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THE POUND STERLING

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THE POUND STERLING

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I. PRESUPPOSITIONS OF EARLY POLICY

STERLING was at its heyday before 1914. It was something more than the British currency; it was universally accepted as the most satisfactory medium for international transactions and might be regarded as a world currency, even indeed as *the* world currency. Its special position was no doubt connected with the widespread ramifications of Britain's foreign trade and investment. It was also due to absolute confidence in its stability, which had been maintained with complete success and without a break since 1821, and, subject to minor disturbances, ever since England wisely decided to allow the free export of gold in 1663.

One may think of the stability of sterling as consisting in the maintenance of a fixed gold value. Fine limits between the buying and selling points were already established in the eighteenth century. Alternatively, one may think of its stability in terms of the other principal currencies; the lion's share in the task of maintaining this stability was undertaken by the Bank of England, whose wise management greatly lightened the task of all other monetary authorities. This stability, combined with the complete freedom for arbitrageurs to carry on their task, insured mutual stability as between other currencies. Sterling was thus the nucleus of a wider system of currencies in stable relations with one another. The whole group attributed the relatively smooth working of their currency arrangements to being on the gold standard. Yet we are not quite sure whether the features of this gold standard would have at all resembled those normally described in text books on the gold standard, had it not been for the focal point of management in London.*

Before 1873 the constellation of stable currencies included those on the bi-metallic standard and, through the working of the bi-metallic system, those on the silver standard also. When the bi-metallic par was broken, difficulties arose in connection with the relation of the

* The first systematic attempt to establish a world-wide gold standard, in which a large number of the adhering nations are, in theory at least, equi-pollent, has been that of the International Monetary Fund. Its troubled career to date has been attributed to the vast dislocations of the post-war period, and that is in the main correct; but it is also possible that its difficulties have been aggravated by the fact that we just do not know, for lack of experience, how a gold standard can or ought to work when adhering members are supposed to operate as if they were equi-pollent.

silver currencies to the gold currencies; the most important problem was that of the rupee, which was at the centre of monetary discussion in the last quarter of the century. The difficulties were not overcome, and India was brought on to the gold standard (variant gold exchange standard) with other immature countries following suit.

The good management of this whole system may have been due in part to favouring circumstances, such as the importance of Britain's foreign trade and the strength of the group of merchant bankers centred in London. The economist would also wish to plead that it was also due at least in part, and perhaps in large measure, to the final, albeit very reluctant, acceptance by the authorities of the theories and practical maxims of the great British economists, notably Ricardo and Walter Bagehot.

Ready convertibility was deemed essential. This stems from the older maxim already mentioned by which, when other countries were still trying to hoard their gold by legal regulation, the free export of gold from England was allowed. I would note here that the suspension by the United States in 1935 of the free convertibility of dollars into gold by individuals, and its restriction of the payment of gold against dollars to transactions between monetary authorities, may have had much wider implications and eventual undesirable repercussions than was realised at the time. The premium at which gold now stands against the dollar in free markets is often regarded as merely a tiresome and vexatious bi-product of world disorder, an irritating irregularity of no great importance. I am not inclined to dismiss the matter so lightly. The American law is based on the idea that in the modern world the primary, and perhaps the sole, proper function of gold in the monetary field is to serve as the medium for the international settlement of balances, and that it is undesirable that it should be held to any great extent by private individuals as a store of value. This is not out of line with the British thinking of the nineteenth century; but the British doctrine, held with great emphasis and often repeated, was that if you wanted to discourage individuals from hoarding gold as a store of value, the sovereign recipe was to make sterling absolutely freely convertible by individuals, without let or hindrance, into gold. By establishing free convertibility, you caused the gold hoarding propensity to wither and die. Diametrically opposed to this view is the idea that if you want to reduce the amount of gold hoarding, the right way to set about it is to make it impossible for individuals, as distinct from central banks, to convert their currencies into gold. This whets the appetite for gold hoarding—as we see at the present day.

Ricardo strongly stressed the point that to re-establish and maintain a gold standard, it was not desirable to collect a large gold reserve.

The prime method of maintaining the gold value of sterling was to limit the quantity of sterling issued. The British authorities eventually accepted this doctrine, and throughout the period of good management of sterling, which in practice meant the good management of a whole constellation of currencies, they held a very small reserve of gold. The free gold in the Bank of England was usually of the order of £20 million. It is instructive to compare this with the present reserve (September 30th 1951) of £1,167 million, which is deemed to be so low as to spell perdition. Even after allowing for the change in the value of gold, this present-day reserve is gigantic by nineteenth century standards.

Of great importance was Bagehot's doctrine, also eventually accepted by the authorities, that in a time of crisis it was needful for the Bank of England to lend freely and without limit of quantity. Lending in limited quantities only was a pure waste of resources. If private interests and expectations were such as to lead to a need for liquidity, limited sums would at once be absorbed and lost to view. It was the sure knowledge that unlimited resources would be put at the disposal of the market that converted private interests and expectations away from the view that liquidity was an imperative necessity, and thus turned the conduct of the multitudes of individuals from being perverse into being helpful. During the war, Keynes's plan for a Clearing Union was criticised by the Americans as involving unlimited liability for potential creditors. As the United States was the foremost potential creditor, the objection had to be taken seriously and was indeed accepted. That acceptance, for all that it was necessary, may have been fatal to the success of the plan. It was a question of first principles. The thinking of the American experts was not yet attuned to the Ricardo-Bagehot doctrines. I suspect that a revolution in their thinking is still required, and that a satisfactory world money will never be got going on the doctrine of limited convertibility and limited assistance. Unlimited convertibility and unlimited assistance (on an adverse turn of circumstances) are needed. I have the uncomfortable feeling that unless advocates of free enterprise are converted to that doctrine, free enterprise in the world will peter out, and that the detailed manipulation of foreign trading relations will grow ever more complex and minute, until we have fastened upon us, not perhaps a totalitarian system, but one equally rigid, the result of jarring bi-lateral bargains. In fine, I hold that the success of nineteenth century sterling management was essentially dependent upon the Ricardo-Bagehot doctrines.

I have referred to the small, one might almost say microscopic, reserve at the disposal of the Bank of England. It is fair to add that Britain's solvency was bolstered by a far larger volume of short term loans to foreigners which could be, and often were, reduced at short notice, by raising interest rates in the London discount market. The focal position of sterling amid the constellation of currencies was essentially connected with Britain's being much the largest international lender on short term account. It has been argued that this was not altogether convenient for foreigners, since the restriction of loans in London sent out ripples of deflation over the world. I doubt if the inconvenience caused was serious, or was more than a trifling price to have to pay for the advantage of the maintenance of a stable currency. Certain older academic theories have held that these monetary pressures caused widespread depression. More modern analysis attributes the successive waves of industrial depression rather to causes connected with fluctuations in investment opportunity.

I have dwelt on the presuppositions of the old historic sterling policy, because they may be relevant, both for sterling if it is to be rehabilitated, and for wider schemes for stable world currency arrangements.

II. LANDMARKS BETWEEN THE WARS

Before proceeding to the present condition of sterling, it is desirable to refer to certain landmarks of history since 1914. I need not go over the story of the troubles connected with the first war and its immediate after-math. One notable landmark in the post-war period, which by repercussion had its importance in the sterling story, was the decision by the Federal Reserve System to contract credit in the spring of 1923 despite the unprecedented magnitude of its gold reserve. London in its management of sterling had always been extremely responsive to the inflow and outflow of gold. The decision of the Federal Reserve System in 1923 deliberately made the dollar unresponsive to the gold position. I quote once more the contemporary comment of Keynes (1923):—"For the past two years the United States has pretended to maintain a gold standard; and instead of ensuring that the value of the dollar shall conform to that of gold, it makes provision, at great expense, that the value of gold shall conform to that of the dollar." I do not criticise the action of the Federal Reserve System. On the contrary, the Federal Reserve attempt to ensure internal stability for the dollar was a notable experiment in monetary reform on modern lines, and it is not to be condemned *ex post* simply because of the failures of 1929-31. But its action was the first great step in time of peace away from the notion that monetary management should be primarily related to the international situation, and tended to set up the dollar as an entity on its own account which, although still convertible into gold, had its value governed by policy measures which were determined by the internal needs or aberrations of American citizens. Sterling was also an independent entity at this time, but that was because Britain had not yet returned to convertibility; she was waiting to do so; it was assumed that, once she did so, sterling policy would be governed, as always, by international considerations. But now here was the dollar, which was of no little importance in the international scene, the value of which was governed by different considerations. In order to take account of this, it might be needful to think through gold standard theory anew and indeed to re-cast it. This was not done.

The revaluation of sterling in 1925 to its pre-war level has been widely recognised as a mistake. After a period of violent re-adjustment, the structure of British wages and prices had been settling down to a new equilibrium in the period 1922 to 1924. This equilibrium was destroyed by the upward movement of sterling against the dollar in 1924-1925, which was stimulated by an expectation of its return to the old gold parity, and culminated in that return. There was great prestige in a parity which had remained undisturbed, save for two wars, since it was established by the famous astronomer, Isaac Newton, in 1717, and had been subject only to minor fluctuations for more than a century before that. How far this unwise gesture weakened Britain's external balance may still be argued, but there can be no doubt of its unfavourable internal effect in precipitating a general strike and a coal strike, and entailing rather high internal unemployment at a time when the rest of Europe was making rapid strides forward.

The opinion that a mistake had been made spread fairly rapidly after the event, and this opinion may have done more harm in the long run on the external side than the event itself. Some exaggerated statements have been made about Britain's conduct of her external affairs in the six years which followed. The expression "borrowed short and lent long" has become an historians' cliché. It is not clear that the amount of long term lending was inappropriate to the circumstances. The use of the active verb "borrowed" is certainly misleading. The position of sterling in this period was certainly weakened by the rise in the ratio of external sight liabilities to external sight (or very short term) assets. Mention has already been made of the importance for the working of the gold standard before 1914 of the large volume of short-term lending, which could always be restricted by bank rate policy to meet a dislocation in the balance of payments. The position was obviously less strong if the short term assets were matched by sight liabilities, which the foreigner, if he so wished, could call. The growth of these liabilities is, however, ill-expressed by the active verb "borrowed."

There were probably two main causes for it. After the great world deflation of 1920-22 expert opinion became anxious lest the lack of abundance of gold might set up a chronic deflationary pressure, and it became established doctrine, as embodied, for instance, in the resolutions of the Genoa Conference of 1922, that nations returning to the gold standard should economise in the use of gold, both by abstaining from minting, and also by holding some proportion of their reserves in the form of "foreign exchange" instead of gold. In many cases "foreign exchange" meant in effect sterling. Thus this world opinion was a primary cause of the substantial growth at this time of those externally held "sterling balances" (the sight liabilities referred to above) which have subsequently had such a woeful history. The growth of these balances should by no means be described as "borrowing" by Britain, but rather as the pursuance by others of measures to economise in gold in the general interest. We should probably add as a second main cause a certain tendency at this time, which was manifested in a wider sphere than that under consideration, for traders to hold working balances in order to meet day to day obligations, rather than to rely exclusively on acceptance credits. This general tendency would automatically weaken the British position. Note of this tendency was taken by the celebrated Macmillan Committee on Finance and Industry, which recommended (1931) that in the new circumstances Britain could no longer afford to rely on so narrow a margin of gold reserve as in the old days. What would the Macmillan Committee have said of the modern situation, in which a free reserve fifty times greater than of old is sometimes regarded as altogether inadequate!

The rupture of the parity in September 1931 was, like that of September 1949, due more to the previous under-mining of confidence than to the facts or requirements of the situation. First, there was the under-mining due to the opinion that the revaluation of 1925 had been a mistake, although the great movement of world prices in 1930-1931 had entirely changed the situation. Second, there was the stupid business about the British budget. Keynes held that it would be wrong in a time of quite unprecedented unemployment either to raise taxation or to reduce governmental expenditure. But his was a voice in the wilderness, and the Labour Government, no less than everyone else, appeared to regard it as essential to have a balanced budget. A parliamentary committee outside the government (the May Committee) gave a rather foolishly lugubrious presentation of the budgetary position. Among economies canvassed was a reduction in the unemployment benefit, which was altogether unacceptable to the Labour rank and file. Thus

Britain presented a picture of herself to the outside world as a country which had a government that knew its duty, but was unwilling or unable to execute it. This naturally under-mined confidence.

The third and immediately operative cause of the breach was the German collapse and the freezing of a large proportion of those short-term assets on which Britain relied as her first-line reserve. Even this was mainly a matter of confidence, since in the normal course the discounts would have been continuously renewed voluntarily, as they were compulsorily under the stand-still agreement. But of course a banker must have his assets liquid. Cumulative under-mining of confidence entailed a run on the British bank, and the gold standard had to be suspended.

It may be well to dwell at slightly greater length on the important period from 1931 to 1939, when sterling was "free." This was an experimental period and the experiment may be deemed to have been eminently successful. Despite the lack of gold convertibility, the status of sterling was well maintained throughout the world, while at the same time Britain enjoyed a remarkable internal recovery. Her position contrasted very favourably with that of the United States—a complete reversal of their relative positions in the 'twenties.

Part of the normal functions of the Bank of England was transferred to the Exchange Equalisation Account. This was operated by the Bank of England, but the British Government became officially responsible for policy. To what extent policy was in fact shaped by the British Treasury and to what extent by the Bank of England remains anyone's guess.

The first line of policy of the Exchange Equalisation Account was to insulate the British internal economy from the effect of short-term movements in the foreign balance. This must remind us strongly of the similar policy adopted by the Federal Reserve System in 1923 and the following years. Thus on both sides of the Atlantic we observe a movement, the United States leading, towards making the internal monetary system less responsive to the international situation. It would probably be a mistake to regard this as a deliberate movement towards autarky, but it has its autarkic implications. It is fair to add that the reorientation of British policy was less radical than that of the Federal Reserve System. The latter relegated the in- and out-flow of gold to a secondary position in the determination of credit policy. The British, on the other hand, attempted to draw the distinction—with what success we cannot be sure—between unbalance due to flows of short-term funds actuated more by political than by purely financial hopes and fears, and unbalance taken to indicate a long-period disequilibrium of the economy. The former was to be offset by the operation of the Exchange

Equalisation Account, the latter to be allowed to have its due effect on the valuation of sterling in the free market. Thus the internal economy was only to be insulated from the movements of what was coming to be called "hot money." (These hot money movements are still proceeding, despite the net-work of tight controls, but the less mellow authorities of the post-war period are by no means prepared to insulate the internal economy, even from the most ephemeral movements, regarding them as justifying violent changes in the level of import restrictions, with all that those involve for the smooth working of the internal economy. One reason may be that, as hot money has at present to avoid the exchange controls, it now takes a good deal longer to diagnose that a given movement in the balance is indeed due to hot money.)

In one respect the re-orientation of British policy was more drastic than that of the Federal Reserve System. In the 'twenties the latter continued to rely on credit policy for regulating the level of internal pressure. Sterling, on the other hand, now being free, it was possible to let the long run external forces (as distinct from hot money), favourable or unfavourable, exert their effect on the internal economy, not mainly via changes in the pressure of credit policy, but via changes in the foreign exchange rates. To sum up, internal credit policy was insulated both from the long term and short term external disequilibria; the foreign exchange market was insulated from the effects of short term disequilibria, but allowed to move—in theory at least—in response to long period disequilibria. In practice even the latter part of the doctrine was probably modified in favour of stability. I personally incline to the view that the long run equilibrium may have required in the period 1932-1939 a somewhat lower foreign exchange quotation for sterling than the Exchange Equalisation Account allowed; in fact the Account should have built up an even larger gold reserve than it did.

The twin objectives of the Exchange Equalisation Account in providing stability as against short term disequilibria and flexibility for the adjustment of long term disequilibria may be deemed to be embodied in principle in the Charter of the International Monetary Fund. The mode, however, of giving effect to these objectives via changes in exchange rates is no longer to be experimental and tentative. The principles have become, so to speak, rigidified. Short run insulation is represented by fixed gold parities established with the International Monetary Fund; the long run flexibilities by changes in the parity, to be permitted, if required, from time to time. Experience has yet to show whether the double principle can be made to work when thus formalised, and, one might say, ossified. The secrecy that was maintained regarding the state of the Equalisation Fund may be deemed undesirable; it would be especially undesirable in connection with an international institution. I suspect that it was unnecessary; it may have been needful in the first year, when all was in a state of flux and uncertain, but not so thereafter. But there is another kind of secrecy, not exposed to the same objections, and that kind of secrecy may be most needful for the successful operation of such a type of system, namely secrecy as regards the *intentions* of those who operate it. Surely it was precisely this secrecy which enabled the British Account to offset the movements of hot money and at the same time to allow adjustments in the foreign exchange rate without provoking large speculative streams anticipatory of such adjustments or consequential to them. In a sense the philosophy of the International Monetary Fund may be deemed to be derived from that of the Exchange Equalisation Account; but the former may be an inanimate copy of the latter, and the question still remains whether life can be infused into it.

After 1931, the concept of a "sterling area" begins to emerge. It is one difficult to define because its content is constantly changing and may continue to do so. Prior to 1939 one could name three leading features of the sterling area as then established. (1) Its members tended to hold "sterling balances" for whole or part of their central monetary reserve. (2) They tended to have their foreign trade invoiced in sterling. I pause here to note that these two characteristics were by no means confined to members of the sterling area, nor did they come into existence only in 1931. Sterling invoicing was a much more widespread practice and dates from remote times. The holding of sterling reserves likewise dates back to before 1914, and had a fillip after the 1914-1918 war, as already described. (3) We must add the new feature that the sterling area group tended to keep their currencies fairly stable in relation to sterling rather than to the dollar. This also had precedents in the period before Britain resumed gold payments in 1925, and of course applied completely in that period to the inner core of the sterling area. The larger sterling area, as it tended to establish itself after 1931, included, as well as the British Commonwealth and Empire (except Canada), Norway, Sweden, Denmark, Portugal, Japan and the Argentine, with Greece and Turkey coming in at a later date.

British patriots, musing retrospectively upon the past, sometimes proclaim it as a triumph and a mark of progress that stability in terms of sterling should have been preferred by a group of countries, which had no legal or constitutional ties with the United Kingdom. They even represent it as a sort of British triumph. It certainly has its interest. But by comparison with the period before 1914, it marks a decline; for before that date, the whole world might with meaning be said to have been the "sterling area."

Finally, it must be noted in regard to this system that it was a costly one, and was successful partly because it was ushered in with a good start. In 1932 there was a revival of confidence in Britain which brought to her a return flow of capital, so that she was able to build up a good reserve of gold or foreign assets. Sundry events that followed, both in the United States and in France, contributed something to making London favoured as a home for deposits. The system was costly. A gold reserve rising to £700 million was at one time built up. On a gold standard with absolutely fixed gold points, private speculators come in to help the authorities and indeed carry the main part of the burden of covering short period inequalities in the balance of payments. With the abandonment of the rigid gold points this prop is removed, and the authorities' reserve has to be increased accordingly. The fine mechanism of the Bank Rate, which under gold standard conditions secured large supporting movements in the foreign balance of payments, also becomes inoperative. Therefore the authorities' reserve has to be increased still more. Then there were the hot money movements. Even with the rigid gold standard, the gold reserve would have had to have been increased largely, to look after these. The recommendation of the Macmillan Committee for an increase in the size of the gold reserve was made prior to the big development of hot money movements; a still larger increase than that recommended by the Committee would in any case have been required on that account. Advocates of the gold standard might argue, however, that a gold standard, which everyone believed to be indefeasible and certain to be maintained, would itself have prevented sizeable outflows of hot money. After all the circumstances of 1931 were rather special—and not for Britain only. This point must remain in doubt.

III. THE STERLING BALANCES

With the outbreak of the second war, the sterling area was consolidated, but with narrower limits. Most of the circumambient countries fell away, and the sterling area was mainly confined to the British Commonwealth and Empire with one or two additions such as Egypt and Iraq. It enjoyed special facilities for the internal movement of funds. Its central feature was the "dollar pool." The net dollar takings were turned in by the whole area to the Bank of England and its dollar requirements financed from this central pool. To the extent that there was a net dollar contribution by the outer area, its sterling balances rose in proportion. At the same time, Britain deliberately let her exports fall away quite regardless of her own solvency, in order to concentrate all her resources upon the war effort. This led to a further growth of the sterling area sterling balances. Large military expenditures were undertaken by Britain, most notably in India and Egypt, and this also led to a growth of sterling balances. It ought in fairness to be emphasised that Britain was quite self-effacing in all this period—no doubt as a bi-product of her engagement in a life and death struggle—, took no trouble to pay her way by exports and did not let finance stand in the way of external expenditure in the common cause. She shouldered the burden herself. Meanwhile a similar process was going on outside the sterling area. Exchange controls took the place of the free foreign exchange market, and "special accounts" were established with foreign countries, normally on a bilateral basis, by which net deficits on current payments took the form of an accumulation of sterling balances. By the end of the war, which for this purpose may be regarded as the end of 1946, externally held sterling balances had risen from £476 million to £3,700 million, of which latter £2,417 million were held in the sterling area and £1,284 outside it. How was this problem to be handled?

In my judgement this was the most momentous policy issue which has confronted Britain in the present century. As I see it, a wrong decision here was bound to have far-reaching consequences in time and space, deeply affecting all future possibilities and policies. Furthermore, I would suggest that this problem was a kind of touchstone which would indicate whether there was anything of the old Ricardo-Bagehot tradition remaining in the British Treasury and the Bank of England. There was a fairly active discussion on this subject at Washington during the negotiations on the United States loan to Britain in the autumn of 1945. Keynes certainly was deeply imbued with the old traditions, and, although he had for a number of years been devoting his mind to problems of a different kind, I am confident that these ideas still weighed strongly with him. After the loan negotiations there was little public interest in or discussion of this matter in Britain; how deeply it was considered by the authorities is not known; no adequate statement on the broad lines of policy was vouchsafed.

I have no doubt that the correct decision was to take the major part of these balances right out of the banking system. It would have been desirable to leave in the names of the various creditors of Britain sufficient working balances; to determine the proper sizes of these, the level of pre-war balances, multiplied by some co-efficient to allow for the rise in the price level of international tradeable goods, would have served as a guide. For the rest, each balance should have been replaced by a non-negotiable acknowledgement of indebtedness of like amount by the British Government. The British Government could then have entered into negotiations in regard to the rate of repayment of these debts, a matter on which there would, no doubt, have been plenty of room for differences of opinion; equitable claims would have had to be balanced against the possibilities of the case.

It has sometimes been objected that this change in the form of Britain's obligation from bank balances to Government certificates of indebtedness could not have been executed unilaterally, on the ground that to have done so would have involved some kind of default. Even on the strictest interpretation of the nature of these obligations, this argument will not hold water. For what was actually done did in effect change the nature of the obligations in an equally drastic, although very different and much less useful, manner. What did creditors of Britain suppose a sterling balance to mean during the years 1939-1946 in which these balances accrued? The dictionary does not help here. The meaning can only be assessed by reference to history. During most of the history of sterling, a sterling balance was convertible into gold at a fixed rate; after 1931 it was legally and freely convertible into gold at a rate which fluctuated in accordance with market conditions. After 1939 it was not of course convertible either way, but it was probably assumed that this was due to the special circumstances of war, and that matters would be changed when the war was over. In no previous epoch of peacetime had such a balance been convertible neither at a fixed rate on the one hand, nor in a free and legally comprehensive open market on the other. To tell creditors that these sterling balances could only be used for the purchase of goods from the sterling area or, in certain cases and subject to the changing directives of the British authorities, to purchase goods in other specified countries (e.g. "transferable account" countries) was to make a most drastic change in what had historically been understood as the very nature of a sterling deposit; it was a change detrimental to the creditors. I do not judge that to have taken the balances right out of the banking system would have been any more drastic than what was actually done—or as detrimental to the creditors. By such a plan, the agreed annual repayments could have been made in sterling freely convertible into dollars or gold. (This corollary would have been required by the terms of the United States loan agreement.) Which was more drastic—to tell the creditors that they could use their credits only to buy sterling goods (and certain other goods) in amounts that would vary in a chancy way according to the availability of desired goods and the bi-lateral balances of trade, so that the utilisation of the balances might be a process of slow advance amounting possibly to standstill, or to tell them that, while these balances were crossed off the books, they could have a reasonable sum of money each year by way of repayment, which would be usable for all purposes whatever, as sterling always had been before 1939?

Some such action as that suggested above would have been necessary to ensure the success of the convertibility experiment in 1947. It was incumbent on Britain to make convertibility a success, not only because the undertaking to do so had been the most important among the considerations which induced the United States in 1946 to grant the large loan, but also because convertibility was an essential condition for the re-establishment of the status of this world currency. The continued existence of these large balances not only doomed the convertibility experiment to failure, but has stood in the way of all plans in the subsequent period for putting sterling onto a better basis and has been responsible for the frequent recurrence of crises.

There is no doubt that the removal of these balances from the banking system would have given a great shock to the creditors. Some disappointment to them was inevitable. They were living in a dream world if they supposed that £3,700 million could be immediately encashed in a few years in either gold or goods. The shock would have been a once-over shock, perhaps causing ill-feeling and recrimination at the time. Once accomplished, however, the curative effects would have been permanent. Sterling thereafter could have been rendered a healthy and desired currency. Memories are short, and business is conducted mainly by reference to present advantage. The old grievance connected with the surgical operation would have been soon forgotten, if these same creditors subsequently found it in their interest to hold sterling. Meanwhile, the British Government debts, as acknowledged, should have been repaid year by year with the utmost punctuality at the agreed upon rates.

The reasons for recommending a surgical operation were connected with sound currency theory. It may have been unfortunate that this reasoning came to some extent to be entangled with another line of thought, namely that some of these balances ought in equity to have been scaled down. It was urged that some of the creditors ought to be asked to make their contributions towards financing the defeat of Hitler; the United States and Canada had already wiped the slate almost clean. Furthermore, it was argued that these balances contained water; that excessive prices had been charged for goods or services provided to British forces overseas; in the dire circumstances of war, Britain had not been able to haggle; the large size of the balances in certain cases was due to the internal inflations of prices proceeding in regions overseas at the same time that the foreign exchange rates of their currencies were kept pegged at the pre-war level; the consequence was that the prices chalked up in sterling against Britain for services rendered to her bore little relation to the values of those services. There is much force in all these arguments. A drastic handling of the sterling balances problem came to be associated in the minds of some with a "tough" handling of them (viz. a scaling down), and the arguments, good or bad, that could be used against the latter, came to stand as an obstacle in the way of the former. To the ordinary man the latter may have seemed more important than the former; if the debts could be scaled down, that would be clear gain to Britain, while the funding or similar treatment of the debts was a technical, and, therefore, it would seem, secondary matter. One who attaches importance to sound currency will take quite the opposite view. A few hundred million plus or minus in the aggregate of debts is a small matter compared with the measureless advantages of having sterling a sound currency. Indeed, Britain has probably already lost more through the vagaries of sterling than she could ever have gained by a scaling down, however drastic, and the measure of future losses, if sterling is not re-established on a better basis, remains untold.

We must sympathise up to a point with those bankers who looked with horror upon the idea of cancelling a banking deposit in return for a different kind of obligation. The integrity of a deposit is rightly very sacrosanct in the banker's mind. But this was too narrow a view in the circumstances. It was failing to see the wood for the trees. The fact of the matter was that, if one looked at the position as a whole, it was quite impossible to treat all the non-resident holders of £3,700 million deposits in a normal way, as ordinary depositors. The question was what kind of abnormality to introduce into the treatment of them. To say that the deposit was struck off the books seemed to the banker very horrifying. Surely, he felt, it would be better to impose certain restrictions on their use—non-convertibility into other currencies etc.—which one would hope to be able to remove in time. That idea was wrong. It was the commercial bankers' view, not the central bankers' view. Perhaps the Bank of England authorities failed to appreciate the true order of magnitude of these balances, in relation to the possibility of balance of trade surpluses, and did not realise how long drawn out the agony of having to restrict the deposits would be.

The central bankers' point of view should have been simply this: it was essential, if the international status of sterling was to be maintained in the changed post-war conditions, that sterling should be regarded as absolutely sound. For this there were two pre-requisites. One was that sterling should be convertible, whether at a fixed parity or in a comprehensive free market such as obtained between 1931 and 1939; the other was that the Bank that issued sterling should be in continuous and absolute control of the quantity of sterling outstanding, so as to be able to take action to restrict that quantity as required from time to time in order to maintain the value of sterling. Within the ambit of the home country she can always do this by "open market operations." To leave a vast mass of sterling in foreign hands was incompatible with both pre-requisites, and incompatible therefore with the eventual restoration of confidence. The surgical operation would have given one sharp stab at confidence, but everything could have gone forward smoothly thereafter. The issue was one of high central banking statesmanship. I do not know if the matter was even considered at the appropriate level of statesmanship and financial philosophy. What is quite clear is that the idea of leaving these large balances outstanding, with piece-meal and patchy negotiations with creditors from time to time, would have been regarded with horror by the school trained in nineteenth century traditions. It is to be feared that those traditions must have died in inner British circles. If this is so, it is very distressing, since those traditions may alone be able to achieve success in practice in maintaining a satisfactory international currency. And it is not clear that they have yet taken root on the other side of the Atlantic.

IV. POST-WAR RESTRICTIONS ON CONVERTIBILITY

Some features of the post-war system must be mentioned briefly. Exchange control has been maintained. Its main object is to prevent capital movements out of the country. It has not been completely successful in this, but it is likely that larger movements would have taken place, had there been no control. There is no doubt that it may prove difficult to combine exchange control with a policy of Ricardian convertibility. It is hardly to be hoped that the free movement of capital can be allowed in the foreseeable future, when tax rates are so onerous in Britain, when interest rates have to be kept fairly low, when the National Debt is so large (nearly two and a half times as great as the American in proportion to National Income) and when a strong political party exists, whether in or out of power, the abstract doctrines of which hold a menace to capital as such. Thus exchange control may have to be kept in force against British residents. But the essence of convertibility is that holders of sterling outside the area should be absolutely free to dispose of it exactly as they wish, and it should not be too difficult to reconcile this condition with exchange control over those inside the area.

Within the general system, American holders of sterling have had a privileged position. For them free convertibility obtains. Outer sterling area sterling is also in a relatively privileged position, since the British authorities are always willing to meet, by the provision of gold (or dollars), any deficit arising between the outer sterling area and the dollar area or any other country requiring gold payment. Thus outer sterling area sterling is fully convertible for genuine current account needs. This has not always been well understood in the United States.

Outside the sterling area, there is a system of bilateral agreements which in many cases carry on the "special accounts" system of wartime. Under these sterling may be used only for the purchase of sterling area goods, but there is sometimes a provision that if a sterling balance increases by more than a certain amount, the excess shall be gold convertible. Within the area of bi-lateral agreements, the "transferable account" system has been developed, by which a transferable account country can use its sterling to make purchases not only from the sterling area, but also from other transferable account countries. The area of transferable accounts changes from time to time with changing circumstances. There is also a limited kind of transferability known as "administrative" transferability.

These sundry agreements serve to prevent the unlimited use of non-sterling area sterling balances and direct their use to the purchase of British goods. Until recently it has appeared that the authorities have held the view that the use of sterling balances was harmless so long as it was directed to the purchase of British goods only. This is profoundly wrong doctrine and has done great injury. Since the war Britain has been suffering more from the excessive strain on her manufacturing capacity than from anything else. The dispatch of "unrequited exports" which serve only to draw down sterling balances has impaired her power to satisfy markets where the exports would have had a more useful effect, and to re-build her own capital equipment.

Thus the maintenance of the sterling balances in being has been combined with a restriction upon their use. In the case of certain balances, known as "restricted" balances, the restriction has been absolute, involving that the balances could not be used at all for the time being. This "restriction," however, has not had the beneficial effect that would have resulted from removing the balances from the banking sphere altogether—for two reasons. The amount of balances restricted in this sense has been much too small; and under pressure of creditors there have been recurrent "releases" from them. If the balances were not there at all, they could not be released. Releases have been made under pressure of bargaining on political and economic grounds. The evil in this system consists not only in the absolute burden on Britain entailed by the releases, but also in the uncertainty as to how great the further releases from time to time may be. There cannot be confidence in the future of sterling so long as it is unknown what proportion of £1,000 million may come on to the market at any moment.

This precarious system led to the failure of the convertibility experiment in 1947. This was a set-back of primary importance to the plans, to which the British themselves had made an important contribution, notably through Lord Keynes, for reconstructing an orderly post-war world currency system. At the time Mr. Dalton, then British Chancellor of the Exchequer, was reported as having told Mr. Snyder that Britain would return to the task of restoring convertibility in accordance with her obligation at the earliest possible date. But whatever Mr. Dalton might say, and there is no need to question his sincerity, the fact remains that British opinion had received a very rude shock indeed. Britain had been publicly humiliated. It was psychologically inevitable that a deep resolve should be made to pause for a very long time and to make assurance doubly sure e'er ever she tried this experiment again. This reaction was inevitable; it was no good exhorting or expatiating; it was too deep for words. But though inevitable, it was very unfortunate, because in fact it was desirable that Britain should try the experiment again, and that as quickly as possible.

V. EXTERNAL ACCOUNTS IN RECENT YEARS

It may be well at this point to take a panoramic view of Britain's external balance during recent years. Her achievement has been a very remarkable one, and it ought to have led to a great strengthening of her position. It is a case where the fruits of hard productive effort have been in part spilled on the ground by currency mis-management. After a steep climb since the war British manufactured exports have during the last year been running at about double their pre-war volume.

In the following figures I rely on the series of British White Papers entitled *United Kingdom Balance of Payments.** Owing to the great complexity of Britain's external relations, many of the items are subject to rather large revision, and are in fact revised retrospectively at intervals of six months. There remains an element of uncertainty in some of the figures; none-the-less, they may suffice to give a broad picture. For our purposes the war may be deemed to have ended on December 31st 1946. Till then, British overseas commitments on defence account were still large and the sterling balances were still rising. I shall therefore consider the period from the beginning of 1947 to mid-1951. 1947 was a bad year and for certain purposes it may be convenient to look also at the period from the beginning of 1948 to mid-1951 as representing Britain's achievement when the worst after-math of war was over.

* Cmd. 8379 is the latest issue to hand.

1. Britain's overall balance of external payments on current account for the three and a half year period, that is excluding 1947, was favourable. *This is the strict account of her earnings, exclusive of all loans or gifts made to or by her.* Already in 1948, she was roughly in balance, the deficit on current account being no more than £29 million. In 1949 the balance became favourable; it seems probable that the balance was almost exactly even in the one and a half years prior to mid-1949. I mention mid-1949 as being the point at which world opinion had crystallised in favour of devaluation.

TABLE I

UNITED KINGDOM BALANCE OF PAYMENTS ON CURRENT ACCOUNT
(£ million)

	*Overall** (a)	*With Non-Dollar Non-Sterling Area* (b)	*With Sterling Area* (c)	*With Dollar Area* (d)
1947 - Mid-1951	−454	+59	+871	−1349
1948 - Mid-1951	+91	+123	+769	−778

* The difference between (a) and the sum of (b), (c), and (d) is due to transactions with "non territorial organizations."

2. The balance with the whole world outside the sterling area and the dollar area was thoroughly satisfactory. It was favourable even when 1947 is included. Britain was actually able to draw down the sterling balances held by this area from £1,269 million at the beginning of 1947 to £997 million at mid-1951, that is by more than one-fifth in the short period of four and a half years; and in addition she was able to make gifts and credits (I.E.P.A. drawing rights and EPU credits) amounting to £262 million, and to make the lamentable and odious devaluation payment of £75 million to that area. I append a table showing what happened during the period, including 1947.

There is a striking feature in this table to which attention must be drawn. The United Kingdom made the colossal gold payment (gold and dollars in this accounting are treated as synonymous) of £279 million to this area alone. Such a gold payment would be reckoned as very large by pre-war standards, even if made to the rest of the world as a whole. Indeed, no such payment had ever been made by Britain in so short a time except in the years immediately before 1939. This payment was made in spite of the fact that Britain had a favourable balance with the area as a whole. This brings out the essential weakness of her position. Where she had favourable balances of trade, payment was made to her by drawing down the old sterling balances, but where she had unfavourable balances, she had to pay in gold. This was

TABLE II

UNITED KINGDOM BALANCE WITH NON-STERLING NON-DOLLAR AREA

JANUARY 1, 1947—JULY 1, 1951*

(£ million)

Sterling balances *drawn down* by	272	Favourable balance of United Kingdom trade with this area		+59
		Paid by this area in sterling to outer sterling area		+275
		Gold payments by United Kingdom to this area		+279
				+613
		Less Gifts or loans by United Kingdom in respect of I.E.P.A. drawing rights and EPU credits	262	
		Devaluation payments	75	−337
				+276

* Minor items are excluded, as are capital movements, which, though substantial, almost exactly cancel out.

one of the most important causes of her so-called "dollar gap." No doubt it was right and proper that she should make some contribution to the paying off of wartime indebtedness. It is by no means clear that it was incumbent upon her to reduce it by more than a fifth in so short a period as four and a half years—as well as paying interest upon it. But what was worse was that the amount by which the indebtedness was repaid was purely fortuitous. The more energetic her manufacturers, the more was the debt automatically paid off. But British manufacturing capacity was required for other purposes. The amount of it devoted to paying off wartime indebtedness should have been planned in advance and duly restricted. If the sterling balances had not been available for payment, the adverse balance countries would either have had to settle multilaterally—in which case Britain would not have had to make the gold payments already mentioned, since the countries having favourable balances with her would have found a ready market for their surplus sterling in the adverse balance countries—or have had to forgo *pro rata* the purchase of sterling goods. If the latter had happened, this would by no means have been disadvantageous to Britain, since manufacturing capacity would have been released for giving more prompt delivery to markets elsewhere—delivery delays have been very long in many lines throughout this period—or for adding to capital equipment at home. As things were, Britain got nothing whatever for these "unrequited" exports except the satisfaction of drawing down the sterling balances at a rate that was unexpectedly great and not required in equity.

In the eighteen months before mid-1949 Britain's favourable balance with this area stood at £36 million and, in addition, the outer sterling area received payments from it amounting to £33 million.

3. The balance of the United Kingdom with the sterling area was very favourable throughout the period. The United Kingdom made a mighty effort to supply goods, perhaps too great an effort.

TABLE III

UNITED KINGDOM BALANCE WITH OUTER STERLING AREA
JANUARY 1, 1947—JULY 1, 1951
(£ million)

Sterling area sterling balances *increased* by	681	Favourable balance of United Kingdom trade with outer sterling area		+871
		Payment by United Kingdom of gold to cover outer sterling area deficit with dollar area	130	
		Less contributed by ERP	59	
		Net United Kingdom payment		+71
		Australian gifts		+46
				+988
		Less		
		United Kingdom purchase of gold from outer sterling area	428	
		Payments received by outer sterling area from non-dollar non-sterling area	295*	
		Capital investment by United Kingdom in outer sterling area	929	
				−1652
				−664**

* The excess of this figure over the corresponding figure in Table II is due to the use of IMF drawing rights.

** Discrepancy with opposite figure due partly to exclusion of certain transactions with "non-territorial organizations" and partly to a small revision in the White Paper's global figure for sterling area sterling balances.

The most striking feature of this position is that the huge favourable balance of trade (£871 million) was more than offset by the flow of capital from the United Kingdom to the outer sterling area (£929 million). The authorities have not informed us how this sum was made up. Some part of it may have been venture capital financing new investment. The greater part probably constituted the withdrawal of capital from Britain by those seeking to diversify their holdings or to avoid the insecurities deemed to beset the holding of capital in the United Kingdom. There was a big outflow of capital from France in the days of M. Blum.

This outward movement need not create disturbance, provided that the machinery of the sterling area operates smoothly; it is a price worth paying for maintaining the unity and integrity of the sterling area and allowing a relatively free movement of money. The only radical remedy, if the outflow is considered objectionable, is to make Britain itself more attractive to capital.

It is important, however, that the effect of this flow on the sterling balances should not be misconstrued. If it had not occurred the sterling area sterling balances, instead of rising by £681 million during the period, would have declined by £248 million. This represents 10% of the initial balances and is a notable contribution to the repayment of the outstanding indebtedness.

It would be desirable in the statement of accounts to show the balances which constitute the counterpart of the outflow of British capital separately; the various parts of the outer sterling area should regard increases of balances due to what in frankness must be called a "hot money" movement out of the United Kingdom as additional reserves earmarked to cover those movements. The "hot money" might one day return to the United Kingdom again. Who knows? When French capital flowed into Britain before the war, the Exchange Equalisation Account offset it by the purchase of gold, which mounted up to a high figure. The British did not say to the French that this increase in the balances of the Equalisation Account was intolerable and that the French ought to step up their exports to Britain. Similarly the present trend of the sterling area sterling balances does not in itself provide a reason why Britain should try to step up her exports to the outer sterling area. If the cover for "hot money" was shown separately, it would appear that Britain had reduced the sterling area sterling balances by "unrequited exports" at a reasonable rate.

Part of the favourable British balance of trade with the outer sterling area was offset by payments due to that area from the non-dollar non-sterling area (£295 million). This was a normal multilateral pattern; the outer sterling area offset part of her very adverse balance with the United Kingdom by having a favourable balance elsewhere. From the British point of view, this item washes out when Tables II and III are taken together. If the sterling area had not had these payments due to her, sterling area sterling balances would have been drawn down that much more and non-dollar non-sterling area sterling balances that much less.

Further to offset her very unfavourable balance with the United Kingdom, the outer sterling area should have had a favourable balance with the dollar area; but she had an unfavourable one, and the United Kingdom had to finance it out of her gold reserve.

The United Kingdom used part of her surplus with the sterling area to buy newly mined gold (£428 million) for use towards meeting her deficit with the dollar area.

Finally, the real investment (as distinct from the purchase of securities) by the United Kingdom in the outer sterling area may be set down as £219 million, viz. £871 million (favourable trade balance) plus £71 (net payment by United Kingdom to cover adverse outer sterling area balance with the dollar area) minus £428 million (purchase of newly mined gold) minus £295 million (outer sterling area's favourable balance of payments with non-sterling non-dollar area).

4. The United Kingdom deficit with the dollar area was not so bad as is usually supposed. It was £1,349 million for the whole period; but, if we leave out the bad year 1947, it was £778 million or £222 million per annum. Having regard to the change in the value of money this does not compare badly with the direct deficit of the United Kingdom with the United States and Canada (a somewhat smaller area) of £90 million in 1938.

This deficit of £778 million was met to the extent of £344 million by newly mined gold from South Africa which Britain was able to buy by using part of her large surplus with the outer sterling area for that purpose. Thus of the direct deficit only the remaining £434 million could be a cause of embarrassment.

It is to be observed that if the United States Treasury had happened to have had the idea of raising the dollar price of gold precisely in proportion to the rise of the United States index of general prices, the newly mined gold acquired by the United Kingdom would have been worth £718.36 million and *her direct dollar deficit would have been practically nil.* All that the United Kingdom would then have had to do, to be completely dollar solvent, would have been to tidy up her arrangements with the non-dollar world, so that she did not have to pay out gold or dollars to all and sundry in spite of having a favourable balance of trade with this non-dollar world as a whole. Thus the decline in the value of gold has been a cause of first magnitude of

Britain's difficulties. And it is the *only* cause that it would have been out of her power to remedy by a fairly straightforward adjustment of her policy.

VI. THE 1949 DEVALUATION

In the eighteen months prior to mid-1949 the balance of Britain's overall external trade was roughly even, and tending to improve. Such improvement was desirable if Britain was (a) to make a steady reduction in her external indebtedness, and (b) to contribute to overseas investment in under-developed regions out of her own resources.* Some improvement would probably have come in the normal course of events; the correct way to expedite it was to carry out measures of internal disinflation, which were required in any case, since her economy was still suffering from some inflationary pressure. Such disinflation should have produced a quick improvement in the external balance, as in many lines her delivery dates were still very long and were causing the loss of export orders.

Then there was the question of her dollar deficit. A special drive for selling in the dollar area was thought to be desirable and may be judged so. It would not, however, have been right to seek to push this so far as to close the direct deficit of the United Kingdom with the dollar area. That would have been to drive trade into violently un-natural channels. It was reasonable to argue that owing to the fallen value of gold the United Kingdom could not hope to finance a direct dollar deficit of the pre-war magnitude and that she must therefore make some special exertions of her own to reduce it. But it was also proper to envisage that there would remain a residue, which she would finance by collecting some dollars from the non-dollar world in part payment for her large surplus of exports to that world.

But in 1949 the tide was still running the other way. Not only did the United Kingdom not collect any dollars in part payment of those export surpluses, but she had to pay out dollars to or on behalf of the non-dollar world to the extent of £163 million in 1948 (Cmd. 8379) and of £102 million in the first half of 1949 (Cmd. 8065). The second mentioned figure may have been swollen by speculation against sterling, rumours about the devaluation of which were already becoming rife.

The correct remedies for this superimposed drain of dollars were two, namely: (a) to persuade the outer sterling area, or parts of it,

* Actually she had been doing both these things, but only because United States (and Canadian) assistance had been available for meeting her direct dollar deficit. To continue doing them out of her own resources she would need a sizable overall surplus.

to introduce stricter discipline, and (b) to put an end to the intolerable system by which British surpluses to the non-sterling non-dollar world were paid for out of old sterling balances while deficits often had to be financed in gold.

In July 1949 measures under the heading (a) were taken, although not necessarily the best measures. At a meeting in London, sterling area Finance Ministers agreed to drastic reductions in dollars imports, which were put into effect. It is a curious thing that there has seldom been more talk in lofty circles of the undesirability of import restriction as a method of curing a disequilibrium, than there was in the later part of the war and subsequently; yet never before has this method been used with such frequency and violence. It is not a good method at any time. It is particularly bad if the restricting country is suffering from domestic inflationary pressure, as most of the sterling area countries were. It automatically increases that pressure. If the domestic inflation is partly suppressed, so that there are long delivery dates, import restriction by increasing industrial congestion may further lengthen those dates and thus have an immediately adverse effect on the country's exports. If the import cuts are partly at the expense of running down stocks (as in the British case in 1950), imports have to be increased later on, and *pro tanto* there is no net curative effect. Furthermore import cuts are provocative of retaliation, so that the flow of international trade, which in the long run is a genuine cure of inflationary pressure, is impeded.

A better method would have been to prevail upon the sterling area countries represented at the conference to carry out some internal disinflation (reduction of capital outlay or budget surplus). Those same sterling balances, which, because they were dollar convertible in the sterling area, enabled certain countries to import more dollar goods than usual, had also been one cause of an internal inflationary tendency; by serving in many cases as a base for the local credit structure, they had made money abnormally easy. It was desirable that inflationary tendencies should be curbed. However, the other course of import restriction was chosen, and it did have a large short-run effect on the dollar drain, thus giving a breathing space, advantage of which was not taken.

Under (b) I still believed in 1949 that a belated freezing of part of the sterling balances was the right course. This would have made sterling scarce and at least enabled Britain to set off her surpluses in some parts of the non-sterling non-dollar world against deficits in others, and have put an end to the unconscionable demand for dollars from her. It is still not clear whether some action on these lines will not have to be taken if sterling is to be re-established as a freely convertible and universally acceptable international currency, and to protect Britain in the future from dollar drains which she may be unable to meet.

Measures of a different kind were, however, adopted to deal with this problem. The Uniscan arrangement for multilateral settlements between Britain and the Scandinavian group was made in the winter of 1949/1950, and was followed by the important European Payments Union plan in the summer of 1950.

It may be said that to supplement these sundry measures a strong dose of internal disinflation was needed. During the years 1946-1948 I was advocating internal disinflation with some intemperance of language; but in 1949 I desisted. By 1949 internal inflationary pressure, although still present, had eased considerably. Furthermore, there was Marshall Aid. Since 1947 I have never recommended a policy which implied much reliance on the wonderfully generous American assistance that has been given, but in retrospect it may be well to bring this into the picture.

Internal disinflation must mean in the British case curtailing capital outlay.* Many wise men held that the capital outlays undertaken at this time in Britain, although large, were still far short of what was needed to make good the backlog of war and to provide an overdue reconstruction of British industries. Now it was precisely for this purpose that Marshall Aid was intended, both for Britain and the other countries of Europe. Americans who interested themselves in British affairs were apt to express the opinion that Britain ought to make still greater efforts to modernize her industrial structure.

All the figures that I have given regarding Britain's overall balance are free of Marshall Aid. In the first half of 1949 Britain was in external balance without bringing Marshall Aid into the reckoning. Marshall Aid therefore gave her a substantial external surplus. It would therefore have seemed rather paradoxical, not to say ungracious and contrary, to insist in 1949 on cutting down that very capital reconstruction, for the sake of which Marshall Aid was being vouchsafed, with the purpose of securing a still larger external surplus.

There have been misconceptions about this in the United States. There has been a persistent opinion that the United States 1946 loan and Marshall Aid went in some indirect way to provide free wigs and false teeth in Britain. It is to be emphasised that this view was entirely without foundation. During this period the monies spent on social services were fully provided for by taxation; the British budget was indeed over-balanced; to some extent the beneficiaries of the services themselves found the money out of another pocket through taxation,

* Cf. pp. 37-38 below.

although some taxpayers have had to pay more than they ever received back; it was a question of internal transfer. It cannot be argued that this transfer made any difference at all to the external balance. The British people have themselves paid in full by sacrifices in their own standard of living in other respects for this increase in the public provision of amenities. Marshall Aid went solely to facilitating a greater amount of capital outlay than could have been undertaken without it, save at the price of a correspondingly diminished external balance.

To resume, Britain was in 1949 making sundry efforts, not necessarily adequate, to deal with the problems presented by her external economic relations. Headway was being made. But the effects of all these efforts were rendered null and void and prospects were dashed by the ill-judged procedure of sterling devaluation in September 1949.

To begin with, there is a strong *prima facie* case against devaluation, when a country is suffering from internal inflationary pressure, since it is bound to re-inforce that pressure. In Britain the inflation was partly suppressed; inability to deliver was responsible for the refusal or loss of many export orders; in these circumstances it was a trifle absurd to seek to push exports by devaluation; it was quite uncertain what the level of payable exports was with the £ at $4.03, if only prompt delivery had been possible. It ought to be laid down as a general rule for international economic policy that a country suffering from internal inflation shall not devalue until she has first tried the remedy of internal disinflation. Such a rule would have disallowed the devaluation of September 1949.

An exception would have to be allowed in extreme cases, e.g. (a) if the country's adverse balance was so adverse that it could reasonably be judged that no practicable amount of internal disinflation would bring it right, or (b) if a country's internal price and cost structure had become quite out of line with the external value of the currency.

In regard to (a) we have already seen that Britain was in no such position. She had been in overall external balance for some time; any further building up of the balance would merely serve to enable her to reduce her external indebtedness and to make overseas investments out of her own resources. It was desirable that she should reduce her direct dollar deficit somewhat, but her larger dollar problem was due to her liabilities as an overseas banker (sterling balances) and devaluation was not an appropriate method for dealing with that problem.

The following table is relevant to the consideration of (b), viz. Britain's internal level of prices and costs. The coverage of these index numbers may not be precisely comparable, but only an approximation is relevant to our purpose.

TABLE IV

PRICES IN THE UNITED KINGDOM AND THE UNITED STATES

	United Kingdom	*United States***
Wage Index 1948/1939	176	258
Wholesale Price Index 1948/1938	216	252
Consumers' Price Index 1948/1938*	183	205
Export Price Index 1948/1938***	244	240

* In the British case I have taken the "national" retail price index of 171 for 1947 supplied by Mr. Dudley Seers (*Bulletin* of Oxford Institute of Statistics, May 1949) and multiplied it by the official "interim index of retail price" of base 1947.

** In each case the United States index has been multiplied by 1.2 to allow for the British devaluation of 1939.

*** United States index: base 1936-1938.

Sources: Monthly Digest of Statistics, Central Statistical Office, London, and Report by the Council of Economic Advisers, Washington.

Who, looking impartially at these figures, would judge that prices and costs had risen so much in Britain that a drastic devaluation of sterling had become inevitable? It almost seems as if a devaluation of the dollar might have been more appropriate! The pattern remained similar in the first half of 1949, except that by the second quarter the wholesale price indices had moved to 223.7 (British) and 235.8 (United States) respectively and the export price indices to 250.9 (British) and 225.6 (United States). But United States wages had risen about 4%, British only 2%. This downward movement of American export prices was no doubt due to the trade recession in the United States (which proved to be transitory) occurring at a time when Britain was still suffering from excessive demand. It may well be that if British business had become slack at the same time some downward shading of export prices would have been possible in her case also. In any event, a discrepancy of 10%, which had lasted for some six months only, cannot be accepted as a justification of so sweeping a measure as a devaluation, presumably intended to be permanent, of more than 30%.

Thus it appears that by ordinary criteria there was at mid-1949 little disequilibrium, if any, to correct. But only a very large and intractable disequilibrium would justify the highly dangerous experiment of devaluation by a country at a time when she was subject to internal inflationary pressure.

It might be argued that the devaluation could be justified proleptically as the advance adjustment to some future cost increases that might eventuate as a result of that inflationary pressure. There is no justification for such a view. The pressure had for some time been easing off; the recent wage increases had been very moderate indeed; such controls as remained were effectively preventing the development of a price and wage spiral. As the pressure eased, controls were successively removed, perhaps not as quickly as they might have been. In the United States the worst of the inflationary pressure due to post-war adjustments was already over; Britain might well be approaching the point when the total demands upon her economy no longer exceeded the supply potential. At that point a government, which wished to, could remove the remainder of the controls. Suppressed inflation would then disappear. There was no reason whatever for supposing in 1949 that Britain had to face any serious rise in the general level of internal prices.

The cause of the devaluation was something quite different, namely the pressure of an un-informed world opinion acting upon Britain's international banking liabilities. One might indeed say that the devaluation of 1949 was the result of her having failed to deal properly with the sterling balances problem in 1946. She seemed to imagine that she could continue handling her creditors like a conjuror keeping a number of balls in the air at the same time. Sound banking cannot be conducted in this way. When some low-browed international financier, swirling the brandy around in his glass, uttered his profound thought, "I don't believe the pound is worth four dollars," there was a run on the bank and all was over.

It seems probable that only an adequate early handling of the sterling balances problem could have prevented a serious crisis in 1949. None the less, one should not accept the view that devaluation was even then inevitable. A British Chancellor, who knew the full facts, could have made a firm stand. Better were it to have frozen every non-resident sterling balance and paid gold out of the reserve down to the last penny, than to allow such an ill-timed devaluation. But it is doubtful if the British Chancellor did know the simple facts that I have set out in this paper. Indeed even now the figures are liable to a margin of error. This same mis-handling of the sterling balances has, in addition to other evil consequences, engendered such a complex system, that it is difficult to understand what is actually happening until a long time after the events. I do not know how long it takes those with full inside information to understand. This point alone suggests that the existing system should be revised. If, as each new crisis occurs, the authorities cannot rightly comprehend its nature or causes, by the ordinary laws of chance their remedial measures are likely to make matters worse. If policy and planning are to be efficient, they require a simpler system.

I judge devaluation to have been a disaster of the first magnitude. In the first half of 1949 British exports were running at 50% above their pre-war level and British manufactured exports (the greater part of the total) at 73% above their pre-war level. Imports were still below their pre-war level. The need for this great increase of exports was due partly to the worsened terms of trade compared with pre-war and partly to the reduced income (in terms of commodities) from invisible items. This was an adverse consequence of the war and Britain was bearing it stoically. It even seemed needful to jack these exports up further by a moderate amount, so as to enable Britain to make a contribution from her own resources to the development of backward regions overseas.

But devaluation caused a colossal and un-natural rise in the volume of exports. During the last year they have been running 20% above their volume in the first half of 1949; manufactured exports are about double their pre-war volume. This doubling is a very heavy strain on the manufacturing capacity of Britain. In 1950 the total value of the manufacturing output of the country was reckoned net at £4,400 million. Manufactured exports stood at £1,882 million. These figures are not comparable since to the former must be added the cost of the raw materials and certain "services" supplied by other industries, but they suffice to indicate the order of magnitude of the export effort, in relation to the manufacturing capacity of the country. Despite this great increase in the volume of exports since the first half of 1949, the import-buying capacity of the total of Britain's exports has fallen. Perhaps in normal times this further large extra burden would also be borne with equanimity. The John Bull of history has become the patient ox. But now there is a question of re-armament, and this puts a different complexion on the matter. It is quite certain that Britain cannot fulfil her obligations to N.A.T.O. and increase, or even, perhaps, sustain, this vast volume of exports. Capital outlay can be reduced and should be, but if this process is carried too far, there may be a loss of productivity even in the short period. Consumers engage but a minor proportion of the manufacturing capacity of the country, and of that proportion what does not supply the bare necessities is a trivial quantity in the whole picture. If only the N.A.T.O. contribution were not required for another ten years, a possible solution would be to make a further large increase in the manufacturing capacity of the country (although from a long-run point of view this would probably provide an unbalanced structure and present an acute problem of surplus capacity at a later date); but this solution is not available if the N.A.T.O. contribution is required more urgently. At this point the economics of devaluation becomes a question of political economy, on which momentous issues—those of peace itself—depend.

Since Britain had an even balance of overall trade prior to mid-1949, there was no case for devaluation; and since she was suffering from internal inflationary pressure, it was bound to be harmful, because adding fuel to the flames of inflation. But if Britain in 1949 had had an adverse balance of trade and under-employment, it would still have been needful to put one further question, before agreeing to devaluation. Would devaluation improve the balance of trade? Economists have laid down that devaluation tends to improve a country's balance of trade, if the sum of the elasticity of the foreign demand for her exports and of the elasticity of her demand for imports is greater than one. It is not easy to interpret the consequences of the British devaluation, since the Korean War has supervened to introduce new forces, and it is impossible to make any certain inference from the figures. It is my opinion, which I have only reached after a lengthy period of suspended judgement, that the sum of elasticities in the British case has not been greater than one, and that, by consequence, devaluation has worsened Britain's balance of trade. It is probable that long-run elasticities are greater than short-run elasticities, but in the case in point the short-run is of special importance owing to the urgency of the re-armament programme.

The trouble was that devaluation should normally work with two engines, namely a restriction in the volume of imports, and an expansion in the volume of exports. But in the British case only one engine was working; by a prolonged process imports had already been pared down to bare essentials and were mainly governed by administrative fiat. It was therefore necessary that the elasticity of the demand for her exports should by itself be greater than one.

TABLE V

VOLUME OF UNITED KINGDOM IMPORTS

(1947 = 100)

1947	100
1948	105
1949	114
1950	114
1951, 1st quarter	120
2nd quarter	134
3rd quarter	140

Source: Monthly Digest of Statistics, Central Statistical Office, London.

The failure of imports to rise in 1950 was due to a stern import programme introduced in mid-1949 before devaluation was finally accepted as inevitable by the British authorities; its consequence was a running down of stocks in 1950 and the need for replenishment in 1951. If import requirements showed the same annual increase between 1949 and 1951 as between 1947 and 1949 and the shortfall of stocks in 1950 was made good in 1951, the average level of that year should stand at 135. It does not appear that devaluation has had any tendency to repress the volume of imports.

The following table relates to the export question.

TABLE VI

UNITED KINGDOM EXPORTS
(First half of 1949 = 100)

		Volume	*Import-Buying Value of Total***
1949	1st half	100	100
	3rd quarter	94*	101
	4th quarter	105	102
1950	1st quarter	112	107
	2nd quarter	110	100.5
	3rd quarter	115	104
	4th quarter	125	100.5
1951	1st quarter	114	90.5
	2nd quarter	126	90
	3rd quarter	117	90.4

* This figure was affected by unwillingness to buy British exports in anticipation of devaluation.

** These figures are the values of ${}_ip_oE_c/{}_ip_cE_o$ where ${}_ip_o$ is the price level of imports in the base period (first half of 1949), E_c the total value of exports in the current period, ${}_ip_c$ the price level of imports in the current period, and E_o the total value of exports in the base period.

Source: As for Table V.

These figures do not fully bring out the extent of the deterioration, since they make no allowance for the fact that marginal exports have a large import content. The favourable balance that Britain actually experienced in 1950 was bogus, since stocks at home were run down. It might serve as a very rough indication of the net gain (or loss) from the increase in the volume of exports, to subtract from the "import-buying value of the total" a figure equal to 25% of the increase in the volume of exports over that in the base period (first half of 1949). If that were done the year 1950 would show no increase in the import-buying capacity of British exports; an increase in the volume of exports of 15%—a mighty effort—yielded no net gain at all. At best the gain was microscopic.

It is a curious fact that in a year in which such a frightful economic calamity befell Britain—an expenditure of so large a fraction of her manufacturing capacity all to no purpose cannot otherwise be described—, the authorities allowed it to appear and the Americans to believe that the British external position had considerably improved, so that it would be reasonable to withdraw E.R.P. assistance, while continuing to supply it to other countries in Europe. In 1950 the true United Kingdom external balance (i.e., assuming no running down of stocks) was roughly the same as it had been in 1949 and 1948, viz. even. But in order to maintain that even position and no more in 1950, Britain had to sweat out of her industrial system and export extra goods worth (at 1949 prices) no less than £268 million.

I have no doubt that the British authorities understood the position in 1950 no better than they had understood it at the time of devaluation. Whether this failure to comprehend was due to a temporary lack of competence in the relevant quarters or to the system being indeed too complex for quick readings to be taken I cannot judge. It certainly appears that it should be laid down as a golden rule that, so long as the system remains as complex as it is, no major policy decision designed to correct a disequilibrium should be taken until a year after that disequilibrium has been notified. Nothing can go seriously wrong in a year if things are let be; reserves are sufficient to cushion anything save a major war for that period. But a wrong policy decision can do grievous harm.

The figures of Table VI *prove* nothing in regard to devaluation. This does not prevent their being suggestive. The consequences of the Korean war hardly began to be felt in the balance until the last quarter of 1950. The large step-up in the volume of exports which occurred during that year must surely be attributed to devaluation; it was an un-naturally rapid increase for a country which had previously been in a near-equilibrium position for two years; and it was fruitless. Now it may be argued that, had there been no devaluation, exports would have fallen rapidly in volume and value. This savours of special pleading. The case of United States exports has been cited; but there was a good reason for their decline: namely, the reduction in the amount of dollars provided gratis through E.R.P. and other channels and the exhaustion of world gold and dollar reserves. No similar forces were bearing upon British exports. Business reports did not suggest at the beginning of 1949 that orders were running out. There was indeed a notorious buyers' strike in the late spring and summer of 1949; but this was admittedly and explicitly due to the expectation of devaluation.

Delivery dates were still long in many lines and in those cases the volume of exports would have been maintained for many months even had the volume of orders begun to decline.

While the British position deteriorated afresh after and because of the Korean outbreak, it seems probable that the full adverse effects of devaluation had not been felt by the fourth quarter of 1950. The majority of British imports are food and raw materials. Eventually the sterling prices of these were bound to rise by some 40% above their dollar prices; but they had not yet risen by 40% while dollar prices had not fallen. Britain was protected during this period by her long-term contracts, but in the end an adjustment would have to come. On this ground it would seem that the net effect of devaluation was worse than that shown for the first year after it, and that the elasticity of the demand for her exports was even lower than that indicated by the figures of Table VI after adjusting them, as suggested, for the import content of exports.

VII. REARMAMENT AND BRITAIN'S TERMS OF TRADE

The Korean war no doubt brought into play new factors adverse to Britain. This is not a reason against, but rather for, seeking to regain the loss due to devaluation, or some of it. Furthermore there is an undue fatalism in regard to the worsening in the terms of trade resulting from the rise of raw material prices. The first impact of an arms programme is to make materials scarce; but equally in due course it should make manufactures scarce, owing to the diversion of skilled men and tools to arms output. Raw materials may remain scarcer, but their excess rise in prices is due in part to an institutional cause. Their prices swing upwards in free markets, while manufacturers meet the situation of scarcity by establishing waiting lists. Thus the terms of trade move against manufacturers more than in proportion to relative scarcities. In normal times manufacturers can endure this because they deem that what they lose in the boom they will gain in the slump. But the year 1951 is not on any reckoning a normal time for Britain.

To those who urge that Britain should now seek, whether by the upward valuation of sterling or otherwise, to get better prices for her exports, it is objected that she would lose her markets to Germany and Japan. I believe that fears of competition are usually exaggerated. If Britain, by raising her export prices, could re-establish prompt delivery, she might gain more in competitive advantage thereby than she would lose by the higher prices. Belgian post-war policy gives a fine example of this. But *some* loss of export markets is not a thing to be avoided. It is desirable—and indeed inevitable if the arms programme is to go forward—that there should be some decline in the volume of exports, and it is much better that this should come through the loss of markets owing to higher prices than through the failure to meet orders. A spotlight tends to be concentrated on the vulnerability of certain British exports to the dollar area; the extreme concern with this point is due to misconceptions about the nature and causes of the dollar gap; in 1950 British exports to the dollar area were only £316 million out of total British exports amounting to £2,223 million; it would be absurd to hold down the import buying capacity of the remaining £1,907 million for fear of losing some proportion of the £316 million.

In the foregoing paragraph I referred to the alternative methods of obtaining higher prices for exports as an "upward revaluation of sterling" or (vaguely) "other methods." There has been some tendency recently for libertarians to favour downward valuations of currencies and conversely. I am myself a libertarian. Consequently, in being opposed to devaluation in 1949 and in favour of upward revaluation now, I find myself somewhat in isolation. Libertarians tend to favour devaluation because this is represented as a method of avoiding an increase, or allowing a relaxation, of direct controls. I am sure that the Americans hoped that this effect would flow from the devaluations of 1949. If one looks at the matter in general terms, it is probably true that in most cases devaluation is an alternative to import restriction. But it is not in the least inconsistent to hold that in the majority of cases devaluation will, by improving the balance of trade, obviate the necessity for import restrictions and that, where it can so obviate that necessity, it is preferable to import restrictions—I hold both these positions in common with other libertarians—and also to hold that there are cases, owing to perverse elasticities, where devaluation will not improve the balance of trade, but rather worsen it, and that the British position to-day is such a case, anyhow in the short-period. I desire an upward valuation because I believe that it would improve the British balance of trade and by consequence make a relaxation of restrictions more feasible and probable. In fine I favour revaluation partly precisely because I am a libertarian.

At the present time (November 1951) it seems probable that an upward valuation will not be undertaken in the near future, but that efforts will be made to increase British export prices, at least in certain lines. This can be done, as a matter of governmental policy, by talking to the trades and using the method of persuasion. This cannot achieve success without some tendency to encourage concerted action or, in other words, monopolistic action. I regret this. I think it is the less good alternative. The better way is to set a difficult price (by revaluation) to exporters and let them cope individually and competitively with the resulting situation. I believe in the method of revaluation because I believe in free competition.

Another solution to the British problem that is much canvassed is international action to put ceilings to primary product prices. The coverage would have to be wide. This proposal implies that the worsening in the terms of exchange of manufactures for primary products is not ineluctable but can be altered by administration. Yet when it is proposed to make precisely this alteration by an upward revaluation of sterling, it is argued that the recent trend in the terms, because due to natural causes, has to be accepted as quite inevitable. International controls over commodities would mark a further step away from the free system towards one of world wide direction. It would have the advantage of turning the terms of trade not only in favour of Britain, but also in favour of the United States. In view of the superb generosity of the United States, the British would certainly not wish to stand in the way of measures advantageous and acceptable to her. It is really for the Americans to decide whether they wish this. The worsened terms of trade do not impose such a burden on the United States as on Britain, owing to the smaller importance of international trade in her economy. Would she prefer this increased *dirigisme*, in order to secure a certain advantage, to the more libertarian method of revaluation which would secure the advantage to the revaluing countries only? Meanwhile it is not quite clear whether this international system of price control will be practicable.

VIII. POLICIES FOR REHABILITATING STERLING

Since 1914 the position of sterling has been greatly weakened. But it is still an international currency of wide ambit, and the sterling area itself constitutes a large region of relative monetary stability. Other things being equal, it seems desirable that this sterling area should be kept in being, if possible. One does not want to encourage, but rather to restrain, fissiparous economic tendencies, which are all too rife in the world to-day. If we had hopes of proceeding rather quickly towards the ideal of stable world currency arrangements, it would still be helpful to have this large area which was looking after its own inter-regional monetary problems in its own traditional way. The larger and the more orderly are the constituent parts of a world monetary system, the easier it will be for the world monetary authority to achieve success in its wider task. Unhappily we cannot be sure that stable world money is within sight; that makes it all the more desirable not to allow a large area of stability that actually exists to crumble away. Of course it must be a presupposition that such an area does not endeavour to establish exclusive and discriminatory monetary arrangements. There is a nice balance of advantages here; a little discrimination may be allowed if it is really a pre-condition for keeping a large orderly area in being, but not too much! Actually, the amount of discrimination involved in the sterling area currency arrangements has been greatly exaggerated. For instance, not all Americans appreciate that during this last period of sterling inconvertibility, sterling balances held outside the United Kingdom, but within the sterling area, have been convertible into dollars. They are not convertible at the will of individuals, but dollars have not been convertible into gold at the will of individuals since 1935. Like dollars, this sterling area sterling has been freely convertible to meet deficits on international account.

It is fair to add that the maintenance of the sterling area is a British interest. It may be pleaded that this is also a world interest at a time when Britain is carrying the lion's share, outside North America, of the burdens entailed by the defence of the free world.

It is certainly to be emphasised that plans for maintaining and strengthening the sterling area should be worked out in the closest co-operation with the authorities responsible for the dollar. There need be no dis-harmony between the aims of the two authorities. Such co-operation has been woefully lacking, with disastrous results, since 1945. I do not know how to allocate the blame for this lack of co-operation.

I must draw to a conclusion. When it comes to the hard decision, unhappily one cannot rely on analysis and statistics alone, but must admittedly introduce an element of judgement about imponderables.

The first and foremost policy of action required of Britain is internal disinflation. This means reducing capital expenditure. While normally this should have an appreciable effect on the external balance, it will not have so large an effect as usual at this time, owing to the fact that some of the resources released from capital outlay would be expected to find their way into higher arms output.

That a sufficient internal disinflation can rectify an adverse balance I take to be axiomatic. Of importance is the question whether the reduction of capital outlay required for this purpose can be found simply by lopping off extravagancies and postponables or would have to extend to cuts which would seriously affect productivity. Would the reduction in question not need greatly to exceed the additional resources needed for the arms programme or would a substantially larger reduction be required? This depends on the answers to two questions, viz. (i) how severe is the present unfavourable overall balance of trade, and (ii) can some other means be used to rectify it?

In regard to (i) it is important to notice that the recent volume of imports contains a re-stocking element to make good the shortfall in 1950 and may also include some wise anticipatory buying during the price lull. If we could take the level of imports currently required to stand at 128 (cf. Table V; base 1947), this would mean that our present equilibrium of foreign payments would be about £200 million per annum more favourable than the actual balance in the second quarter of 1951 and about £400 million per annum more favourable than the actual balance in the third quarter. (ii) I shall deal with another method of rectifying the balance under my second remedy.

I have assumed in the foregoing paragraphs that internal disinflation would consist essentially in a reduction of capital outlay. There is also a new-~~fangled, and~~ in appropriate circumstances perfectly respectable, alternative mode of securing disinflation, viz. a budget surplus designed to reduce consumers' ~~expenditure.~~ I assume that this cannot be brought to play to a significant extent in existing circumstances for three reasons.

1. British consumers have had too much to bear already. Taxation has been maintained roughly at war time levels since 1945. In 1948/1949, 1949/1950 and 1950/1951 governmental budget surpluses stood by the orthodox method of accounting at £831 million, £549 million and £720 million. These are very large sums.* Consumers tightened their belts and provided these surpluses to enable the government to finance items of capital outlay out of income and to pay off debt in the interest of disinflation. The burden on taxpayers continues and has been intensified, but the surpluses will be wiped out by rearmament expenditure. Consumers cannot be expected in equity to find all the monies required for re-armament and on top of that large disinflationary surpluses as well.

2. Although the need to reduce the standard of living has become a cliché of journalism, I do not believe that there is at present a manful resolve sufficient to achieve this. Both political parties have recently eschewed the proposal for a substantial reduction of food subsidies—the easiest method of increasing the tax burden. I judge that they would not have done this, if they had really intended to press down the standard of living very drastically.

3. Most important, a harsh oppression of consumers would have little disinflationary effect. Within the wider economy the main pressure of inflation is centred upon manufacturing industry. It is on this that the requirements for a high level of capital outlay, a high level of exports and a high armament production all impinge. It is

* They might be taken to be roughly equivalent to budget surpluses of $18 billions, $12 billions and $15.6 billions in the United States economy.

here that we find the great shortages—in skilled manpower, steel and other materials, fuel, machine tools. Only a small part of consumers' outlay impinges on manufacturing capacity. We lack statistical information about what proportion of manufacturing capacity is used to provide consumer goods. It can hardly be more than 40% and may well be very much less. In this respect the British position is totally different from the American. Furthermore the expenditure that would be cut, if citizens had to reduce living standards by 10%, would probably contain less than the average manufacturing content. To get an overall reduction in consumption of 10%, save by full-fledged inflation, would require most heroic efforts in the British economy; it is the sort of thing that only happens in time of major war. And the result of this heroic belt-tightening would be a release of manufacturing capacity which in the general picture would be trifling.

Accordingly I hold that it should be taken as axiomatic that for Britain disinflation means, simply and solely, a reduction of capital outlay.

My second remedy is an upward revaluation of sterling. This would bring a number of sure benefits, namely (i) a reduction in the volume of exports and consequently of inflationary pressure on manufacturing capacity, (ii) a reduction in the prices of imports both from the sterling area and elsewhere and consequently of the tendency to an internal spiral of price-wage inflation, and (iii) an increase in the tempo of arms output. These would be great benefits. I should hope also for a fourth benefit, although bound to recognize that it is not sure, namely an improvement in the British external balance of payments.

As in war, some risk must be accepted if victory is to be achieved. British exporters are naturally anxious about their power to sell abroad, if sterling were raised. It is to be observed, however, that British wages had by mid-1951 risen less (9%) than American wages (14%) since before devaluation. To the extent that material costs have risen more in Britain than in the United States, this would be reversed in proportion to the amount of revaluation.

I submit that there are only two methods of getting more than a fleeting improvement in the external balance, namely (i) a reduction in domestic capital outlay and (ii) revaluation. The former is a sure method, the latter problematic; but the latter, even if unsuccessful in this regard, would have great incidental benefits. Revaluation, which might be undertaken in tentative stages, could at the worst do little harm to the external balance; it might do great good. The gain from revaluation might make just the difference between the need to have a fairly innocuous reduction of domestic capital outlay and to have one which did substantial injury to productivity prospects. It is quite certain that Britain cannot fulfil her obligations to N.A.T.O. and maintain or increase her volume of exports, without an injurious restriction of capital outlay. Let her try the alternative of a systematic reduction of the volume of exports.

There remains the question of the dollar gap. This cannot be directly affected to any sizeable amount by what Britain does in the way of disinflation, revaluation etc., save to the extent that her measures in this regard revive or undermine confidence. It is often urged that revaluation would provoke an adverse speculation in sterling. This all depends on whether or not it was seen to be part of a cool and resolute policy for solvency. Once it was perceived that the British authorities had ceased to flounder mentally and had acquired a real intellectual grasp—a few words in a speech would tell the world that—confidence would revive very quickly. It is to be remembered that M. Poincaré saved the French franc from destruction by revaluing it upwards from 200 to 124 per pound sterling.

The substantial problem of the dollar gap depends not on anything that Britain can do in regard to her own economy, but (a) on the dollar balances of the other countries holding sterling balances and (b) on British policy in regard to them. I am inclined to believe that—apart from adverse speculation—the dollar balance of the outer sterling area will become strongly positive when American arms output gets underway. If that happens, Britain may have a respite free from dollar worries.

But the position will remain precarious. Britain will remain liable to be strongly affected by the least wind of rumour and subject to crises and runs on the bank until she clears up the non-resident sterling balances position. Recently it became the fashion to be exceedingly bored by any reference to these balances; well-informed persons took the line that this matter had been pretty well settled, for good or ill, and that it was no longer a live issue. It is true that Britain's exposed position has been modified by the European Payments Union, while the Colombo Plan envisages an orderly liquidation of some of the balances. It is held that, what with one special arrangement and another, there is no longer any need for a drastic freeze. This may be so. It is impossible for anyone lacking inside information about the details of all the various balances to pronounce judgement.

None-the-less the matter may be brought to a crucial test. On this external side the primary need now is for sterling to be convertible. Convertibility is too often regarded as a Utopian aim, something that it would be very nice to have if one could afford it, and, if only it could be achieved, a gracious concession to the ideology of the Americans, who have done so much to help Britain. I regard the matter entirely differently. In my judgement, the restoration of convertibility is the only sound and sure method of closing the dollar gap in the long run. Convertibility is by no means a luxury for Britain, but a prime necessity, if she is not to continue to be harassed by recurrent external crises which do so much to upset her internal economy. Just as the inability of individuals to convert currency into gold (cf. page 2 above) sets up a tendency to gold hoarding, so the inconvertibility of sterling balances into dollars inflames the desires of holders from time to time to find some method of turning them into dollars.

Britain should seek to reform her position on the basis of certain straightforward principles. Her first principle must be so to regulate internal capital outlay as to keep her overall external balance roughly in equilibrium. Some fluctuations are inevitable, and a gold reserve of moderate size, but of moderate size only,—say one third of her present gold reserve—is required to meet these. The main part of the gold reserve should be ear-marked to cover short-term capital movements, i.e., in the present instance, the conversion of non-resident sterling balances into gold or dollars. The crucial question then becomes—are her existing external sight liabilities too great to be met out of her gold reserve?

So long as the sterling area holds together, sterling area sterling balances may be dealt with somewhat differently, namely more or less on present lines. Britain must insist on good discipline. She should by no means exert any pressure to persuade members to retain membership of the sterling area, but rather take the line that membership is a privilege obtainable on certain terms. She must retain a sufficient active balance of trade with this area to buy the gold required to meet her direct dollar area deficit. Some further surplus in her trade account with the area is required to enable the outstanding sterling balances in the area to be slowly liquidated at an agreed upon rate. For this purpose, balances arising in consequence of the flight of "hot money" from the United Kingdom into the outer sterling area must not be reckoned in, but should be accounted for separately. The free movement of money within the large area is beneficial to all parties, but abnormally large movements should not be held to require that physical trade should conform itself to each new temporary pattern. The area cannot expect to receive dollars from the United Kingdom, with which it has a strong adverse balance, save on exceptional occasions. (No doubt the problem is not quite so simple as this, as each region must be considered separately.) Such a general ordering of events should be achievable by a friendly understanding within the area.

Sterling balances held outside the sterling area should be freely convertible into gold. Thus the crucial question is—has Britain a large enough gold reserve to make them so? In other times one might hold that the banker needed to have only a proportion of his sight liabilities covered by gold; but owing to the long undermining of confidence, it is probable that in existing circumstances the British gold reserve cannot be considered adequate unless it provides 100% cover. Thus at last we bring into focus the question—is any surgical operation on the balances needed? If it is the opinion of the authorities that a sufficient number of the balances are in fact frozen by special arrangements and that the remainder is not greater than the available gold reserve, say two thirds of the total existing British gold reserves, then convertibility can be undertaken at once, or as soon as it becomes clear that internal disinflationary measures are getting Britain's overall balance straight.

Thus the convertibility question and the question of the external sterling balances are one. If convertibility cannot be restored in the near future with the balances at their existing level, then a surgical operation upon the balances should be undertaken without further delay. I have no doubt that this is the foremost problem of all for Britain, and that, once it were properly tackled, she would quickly move forward to a position of great strength and be relieved of periodic crises.

One final word must be said about what may happen, if these salutary measures are not adopted. The economist ought probably to assume normally that what will in fact happen is a movement, roughly along the line of least resistance according to current ideology, but is somewhat deflected in the direction of what really ought to be done. It is a mistake to suppose that in general governments are capable of assessing the situation and taking the correct measures. Yet somehow, owing to a multiplicity of pressures, things are managed somewhat better than they would be, if we were at the mercy of the raw conceptions of the authorities. Britain has shown prodigious strength since the war in her capacity for production and exportation. This fact is likely to see her through, although with much unnecessary muddle and disturbance.

Current ideology is not likely to allow a sufficiently drastic curtailment of capital outlay. The consequence will be continued internal inflationary pressure and dislocation in the flow of production. Import restrictions, the most popular remedy, may appear futile. If they are made, as in 1950, at the expense of stocks, they merely store up balance of payments troubles for the future. But if they actually produce shortages of required materials, production cannot go forward. The analogy of a business may be offered. The head of it might find that, although working to capacity, he was running at a loss, and seek about for ways to restore his position. Suppose he then decided to reduce his orders for the materials needed for his production. To his great satisfaction he would then find his cash account at the bank showing a marked improvement in the next few weeks or months. I forebear to trace out the further consequences of this wise expedient!

What is required, of course, is not to make cuts in imports, but in the requirements for imports. To cut imports while leaving requirements as they are can only lead to confusion. To all intents and purposes, cutting the requirements for imports means cutting capital outlay. None-the-less, cutting imports may lead in the end, via a circuitous route of muddle and dislocation, to the same result. Through the lack of ready availability of materials, projected capital programmes will fail of execution, and so after all capital outlay will be cut down.

General opinion seems hostile to the revaluation of sterling. Yet, again in a roundabout way, similar results may be achieved. Failing revaluation, prices, wages and other costs in Britain are likely to pursue a steady upward course for some time. Thus in the end exporters will have to charge higher prices for British goods, owing to the rise in their sterling costs, and the terms of trade will move in favour of Britain. The volume of exports will be cut down through the prolongation of delivery dates, and the consequent loss of orders. If the British authorities fail to raise the external value of sterling into line with its internal value, then in due course its internal value will move downwards into line with its external value. I should judge that the internal level of wages, etc., has scarcely begun to adjust itself to the new external value of sterling as established in September 1949. This long painful process lies ahead of Britain, if no upward valuation of sterling is undertaken, with all the debilitating effects of a decline in the internal value of a currency. Thus events will in a slow and painful way produce a result that could be achieved by right policy more quickly. But, all's well that ends well.

It is not clear that so satisfactory a consummation can eventually be reached in regard to the sterling balances and the dollar gap, if policy fails. A world-wide banking position is not something which any particular country can expect in the course of nature, but is rather the reward of statesmanship and of the idea apt to the situation. However, there may be a revival of British statesmanship in this matter in the next few years.

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