still some distance from thinking of the form of presentation. The Bank's document would be useful when that stage was reached.

The Bank

The Bank did not comment on the Treasury's next draft, nor on a memorandum from Lord Keynes (9th November) on the sterling area which made reference to the Bank's paper of 4th November.

Further American views were now received. On 12th December a document produced in the State Department, signed by Leo Pasvolsky, a Special Assistant to the Secretary of State, was handed to Mr.Cordell Hull. It was on the subject of "the possibilities of conflict between British and American views on post-war economic policy". A copy was given confidentially and unofficially to the British Embassy. In forwarding it to the Foreign Office, Lord Halifax said he had reason to believe that it was the product of many discussions in the State Department and expressed Mr.Cordell Hull's views fairly accurately. "The State Department intend to try to get the President to read the document despite its length (23 pages) - which is perhaps a measure of the importance attached by the Americans to the question".

Mr.Pasvolsky's

Mr.Pasvolsky's Memorandum, dated 12th December 1941, referred to Great Britain and the U.S.A. as each so important economically that if they could not agree economic peace would fail everywhere in the world: yet there seemed a likelihood that there would be no agreement.

Leaving aside vested interests in each country, there were in the U.K. three principal groups: those who believed that Great Britain's balance of payments would be such that the country would have no choice but to continue exchange control "and other forms of quantitative regulation of imports", and by clearing and payments arrangements to continue bilateral agreements, etc.; those who thought such controls were beneficial in themselves; and those who were willing to go along with the U.S.A. for the most part, except as regards the most-favoured-nation principle "in other words the convinced advocates of a system of Imperial preference".

The Memorandum examined Great Britain's post-war balance of payments problem, concluding that the volume of exports would have to be at least 38% greater than in 1938 or if, as was likely, imports would need to grow by one-quarter exports would have to exceed 1938 by 80%. "A rapid expansion of exports on anything even remotely approaching this scale will be out of the question."

Pre-war experience with bilateral trade was next examined, with special reference to Germany: "It is arguable that the war came just in time to save Germany from a really embarrassing economic situation."

Bilateral balancing as a solution for the U.K. would mean either the restriction of British imports to the volume of her reduced exports plus what remained of her other international income; or that countries from which Britain bought would be compelled to extend to her voluntary or involuntary credits by accepting payment in blocked sterling. Neither Empire countries nor others would be in the position to do this. Empire countries would already be heavily loaded with blocked sterling, which they would be anxious to convert into goods or use for the liquidation of debt. If the Empire were treated as a whole it would "from the Empire's point of view ..... merely result in a still greater accumulation of blocked sterling which, in practice, would be unavailable for purchases anywhere but in Great Britain" ....

"For Latin-America and the British Dominions the problem will be that of obtaining sufficient volume of badly-needed imports in conditions in which a substantial part of their exports will be possible only if they are willing to supply them on credit, and in which, therefore, they themselves will have to obtain on credit somewhere a part of their own imports." The U.S. would be the only area capable of supplying the shortage; hence Great Britain would succeed in solving her problem only if the U.S.A. were willing to make the sacrifices required, "and, at the same time, acquiesce, without retaliation, in her use of these instruments of economic warfare. We shall have to do this in complete certainty that the adoption of such policies ..... will inevitably lead to their adoption by other countries, and with full knowledge that the eventual result of this will be inescapable economic disaster for everybody including Britain and ourselves."

Imperial preference was next examined, the conclusion being that no preferential grouping, unless indeed almost universal in scope - "in which case it ceases to be preferential - can hope to attain self-sufficiency." ....

"When, as was the case in Ottawa, such an arrangement is based upon the creation of preference through the raising of tariffs against non-participating countries, it obviously adds to the world's arsenal of trade-diverting and trade-destroying obstacles to world commerce. Even when preference is created through a lowering of existing barriers in favour of the participating countries, the arrangement still causes artificial diversion of trade, which is much more likely to lead to an increase rather than a decrease of trade barriers and thus to destroy more commerce than it generates" .... "In any event, it is doubtful that after the war we would accept, without counteraction, a reaffirmation of the British system of Imperial preference; or be willing, on that basis, to assume in adequate measure the vast reconstruction responsibilities indicated." ...

"In the long run there is only one solution for Great Britain's basic economic problem. She must expand and improve her production facilities along the lines of her greatest national aptitudes and she must increase her foreign trade or suffer a permanent economic decline."

Completely free trade, however, is not necessary. What is required "is a large measure of flexibility in trade movements, which is possible only through a trade process which is regulated, if at all, solely by such methods as reasonable tariffs and not by quantitative controls and other devices for artificial canalisation of trade movements".

The paper closes with an analysis of the mistakes of the 1920's. "The greatest tragedy of the years which intervened between the two wars was that the U.S.and Great Britain did not advocate and follow policies of economic peace at the same time. The tragedy of the future reconstruction effort may well be exactly the same if proponents of economic warfare should gain ascendency in either one of our countries".

The Memorandum is of importance as apparently representing the State Department's view not only at the time, but for some years afterwards.

Some comments on the Pasvolsky memorandum prepared in the Bank and dated 14.1.42 were sent unofficially to Sir Richard Hopkins.

The burden of criticism in these comments was that the State Department, well aware of the difficulties which would face the U.K.after the war, but regarding the device of Bilateral Special Accounts as a deliberate one to reduce U.K.imports and increase U.K. exports, (a Schachtian device, in fact), displayed "an almost blind devotion to the free trade doctrine". Although threatening to withhold American support for economic isolationism on our part, Section 7 of the memorandum was founded on a belief that neither America nor ourselves can succeed alone in establishing economic well-being (since, in the State Department's view, we had the power to wreck the economic structure no matter how enlightened a policy might be followed in America).

But the document, far from being discouraging, seemed to offer the most valuable opportunities for reaching agreement that we should not be stripped of our gold and other assets. We ourselves disliked bilateral arrangements; but unilateral clearing needed substantial reserves.

It was

It was recommended that, "as an earnest of our sincerity", we should declare ourselves ready to introduce multilateral, in place of bilateral, clearing as soon as we had adequate reserves. We should not aim at too high a figure (none suggested). We must insist that our own soundness, unthreatened by American policy, was a key factor in international economic soundness. The offer to substitute multilateral for bilateral arrangements must be "a trump card in the early part of the game".

On 6th

On 6th January 1942 another draft of Article 7 of the Mutual Aid Agreement was received by the Governor from the Treasury. This was a draft proposed by the U.S. Administration, and finally adopted. For political reasons our Ambassador strongly urged its acceptance. It appeared that the Cabinet was likely to accept the formula provided they were "satisfied that our position is fully covered both in regard to Imperial Preference* and in regard to our need to make use of protective and safeguarding measures, including bilateral arrangements, so long as they are necessary for our welfare".

The Governor's reply of the following day reads in part:-

"If it is a fact that our position is fully covered both in regard to Imperial Preference and in regard to protective and safeguarding measures, including bilateral arrangements, then surely the phrase about "discriminatory treatment" is meaningless. Even if this cover is admitted by the present U.S. Administration, it seems to me unwise if not dangerous thus to include words which are not intended to mean what they say: that could only lay up trouble for the future when we may have to deal with a different Administration.

But does not the real objection in present circumstances lie generally in the whole conception of this Article and particularly in the first sentence? Are we as Allies to be committed to the conception that "benefits are to be provided to the United States of America by the Government of the United Kingdom" for the former's contribution to the joint effort and that there is to be "a final determination" of such benefits? As I see it this conception is in radical and fundamental contradiction with the policy of unification of the war effort which is now being adopted in other fields and should extend to the financial field.

....

I believe that the policy of pooling resources without any talk of consideration now or hereafter is the right - and indeed the only possible - solution and that now is the time to press it."

*Later claimed by Mr.Winston Churchill as due to his insistence

However, under very strong pressure from the highest quarters in Washington H.M. Government decided to accept Article 7 as drafted by the U.S. authorities, provided that an exchange of letters could be arranged containing a formula reserving the rights of the U.K. to continue "discriminatory" agreements, etc., so long as this country might be forced to do so by conditions ruling immediately after the war (Mem.11.2.42).

The Bank do not appear to have seen any more texts of the Treasury memorandum between November 1941 and February 1942. Further revisions were forwarded to them on 2nd, 4th and 5th February, which were said to be subject to yet more re-arrangement and re-drafting. Sir Richard Hopkins expressed a hope that the discussion of the draft could be concluded by the 10th, after which it would have to be submitted to "about a dozen different departments" and finally to Ministers. The Bank's suggestions concerning monetary arrangements between Central Banks for exchange stability, the holding of each other's currencies, etc., would only be touched upon, Sir Richard said, as they would be a question for the Chancellor and the Bank to settle rather than a matter to be pronounced on by a large body of Ministers; and pending general decisions no attempt had been made "to settle the diplomatic lines of approach in discussion with America".

On 6th February the Deputy Governor sent four pages of textual amendments and some general comments:

> ".... The need for supervision of movements on capital account (i.e., control of capital movements) is admirably brought out. We maintain, however, that, whatever monetary mechanism may be introduced, the need for a considerable degree of direction and control over the factors underlying current account movements is also essential. Although this is brought out in several parts ...... of your note, there nevertheless remain certain passages ...... which suggest that a monetary mechanism on the lines of the Clearing Union would remove the underlying difficulties of the current balance of payments and therefore make control and direction of current items unnecessary.
>
> ....

Our own approach to the problem, outlined in the papers sent with my letter of the 4th November, is somewhat more evolutionary and does not seek to be immediately comprehensive or universal. We prefer to see the goal of multilateral exchange clearing expressed in terms of progressive development towards a position in which there would be only two kinds of sterling, "resident" and "non-resident". There is, we believe, little difference in the goal, but the particular point we wish to make is that, in our judgment, whether a comprehensive scheme can be reached at once or by a more gradual process, the fundamental need remains to ensure healthy underlying conditions, which cannot be ensured by any monetary mechanism alone: the choice cannot properly be described ..... as lying between a Clearing Union, which would be a solvent in itself, and a system of monetary agreements which would be dependent on underlying controls. From another aspect also we would stress that the two approaches are not alternative but may well even be complementary: whatever form of international exchange clearing is adopted there will have to be direct underlying agreements between the various monetary authorities for day to day settlements, and it is only the balance arising out of these settlements which would be dealt with by a clearing mechanism.

We feel that your paragraphs on control of capital movements, which as I have said we find admirable, could be strengthened by an allusion to the desirability, with which I believe you agree, of conducting exchange transactions through official or "authorised" channels and not allowing the reappearance of an irresponsible foreign exchange market.

Although the sterling area difficulties are clearly brought out, we do not find it adequately stressed that there are two distinct balance of payments problems -

(a) U.K. with the rest of the world (including sterling area):
(b) sterling area with the rest of the world.

We believe that there is some confusion of thought .... in the use of the term "multilateralism" which is used sometimes in its monetary sense with reference to the clearing of exchange balances and sometimes with reference to trade movements where it comes near to meaning free trade. We believe that emphasis should be laid on the great difference between the two uses of this and similar terms and that unless this difference can be more clearly brought out some sections of the note ...... will prove confusing.

As regards the Hansen-Gulick proposals ..... our view is that you go much too far .... towards committing yourselves to their acceptance. We are by no means convinced that the sort of organisation proposed will be the best adapted to deal with foreign lending after the war. The whole line of thought seems to us to savour more of the 1920's than the 1940's. In particular we regard the suggestion to link up the clearing union proposals with the Hansen and Gulick proposals as wholly premature and as being merely likely to confuse both issues.

We have no particular criticisms of Section VIII (possible American contributions) except that we should like to see even stronger reservations to the idea .... that we might hope (or indeed wish) to live on American charity rather than stand on our own feet.

With regard to Section IX, although we have been able to give it scant attention, we find ourselves definitely on the side of those who argue against any commitment to return to laissez-faire in the international economic sphere or to accept the American conception of free trade. We fully agree that the greatest importance is to be attached to Anglo-American co-operation in the post-war period but we do not believe that this co-operation will best be achieved by committing ourselves at the behest of the present U.S. Administration to a policy which might well debar us from reaching and maintaining the stability which is almost as essential to others as to ourselves.

We firmly believe that the best contribution which we and the sterling area can make to post-war international prosperity is to put and keep our own house in order, and to encourage and enable others to do the same. We should like to see much more emphasis laid on this point in your note and hope that you may find room for something on the lines of the relevant paragraphs in our earlier memorandum, which I quote overleaf.

........"

"Paragraphs from Bank's ("Skeleton Draft") Memorandum of 4th November 1941 which it is suggested might be inserted

The U.K. Government believe that, although help and co-operation may be expected from others able to give it, it is primarily for each nation and group of nations to examine their own position and to set their own house in order, as the best possible contribution to a balanced world economy.

The U.K. Government therefore believe that the first objective which, in the interests of world order, they should set themselves in the immediate post-war period is to achieve approximate equilibrium in the current balance of payments both

(a) between the United Kingdom and the rest of the world, including the sterling area, and

(b) between the sterling area and the rest of the world.

In both these spheres the assistance which can be rendered by the U.S.A. will be paramount. But it will remain primarily the responsibility of the U.K. Government themselves, in co-operation with the other Governments of the British Commonwealth concerned, to take the measures necessary to achieve and maintain equilibrium."

Again on the 9th February the Deputy Governor wrote:-

".....

I should, ..., like to make one general point ...... the argument is developed that a considerable degree of planning and direction in the international economic sphere is to be regarded as a constructive contribution towards healthy economic conditions and not merely as a pis-aller to be adopted only if things look desperate. This argument, which was so well developed in Sir Hubert Henderson's earlier memorandum on the 1930's, seems to us to have much to commend it. We should like to see more stress laid upon it in the concluding and summarising paragraphs ..... where this side of the case is in our view presented somewhat too apologetically and without sufficient emphasis on the constructive uses to which bilateral or multilateral agreements can be put or on the dangers to world economy involved in blind acceptance of the U.S. State Department's theory of non-discrimination."

There was apparently a discussion with the Bank on the 10th, and on the 11th a final draft* was sent to the Bank - final, except that the Treasury felt that a summary statement to introduce and facilitate the study of the memorandum by Ministers should be prepared. This summary was forwarded to the Bank on 10th March with a request for immediate comment.

The Governor replied:-

"You sent us last evening copies of a "summary statement" on post-war external monetary and economic policy. From the facts that you ask for comments on this fundamental document by mid-day to-day and that the document is a "revised draft" to be considered at a "final meeting" this afternoon, I assume that you do not expect the Bank to make any serious contribution. I will therefore confine

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*This seems to have embodied most of the Bank's suggestions.

myself to making three observations - two general and one particular.

The general tone of the body of the note does not in our view give a balanced summary of the longer document agreed some weeks ago. The emphasis appears to us in several respects faulty and likely to suggest to an objective reader various conclusions from which we dissent, e.g. -

(a) That this country must, in theory, renounce all regulation of international trade and payments (except for capital movements), whilst in practice finding excuses for not being able to put this policy into force at once.

We believe in the need for constructive planning and control.

(b) That the prime objective in forming British post-war policy must be to conciliate the present U.S. Administration.

We believe in setting our own house in order.

(c) That the post-war economic world can be run as an Anglo-American syndicate without taking much account of other countries.

We have not forgotten Europe.

The general tone of the summary of questions for ministerial decision also appears to us to give a misleading picture of the nature of the problems to be faced and of their relative importance.

In particular, I must add that in our view paragraph 9*, which has little relation to the paragraphs of the earlier note which it purports to summarise, is inaccurate and misleading and should be dropped."

Modifications were made to meet the first of the Governor's points, on which he commented:

"I note that you did not find it possible to take account of the points raised in my letter of the 11th March except for the alterations in paragraph 26 of the short note, which I fear I must regard as a rather meagre crumb."

The final version of the Memorandum was submitted to a Ministerial Committee on Reconstruction Problems (Chairman, Sir William Jowitt) on 24th March 1942.

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*Paragraph 9 read:-

"The declarations are especially concerned with expansion of production, interchange of goods and improved labour standards. But at the outset a general problem presents itself - that of both capital movements and of current trade transactions: in the latter connection it is capable of being highly discriminatory to the extent that it is possible to refuse or allow exchange for particular trade transactions. Thus the relaxation and eventual abolition of the use of exchange control for regulating trade transactions must be an important objective. But the question remains whether its machinery ought not to be retained for use in connection with capital movements."