

ESSAYS IN INTERNATIONAL FINANCE

No. 30, August 1958

THE POUND STERLING, 1951-1958

ROY F. HARROD



INTERNATIONAL FINANCE SECTION

DEPARTMENT OF ECONOMICS AND SOCIOLOGY

PRINCETON UNIVERSITY

Princeton, New Jersey

This is the thirtieth in the series **ESSAYS IN INTERNATIONAL FINANCE** *published by the International Finance Section of the Department of Economics and Sociology in Princeton University. Seven years ago, the author, Roy F. Harrod, wrote an essay entitled "The Pound Sterling" which was published as Number 13 in this series. The present paper, while written to stand alone, is a continuation of the account he gave earlier.*

Mr. Harrod is Joint Editor of the **ECONOMIC JOURNAL**, *Lecturer in Economics at Christ Church, Oxford, and a member of the Council of the Royal Economic Society. In addition to his duties in the Prime Minister's Office during World War II, he has served with the United Nations and with the International Monetary Fund.*

The Section sponsors the essays in this series but takes no further responsibility for the opinions expressed in them. The writers are free to develop their topics as they will. Their ideas may or may not be shared by the editorial committee of the Section or the members of the Department.

The submission of manuscripts for this series is welcomed.

GARDNER PATTERSON, *Director*
International Finance Section

ESSAYS IN INTERNATIONAL FINANCE

No. 30, August 1958

THE POUND STERLING, 1951-1958

ROY F. HARROD

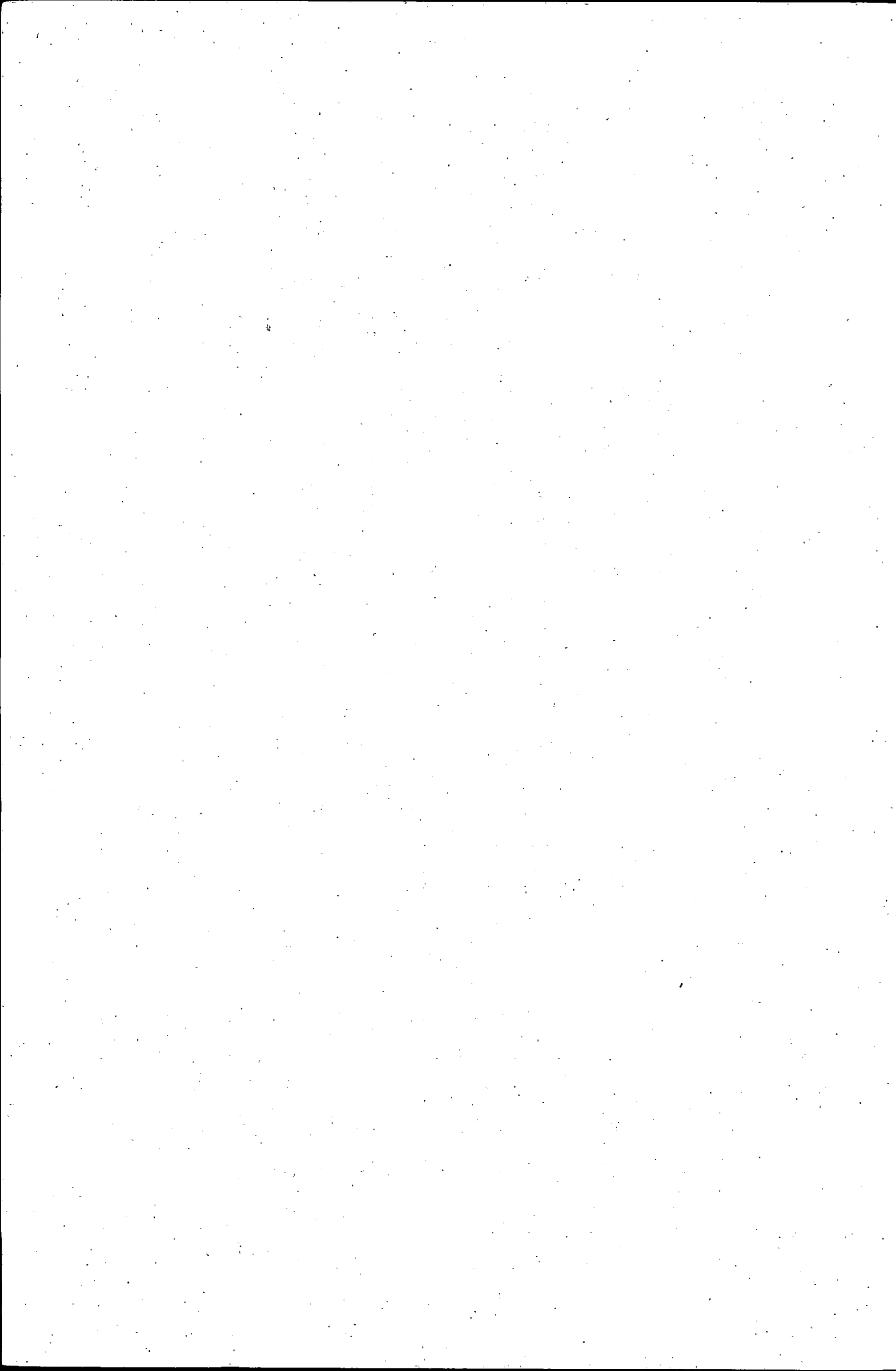


INTERNATIONAL FINANCE SECTION

DEPARTMENT OF ECONOMICS AND SOCIOLOGY

PRINCETON UNIVERSITY

Princeton, New Jersey



THE POUND STERLING, 1951-1958

I. ECONOMIC BACKGROUND

IT SEEMS expedient, before proceeding to a monetary analysis, to set out some basic economic facts for the period under review. During this time the population of working age in Britain was almost constant; but the working population increased by 3.4 percent owing to an increasing employment of women, and of men also, the latter presumably owing to late retirement. This may have been a natural trend; but it may have been due, in whole or in part, to the prevalence of an excess of aggregate demand over the supply potential of the economy during some of the years in question. In the following table the growth of various economic magnitudes is expressed both in absolute terms and *per person in civil employment*. It would be difficult to estimate the numbers employed under some of these heads separately; there are some advantages in using a single divisor for all the magnitudes; but the consequence is that they must not be taken to show productivity per person under each of the heads separately.

TABLE I
INCREASE IN UNITED KINGDOM ACTIVITY
1948-1956
(*In volume or at constant prices*)

	Level in 1956 (1948 = 100)	Average annual rate of increase per person in civil employment
Gross domestic product	125.7	2.0
Industrial production	136.0	3.0
Manufacturing production	140.0	3.4
Consumption	116.2	1.0
Government expenditure on goods and services	129.7	2.4
Fixed capital formation	156.2	4.8
Exports	149.0	4.2
Imports	137.0	3.1

The high rates of increase in fixed capital formation and exports may be observed. The rate of increase in consumption was notably low; thus in this post-war period the British people maintained the "austerity"

for which they had previously gained a reputation; this fact was not fully appreciated during some periods when sterling was under suspicion.

Magnitudes such as these are not fully informative without a yardstick for comparison. It seems suitable to refer to the United States as a country of vigorous progress. Higher rates of increase may be expected in countries working their way up from an initial low level of income or capital endowment, or regaining ground lost by war-time devastation or dislocation. I have taken 1955 as a more suitable terminal date than 1956, since the latter year was one of boom in the United States while the United Kingdom had already entered a phase of pause or recession.

TABLE II
AVERAGE ANNUAL RATE OF INCREASE PER PERSON
IN CIVIL EMPLOYMENT
1948-1955

	<i>United Kingdom</i>	<i>United States</i>
Gross national product	2.2*	3.1
Industrial production	3.7	3.2
Manufacturing production	4.2	3.5
Consumption	1.2	2.5
Government expenditure on goods and services	2.9	6.4
Fixed capital formation	4.9	2.4
Exports	4.2	0.6
Imports	3.8	3.0

* Gross domestic product.

It is to be observed that the first three items resemble each other more closely in the United States than in the United Kingdom. This was due to the fact that the American economy was better balanced in 1948. Britain had more leeway to make from the war, and this called for concentration of attention upon an increase in manufacturing output. What is called "tertiary" production—the provision of services—is a large component of gross domestic product. Parts of this rise automatically with increased output, e.g. those required for its distribution to consumers. The goods representing the increase in British physical production were largely destined for export or gross capital formation, and, as such, would not be likely to give rise to so much "tertiary" production as consumer goods. The lower increase in services may also have been

connected directly with "austerity." This British lack of balance is reflected in the fact that 78.4 percent of the number added to her labor force in this period went into manufacturing industry, while only 28.2 percent so went in the United States.

The government expenditure figures indicate the more massive provision by the United States of weapons for the defence of the free world.

The exceptionally low level of the increase of United States exports was due to the greater dependence of the rest of the world on imports from the United States in the opening year, which led to the well known "dollar shortage" of extreme severity. It was incumbent on Britain, by contrast, to increase her rate of exportation.

It seems desirable also at the outset to group together certain key figures on a yearly basis for the whole period. The strands in the following discussion will necessarily be interwoven and a general conspectus may prove useful in more than one of the following sections. In order to obtain a clear view of the course of the trade cycle, I have put down for each year its increase over the preceding year.

The well known general recession in 1952 comes out clearly. The increase in government expenditure, which goes against the trend in that year, was due to defense items. These, however, although substantial in relation to British resources, were not so large as those in the United States, where they made 1952 a year of continuing expansion. The American recession, which was the counterpart of the British 1952 recession, came in 1953-1954. The subsequent industrial investment boom in the United States also lagged behind the British by about a year. It is vital to bear this in mind in the interpretation of more recent events, not least of those of the present (1958) recession.

The course of the British investment boom of 1954-1956 can also be traced. The steep increase in fixed capital formation in 1953 was solely due to the special efforts made by the Conservative Government (elected in the second half of 1951) to increase residential house building. The rather low figure for the increase in fixed capital formation by manufacturing industry (column 7) in 1954, was due to the fact that the orders which gathered strong momentum during that year had not had time to cause a corresponding increase in output. Deliveries of plant and machinery did, however, increase strongly in 1954; it was natural that they should respond to higher orders more rapidly than fixed capital formation, because the latter includes construction. The last two columns (9 and 10) provide the most cycle-sensitive figures. The increase in factory building starts in 1953 shows revival from the previous recession. The further increases in 1954 and 1955 engendered strong inflationary pressure.

TABLE III
PERCENTAGE INCREASE OVER PRECEDING YEAR
1949-1957
(In volume or at constant prices)

	Gross Domestic Product (1)	Consump- tion (2)	Govt. Expend- iture on Goods and Services (3)	Exports (4)	Manufac- turing Produc- tion (5)	Fixed Capital Forma- tion (6)	Fixed Capital Forma- tion by Manufac- turing Industry (7)	Deliveries of Plant and Machinery (8)	Factory Build- ing Starts by Manufac- turing Industry (9)	Domestic Machine Tool Orders (10)
1949	3.6	1.7	8.7	10.0	7.0	9.3	12.0	9.6	—	—
1950	2.7	2.4	-0.8	15.0	8.4	5.0	15.1	12.1	14.5	—
1951	3.9	-0.5	7.8	-1.5	4.3	0.4	7.1	9.5	-8.3	—
1952	0.3	-0.6	10.7	-6.4	-4.1	1.5	-3.1	-5.3	-39.8	—
1953	3.9	4.2	1.6	2.2	6.0	10.7	-2.8	1.3	45.6	—
1954	4.1	4.4	-0.8	4.5	8.1	7.9	2.2	10.0	57.7	49.5**
1955	3.5	3.1	-1.4	7.4	6.8	6.4	18.1	10.3	42.9	27.4**
1956	1.4	0.5	1.3	5.7	-1.4	5.2	13.7	2.2	-13.5	-15.2
1957	—	2.0	—	1.9	1.9	5.2	—	—	-28.2*	-11.1

* First three quarters of 1957.

** All orders; separate figures for domestic orders not available.

These last two columns comprise the best figures we have—and they certainly need supplementing—to indicate the course of “*ex ante* investment.” They confirm the view that variations in *ex ante* investment play a key part in the trade cycle. The figures showing *ex post* investment (6 and 8) are naturally more damped.

The year 1956 shows a flattening out, and even symptoms of recession. The only items showing normal rates of increase in that year are exports, which do not depend mainly on British internal conditions, and the two capital formation items (6 and 7), which contain a big element of construction and were therefore sustained by orders placed in earlier years. The substantial decline in the sensitive items (9 and 10) is to be observed.

II. LEGACY OF PREVIOUS PERIOD

In *The Pound Sterling*,* I focussed attention upon the two large mistakes made in the post-war quinquennium, the failure to fund externally held sterling balances and the devaluation of sterling in 1949.

Britain has continued to be harassed by sterling balances held outside the sterling area. She has had to pay out far more gold on these than could possibly have been required by any reasonable terms of funding, containing an obligation for annual gold payments. They have continued until 1958 to be a cause of acute embarrassment, and domestic monetary policy has from time to time been deflected from its best course with a view to courting the opinion of the holders of balances and preventing their making further withdrawals.

Opinions may differ about whether there need ever have been any post-war devaluation of sterling (i.e. below the level of \$4.03); it seems incontestable that the devaluation to \$2.8 in 1949 was premature and excessive. The year in which to have allowed a much more moderate devaluation, if one was required at all, would seem to have been 1952, when the British economy was somewhat slack, and would therefore have benefited from an abnormally large increase in the volume of exports, when the American economy was booming, and when world dollar prices were falling, so that a moderate increase in the sterling price of the dollar would not have set up any substantial price spiral inside Britain. Furthermore, had it been possible to prolong the restraint in wage demands, which was successfully achieved in the period 1948-1950, for another three years, the habit of expecting a substantial annual increase in money wages might never have been re-formed.

* *Essays in International Finance*, No. 13, written in 1951 and published February 1952.

It may be permitted to quote from the concluding page of *The Pound Sterling*. The following words were written during 1951 :

"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 here predicted that "exporters will have to charge higher prices." Export prices rose by 5 percent in the following year. It is predicted that "the terms of trade will move in favour of Britain." They moved by 18 percent in favour of Britain in the two following years. It is predicted that "the volume of exports will be cut down." They fell by 7 percent in the following two years. It is predicted that "prices, wages and other costs in Britain are likely to pursue a steady upward course for some time." This last prediction has very evidently been fulfilled.

In 1951 the prices that Britain had to pay for imports had risen by 53 percent over 1948. Part of this increase was due to the Korean war. In 1953 and 1954 the import price index ran roughly level at 131 (1948 = 100), after which it began to move up again. While a rise of 31 percent is decidedly less than we would expect as the long-run effect of a devaluation of 44 percent, in the absence of any fall of dollar prices, we may provisionally accept it as the effect of devaluation for comparison with the internal price level. In 1951 consumer prices had risen 15 percent on 1948, the prices of fixed assets by 15 percent, the index of official wage rates by 13 percent and average weekly wage earnings ("weekly pay packet") by 20 percent. These internal prices had not been adjusted to a rise in import prices of 53 percent, or even 31 percent.

In 1948 wages had not yet risen as much as the cost of living by

comparison with 1938. British workers had had ten hard years of austerity, and it was idle to expect that they would accept another 2 percent reduction in their standard of living below the 1948 level, at a time when output per head was notoriously rising. Even the increase of weekly wage earnings by 1951 was inadequate from the workers' point of view, giving a lift of only 4.4 percent over the cost of living in three years (1948-1951) during which the gross domestic produce per person in civil employment had risen 10.5 percent and the index of manufacturing production per person in manufacturing employment had risen 13 percent. A Draconian policy of compressing the real standard of living of wage earners, after so long a period of real austerity, was not in question at that time. Nor is it by any means clear that it would have been desirable, quite apart from the human aspect. It might have prevented the improvement in the terms of trade which subsequently occurred, and thus have worsened Britain's external balance. By holding down consumption so severely, it might have reduced the motive for investment—for consumption and investment must grow in a balanced relation to one another. Table I does not suggest that the increase in consumption has been excessive.

It is also to be noted that export prices in 1951 (at + 27 percent) had risen more than wage rates or wage earnings.

Thus it was inevitable that after 1951 there would be a spiralling process, most deleterious to the sound working of the economy. Wage earners were bound to insist on higher pay. This would necessitate an increase in end-product prices, which would cause and justify still further wage demands. It is a familiar story. The point is that, given the price structure as it existed in 1951, this development was quite inevitable.

There was at the time, and has since been, some confusion about the Korean war, which has caused commentators to under-estimate the debilitating effect of the devaluation. The Korean war caused a sharp worsening in Britain's terms of trade; this proved to be temporary and the terms were subsequently restored to the pre-devaluation level, although—until very recently—remaining much less favourable to Britain than before the second world war. The Korean war also caused a rise in import prices additional to that due to devaluation, and these subsequently fell. All this caused embarrassment. The fact that these effects of the Korean war were temporary has distracted attention from the fact that the rise in import prices due to devaluation was a lasting one and was the prime mover in the upward spiral of wages and prices that Britain has subsequently experienced.

The largest effect of the devaluation on the wage/price structure may have been achieved by 1954. The whole effect had not been achieved by

then; for instance, the price of a postage stamp was put up for the first time in 1957, a clear effect of the devaluation; it is impossible to judge whether even in 1958 there may not still be some maladjustment between the internal and external price structure. In 1954, which we take as the year in which the main effect had worn through, import prices stood at 131, consumer prices at 126, fixed assets prices at 128, wage rates at 132 and wage earnings at 150. This was clearly a more tenable relation than that obtaining in 1951. It is to be noted that "real" wage earnings had risen 19 percent in this six-year period (1948-1954) during which manufacturing output per person in manufacturing employment had risen 20 percent and the gross domestic product per person in civil employment 15 percent. Thus in this period wage earners managed to secure entitlement only to a very small increase in their share of the gross domestic product.

It appears that the rise in prices until 1954 may be attributed to the rise in costs, stemming ultimately from the devaluation. In this three year period, from 1951 to 1954, the price increase cannot be attributed to a demand-inflation. 1952 was notoriously a year of recession (as indicated in Table III). Throughout this period (1951-1954), the number of unemployed was considerably greater than the number of unfilled vacancies; this was the only post-war period in which this has been so, except for 1957-1958. From 1951 until mid-1954 the machine tool industry was working off its backlog of orders.

In 1954 the economy reentered a period of demand inflation, and a new force was introduced tending to raise wages and prices. But even in this period (1954-1956) the previous formation of a habit of expecting money wage increases every year since the war, except in the two years of restraint 1948-1950, may well have caused the upward movement of wages to have been greater than it would otherwise have been. It is to be stressed that these annual increases had been justified by the upsurge of world prices, which impinged on British import prices, in the three years after the war, and then by devaluation. It is difficult to persuade those, for whom a habit has in fact been well justified for so long a period, that it has ceased to be so. This habit has persisted after 1956, when demand-inflation was no longer present; but a change now appears to be occurring.

III. EXTERNAL ACCOUNTS OF THE UNITED KINGDOM

In *The Pound Sterling* certain tables were presented which, taken together, gave a conspectus of the external balance of the United Kingdom in the preceding years. The twice yearly White Papers on the United

Kingdom balance of payments provide a great wealth of information, meticulously marshalled and sorted. Yet from these it is not always easy to get a bird's eye view of the realities of the situation. Accordingly I have provided tables, in continuation, grouping items under very broad categories.

TABLE IV

UNITED KINGDOM BALANCE OF PAYMENTS ON CURRENT ACCOUNT
1952-1957 (INCLUSIVE)
(£ million)

			With Non- Dollar, Non- Sterling Area	With Sterling Area	With Dollar Area	With Non- Territorial Organi- sations
Overall						
Exports		18,317				
"Invisible" exports*		7,332				
		<hr/>				
		25,649				
Imports,						
f.o.b.	19,360					
"Invisible"						
imports	5,556	24,916				
	<hr/>	<hr/>				
Balance		+ 733	-1	+1,670	-892	-44

* Defense aid is *not* included.

Source: The *United Kingdom Balance of Payments* White Papers are subject to revisions in successive issues. But the latest issues do not give all the figures required for the following tables. In these tables each year has been taken as a self-consistent whole from the latest issue that gives all the relevant figures, and the figures for each year have been added together. Cmd. 399 (1958) has been used for the years 1955-57, Cmd. 273 (1957) for 1954, Cmd. 122 (1957) for 1953 and Cmd. 9731 (1956) for 1952.

It should be noted that the gain of gold to Britain from the external trade of the Rest of the Sterling Area shown as £244 million, was not a net gain in gold, since the deficit of £156 million shown in the opposite column had to be paid for entirely in gold (see Table VI).

This table reveals a pattern that is profoundly unsatisfactory. This large sum of gold paid out to the non-dollar non-sterling world, with which the United Kingdom was not in deficit, may be contrasted with the comparatively small sum paid to the dollar area with which the United Kingdom has, and ought to continue to have, if multilateral trade is to flow in its natural channels, a substantial deficit. The figure for investment appears to be on the high side. It includes unidentified

TABLE V

UNITED KINGDOM BALANCE WITH THE REST OF THE STERLING AREA
1952-1957 (INCLUSIVE)
(£ million)

<i>Credit to United Kingdom</i>		<i>Debit to United Kingdom</i>	
1. Favourable balance on current account (see Table IV)	1,670	4. Purchase of newly mined gold from Rest of Sterling Area	906
2. Deficit of Rest of Sterling Area with non-dollar non-sterling world, as financed by transfer by Rest of Sterling Area of sterling to that world (see Table VI)	156	5. Purchase of gold or dollars arising from Rest of Sterling Area surplus with dollar area	244
	1,826	6. Investment by United Kingdom in Rest of Sterling Area	1,021
3. Excess of debits as shown led to increase of sterling area sterling balances	45	7. Transfer of sterling by Non-Territorial organisations to Rest of Sterling Area	22
	<u>1,871*</u>		<u>2,193*</u>

* The apparent excess of debits (£322 million) is equal to the sum of the "balancing items" recorded for 1954-1957. This may mean that investment by the United Kingdom in the Rest of the Sterling Area is over-stated in the above table, or that the "leads and lags" of trade have moved in favor of the United Kingdom, or that there are other items unaccounted for.

items and may therefore contain an element arising out of a change in the leads and lags of trade unfavorable to Britain. There is some continuing anxiety in Britain about whether movements of portfolio capital are completely blocked by the Exchange Control. The tables suggest that this ought to continue to be administered tightly. The most objectionable feature in this table is the use of £370 million for the paying off of sterling balances held in this area by which a total of £980 million outstanding at the end of 1951 was reduced to £533 million. To this must be added the repayment of E.P.U. obligations amounting to £30 million. This rate of paying off the sterling balances in gold far exceeds anything that would have been reached in a generous funding arrangement. It is to be remembered that substantial payments of interest on the

TABLE VI

UNITED KINGDOM BALANCE WITH NON-STERLING NON-DOLLAR AREA
1952-1957 (INCLUSIVE)
(£ million)

<i>Credit</i>		<i>Debit</i>	
Paid in gold or dollars	5 947	1. Unfavourable balance on current account (Table IV)	I
		2. Investment by United King- dom in this area. (Includes balancing items*)	297
		3. To pay for surplus of this area with Rest of Sterling Area as financed by transfer by Rest of Sterling Area of sterling to it. (Table V)	156
		4. To redeem sterling trans- ferred to this area by Non- Territorial organisations	25
		5. To redeem sterling drawn by this area from the Inter- national Monetary Fund	56
		6. Reduction of debit in E.P.U.	30
		7. Accumulation of holding of non-dollar currencies	22
		8. Reduction of sterling bal- ances held by this area	370
			<u>6</u> 947

* These are not shown separately in the White Papers.

sterling balances were made to this area *in addition to* the capital repayment of £370 million. (They are included in the balance on current account.)

Funding is now out of the question. If, owing to lack of confidence in Britain, or for any other reason, creditors insist on a further large-scale drawing down of the sterling balances, it should be a matter of firm principle by the British authorities that this should be paid out of the reserve and not out of the annual trade balance. Indeed, the authorities would do well to plan policy on the basis of Britain's *net* reserve,

viz. the gold and dollar holdings minus the sterling balances outstanding in the non-sterling area.

It is not suggested that it is undesirable for Britain to pay out a substantial sum of gold each year to the non-dollar non-sterling area. By this means that area receives its fair share of newly-mined gold, many sources of which are inside the sterling area; it may need this gold to replenish its own reserves and to balance its deficit with the dollar area; but this outflow of gold should not mainly serve to pay off old debts, but, after provision for a moderate sum for investment, should pay for a net import of goods from this area into Britain. It is desirable that Britain should see something tangible in return for this great outpouring of gold. For instance, some of the gold might well be used to finance an excess of imports from O.E.E.C. countries, such as might be consequent upon the opening of a Free Trade Area—it might well happen that the resulting increase of imports by Britain would exceed her increase of exports to continental Europe. Such an excess of imports ought to be regarded as welcome, since it would enable her to devote more of her own productive resources both to internal investment and to higher investment in the Commonwealth and outside it without involving herself in renewed inflationary pressures.

TABLE VII
UNITED KINGDOM BALANCE WITH DOLLAR AREA
1952-1957 (INCLUSIVE)
(£ million)

<i>Credit</i>		<i>Debit</i>	
1. Capital investment by dollar area in United Kingdom (including balancing item)	288	4. Unfavourable balance on current account (Table IV)	892
2. Defence Aid	366	5. Repayment by United Kingdom of loans	123
3. Paid by United Kingdom to dollar area in gold (Table VIII)	364	6. Reduction of sterling balances held by dollar area	3
	<hr/> 1,018 <hr/>		<hr/> 1,018 <hr/>

It is to be noted that defence aid was running at a lower rate in the later part of the period and amounted only to £96 million in the second half of it.

TABLE VIII

GOLD AND DOLLAR POSITION OF UNITED KINGDOM
1952-1957 (INCLUSIVE)
(£ million)

<i>Credit</i>		<i>Debit</i>	
1. Purchase of newly-mined gold from Rest of Sterling Area (Table V)	906	5. Payment of gold to non-sterling non-dollar world (Table VI)	957
2. Purchase from Rest of Sterling Area of gold and dollars arising from its surplus with the dollar area. (Table V)	244	6. To meet deficit with dollar area (Table VII)	364
3. Net drawing on International Monetary Fund	161	7. Paid to Non-Territorial organisations (Table IX)	12
4. Reduction in gold and dollar reserve of United Kingdom	22		
	<hr/> 1,333 <hr/>		<hr/> 1,333 <hr/>

It has been widely stated that the surplus on the current balance of payments, which has run at an average of about £125 million a year, is quite inadequate. It has even been suggested that this should be raised to the figure of £300 million a year. It may be that the current surplus should be raised moderately. For instance, the British system ought to be independent of defence aid. But proposals for a target figure of £300 million per annum are often based on confused thinking and involve fallacies which are dangerous and even pernicious.

It seems likely that Britain ought to invest more overseas in the coming years than in these last six. Whether it is desirable for her to do so or not depends solely on whether the total effective demand impinging on her economy does or does not lead to the full use of her resources, including a growth in line with her potential capacity. In other words, whether she can undertake such an increase in investment depends on whether she does or does not have spare productive capacity. For Britain to have undertaken additional overseas investment during the investment boom of 1954-1956, when her factories were already overloaded, would have merely led to increased inflationary pressure, foreign

TABLE IX

BALANCE OF UNITED KINGDOM WITH NON-TERRITORIAL ORGANIZATIONS 1952-1957 (INCLUSIVE) (£ million)

<i>Credit</i>		<i>Debit</i>	
1. Net accommodation provided by Non-Territorial organisations to United Kingdom. (Increase of sterling balances held by them)	79	7. Unfavourable balance on current account. (Table IV)	44
2. Transfer of sterling by Non-Territorial organisations to Rest of Sterling Area. (Table V)	22	8. Net drawing on I.M.F. (Table VIII)	161
3. Transfer of sterling by Non-Territorial organisations to non-sterling non-dollar area. (Table VI)	25		205
4. Sterling drawings on I.M.F. by non-sterling non-dollar area. (Table VI)	56		
5. Gold or dollars paid by United Kingdom to Non-Territorial organisations. (Table VIII)	12		
6. Capital provided to United Kingdom by Non-Territorial organisations	11		
	<hr/> 205		

exchange difficulties and frustration. But now that spare capacity is coming into existence, and likely to remain, the prospect is entirely altered. If additional investment projects are put in hand, and capital goods are exported in accordance with them, that would automatically raise the value of her exports and one might even see the target surplus of £300 million reached quite easily in that way. It is to be noted that ac-

According to modern theory and modern ideology, the countries, in which foreign investments are made, usually prefer to tailor the external finance for such projects to their need to import the capital goods for them from abroad, and to raise the capital required for local expenses locally. Accordingly, so far as the British balance of payments is concerned, such investment projects would be self-balancing. Exports would rise by £X, and the countervailing item of overseas investment would rise by £X also. The question of Britain's ability to carry out such projects is not a foreign exchange problem at all, but a problem of her own internal industrial capacity. Thus it would be totally wrong to suppose that, with a view to undertaking such overseas investments, it would be desirable for Britain to strive to improve her external balance of payments by curbing imports. Still more fallacious is the idea that Britain ought to achieve a strong balance on current account *before* contemplating such investment projects. This idea is quite topsy-turvy; it is furthermore quite safe to say that there is not the remotest chance of her achieving such a balance for any reasonable length of time, unless and until such investment projects have *already* been put into operation.

It is further contended that Britain should increase her favourable balance on current account in order to add to her reserve. It is to be noted that in this six-year period, so far from having increased her gold reserve, she has allowed it to be drawn down by £22 million. On the other hand, there has been a sizable increase in her true net reserve, owing mainly to the reduction in her sterling liabilities to the non-sterling world, viz. an increase of £314 million.* This increase is on the low side, but it is by no means obvious that it is grossly inadequate. The absolute rise of Britain's true net reserve is undoubtedly inadequate in relation to her external turnover; that is the unfortunate consequence of the second world war. It by no means follows that it is wise or right to endeavour to increase the net reserve by substantial amounts within a short period. It must be remembered that the whole world is short of reserves. There is no single action by the United States that could benefit the world a quarter as much as an increase in the dollar price of gold. Failing that, the various countries will have to continue to struggle on with inadequate reserves. For one country, out of a sense of self-importance, to endeavour to raise its reserve at an abnormal rate is un-neighbourly and bound to bring retribution. It reduces the reserves of other countries, which are likely to react by imposing restrictions on the exports of the country that is seeking to build its own position up.

It would be particularly deleterious for a country to seek to increase

* Items 6, 7, and 8 of Table VI, plus item 6 of Table VII, minus item 4 of Table VIII, minus item 1 of Table IX.

its own reserve substantially by holding down its imports below their normal rate of increase. The various parts of the world are now thoroughly inter-connected. If a balanced growth in the whole complex is desired, it is important that each part should grow in balanced relation. If one country impedes the normal growth of its imports for several years, that is likely to have a serious effect on the balanced growth of the remainder. It may even contribute to a world recession. This matter is further discussed in the concluding section.

IV. RESTORATION OF CONVERTIBILITY

Much stress was laid in *The Pound Sterling* on the importance of restoring sterling convertibility. The major part of this task has been achieved since then.

The project suffered a great set-back owing to the premature attempt to restore convertibility in 1947.* Not only had the sterling balances, then at their maximum level, not been funded, but also Britain had a large external deficit on current account (£443 million) in that year. In 1949 there was a fresh crisis involving devaluation.

The year 1951 was also one of crisis. This was the consequence of the Korean war. Nonetheless, it is doubtful if this adverse turn of events would have produced so severe a crisis atmosphere, had it not been for the vulnerability of sterling due to the large sterling balances that remained outstanding.

Subsequent calculations show that the British current balance on external account deteriorated by no less than £700 million in 1951, passing from a favourable one of £300 million to an unfavourable one of £400 million; £600 million was on trade account. Of this, £400 million is accounted for by the deterioration in the "terms of trade." World prices of primary products soared up after the Korean outbreak, and these figured largely in her import bill, while her export prices were rising comparatively slowly. Although the devaluation does not appear in the end to have worsened Britain's terms of trade, its short period effect was probably to make the impact of the Korean war on the terms of trade more serious than it would otherwise have been.

Prior to the devaluation of 1949 a meeting of Commonwealth Finance Ministers occurred which agreed that imports should be restricted throughout the Commonwealth with a view to restoring the Commonwealth external balance, which was already deteriorating owing to lags in payment and postponing of purchases consequent upon the rumours of a forthcoming devaluation of sterling that were already rife. This agreement was honoured in the twelve months following, despite the

* c.p. *The Pound Sterling*, page 17.

fact that its objective, viz. to prevent a devaluation, was no longer obtainable; and the external balance was improved by consequence in 1950. So favourable had the situation become by the end of that year, that the government then in power waived Britain's claims to any draft upon the remainder of Marshall Aid (due for another one and a half years), although the British people felt themselves entitled by their war record to their fair share of this American assistance so generously extended to help Europe. Restrictions on imports were then relaxed. They had caused a drawing-down of internal stocks in 1950, and Britain's external balance in 1951 suffered from the subsequent replenishment of these. This alone accounts for the remainder of the deterioration in the external trade balance in 1951.* These matters are made clear in the following table.

TABLE X

	<i>Value of Physical Increase of Stocks and Work in Progress</i>	<i>Volume of Imports</i>
1948	+ £175	92
1949	+ £65	100
1950	— £210	100
1951	+ £575	112.5
1952	+ £50	102.8
1953	+ £125	113.3
1948-53 (average)	+ £130 per year	+ 4½% per year

This table shows the urgent need to consider current events in the light of trends of growth, as shown in Tables I-III, as well as the need for up-to-date statistics. It is clear that the upsurge in the value of stocks in 1951 was due in large part to the depletion of the preceding year and did not portend a permanent annual increase at this rate. Similarly the rise in imports by 12.5 percent in 1951 was the consequence of the restriction and repression of the preceding year. An understanding of this would have mitigated the sense of crisis in 1951.

Actually the troubles blew away in the following year. The current balance improved by £650 million, mainly on trade account, of which somewhat less than half was due to the restored terms of trade and the remainder to diminished requirements. It is fair to add that the restoration in the terms of trade could not have been relied upon by those responsible for policy in 1951; world prices began their downward trend

* Attention was drawn to this phenomenon, while it was proceeding, in *The Pound Sterling*, page 37.

in April, but it was widely believed that this was merely a "lull," and that prices would later resume an upward course owing to the pressure upon the world's resources caused by the great American defence programme.

Inflationary symptoms manifested themselves on the home front during 1951. Unfilled vacancies exceeded the numbers seeking work, and there were acute shortages of steel, coal and skilled manpower. The new defence programme was straining British resources, and it was believed that the (Labour) Government had not taken sufficient steps to curb other forms of spending to match. There had been a substantial investment boom in 1950, and in the first half of 1951 factory building starts continued to rise.

When the Conservative Government took office, they introduced a policy of monetary deflation and increased import restrictions. Monetary policy had been out of vogue since the war, and indeed since 1932; for in all that period a policy of cheap money had been consistently pursued. It is interesting to observe that this revival of monetary policy followed hard on the heels of a similar departure in the United States, signalled particularly by the "accord" between the Federal Reserve System and the United States Treasury in March 1951. Interest in the monetary weapon as a method for controlling inflation began to spread widely. The British experiment began most felicitously by the success of the authorities in funding £1,000 million worth of Treasury Bills, a manoeuvre which they were not able to repeat in 1955, when it was more urgently needed.

The restriction of imports at this juncture was a step backwards in the attempts to "liberalise" intra-European trade, and caused the French to react in a similar direction in self-defence. This was all very unfortunate from the point of view of European integration. While some monetary tightening was probably desirable, it can be argued that, if only the authorities had kept a cool head, they might have dispensed with the import restrictions. Having, presumably, greater knowledge than the author of *The Pound Sterling* at the time, they could have perceived, as he did, how large a part of the adverse balance was due to a backwash from the restrictions of 1950 and not therefore destined to last.* On the more difficult question of the terms of trade, the matter was uncertain; material prices had begun to move downwards and the British terms of trade to improve rapidly, before the import restrictions were imposed. The turn-about of 1952 showed that the restrictions had been unnecessary; but they did harm.

More generally, the events of 1951 suggest that the authorities re-

* cp. p. 37.

sponsible for policy should strive harder to insulate themselves from the crisis mentality, keeping trends of growth in the forefront of their minds, acquiring the greatest possible knowledge of current facts and assessing them in the light of those trends. This is specially incumbent on the British authorities, since if these are seen to be infected by the crisis mentality, and to falter at all in the straight line of policy, a situation not in itself at all critical can easily turn into one of crisis, owing to the influence of lack of confidence operating on the sterling balances. This lesson was more sharply taught in 1955 and 1957.

The year 1952 was one of moderate recession at home and declining exports, but strong improvement in the external balance. At the end of the year an important Commonwealth conference was held and at long last attention was redirected to the restoration of convertibility, which no longer seemed beyond the realm of feasibility. It was decided that members of the sterling area should severally do their best to maintain their external balances in good shape with a view to the earliest possible return to convertibility. It was also decided, although this was not published, that, in the event of convertibility, larger margins of fluctuation should be allowed around the official par of exchange as established at the International Monetary Fund.

About this time and in the years immediately following, there was much discussion about the merits of a fixed par of exchange; not only were wider margins canvassed, but it was also proposed to allow the pound to "float freely" in foreign exchange markets. It was suggested that convertibility might be established with a freely floating pound; this terminology is not in agreement with historic usage, by which convertibility implies a fixed par. Proponents no doubt had in mind some such system as operated in 1932-1939; "convertibility" in this debased sense referred merely to negotiability, i.e. the right by foreign holders to use sterling, at whatever rate it might fetch in a free market, in the multilateral settlement of claims in any part of the world, including the American Account area. This may be a fitting opportunity to review the merits of such proposals.

It is claimed that a freely floating currency facilitates readjustment in a painless manner. If a country finds itself involved in rising costs of production, not paralleled elsewhere, owing, for instance, to the granting of wage increases that are considered irreversible, then it could regain its proper alignment with other countries by allowing its currency to float downwards on a foreign exchange market.

Such a realignment could also be achieved by a once-over change in the fixed par of exchange by agreement with the International Monetary

Fund. Those who favour the floating rate doubted, justly, whether the machinery of the International Monetary Fund was likely to work smoothly in this regard. If a currency of a country appears to be weak, then the question will inevitably be asked whether its devaluation will presently be considered; that gives rise to speculation. The speculation in its turn, which extends to "leads and lags" in trade payments, has its own influence on the total situation and may make it quite obscure what the true balance of payments of the country in question is and whether its currency ought to be devalued or not. That was preeminently so in regard to sterling in the spring and summer of 1949. Will it not always be so, the question was raised, whenever a time comes when a devaluation ought at least to be considered? By contrast, the trial and error management of the British Exchange Equalisation Account in 1932 to 1939, by which one could feel one's way tentatively, provisionally, and reversibly to a new rate, when the old one was out of equilibrium, seemed to be a more efficient method. Some, but not all, of the advocates of floating currencies, thought that the market itself could provide a "true" equilibrium rate. Reflection showed, however, that a currency would not in any case be left entirely to the tender mercies of the market, since an Exchange Account would be required to even out seasonal or chance variations, and would have to retain a residue of discretion for judging whether a downward pressure was due to a merely temporary cause and ought to be offset by official support, or was a symptom of true disequilibrium. Perhaps the best version of this view is that the market and the Exchange Account would somehow work together, by their own probing and trials, to establish a true equilibrium rate.

This view seemed to have academic backing in the fact that Keynes, disgusted at the working of the old rigid gold standard, had favoured adjustable rates before the war. Exchange flexibility has more recently been advocated by Professor James Meade from the standpoint of high economic analysis. He has argued that one will not be able to have the benefits both of full employment and unrestricted multilateral trade, if one does not have the degree of freedom allowed by exchange variation.

My own opinion is that such a system might be the most desirable in favourable conditions, but that it is not to be recommended in the near future. I will set out my reasons.

(1) By the fostering of foreign exchange markets and in other ways the Bank of England has seemed in recent years to be entertaining the hope that the Bank Rate might once again be brought into use, as it was so successfully before 1914, to influence international short-term capital movements. There may even have been occasions when it had

some slight effect in this sense in recent years. This system is totally inoperable if a currency is freely floating, since the exchange risk is always greater than any feasible differential between the Bank Rates (more properly, between the money market rates) in the various financial centres. I believe that some of the advocates of the freely floating currency have not appreciated how wide and unbridgeable the gulf is between the system they recommend and the use of the Bank Rate to have a quick influence on the external balance of payments.

The revival of this function of the short-term interest rate, not only by the Bank of England, but by other central banks also, would be of quite exceptional value, if only it could be encompassed in the years immediately ahead. The possibility of using the Bank Rate in this way creates for each country what is sometimes called a "second line reserve." At present the world is suffering from an acute shortage of media of reserve; this is constantly obstructing the further development of multilateral trade, and even threatens its complete breakdown. Whatever the Americans might do, if converted, in raising the dollar price of gold, there would still not be enough gold reserves in the world to meet the situation adequately. If each nation could rely on a substantial second line reserve, and prior to 1914 Britain's second line reserve was many times greater than her own free gold holding, this would entirely transform the scene as regards putting multilateral trade on a more secure basis. This argument weighs heavily against contemplating floating currencies in the near future. At some other time, if it ever happens that the situation in regard to tangible reserves is totally transformed, then the floating exchange system should be reconsidered.

(2) The experience of the Exchange Equalisation Account makes some British favourably disposed to the idea of a floating rate. But the situation has changed somewhat since before the war, and in existing circumstances this attitude may be a little insular. A British person may be apt to think in terms of two currencies floating freely against one another, sterling and the dollar; and before the war this way of looking at the matter was not altogether out of perspective, when most currencies were either linked to the dollar, through a gold parity, or associated with the pound in the looser form of the "sterling area" then obtaining, which extended far beyond the Commonwealth. Now the matter has become more complicated. The importance of other currencies has grown, and may continue to do so. If there were many Exchange Accounts, all operating as actively as the British account in the 'thirties, and all taking some independent line as to whether their own currency should be supported or allowed to drift downwards in a given phase,

there might be cross purposes—and conflicting policies bearing on cross-rates! As things are, these different currencies have their parts registered with the International Monetary Fund. Although there are irregularities, and even settled practices not altogether in line with the theory of the Fund, it can be said that there has been less currency disorder, on the side of foreign exchange rates, than there was in the eight years after the end of the first world war. It is hard to see how a truly independent policy on the part of a great number of authorities responsible for different currencies, each looking after and having some influence on the manner in which its own “floated,” is reconcilable with any regular international system of cooperation. One might of course link together groups of currencies into two or three main systems, but this would not secure fulfilment of the ideals of Professor Meade, which require that each country separately, with its own special problems, be enabled to maintain full employment, internal stability and free trade; and it might be deemed to lead to a sort of subordination of the less important currencies, which would not be in line with current ideology.

(3) Experience after the first world war strongly pointed to the conclusion that, if there was any lack of confidence in the future of a currency, it would tend to be under-valued in the foreign exchange markets. And this same under-valuation made it more difficult in many cases for countries to get to grips with their own inflationary problems. In certain cases the under-valuation was actually the cause of a greater rate of internal inflation in each succeeding period, which in turn seemed to justify the under-valuation *ex post*. It is still widely believed that there has not been a sufficient readjustment in the structure of production or in the pattern of international trade since the war, to make everyone feel that the “dollar problem,” which was so prominent in the post-war quinquennium, is completely solved. A serious American recession, which still cannot be entirely ruled out, could make this problem very acute. Accordingly there is a background lack of confidence in the future of non-dollar currencies, and this, impinging on freely floating rates, could easily cause under-valuation. This would be an evil, not only because it might set up new cost inflations inside countries, but also because it might cause a worsening in their external balances of payments.

(4) Some weight, although not too much, must be given to the argument that a fixed rate of exchange may assist those who are resisting the tendency for demands for wages and other forms of income to move up more rapidly than the gross domestic product. In fact the fixed rate does impose a kind of discipline. It has no tendency to prevent all countries sinning together in this respect, but it may give an argument

to the authorities in countries where there is a tendency for money income increases to go forward more rapidly than elsewhere.

I would add, however, in this connection that the modern objective of full employment, including a rate of growth of activity in line with the potential of the country, is and should be the paramount aim of policy. It would be unfortunate, and in the long run unacceptable to electorates in democratic countries, if the authorities put the need to maintain a fixed rate of exchange above the need to maintain economic growth in accordance with the potential of the country.

My conclusion is that the arguments in favour of fixed rates in existing circumstances outweigh those for flexible exchanges. The first and most important argument set out above further requires that countries should not normally contemplate resorting to the right, provided in the Articles of Agreement of the International Monetary Fund, for devaluing their currencies in certain circumstances. Any fear, however slight, that a currency might be devalued within a foreseeable future would deprive the country of its "second line reserve" just as effectively as a freely floating rate.

Consequently it becomes very important for the authorities, by whatever means of negotiation are available to them, to ensure that money incomes do not rise too rapidly. Only if they achieve that, can they both ensure full employment in accordance with growth potential, and also such confidence that the currency is not likely to be devalued in the foreseeable future as will enable them to supplement their gold reserve by a "second line reserve."

During 1953 two factors began to operate favourably to sterling. The British balance of payments was reasonably good. And the overall balance of payments of the United States was not unfavourable to the rest of the world. The latter was assisted by the expanding overseas military expenditures of the United States and by the aid which continued to be given in generous measure.

The existence of sterling balances held outside the sterling area made sterling extremely sensitive to the overall world-wide dollar balance. Transferable account sterling and the sterlings held by various countries under bilateral Payments Agreements with Britain made during the war, and extended afterwards, have been used for conversion into dollars at a discount. Although by British theory these kinds of sterling were not negotiable for payment to the American Account area, free markets existed in which they could in fact be sold for dollars, if their owners were prepared to accept a rate of exchange less favourable than the official rate. An example may be given—although doubtless greatly

over-simplified—of how the two parties to such a deal could be satisfied. An American wishing to buy goods from the sterling area would naturally be glad if he could obtain sterling in exchange for dollars below the official rate. The holder of sterling in a non-dollar, non-sterling country might be glad to sell sterling at a discount, if he had no immediate prospect of a proper use for the sterling, e.g. for buying goods from the sterling area, but was very anxious to acquire dollars for some other purpose. All that was required was some invoicing by which it appeared that the sterling area exports were being consigned, not to the American as in fact they were, but to the country (or transferable account area) where the holder of the sterling was resident. No doubt the subterfuge had to be a little more complicated; very numerous devices were worked out, especially in periods such as early 1949 when sterling was suspect; a non-resident holder at that time saw no immediate prospect of convertibility and a very likely prospect that the sterling he held would presently be devalued. He was accordingly quite anxious to get rid of it. From the British point of view the net result of such a transaction was that instead of receiving dollars for the sterling area export to the dollar area, Britain merely received a discharge of its liability to some non-dollar area, which was for the time being less important to her. It is to be noted that the need to have subterfuges involved payments to intermediaries, and that the transaction would not be worth while from the point of view of the American unless the discount on the unofficial sterling was sufficient to cover such payments. Among the circumstances required for such a deal as that described above to bring gain to both partners to it was the keen desire by the non-resident holder of sterling to acquire dollars. If he had no such desire, then there was no good reason for disposing of it at a discount—except when there was a lively fear of devaluation; he would do better to hold it and use it later for a legitimate purpose, or even get dollars for it at the official rate, should sterling convertibility be restored. Accordingly these transactions were much more likely to become rife, if there was a world-wide shortage of dollars; if there was no such shortage, non-resident holders of sterling would not be anxious to convert it into dollars at a discount. Therefore the absence of a world-wide dollar shortage in 1953 tended to raise quotations for the sterlings held outside the sterling and dollar areas.

By December the free market quotations for transferable sterling had actually risen to inside the official limits for official sterling. Transferable sterling was also at this high point for several months in the early part of 1954.

The British took this happy opportunity to unify the sterlings in all

countries outside the dollar and sterling areas, except for Portugal, Turkey and Persia, into one single "transferable sterling." At the same time they reopened the London gold bullion market.

By now there were high hopes that this transferable account sterling would soon be made convertible. The high quotations in free markets showed that transferable sterling was not under pressure; holders of it could in fact for the time being get dollars for it at a very small rate of discount. The fact that this discount was so small suggested that, if sterling were made officially convertible, there would be no great flight out of sterling into dollars.

However a shadow fell, which postponed official action for the time being. This was the American recession of 1953-1954. Despite the opinions of American experts, there seemed no assurance that this would not in due course deepen and revive the dollar shortage. It was argued that this was an unsuitable time for the British to take the plunge. This argument gave strength to some who were influential at the top level and were doubtful of the whole principle of convertibility. I regret that the step was not taken at that favourable occasion.

At the September meeting of the International Monetary Fund in Washington, the British Chancellor announced that the time was not yet ripe for convertibility. He adjured the Americans to contribute to this desirable objective by further efforts to liberalise their trade policy. World opinion reacted badly to this. If the British were unwilling to take the plunge when on the whole the situation was so favourable, there were doubts whether they ever would be.

Accordingly during the autumn and winter transferable sterling fell to a larger discount. The margin between its rate and that of official sterling broadened enough to make the use of transferable sterling for dollar purchases profitable once more. The British authorities lost dollars by consequence. It may be convenient to call the quotation for transferable sterling that is just low enough to make irregular transactions possible the "commodity shunting point," by analogy with the "gold export point" which was the market quotation under the old gold standard regime that was just low enough to cover the costs of remitting gold.

February 24, 1955, should be thought of as the date at which the British authorities restored the *de facto* convertibility of sterling after the second world war. Other steps remained to be taken to restore convertibility in the fullest sense, but no future step could be nearly so important as that one was. The British authorities decided to intervene in the free markets for transferable sterling and to sustain it above the commodity shunting point. This meant that the authorities were willing

to convert sterling held by non-residents into gold or dollars at a very small discount (about 1 percent) on the official rate.

The true definition of convertibility has two branches. First, the authorities responsible for the currency must be *de facto* willing to convert it. Secondly, there must be complete confidence that they will continue to be willing to convert it. If both these conditions are fulfilled, then the currency may be said to be "convertible." It may be difficult to define an absolutely rigid criterion for assessing whether the second condition is fulfilled, in the absence of a positive enactment obligating the authorities to convert. But economic history would be very wrongly written if monetary arrangements had to be described in terms of legal enactments only. Thus the Federal Reserve Act of 1913 did not make Federal Reserve notes legal tender. Economic historians would describe the Indian rupee as a gold convertible currency between 1900 and 1914, although there was no enactment compelling the authorities to convert it. There was confidence that they would in fact do so.

It cannot be said that there was absolute confidence that the British authorities would continue to maintain transferable sterling above the commodity shunting point, but it can be said that there was a sufficient amount of confidence to justify the use of the word "convertible." For a considerable period prior to September 1954 the discount was too small to allow commodity shunting; then it became larger and commodity shunting began; then the British decided to stop that by the only method available, namely by making transferable sterling convertible, i.e. by being willing to convert it into gold or dollars themselves at a sufficiently small discount below the official rate.

The question of the margin between official sterling and transferable sterling must not be confused with the question of devaluation. After June 1955 fears of sterling devaluation became quite lively for the first time since the large devaluation of 1949. These fears played on both official sterling and transferable sterling alike, rather than on the margin between them. If there was to be devaluation, then both kinds of sterling would presumably be devalued by the same stroke. It was not supposed that the British were likely to devalue transferable sterling by a larger amount than official sterling, for the simple reason that they would not want commodity shunting to be resumed.

If there was confidence that the authorities would maintain the *de facto* convertibility of sterling at a small discount, that confidence was proved justified. Sterling has moved through very troubled waters since mid-1955, but the authorities have continued through the various "crises" to be willing to convert transferable sterling into gold or dollars at a small discount below the official rate; only for a few days dur-

ing the worst part of the Suez crisis was transferable sterling allowed to slip down.

All that remains for *de facto* convertibility in the fullest sense is the unification of the official and the transferable account rates. The true description of the existing situation is that sterling is *de facto* convertible throughout, but that one class of holder has to accept slightly wider margins than the other.

The bold move in February 1955 caused apprehension in certain quarters, lest the convertibility of transferable sterling should prove very expensive in terms of the British gold reserve. Actually the authorities executed their manoeuvre at a very small cost indeed. It was accompanied by a rise in the Bank Rate from $3\frac{1}{2}$ percent to $4\frac{1}{2}$ percent. This move, combined with the announcement that the British authorities from now onwards were supporting transferable sterling, may for the time being have had a favourable effect on international capital movements.

This happy outcome did not, however, bring British troubles in regard to sterling to an end; on the contrary, they subsequently deepened. By this time Britain was in the throes of an investment boom of great magnitude, to be described below. This led to rather strong internal demand-inflation. Labour and materials became scarce, and the external balance of payments began to deteriorate. The inflationary symptoms were solely due, as may be seen from Table III, to the pile up of orders on investment account. No abnormal increase of consumption was proceeding. That the authorities were throughout 1955 unwilling to admit that the inflationary pressure was solely caused by an investment boom was partly due to the just idea that Britain needed a higher rate of investment; it accordingly seemed a pity to say that investment orders had become excessive. It may be hard for a statesman to draw a nice distinction between the desirability for a higher rate of investment, even a much higher rate, on the one hand, and, on the other, the undesirability of trying to step up investment by a huge amount in a single year. But the lack of any proper explanation of the cause of the inflationary pressure, which was undoubtedly present in 1955, had a very adverse effect on sterling. Foreigners believed that the inflationary symptoms were due to the British unloosening their belts and indulging in an orgy of consumer spending. It was thought that this would be enhanced by wage increases granted; while these may have been a little excessive, although it is arguable that they were still justified as an aftermath of the devaluation of 1949, they could by no means be deemed to be a cause of the inflationary pressures then obtaining in Britain. But foreigners thought otherwise and this engendered a lack of confidence in sterling. There were two serious strikes in May.

Against this background of waning confidence, the British delegation to the O.E.E.C. meeting in Paris in June made a most unfortunate *démarche*. Under pressure to agree that, in the event of formal convertibility, the monthly E.P.U. settlements should be put on a 100 percent gold basis, they claimed, no doubt with the Commonwealth Conference of 1952 in mind (see above), that 3 percent margins of fluctuation on either side of par should be allowed. Three percent must be deemed a large amount, considering that transferable sterling was being held at within 1 percent. It was a curious proposal in the circumstances. The British encouragement of organised foreign exchange markets, and the raising of the Bank Rate from $3\frac{1}{2}$ percent to $4\frac{1}{2}$ percent simultaneously with the adoption of a support price for transferable sterling, suggested that the British authorities hoped to revive the old-time mechanism by which the Bank Rate influenced short-term capital movements and thus evened out short-term oscillations in the external balance of payments. But it would be very hard to use the Bank Rate effectively for this purpose with margins as large as 3 percent on either side of par.

Thus the construction so recently put upon the events of February seem to be contradicted by the delegates' proposals in June. Furthermore, in view of the general lack of confidence concerning domestic British inflation that was beginning to arise, the British proposal was interpreted as representing a wish that sterling should in fact be devalued by 3 percent. From that moment forward there were recurrent fears of devaluation. Thus the good beginning made by the Bank of England in February was in part frustrated.

The British authorities soon realised how big a mistake had been made in Paris, and the Chancellor at the meeting of the International Monetary Fund in September at Istanbul announced that any reference to wider margins was "irrelevant and unrealistic." But it should not have been made in June.

It may be expedient here to wind up the story on the external side by referring to the foreign exchange crisis of August and September 1957. By that time demand-inflation had long ceased to exist in Britain. Indeed the economy had been stagnant for nearly two years and orders were running well below deliveries; but a certain cost-inflation still persisted, analogous to those proceeding in other countries. Once again, statements made for internal consumption had a malign effect abroad. With a view to getting wage restraint, Ministers used rather strong language about the disastrous effects that further wage increases would have; it was even hinted that, should they occur, "the defence of sterling" might be in jeopardy. This expression, "the defence of

sterling," which has been much used by the authorities in 1957-1958, naturally has a disastrous effect on foreign confidence in sterling.

While it is no doubt the case that wage increases, if carried to an extreme point, could in principle necessitate another devaluation, it should have been observed that from the immediate point of view the increases actually occurring were not of that character. During the two years 1956 and 1957 British hourly earnings rose less than the German and only slightly more than the American (see below). This pattern does not suggest that, other things being equal, the course of wages was likely to precipitate the need for a devaluation of sterling against the dollar and the mark. Yet the language used for internal consumption, notably in order to secure an abatement of wage claims, suggested precisely this to the minds of foreign (and even British) financiers, who were not acquainted with the true facts of the case.

Against this background of a renewed lack of confidence, the British made another grave mistake, not unlike that made in June 1955. A European Customs Union had been agreed to and negotiations were pending for a larger Free Trade Area. It was rightly argued that an indispensable pre-condition for the good working of such arrangements was the correct mutual alignment of the European currencies; if the currencies were wrongly valued, this would be bound to set up severe strains within an area where mutual freedom of importation was allowed. In the summer of 1957 this was considered to be a rather pressing problem. It was generally held that the French franc was overvalued and it was also held that the German mark was undervalued. One possibility accordingly was that the German mark should be valued upwards, the French franc downwards, while the other currencies remained betwixt and between. It was perfectly well known in continental quarters that the Germans would not consent to a valuation of the mark upwards against the dollar, since they had an irrefutable argument against doing so; namely that they had a heavy deficit in their direct balance of trade with the dollar area. But it was thought that the Germans might be driven to consent, as a contribution to European realignment, to the upward valuation of their mark against European currencies. (The Germans have continued to argue that their recent very favourable balance on current account might easily be much reduced owing to strong wage increases, which were expected, and have happened, and to increased governmental expenditures without a corresponding increase in taxation.)

Such was the pattern of thinking on the continent. These matters were due to be discussed in a general way at the forthcoming meeting of the International Monetary Fund in Washington in September, and

more particularly at an O.E.E.C. meeting in Paris in October. It was believed that the British wished the German mark to be valued upwards; and nothing was ever said to scotch this belief. Accordingly it seemed likely that the outcome of all the proceedings would be that the British would wish the pound to be valued downwards against the mark (and thereby of necessity against the dollar) and that the franc would be devalued to a still lower level.

Then came the fall of the French franc under heavy pressures, including lack of confidence, in August. It was natural to think that the remaining realignments might come more quickly than was expected. Accordingly the obvious tip was to expedite payments to Germany, to retard payments to Britain, and even to engage in speculative operations against the pound and in favour of the mark. All this was the absolutely inevitable consequence of the British failure to scotch the rumours that they wished the mark valued upwards. If they did so wish, then all those who were bears of sterling and bulls of marks were doing absolutely the right thing.

The British reacted by raising the Bank Rate to 7 percent on September 19 and issuing strong statements against the possibility of a devaluation of sterling. But a perfectly mild statement three months earlier that they by no means wished the mark to be valued upwards (which in effect would have been saying the same thing as that they did not wish sterling devalued) would have sufficed to prevent the sterling crisis in August. This was stated at long last by Mr. Thorneycroft in Washington in the last week of September and, more effective still, the projected meeting of the O.E.E.C. in Paris was cancelled. And thus the financiers of the world came to the conclusion that, after all, the mark was not going to be valued upwards, i.e. sterling was not going to be devalued, in the near future. Thus the sterling crisis blew over. A small amount of common sense could have prevented its ever happening.

Thus in the earlier part of this period the journey towards convertibility went well; *de facto* convertibility was restored in February 1955; only the last final touches remained to complete the work. But after that mistakes were made and fears of devaluation arose, so that the environment was not right for putting on these final touches. Meanwhile a world recession has supervened, and this may complicate the problem.

V. BOOM AND MONETARY POLICY, 1954-1956

The figures supplied in Table III indicate the onset of an industrial investment boom in 1954.* The rise of orders in 1953 may be regarded

* For a fuller account of this see R. F. Harrod, "The British Boom of 1954-55," *The Economic Journal*, March 1956.

simply as a revival from the recession of the previous year. But the large increase in the following year gave a total which was greater than the economy could digest in the normal course, and gave rise to symptoms of inflationary pressure. In the post-war period British productivity and exports were much handicapped by long delivery dates and a heavy backlog of unfilled orders. In this respect the situation had returned to normal in 1952, but in the autumn of 1954 there were widespread reports by purchasers that the situation was slipping back to its earlier bad condition. The figure for unfilled vacancies, which had also been above that for the unemployed in the six years after the war, but had then receded, rose above it again during 1954. Shortages of labour and materials were also reported.

There should have been enough data for a correct diagnosis that investment orders were rising unhealthily during 1954.** But the British authorities would gain if they had more detailed figures for orders. For good management it is very important that statistics on these topics should become available promptly.

No official statement was made with reference to the dangers of the situation, and it may be that the diagnosis was imperfect. Quick action was also impeded by the attitude taken towards investment at that time. Owing to the correct view that the British economy required a higher rate of investment, there was an extreme reluctance to stating that investment orders were running too high. In the early phases of thought upon this matter at that time a sufficiently clear distinction was not drawn between investment orders and achieved investment, between investment *ex ante* and investment *ex post*. There was nothing wrong with the rate of achieved investment during 1954, and the increases in achieved investment that occurred in the following years were all to the good. Critics of those who complained that investment orders were unhealthily high pointed to figures comparing the proportion of resources devoted to investment in Britain with those of other countries. But if British investment was still too low, that was beside the point. It would not be helpful, and did not prove helpful, to the long-run level of investment in Britain to allow an inflationary boom to develop.

Accordingly corrective measures were not taken quickly. And when they were taken they were not announced as being specifically designed to reduce investment orders. In modern conditions an announcement of the purpose of a given policy can make that policy more effective. Furthermore, the lack of announcement did serious damage to sterling on the external side in the second half of 1955.

** For such a diagnosis see R. F. Harrod, "A Drift towards Inflation?" *Financial Times*, November 30, 1954.

It was, indeed, the policy of the authorities to cause a reduction in orders on consumer account also. The increase in consumption during 1955 (see Table III) can hardly be said to have been unduly high. This was a year in which the number in civil employment increased strongly, viz. by 1.4 percent, so that the increased consumption per person in civil employment was only 1.7 percent. If anything, this was subnormal. The increase in consumption was certainly not a cause of the inflationary pressures that grew more intense during the year. This should have been stated.

But an attempt to reduce consumption was not inconsistent with the diagnosis given above. While it was quite certain that the investment goods industries could not meet the orders at the rate that they were then coming along, yet, if the correct view was that the greatest possible expansion of investment was desirable, it would be expedient to curb consumption with a view to releasing productive resources for the output of investment goods. It was a consistent line of policy on the one hand to curb investment orders and on the other hand to boost to the greatest possible extent production for investment, since in that way one would hope to get rid of the excess of demand for investment goods over the supply potential of industry and thus to bring the inflationary pressure to an end.

It was important, however, to explain these aims precisely. Lack of such explanation and sundry references to undue consumer-spending gave rise to the incorrect idea that consumer-spending was booming heavily and that it was partly responsible for the inflationary pressure. High investment is a symptom of a healthy economy and portends a stronger position in the future, while an increase of consumption suggests that things are getting out of hand, especially when there are strikes and substantial money wage increases are granted. The incorrect view about the causes of domestic inflation in Britain undoubtedly caused the fall of foreign confidence in sterling in the second part of the year, which was touched off by the mistake about margins made at the June meeting in Paris, as described above.

The disinflationary measures finally taken seemed, anyhow on the surface, to have a stronger effect in causing a flattening of consumption than in reducing the investment boom. This flattening is shown in the 1956 figure for consumption in Table III. Although the policy was sensible in itself, it does not appear to have had much success in achieving the objective of releasing resources for investment, except possibly in the case of steel. The consumer goods industries were releasing labour in the early part of 1956, but the capital goods industries ceased at that time to draw labour in, probably owing to a shortage of key

personnel, and perhaps also because those capital goods industries were themselves short of capacity and did not yet benefit by the orders that had been placed for more capacity in the preceding year. Figures for the delivery of plant and machinery valued at constant prices are not yet available for 1957, but there is no doubt that they were above those of 1956, although orders were lower. This seems to indicate that the relevant industries had been exhausted by the strong increases in the rate of deliveries shown in 1954 and 1955, and could not in 1956 make much further increase until they themselves received more equipment. Consequently, the policy of releasing labour for them misfired; labour stood off by the consumer goods industries in 1956 either went into tertiary industry or went home.

Not only was the disinflationary policy of 1955 not announced as being specifically directed against the excess of orders on investment account, but also it was not applied very strongly.

The rise in the Bank Rate from $3\frac{1}{2}$ percent to $4\frac{1}{2}$ percent in February has already been mentioned. Its primary object was to support the return to the *de facto* convertibility of sterling. But the authorities no doubt also had the idea of curbing the strong domestic boom. In a disinflationary policy directed against domestic inflation, the reduction in the quantity of money is likely to be more important than the rise in the short-term rate of interest. There is usually a seasonal reduction in the quantity in the spring in Britain, when government receipts exceed disbursements; but it appears that the reduction in the spring of 1955 was a little more than seasonal. The deposit banks reacted to the reduction in their cash basis by selling from their portfolio of shorter-dated investments, and this caused a depression in the gilt-edged market. This was a natural and normal opening gambit in a disinflationary process. But thereafter the disinflation proceeded on less orthodox lines.

It was generally expected that the Conservative Government, which had distinguished itself from a Labour Government by a reluctance to proceed by direct controls, would carry forward with the further implementation of a "credit squeeze" in an orthodox manner. But when the Chancellor of the Exchequer wrote a letter to the Governor of the Bank of England in July, asking him if he could get an agreement among the deposit banks to reduce their advances, this seemed to be relying on some kind of direct intervention rather than on the supposedly impersonal and automatic forces set up by a reduction in the quantity of money. And in fact the quantity of money was not much reduced in the autumn of 1955.

The traditional and time-honoured method of imposing a credit squeeze in Britain was for the Bank of England to conduct open market

operations by selling securities; the deposit banks acted in the first instance by reducing their accommodation to the short loan market; discount houses were then compelled to rediscount with the Bank of England at Bank Rate; but, as the Bank Rate was a penal rate for them, they were compelled to readjust their position in the next few days, so as to get out of debt to the Bank, and thus the net effect of the open market operations was to reduce the quantity of money in the system very quickly. There were indeed two effects, both quick. One was a rise in the short-term rate of interest, especially if open market operations were reinforced by a rise of Bank Rate, and this used to have a quick effect on the external balance of payments through the discouragement of short-term borrowing by foreigners or the attraction of foreign balances. The second effect, also quick, was a reduction in the total quantity of money within the internal economy. Owing to the far greater relative importance of the external balance of payments in Britain, and her tradition of having a very narrow gold reserve, it was more important to her than it has been to the United States that the effect of the operations of the Bank of England should be quick.

There have been only brief periods since the war, in which the short-term rate of interest is likely to have affected the external balance on short-term capital account in the old traditional way. The interval from February 1955 to June 1955 may have been such a period and the rise in the Bank Rate may actually have had some effect on the external capital movements then; it was aided by the good impression created by the *de facto* convertibility of transferable sterling. But after June fears of a possible devaluation arose and were recurrent until the cancellation of the O.E.E.C. meeting in the last week of September 1957. Since September 1957 the very high rate of 7 percent may have had some influence on short-term capital movements; but in this recent period it is difficult to separate the effect of the positive attractiveness of the high rate from the return flow of short-term capital (including a return flow under "leads and lags" of trade payments), due to persons correcting the abnormal positions that they had taken up in the period prior to the last week of September, when a devaluation had been strongly expected.

It was not only on the external side that the effect of the open market operations by the Bank of England was expected to be quick. Here there was supposed to be a contrast between the United Kingdom and the United States. In the former the open market operations of the Bank of England served to contract the total quantity of circulating medium by pressure upon the discount market for whom the Bank Rate was penal. In the United States on the other hand the whole or part of the

reduction in the cash basis due to open market operations might be offset for the time being by member banks using their rediscount facilities and borrowing from their Federal Reserve banks. Those member banks would indeed wish to get out of indebtedness as quickly as possible; but a contrast was noted between the position of the British discount houses who had to get out of indebtedness in a few days, because the Bank Rate for them was penal, and the position of the member banks of the Federal Reserve System who might remain in debt for a longer period, because for them rediscounting with their Federal Reserve Bank did not cause an actual loss of money. But since the war the Bank of England has from time to time allowed the discount houses to rediscount "by the back door" at a less than penal rate. To the extent that this has happened the British system has come more to resemble the traditional American system. If the discount houses continue to rediscount, the reduction in the quantity of (bank) money circulating throughout the system will not be quick.

This brings us to the question of Treasury Bills. If the funds available for the discount market are reduced but the offer of Treasury Bills is not, the discount market will tend to bid up the rate of interest with a view to attracting outside bidders and ensuring that those get a larger share of the allocation. But in certain circumstances outside bidders may not be attracted strongly enough by the going rate of interest. In such circumstances, always supposing that the quantity of Treasury Bills on offer is not reduced, it will be incumbent upon the Bank of England to help the discount market by the back door, since otherwise it might be driven into a position in which it was unreasonable to expect it to take up the whole tender of Treasury Bills, and that would put the government into an embarrassing position. If this state of affairs continues for some time, it may occur to the Bank of England that it had just as well not try to reduce the quantity of money by open market operations in the first instance; it is futile to reduce the quantity of money by one method and then have to re-supply it again by another. Thus it has been said that the old open market weapon has been somewhat blunted.

This matter would be put right if, simultaneously with a Bank of England selling operation, the government could reduce its weekly offer of tender Treasury Bills. If the government could pursue a thoroughly flexible policy in this regard, then one could secure both a rise in the short-term rate of interest and a reduction in the quantity of money, laying stress on whichever side was suitable for the occasion. If one reduced the offer of Treasury Bills by the full amount when the cash basis had been reduced by the Bank of England through open market operations, then the quantity of money would be reduced throughout the

system without there having been any rise in the short-term rate of interest. If one wanted to secure such a rise, then one would not reduce the offer of Treasury Bills by quite so much as the cash basis had been reduced.

Accordingly the government has been criticized for not having funded Treasury Bills in 1955 in the manner that it did in 1951. But it may be that it is not so easy to do this as it is to say it. The authorities have had to issue stock, first by way of re-funding the various war or post-war issues that have been maturing, and, secondly, to raise new money in large amount. Thus the issue of longer-dated stock with a view to funding Treasury Bills would be additional to the need to issue it under these other two heads. It is to be noted that it is useless to issue, unless the stock is taken up by "genuine" investors; otherwise it has to be taken up *pro tem* by the government departments; these are thereby forced to reduce their holding of tap Treasury Bills, which then have to be put out for tender, so that the original purpose of reducing the quantity of tender Treasury Bills is frustrated. It has been said that the government can get any amount of new stock taken up by genuine investors, if it offers a sufficiently attractive price. This position is not tenable. The price might in certain circumstances have to be so "attractive" as to be discreditable to the British Government and to cause foreigners to sell sterling, which would be contrary to the more general aim of policy. Or it could even happen that the gilt-edged market, wide as it is, just became jammed with new issues.

Now if the government was concerned only with the refunding of previous issues and with the funding of Treasury Bills, it ought to be possible to attune its policy to the needs of credit squeeze or credit relaxation and be able to reduce the flow of tender Treasury Bills as required in line with a credit squeeze policy. What has really made the position impossible is that, in addition to that, the British government has recently had to borrow new money on a substantial scale.

In 1955 it had to do so on behalf of the local authorities and on behalf of the nationalized industries. In due course the greater part of the local authority demand was effectively removed from the central government. But the needs of the nationalized industries remained and still do. Their issues, having a Treasury guarantee, may be reckoned for this purpose as an addition to gilt-edged stock, and may weigh down upon the gilt-edged market. Furthermore, if they are not taken up by genuine investors, they have to be carried by the government departments in lieu of tap Treasury Bills and thus serve to add to the flow of tender Treasury Bills. It is to be noted that the capital requirements of the nationalized industries, which happen to be heavy capital users, have been

running at not far short of half the total annual requirements of new capital by industry. Thus the need to finance nearly half of British industry has been thrown on to the gilt-edged market. At the same time there has been a marked trend, which was already well-developed before the war, for genuine investors to rearrange their portfolios in favour of ordinary shares and against gilt-edged stock. Thus there has been a pincer movement upon the government.

This was the fundamental reason why it was impossible for the Bank of England to impose a strong credit squeeze in 1955 in the traditional manner, and why it had to rely instead on the rather odd expedient of getting the quantity of money reduced by an agreement among the deposit banks to curtail their customer loans. As well as having the disadvantage of being slow working, this method is harmful in that it is disturbing to good bank-customer relations. It will be difficult to solve this problem unless the finance of the nationalized industries is radically reformed. There are hopes that the Radcliffe Committee on "The Working of the Monetary System" may be able to excogitate some solution for this problem.

A partial but unsatisfactory solution has had to be found in recent years by the government providing a large "above the line" surplus in the budget; this means in effect that a considerable proportion of the finance for the nationalized industries, which in the old days was provided through ordinary financial channels, has now to be found by the taxpayer. This solution may be satisfactory in conditions when inflation has to be fought. A large budget surplus is an effective weapon in that battle; it means essentially that forced savings are imposed upon the citizen body with a view to providing the capital for this range of industries. But in other circumstances the provision of money to meet the normal capital requirements of industry out of taxation on current income may have an unduly deflationary effect on the economy. It is probably having an unduly deflationary effect now (1958). It might be argued that the budget surplus could be removed in times when total demand was not excessive and restored on the occasions when it was desirable to curb a boom. The objection to this is that this "fiscal" weapon is much too slow working for the ordinary type of investment boom, which is apt to gather momentum, as it did in 1954, rather rapidly. The Chancellor has to provide a new set of taxes, which he normally does once a year only, and these in turn take some time to have their effect in yielding the surplus. If it is desired to impose an orthodox banking credit squeeze more rapidly, then the authorities will be hamstrung, if they continue to have to find new capital in large quantities for the nationalized industries through issues in the gilt-edged market.

The disinflation in the autumn of 1955, which worked mainly through the curbing of customer loans, was reinforced by restrictions on the provision of consumer credit for the purchase of consumer durables. This seems a satisfactory weapon for producing a quick effect; Congress has seemed doubtful whether it is prepared to allow the Federal Reserve System to have it as a permanent weapon in its armoury.

The credit squeeze was further enforced by such methods as instructions to the Capital Issues Committee, and by some minor measures, such as an adjustment of indirect taxes on consumer goods.

Nonetheless, despite all these difficulties, the disinflationary policy did in fact work fairly quickly. It must be remembered that no vigorous measures were taken until the late summer of 1955.

VI. END OF BOOM: COST INFLATION

Factory building starts turned down in the last quarter of 1955 and have continued since then to move down; and domestic orders for machine tools turned down in March 1956 and have continued since then to move down. This time interval for the reaction cannot be regarded as great, especially in view of the fact that the disinflationary measures were not taken, as they should have been, at an early phase of the boom. The more a boom gathers momentum, the stronger the measures have to be, if it is to be brought to at all a rapid end.

Although the recession in orders began in the winter of 1955-1956, the rate of ordering remained too high. Only in the last quarter of 1956 did the factory building completions begin to exceed factory building starts. Machine tool orders fell below deliveries in the late summer of 1956. Both kinds of orders have declined progressively since then.

Some symptoms of a flattening or down-turn of activity came still earlier. One marked feature of boom conditions since the war has been a tendency of the "weekly pay packet" to rise more quickly than the average of official trade union wage rates. In the six months from October 1955 to April 1956 official rates rose more than the weekly pay packet for the first time since the end of the war, except for the six months from October 1951 to April 1952, which was a phase of recession. Early in 1956 employment in manufacturing industry began to drop, and at the same time output per person employed in manufacturing industry dropped more strongly. The figure for the unemployed did not, however, rise above unfilled vacancies until the end of 1956.

Although there were these manifest signs of demand moving down during 1956 and falling below the supply potential of the economy, in many parts of industry there were large backlogs of unfilled orders. And

so, an important question of principle arises. Should the credit squeeze be terminated as soon as it is clearly established that aggregate demand has fallen below the supply potential of the economy, or should the squeeze be kept on for a longer period in order to enable industry to work off its backlog of orders? A right answer to this is only likely to be gained by experience; it will not be gained at all unless current events are fully revealed in current figures and continuously studied closely by those responsible for action. My own provisional view is that, owing to the delayed effect of measures, whether of restriction or relaxation, abnormal restrictions should be removed as soon as aggregate demand falls below supply potential.

A strong case could be made for ending the credit squeeze in the last quarter of 1956. However, the Suez episode created uncertainties about the future, and that was an awkward period for changing course. Serious argument about whether the credit squeeze should be ended began only in early 1957.

The case against terminating it fell under three heads. (1) Concern about the backlog of unfilled orders, already mentioned, was combined with an anxious feeling that, once the restrictive measures were removed, orders would rapidly rise again and the whole inflationary trend be resumed. (2) A cost inflation, caused by wage increases in excess of productivity increases, was proceeding in Britain, as elsewhere, and some held that a further period of deflation was desirable in order to cause an abatement of wage demands. (3) There were anxieties about the external balance.

The question of the backlog has already been discussed. The possibility of a renewed upsurge does not appear to be a valid argument, since in such an event it would always be possible to resume the monetary disinflation; banking policy ought to be flexible and capable of quick adjustment in response to the changes as they occur. That this point of view did not appeal to the authorities may have been due to their having taken quite a wrong attitude to the problem with which they had to deal in this period; instead of supposing that inflationary pressure is something likely to arise at relatively frequent intervals in a free economy and requiring expeditious corrective measures, they seemed to suppose that "inflation" was a sort of disease that, once cured, would be cured forever. It seemed as if they were anxious not to relax discipline until they were quite sure that the disease was thoroughly cured, as though, the job once well done, this problem would give them no further trouble over the years to come. Such a point of view is quite untenable.

The question of the exchange position is reserved for the next section.

The wages problem was a complex one. It is likely that a tendency

to excessive wage increases during this period was due not only to the devaluation of 1949 and other causes setting up an increase of import prices and the consequent spiralling between domestic prices and wages, but also, during certain parts of the period, to demand inflation. Overfull demand, leading to labour shortage, high profits and an upward trend of prices, makes employers willing to grant wage increases easily and gives claimants good arguments on their side. When demand inflation, consisting of an excess in aggregate demand over the supply potential comes to an end, the question may be raised whether it is expedient to push deflation further with a view to reducing employers' readiness to grant further wage increases and to damp the spirit of the operatives in demanding them. While it must be granted that the creation of massive unemployment would produce a substantial effect in this direction, it is by no means so clear that pushing down demand just a little below the full employment level has a good effect in this sense. There is one important respect in which it has a bad effect. In the case of prices fixed in relation to costs, a reduction of turnover and consequent smaller spread of overheads may actually cause producers to put up prices when they would not otherwise do so; this is likely to apply strongly to public services where the reduced use of the services may make a price increase necessary, and, if they are to continue at a profit, inevitable. The experience of Germany is worth noting; during the period after the investment boom production continued to expand; she had larger wage increases than Britain, and the fact that these did not give rise to such large increases in end-product prices was probably due to her maintenance of production at a high level. If weak demand causes prices to rise more than they otherwise would have done, then that is also bad for the attempt to curb wages, since a rising cost of living gives power to the elbow of wage claimants. It may well be that the best possible state of affairs for getting an abatement of wage claims is precisely the golden mean, where demand is not so high as to create pressures and shortages, but high enough to maintain the working of the industrial machine up to full capacity.

Undue wage increases may give anxiety both on the ground of the external balance and on the ground of the internal cost of living. The former is clearly the more important. In considering wages as a cost, to be compared with competitors' costs, hourly earnings seems the best figure to take.* In 1956 German hourly earnings rose 9.5 percent, United States hourly earnings rose 5.2 percent and the British 7.4 percent; in 1957 German hourly earnings rose 8.4 percent, United States 3.9 per-

* Since British official wage rates and weekly earnings rose nearly in line in these two years, the hourly earnings may be presumed to have done so also.

cent. and British 5.7 percent. Although the slight edging up of British hourly earnings over the American was unsatisfactory, the general pattern does not give cause for grave alarm on the score of external competitiveness. Prominent British statements about wages gave world opinion an altogether wrong view of the matter. Even from the point of view of internal policy, the anxiety in these years may have been somewhat overdone. This pattern certainly does not justify any decision on so grave a matter as checking the normal trend of growth of productive activity with a view to influencing the course of wages.

The rate of wage increase was undoubtedly unsatisfactory from the point of view of the internal cost of living. The citizen body was becoming restive and the government was anxious to show that it was doing its best to check what appeared to be a chronic increase. The mere fact that other countries were having the same difficulty might be no consolation to British citizens on fixed income. It would not be correct to compare the wage increases with the increase in productivity in this particular period, since the latter was being held down by deliberate monetary policy. The wage earners would have justice on their side if they retorted that the lack of increase in their production was by no means their own fault. Rather one should compare the wage increases with the normal trend of increase of productivity, as assessed over a term of years. Table II shows an increase in the gross domestic product per person in civil employment of 2.2 percent. By this criterion the money wage increases were markedly excessive. Nonetheless this criterion is not decisive. For we have even at this late period to bear in mind the devaluation of 1949. By 1956 the purchasing power of wages as shown in the official index had risen only by 3.3 percent on the 1938 level giving an average of no more than about + 0.2 percent a year. As productivity had risen by a far larger amount this seems to indicate that even in 1956 there was still a lag of adjustment of wages to the level of prices as established in consequence of the devaluation of sterling in 1949. It is true that by 1956 weekly wage earnings were 41.3 percent up on 1938; this increase was probably substantially greater than that of productivity per person in the 18-year period. The true problem for Britain in these recent years has been the great spread, which is largely due to the demand-inflation which was rife during certain periods, between the average of wages actually paid each week and the official wage rates. The trouble has been that official negotiations relate to official wage rates which appear to have continued to be low. The superior rise in wage earnings was due to special arrangements by particular firms for bonus payments, to overtime work, etc. The authorities may be in the wrong in taking a severe attitude about wage rates when

the trouble bearing upon the British competitive position is the higher level of actual wage payments. It may be the fact that many particular workers have been getting no more than the basic rates; and it is these whose interests trade union officials have to look after. This pattern has presented a tangled and awkward problem.

It has been stated that a demand-pull-inflation may cause earnings to rise more rapidly than official rates. In this connection it has to be most strongly emphasized that this superior rise was checked at the close of 1955. Since then wage earnings have risen, not because of any demand-inflation, but simply because they were being pushed up in conformity with the increases in basic rates. The earnings are often geared by some formula, agreed between the management and employees in a particular firm, which relates them to the standard basic rates; thus they rise automatically if the latter are raised. If the basic rates are unduly low, it is hardly a sound argument to plead that they must not be raised, because that will automatically raise certain earnings that are geared far above them. It is not the right way of dealing with this tangled problem to contract the level of industrial activity.

VII. BRITISH EXTERNAL BALANCE AND WORLD RECESSION

The primary manifestation of the world recession, which developed during 1957, was a fall in primary product prices, leading to a fall in incomes and exchange difficulties in areas particularly dependent upon primary products. Attention has been drawn to the fact of diminished American purchases of the non-ferrous metals. The following Table XI suggests, however, that the United States was not primarily responsible for the adverse development in 1957.

TABLE XI

DOLLAR VALUE OF IMPORTS

	$\left. \begin{array}{l} 4\text{th quarter } 1956 \\ 1\text{st quarter } 1957 \end{array} \right\} = 100$	
	United States	O.E.E.C. countries from outside O.E.E.C. countries' area
1957 2nd quarter	98.4	103.7
3rd quarter	99.7	95.8
4th quarter	104.0	95.0
	101.7	98.2

Source: *General Statistics, O.E.E.C. Statistical Bulletin*, May 1958, pp. 62-64.

The Survey of Current Business (Mar. 1958, p. 15) remarks:

"Purchases from the western European dependencies, Latin-America, and the independent countries of Asia and Africa were substantially higher during the last quarter of 1957 than a year earlier and the same applies if the last six months of these two years are compared. . . . It appears, therefore, that through the last quarter of 1957 at least, any adverse effects of the business decline in the United States upon our imports from the less developed areas was more than offset by the other developments."

The imports of European (O.E.E.C.) countries from non-European countries, are greater than total American imports, and they were rising at a substantially more rapid rate in the years before 1957. Primary products had been geared to the high and rising demand of Europe. In the last quarter of 1956 and the first quarter of 1957 United States imports were running at the annual rate of \$1,069 million, f.o.b., while the imports of European countries from non-Europe were at the annual rate of \$2,149 million, c.i.f. The superior rate of increase by Europe was not due to greater progressiveness, but rather to the fact that her expansion was concentrated upon manufacture, and especially on investment, owing to her unbalanced position at the end of the war. The United States economy expanded more evenly in its different parts. But manufacture has a higher requirement for primary products than "tertiary services." The superior rise in European imports is shown in Table XII. In 1957 European imports flattened off, and indeed declined slightly, while American imports continued to expand. The continued expansion of non-British European imports through 1956 is to be contrasted with relative stagnation in Britain.

The rise in world dollar prices during this period affected both hemispheres. The volume figures, given in Table XIII, bring out clearly the greater expansiveness of Europe. Figures are not available for the volume of O.E.E.C. countries' imports from non-O.E.E.C. countries. Thus Table XIII cannot be directly compared with Table XII.

The American recession has deepened since 1957. Vigorous measures have already been taken, and these measures may serve to prevent any further deepening of substantial importance. On the other hand experts have not been able to point to sources of strong revival, so that it may well be that in the period ahead the United States will be in relatively neutral equilibrium in relation to the rest of the world, and that revival or deeper recession in the non-dollar world will depend more largely on whether there is a marked recovery in Europe. In this respect Britain can play an important part, especially if acting in concert with the Com-

TABLE XII
DOLLAR VALUE OF IMPORTS
1951-1957
(1950 = 100)

	United States	All O.E.E.C. countries from outside O.E.E.C. countries' area	United Kingdom from outside O.E.E.C. countries' area
1951	123.7	143.1	148.2
1952	122.9	132.2	134.4
1953	123.3	123.7	131.8
1954	117.0	130.9	130.9
1955	129.6	149.2	150.2
1956 and 1st quarter of 1957 (annual average).	143.9	167.8	153.6
1956 4th quarter	146.7	178.7	159.0
1957 1st quarter			
1957 2nd quarter			
3rd quarter			
4th quarter	147.7	175.3	155.5
Annual average rate of increase 1950-1956	6.2%	9.0%	7.2%

TABLE XIII
VOLUME OF IMPORTS
(1950 = 100)

	United States	All O.E.E.C. countries	Continental O.E.E.C. countries	United Kingdom
1957	123.9	158.4	175.0	128.9

monwealth, both by the direct effect of a revival of her importation on world markets, and by her example to other European countries that are in a similar position.

In 1957 the United Kingdom had a favourable balance on current account, net of defence aid, of £216 million. If the terms of trade in

1958 remain at the same level as they were in the first quarter of it—and they might get better still, although this would be a bad symptom—and if other things were equal, her balance of payments would improve by £250 million.

If, on the other hand, her production and imports revived so much as to be on the line extrapolating the rate of growth that terminated in 1955, she would have to import about £250 million more goods than before. Thus taking the improved terms of trade and imports appropriate to a really full level of activity in Britain, and assuming invisibles unchanged, her position in 1958 would be the same as 1957. It is immensely preferable, both for her own sake and that of the whole world, that she should take out what she gains by improved terms of trade, in increasing the quantum of her imports. Then, if exports and invisibles remained unchanged, she would have the same favourable balance as she did in 1957. But exports are likely to decline before 1958 is over, and this must cause anxiety to the British authorities. Nonetheless it is desirable to pursue the expansion policy rather than to use a fleeting opportunity to add to gold reserves. If the world recession deepens, British exports will fall more than they otherwise would. It may seem audacious to dissipate the improved balance now accruing from the improved terms of trade by spending on higher imports; but it is in fact much more dangerous not to do so. The dangers inherent in a deepened world recession are far greater than those involved in continuing for a further period to have to live, as Britain has had to ever since the end of the war, on a very narrow reserve.

At the end of 1957 her true net reserve may on one reckoning be stated at £244 million, namely £812 million gold and dollar holdings minus £568 million sterling liabilities outside the sterling area. This was a vast improvement on 1947 when the gold reserve was £512 million and the sterling liabilities outside the sterling area were £1,234.

With this narrow reserve Britain has to face not only the possibility of a worsening in her balance, but also a worsening in that of the whole sterling area. She has to face a possible change in the "leads and lags" of trade, which can run away with £200/300 million in a short time. She also has to repay the International Monetary Fund £201 million in due course. As against this gloomy picture may be set the fact that a complete drawing down to zero of the external sterling liabilities is unthinkable, so that the true net reserve is substantially in excess of the £244 million stated above. Furthermore there are unexhausted drawing rights of about £260 million in the International Monetary Fund. In this present phase, when the world is still on the brink of a deep depression, the British authorities ought to be thinking rather of the possi-

bility of using their unexhausted I.M.F. drawing rights, than of repaying past drawings. This is precisely the kind of situation for which the International Monetary Fund was invented. As regards its usefulness it is a question of "now or never." This is precisely the moment when Britain, and other similarly placed countries, should go forward with a policy of expansion and allow imports to rise at a normal rate at least, with a view to preventing the world recession deepening. This is by no means the moment at which to play the miser and take advantage of a short-period opportunity for raising gold reserves (or for paying off indebtedness to the I.M.F.).

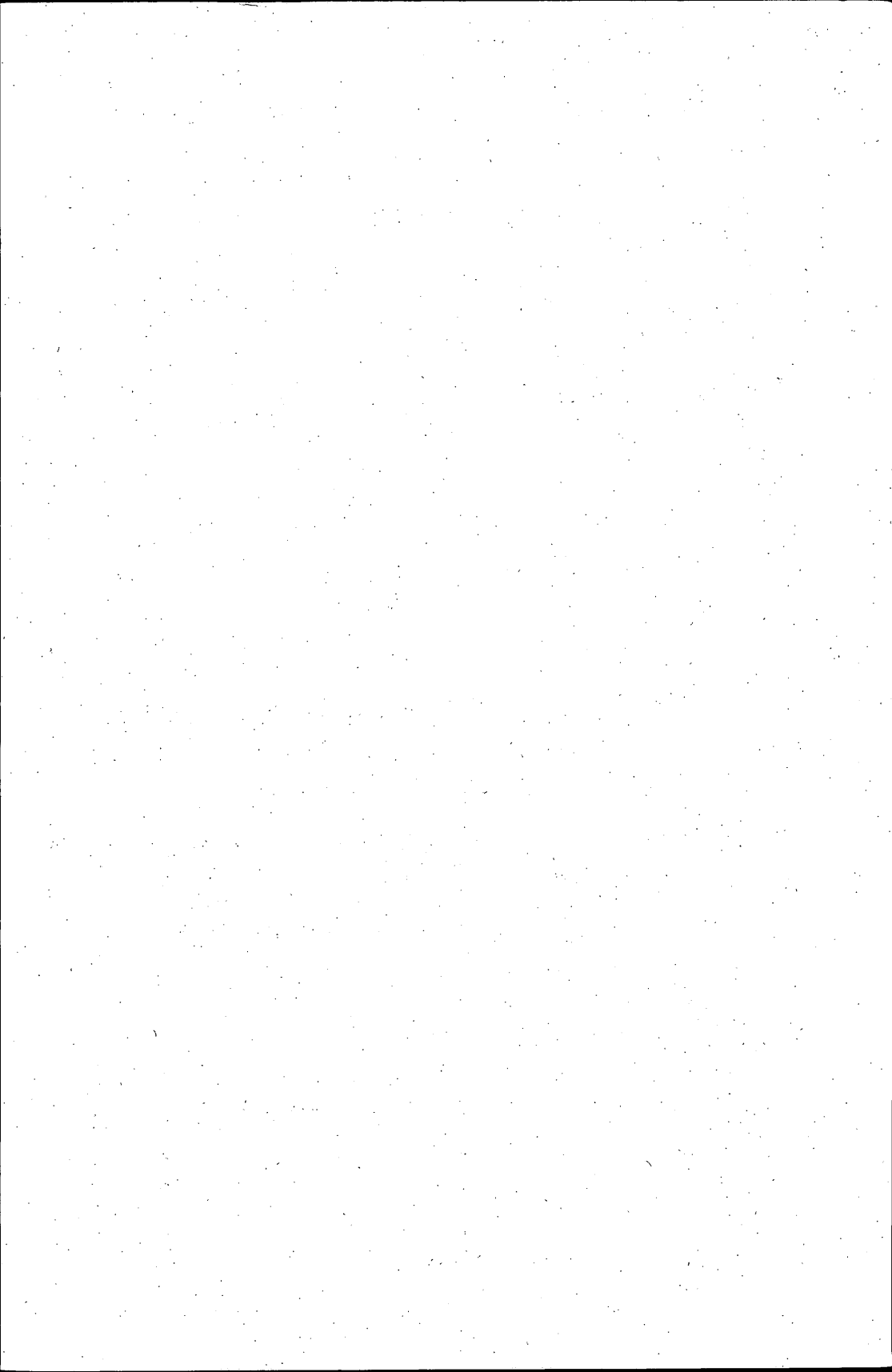
It is true that the British gold reserve is undesirably low; it would be to the benefit of all if it were higher. Its low level is the consequence of the second world war, and also of the failure to fund the sterling balances, the importance of which has already been stressed. But this evil is something that has to be faced and for which there is no short-period remedy.

The increase in the gold reserve of the world is now running at about £200 million a year. This has been to a small extent supplemented in recent years by the increased world holdings of dollars. But, in the absence of an increase in United States gold holdings, an increase in external dollar holdings cannot proceed much further without giving rise to American anxieties about the adequacy of the size of the existing United States gold reserve. It is not generally appreciated that the United States has *already* distributed all her surplus gold (viz. through her liability on external dollar holdings), by generously allowing a negative overall balance in her external payments to subsist for a number of years.

The consequence of this is that, unless there is some radical change in the gold situation, the free world cannot expect its liquid reserves to rise by much more than the actual increase in the monetary gold stock (say £200 million a year) becoming available to it. The entitlement of Britain, as custodian of the whole sterling system, to a share of this increased monetary stock can hardly be put at more than £50 million a year. It is arguable that this is the maximum rate at which, as good neighbour, Britain should seek to add to her own net gold reserves. But self-interest as well as good neighbourliness comes into play here. If Britain seeks to add to her reserves at a greater rate she will inevitably exacerbate the exchange difficulties of other countries and be likely, therefore, to increase the momentum of world recession.

It is the duty of all responsible powers to do their best in such a time as the present to avoid making matters worse for others. In this context Britain's most solemn duty is *not* to try to add to her reserve too quickly.

Britain has the tradition of taking some risks, both in regard to her gold reserve—she has an unbroken tradition of living on a very narrow one—and in regard to military matters. There is an old expression, of patriotic content, relating to battles of former times—"the thin red line"; this military tradition was maintained in the Battle of Britain (1940). Much may depend, in the year or two ahead, on whether Britain continues to maintain this tradition in monetary policy, by adopting a policy of industrial expansion now, and by deliberately taking no more out of the liquid monetary reserves available to the world—unless they are rather dramatically increased—than the £50 million a year, which is about her fair share as custodian of the whole sterling sphere.



RECENT PUBLICATIONS OF INTERNATIONAL FINANCE SECTION

The International Finance Section publishes from time to time papers in three series. These may be ordered directly from the Section. The STUDIES are distributed without charge to persons abroad, but a charge of \$.25, in coin or stamps, is made to cover postage and handling costs for United States residents. The ESSAYS and the SPECIAL PAPERS are distributed without charge by the Section to all interested persons, and standing requests to receive new numbers as they are published will be honored. Only the following papers in these three series are still in print.

SPECIAL PAPERS IN INTERNATIONAL ECONOMICS

A Survey of International Trade Theory. By Gottfried Haberler.
(September 1955)

PRINCETON STUDIES IN INTERNATIONAL FINANCE

The First Three Years of the Schuman Plan. By Derek Curtis Bok.
(December 1955)

Negotiations for Benelux: An Annotated Chronicle, 1943-1956.
By James E. Meade. (March 1957)

Financing Free World Trade with the Sino-Soviet Bloc. By Raymond
F. Mikesell and Jack N. Behrman. (September 1958)

ESSAYS IN INTERNATIONAL FINANCE

Trade Policy in Crisis. By Raymond Vernon. (March 1958)

The Pound Sterling, 1951-1958. By Roy F. Harrod. (August 1958)

