

ESSAYS IN INTERNATIONAL FINANCE

No. 6, Autumn 1945

THE BRITISH BALANCE-OF-PAYMENTS
PROBLEM

ARTHUR I. BLOOMFIELD



INTERNATIONAL FINANCE SECTION
DEPARTMENT OF ECONOMICS AND SOCIAL INSTITUTIONS
PRINCETON UNIVERSITY
Princeton, New Jersey

The present essay, the sixth in the series published by the International Finance Section of the Department of Economics and Social Institutions in Princeton University, deals with a problem of great significance and of high current interest. The author is in the Foreign Research Division of the Federal Reserve Bank of New York and was formerly consultant to the Foreign Economic Administration.

While the Section sponsors the essays of this series it takes no further responsibility for the opinions therein expressed. The writers of the essays are free to develop their topics as they will and their ideas may or may not be shared by the committee on publication of the Section or the members of the Department. The present writer's views are, of course, moreover, not to be construed as representing the attitude of the institution, or official group, with which he is associated.

THE BRITISH BALANCE-OF-PAYMENTS PROBLEM

Arthur I. Bloomfield

Federal Reserve Bank of New York

I. INTRODUCTION

IN the discussions and planning of post-war international financial and economic reconstruction the war-time deterioration in the external financial position of Great Britain, and the probable consequences stemming therefrom, have occupied a prominent, indeed a strategic, place.¹

As far back as 1942 Professor Hansen stated that "the structural change in the English international financial position may be regarded as a major world problem upon the solution of which the course of international relations will fundamentally depend."² More recently Professor Williams has argued that "the solution of England's special difficulties [is] the central post-war problem . . . [and] it seems essential to know how England's problems are to be dealt with before other financial or monetary plans are made."³ As long as the war was in progress no special action could be taken towards solving those problems, nor was any such action strictly necessary in view of lend-lease, Canadian mutual aid, and the willingness of other countries to accumulate sterling balances. The conclusion of the war, however, and the abrupt termination of lend-lease and mutual aid, have at last brought the long-festering British problem to a head. At the moment of writing, ambitious Anglo-American negotiations are being conducted in Washington with a view to devising means of helping Britain over the difficult period ahead, and the outcome of these negotiations will play a crucial role in shaping the future pattern of international trade and finance. Regardless of the

¹ [Editors' Note] This essay was originally prepared for publication about a year ago. As a result of the great changes which have occurred since then, it was necessary to make certain revisions in the text, in order to bring it up to date, but the presentation and general argument have remained essentially unaltered. In view of the considerable amount of writing and discussion on the British problem during the past year, moreover, the essay does not claim to add much that is now "new" to the subject, and parts of it may be a bit stale, at the time of publication, if detailed information regarding the British balance-of-payments position and prospective policies is released as a result of the current negotiations. The editors feel, however, that the value of the essay is unimpaired.

² A. H. Hansen, "Changes in Economic Structure Arising out of the War and their Implications for Public Policy," *Public Policy* (Harvard University Press, 1942), Vol. III, p. 261.

³ J. H. Williams, "International Monetary Plans: After Bretton Woods," *Foreign Affairs*, October 1944, p. 56.

degree of emphasis which one might place upon the relative significance of Britain's external difficulties, there is at least widespread agreement that, until these difficulties are adequately resolved, there can be no hope of achieving a prosperous and well-ordered world economy organized on genuinely multilateral lines.

The basic elements of the British problem may first be briefly summarized. As the result of a huge war-time balance-of-payments deficit, Britain has liquidated over £1,000 million of its most marketable foreign investments, increased its foreign liabilities by about £3,000 million (over and above its lend-lease and mutual-aid liabilities), and disposed of a fraction of its pre-war gold and dollar holdings. As a result of enemy action, moreover, there have been losses and damage of other British foreign investments (notably in the Far East), a decline in British merchant marine tonnage, and substantial destruction of property within Britain itself. These and other striking changes make it inevitable that for some time to come the British balance of payments will be in an extremely tight position. Over-all net receipts from foreign investments, shipping, and other services have been sharply reduced, while imports, as a result of reconstruction, re-equipment, and other requirements, will be high in relation to immediate pre-war levels. Not only will there have to be a very large expansion of exports, estimated at well over 50 per cent above the 1938 volume, if an anticipated deficit on current account of about £400 million a year over the next three years is to be eventually wiped out, but still greater increases in exports will be needed to work off the huge foreign debt. Unless the necessary growth of exports is ultimately forthcoming (and the obstacles in its way are not to be minimized), Britain will be forced indefinitely to continue, or even intensify, its present restrictive and discriminatory trade and exchange policies, with deleterious effects not only on its own well-being but on that of the world as a whole.

The striking war-time deterioration in Britain's international financial position has strongly colored British thinking and planning on post-war reconstruction policies and has resulted in many sharp differences of opinion, and in real and imagined conflicts of interest, with this country. Whereas American opinion, for example, is overwhelmingly in favor of an early restoration of a multilateral trading and exchange system, large and informed sections of the British public are thinking in terms of the need, or even desirability for its own sake, of strictly bilateral, less-than-fully-multilateral, or other such discriminatory policies, including a more or less permanent continuance of state trading, bulk purchases, import licensing, exchange control, payments agreements, and rigid sterling-area arrangements. Differences of opinion regarding international monetary arrangements were amply exposed in the negotiations leading up to the compromise effected at Bretton Woods. Not

only did the British urge the provisional retention of war-time exchange controls, but they called for an international monetary institution with large resources and for a considerable degree of exchange rate flexibility. The Americans, on the other hand, favored the early removal of exchange controls, a smaller Fund, and fewer opportunities to adjust exchange rates. With regard to international cartels, the American attitude is predominantly one of hostility, whereas British opinion, reinforced by the deterioration in Britain's external position, is generally not unsympathetic. Some differences of opinion regarding questions of raw-materials control are also evident in recent Anglo-American negotiations on oil, rubber, and cocoa. In British circles there is a desire for post-war "regulation" in the fields of shipping and civil aviation as contrasted with American insistence on unrestricted international competition. Changes in the relative economic status of the two countries have also led to mutual suspicions. The British, for example, fear a huge post-war American export drive, which would aggravate their own difficulties, while Americans fear that Britain will expand and tighten the present sterling area into an even larger and more closely integrated trading bloc which would continuously discriminate against American exports.

What is frequently overlooked in this country is that these differences in Anglo-American attitudes and projected post-war policies reflect not so much conflicting long-term objectives or national interests, which indeed are virtually identical, as a change in Britain's economic *Weltanschauung* engendered by the war-time shift in its international financial position. The United States has a peculiarly vital stake, both economic and political, in the post-war course which Britain will pursue. By sympathetic understanding of the British problem, and by tangible aid and cooperation, this country can play a strategic part in determining the pattern of Britain's post-war international economic policies and to that degree best serve its own national interests. This essay will outline, on the basis of the limited statistics available, the great transformation which has occurred in the British position, and will analyze its probable *sequelae*, the policy alternatives suggested thereby, and the role which the United States may play in contributing to a satisfactory solution of the British difficulties.

II. THE BRITISH BALANCE OF PAYMENTS:

1939-1945⁴

Although there had been some deterioration during the thirties in its traditionally strong balance-of-payments position, as evidenced by the

⁴ The statistics used in this section have been drawn from so wide a variety of published sources, both official and private, that specific references have been deliberately omitted because of space limitations.

emergence and persistence of an over-all deficit on current account and by a modest reduction in its net overseas assets, Great Britain entered the war an international creditor of impressive proportions with foreign assets greatly in excess of its foreign liabilities. In addition to geographically widespread foreign investments, with a nominal value of almost £4,000 million, Britain held about £500 million of gold and £150 million of dollars (official and private). Chiefly because of the prospects of a heavy war-time balance-of-payments deficit, however, a comprehensive system of exchange and direct trade controls, designed to safeguard and strengthen Britain's external position, was introduced in September 1939.⁵ Among other things, the loosely-knit pre-war sterling area was welded into a closely integrated financial bloc, consisting of the British Empire as a whole (except Canada and Newfoundland) and certain non-British countries, such as Egypt, Iraq, and Iceland, linked together by a common pattern of exchange, trade, and shipping controls. Within this area exchange transactions have been relatively unrestricted, settlements between the members being effected by transfers of sterling in London, but transactions *vis-à-vis* the rest of the world have been rigidly controlled. In addition, there has been a pooling of external monetary reserves so that members of the area outside of Britain have turned over to that country, in exchange for sterling, any current acquisitions of the so-called hard currencies (notably U.S. and Canadian dollars) over and above their current requirements for these currencies. Conversely, the British control has released hard currencies to meet any net requirements of individual members, but the latter have cooperated (to the degree that they have had free choice in the matter) to keep down to a minimum their net demands upon the pool through restrictive licensing designed to hold imports from *outside* the area to those goods which were essential and could not be procured from countries *within* the area. In the early months of the war certain loopholes in the exchange regulations made possible a substantial leakage of foreign balances to countries outside the area, but these gaps were progressively closed after the summer of 1940 by the establishment of a system of bilateral payments agreements with non-area countries. There emerged a network of carefully segregated foreign sterling accounts through which were channeled payments and receipts, in

⁵ In addition, the pound sterling, which had been permitted late in August 1939 to drop sharply below its previous rate of \$4.68, was pegged to the dollar, early in September 1939, at a mean rate of \$4.03 which has been since maintained. The currencies of all countries which remained within the sterling area were depreciated correspondingly. Further to strengthen its position, the British Government made an agreement early in the war with the South African Government whereby the latter undertook to sell to the former all of the Union's current gold output except what was required for its own "use."

terms of sterling, covering trade and specified financial transactions between the individual countries concerned and the sterling area as a whole. With a few exceptions, any sterling accumulating in these accounts has not been convertible into hard currencies, and to this degree has been blocked.

During the war the British balance of payments was revolutionized. The deficit on current account, which averaged a mere £45 million a year in 1936-38, rose spectacularly to an annual average of £719 million in 1940-44 and totaled approximately £4,055 million from September 1, 1939 to June 30, 1945.⁶ These figures, it might be noted, cover only *cash* balance-of-payments transactions, and thereby exclude goods and services received from the United States under lend-lease, and from Canada under gifts in 1942 and mutual aid in 1943-45, as well as goods and services provided by Britain to foreign countries under British mutual aid.⁷ If account is taken of these non-cash transactions, the total deficit during the period would be raised to approximately £8,500 million. The cash deficit of £4,055 million, up to June 30, 1945, was compounded of deficits *vis-à-vis* each of the major areas with which Britain had balance-of-payments relationships during the war, namely, the United States, the rest of the sterling area, Canada, and all other (non-enemy and non-enemy-occupied) countries as a group. The bulk of the cash deficit with the United States was incurred before the introduction of lend-lease in March 1941, although large dollar payments had still to be made thereafter;⁸ there was a huge and continuing deficit with the rest of the sterling area, amounting in the case of India alone to about £1,300 million (or almost one-third of the total cash deficit) and in the case of Egypt to over £300 million; the cash deficit with Canada totaled about £425 million, nearly all of which was incurred before March 1942;⁹ the deficit with the rest of the world was apparently relatively small.

⁶ Chronologically, this deficit may be broken up as follows: September to December 1939, £129 million; 1940, £796 million; 1941, £795 million; 1942, £666 million; 1943, £684 million; 1944, £655 million; and January to June 1945 (estimate), £330 million.

⁷ A rough picture of the magnitude of these items may be given. Total lend-lease aid to Britain up to June 30, 1945 may be estimated at approximately £5,000 million. The gift from the Canadian Government in 1942 (virtually all of which was for direct British use) amounted to £225 million, while Canadian mutual aid from May 1943 (when the program commenced) to March 31, 1945 totaled £325 million. British mutual aid to foreign countries, on the other hand, amounted to £1,079 million up to June 30, 1944 (no later figures being available).

⁸ Britain is officially reported to have spent £1,500 million on cash purchases in the United States up to March 1943, and a further £250 million in 1944. These figures, however, are apparently gross, and thus overstate the actual cash deficit.

⁹ After March 1942, in fact, there was, except for the period January-May 1943, no British *cash* deficit with Canada at all, the overall deficit being covered by the £225 million gift from March to December 1942, and by mutual aid after May 1943.

Although it is impossible accurately to reconstruct, item by item, the composition of Britain's war-time balance of payments on current account (owing to shortcomings and gaps in the available statistics) the major factors causing the huge deficit, and their probable order of magnitude, may be outlined.

The predominant explanation for the sharp deterioration in the British balance-of-payments position was the heavy volume of military expenditures by the British Government in foreign countries, notably India and the Middle East generally, on goods and services necessary for the provisioning and equipping of British troops operating in these areas, together with outlays for the construction of capital installations therein. These expenditures, negligible before the war and substantially inflated by sharp war-time price rises in many of the countries concerned (in the face of unaltered rates of exchange *vis-à-vis* the pound) are known to have aggregated £1,989 million in the three years 1942-1944 alone, an amount almost identical with the total British cash deficit during these years (indicating that the other cash transactions on current account roughly cancelled out). Indirectly contributing to the over-all magnitude of these expenditures was the fact that India, Egypt, and other Middle Eastern countries gave no mutual aid to Britain, even though the presence and military activities of British forces contributed to their own defence. More important, these expenditures include large sums, officially estimated at over £1,000 million up to March 31, 1945, spent primarily on the maintenance of Indian troops outside the frontiers of India under the terms of an agreement reached early in the war.¹⁰

A minor offset to British military expenditures abroad has been foreign military expenditures in Britain, notably by resident Canadian and American forces. Canadian expenditures are known to have totaled £185 million to the end of 1943, and something like twice as large a sum was spent in the subsequent eighteen months. Net American expenditures from July 1, 1940 to March 31, 1945 (after allowance for troop pay sent home) aggregated £240 million (as compared with reverse lend-lease extended to American forces of £940 million).

Further contributing to the war-time growth in Britain's cash balance-of-payments deficit was a reduction in the traditionally large net receipts from foreign investments, shipping, and other service items. As a result of war-time sales, losses attributable to enemy action or occupation, and pledging of foreign investments (against a loan from the R.F.C. in

¹⁰ The other leading members of the Empire, however, *viz.* Canada, Australia, New Zealand, and South Africa, paid for their overseas military expenditures in full, even though in some of these cases temporary advances from the British Government were necessitated.

1941), and also of increases in foreign liabilities, net receipts from foreign investments may be estimated to have declined steadily from an average of £203 million a year in 1936-38 to about £110 million by 1944.¹¹ Net shipping receipts may also be presumed to have registered sharp declines during the war (the 1936-38 average was £105 million a year) as a result of tonnage losses from enemy action¹² and of heavy calls upon foreign shipping services. Reductions are also likely to have occurred, under the impact of war-time trade and exchange controls, in the net earnings from a wide range of miscellaneous service items which averaged £45 million a year in 1936-38 and which chiefly reflected Britain's position as a world banking, insurance, trade, and entrepôt center.

The war-time increase in the British cash deficit may have also reflected, in relatively small part, a higher annual cash trade deficit than before the war, but this possibility is not unambiguously corroborated by the available statistics which are somewhat incomplete and which cannot be accurately adjusted to a cash basis. Between 1938 and 1944 British exports declined sharply from £471 million to £258 million, representing a 69 per cent drop in volume terms on the basis of an average price rise of 78 per cent.¹³ On the other hand, total retained imports (including munitions) rose from £858 million in 1938 to £2,361 million in 1944. This represents an increase of 36 per cent in volume, but, if one excludes munitions, there was actually a decline in volume of 21 per cent in the face of an average price rise of 91 per cent. The import value figures are greatly inflated by the inclusion of goods received under lend-lease and Canadian gifts and mutual aid. In fact, on the basis of such adjustments as can be made for these items, it appears that, over part of the period (e.g., 1942-1944), annual *cash* imports may have actually been lower than in 1938. On balance, the export and import statistics suggest some increase in the average annual cash trade deficit, as compared with 1938, but not on a scale large enough to have played a significant part in accounting for the greatly expanded deficit on current account as a whole.

The British cash deficit of £4,055 million up to June 30, 1945 was

¹¹ This estimate was made on the basis of (i) the pre-war rates of return on the investments sold, lost, or pledged, and (ii) the rate of interest (generally 1 per cent) paid on the increased amount of foreign liabilities.

¹² From the beginning of the war to the end of 1943 the size of the ocean-going fleet under the British flag declined from 17.5 to 15.5 million tons, or, if one excludes ships that were returnable to other flags after the war, to 13.5 million. Since that date, however, there has undoubtedly been some improvement in the British position.

¹³ This sharp decline in exports chiefly reflects the heavy domestic pull on British resources, the influence of lend-lease and mutual aid which reduced the need for pushing exports to obtain foreign exchange, restrictions on exports imposed by the Lend-Lease White Paper of September 1941, and loss of enemy and enemy-occupied markets.

accompanied, of course, by an identical amount of overseas disinvestment of assets and accumulation of foreign liabilities, since the excess of goods and services purchased over those sold had obviously to be paid for in one of these ways. This deficit might be estimated to have been financed roughly as follows: £2,950 million by an increase in foreign liabilities (including increased foreign sterling balances of £2,690 million and foreign borrowings by the British Government of £260 million);¹⁴ £1,000 million by net liquidation of foreign long-term investments (of a nominal value somewhat in excess of that amount);¹⁵ and £105 million by net sales of gold and dollars.¹⁶ Thus, from the beginning of the war to June 30, 1945, British foreign liabilities rose from roughly £400 million to £3,350 million; the value of foreign investments declined from £4,000 million to somewhat under £3,000 million; and holdings of gold and dollars dropped from £650 million to £545 million.¹⁷ It might be noted that, of the increase in foreign sterling balances, a relatively small part reflected the net sale to Britain of dollars by the rest of the sterling area under the sterling area pooling arrangements.¹⁸

The following table summarizes the geographical distribution of the two major constituents, as estimated above, of British overseas disinvestment, *viz*, increases in foreign liabilities and sales of foreign investments.

¹⁴ Derived by subtracting £400 million, which is believed to have been the total of foreign liabilities on September 1, 1939, from £3,350 million, which was the approximate total on June 30, 1945. (At the end of August, 1945, the total was officially reported at about £3,500 million).

¹⁵ Derived by adding together the cash receipts from known sales of British foreign investments (see Table p. 9). This total, of course, excludes foreign investments permanently lost through enemy action and about £125 million of investments in the United States pledged against the R.F.C. loan (which will be returned when the loan is repaid). The investments sold consisted of (i) sterling securities issued or guaranteed by foreign governments, (ii) foreign corporate securities, chiefly denominated in foreign currencies, and (iii) small blocks of direct investments.

¹⁶ This figure is a residual obtained by subtracting the increase in foreign liabilities and sales of foreign investments from total cash overseas disinvestment. (Net sales of foreign exchange other than dollars were apparently negligible). Because it is a residual, this figure is affected by any errors in the estimates of the other two items. It may also be affected by the fact that no allowance is made in these estimates for loans which the British Government has made during the war to foreign governments, totaling £308 million at the end of 1944. No adjustment can be made here because the writer does not know how or whether this item has been taken account of in the British estimates of overseas disinvestment.

¹⁷ By September 1, 1941, British gold and dollar holdings, according to the last official estimates, had actually declined to a mere £128 million, but there was a steady increase thereafter as a result of continued acquisitions of gold from South Africa, and of net supplies of dollars from the rest of the sterling area under the system of dollar pooling, in the face of reduced British gold and dollar disbursements following the introduction of lend-lease. This estimate of British holdings of gold and dollars, on June 30, 1945, agrees closely with a widely circulated current estimate of about £500 million.

¹⁸ India, Australia, and (before the Japanese invasion) Malaya are believed to have been the major net dollar contributors to the pool.

*Major Items in Britain's Overseas
Disinvestment: By Countries.
September 1, 1939-June 30, 1945
(millions of pounds)*

<i>Country</i>	<i>Increase in Foreign-owned Sterling Balances</i>	<i>Loans to British Government</i>	<i>Sales of British Investments</i>	<i>Total*</i>
India	1,020	30	325	1,375
Egypt	325	—	15	340
Canada	—	140	195	335
United States	—	67	175	242
South Africa	20	—	135	155
Australia	90	—	65	155
Argentina	70	—	35	105
Eire	100	—	—	100
Palestine	95	—	—	95
Malaya	85	—	—	85
New Zealand	55	—	15	70
All others†	830	23	40	893
Total	2,690	260	1,000	3,950

* These figures understate the British cash disinvestment *vis-à-vis* the United States and Canada because no allowance is made for the large net sales of gold and dollars to these countries. On the other hand, the disinvestment *vis-à-vis* India, South Africa, Malaya, and Australia is overstated because no allowance is made for net dollars and/or gold received from these countries. No breakdown is possible.

† Especially the British colonies not otherwise specified, Portugal, Iraq, and Brazil.

III. POST-WAR PROBLEMS AND POLICIES

Great Britain, to quote Lord Keynes, "has fought the war on the principle of unlimited liability and reckless disregard of economic consequences," and "has sacrificed every precaution for the future in the interests of immediate strength." One conspicuous result of this policy, courageous though it may have been, has been that while Britain, long the world's leading creditor nation, has emerged from the war a debtor, with foreign liabilities of some £3,500 million and foreign investments reduced to under £3,000 million, most of its allies have greatly improved their international financial position and generally at British expense. This shift is merely one conspicuous manifestation of the fact that Britain has undoubtedly borne a disproportionately large share of the allied war effort. Notoriously difficult though it may be to define with any precision the concept of "international equality of sacrifice," there is widespread agreement that Britain's total contribution, relative

to its resources, has been greater, with the possible exception of Russia, than that of any other allied participant.¹⁹ Had there been equal sharing of the joint costs of the war, Britain's external financial deterioration would have been appreciably moderated, although some considerable deterioration was in any case inevitable in view of Britain's extremely heavy dependence upon foreign sources of supply.

War-time changes in Britain's position have left as their legacy two major external problems which will set the pattern of economic policies for some time to come. First, the British balance of payments on current account will be characterized by a heavy deficit, though presumably a rapidly diminishing one, which may average £400 million a year, for the next three years, even on the assumption of continuing close controls over British foreign expenditures.²⁰ Second, Britain has accumulated huge external liabilities (exclusive of lend-lease and mutual aid) which will require some form of settlement.²¹ Both problems merge into one in that the ultimate solution in each case must lie in a very great increase in exports relative to imports. Since there is no inclination to reduce imports, so vital to the traditional British standard of living, export expansion has become one of the overriding objectives of present-day British economic policies.

In analyzing Britain's external financial problems and policies, it is important to distinguish the early post-war years from the so-called longer run. The former period will be characterized, in Britain as in much of the world, by problems of demobilization, reconversion, the satisfying of huge accumulated backlogs of demand, and restoration of war damages, and there will consequently be over-all shortages in relation to demand, high levels of incomes and prices, and the retention, though on a gradually diminishing scale, of internal controls over production, consumption, and prices, for probably as much as five years after the war. During this period the British balance of payments will be in an extremely tight position, necessitating the continuance of direct controls over imports, exports, capital movements, and the foreign exchanges, and presumably of the present rigid sterling-area arrangements in which the various members will probably continue to participate.²² In

¹⁹ This fact strengthens the case for generous post-war financial assistance including the scaling down of Britain's debts by the various creditors.

²⁰ The three-year period 1946-1948 is chosen because it is assumed here that by 1949 the British deficit on current account will have been reduced to at least nominal, i.e., pre-war, levels. This assumption, which may be unduly optimistic, is based on an expectation of a fairly rapid improvement in exports, sufficient, along with other invisible receipts, to pay for essential imports and other current account expenditures which will be kept down by careful economies.

²¹ There are widespread indications that the settlement of these obligations will be generous, although the matter cannot be gone into here.

²² But see below the discussion of the possible discontinuance of the dollar pool system. It might be noted that the Bretton Woods Fund agreement, to which Britain will pre-

fact, during this period there may be an almost irresistible temptation for Britain, given its large import deficits *vis-à-vis* many individual countries, its semi-monopsonistic position in many commodities, and the existence of huge foreign balances in London, to pursue restrictive and discriminatory practices (designed to exploit its position and to acquire its essential import needs on terms favorable to itself) such as bilateral trade balancing and preferential treatment for its exports. In the longer run, however, when the problem of "internal" shortages throughout the world has disappeared, the probable pattern of Britain's balance of payments becomes much more cloudy, and it is correspondingly difficult to make assumptions as to the critical variables involved in its foreign economic policies, such as the level of world incomes, the adaptability of British export trade to altered world conditions, and the character of American policies.

Transitional Problems. For several years to come Britain will be faced with sharp declines in its net returns from invisible items, which played so important a role before the war in balancing the British international accounts. By 1944, as estimated above, net receipts from overseas investments had declined to about £110 million as compared with £203 million a year in 1936-38. Whether or not there will be significant changes in these net receipts during the next few years will depend upon such factors as the extent of further sales of foreign investments, the degree of change in the outstanding volume of foreign liabilities, the rate of interest to be paid on these liabilities,²³ the amount of damage to British investments in formerly occupied territories, and the levels of income throughout the world. In the absence of specific information on these matters, it may be broadly estimated that net receipts from overseas investments may average £80 to £130 million a year in 1946-48. Some modest declines in net shipping receipts, as compared with the 1936-38 average of £105 million, may also be anticipated, but the generally accepted estimate of a £50 to £60 million a year reduction in the next few years seems too high in view of the fact that the effects upon receipts of the war-time reduction in the size and efficiency of the British merchant marine may be substantially, if not entirely, offset by high freight rates, fuller utilization of tonnage, and rapid replacement of war-time tonnage losses. Net receipts from financial and miscellaneous services may also remain somewhat below the 1936-38 average of £45 million a year as a result of continuing controls over foreign trade and the exchanges. The greatest unknown among the invisible items in the early post-war years, however, is overseas military expendi-

sumably adhere, sanctions the continued retention of "restrictions on payments and transfers for current international transactions," and thereby implicitly legitimizes, among other practices, the present sterling-area arrangements, for as much as five years after the Fund is set up.

²³ Possible methods of handling the sterling balances problem are discussed below.

tures. This item, which was negligible before the war, amounted to £716 million in 1944, though it was offset in relatively small part by foreign military expenditures in Britain. While the net debit item on this account should drop off rapidly to nominal levels, within the next few years, it may aggregate a substantial sum over the next year or two in view of the time required to bring troops home and the need for maintaining some occupation forces abroad. On balance, British net receipts from invisible items as a whole might average as low as £150 million a year in 1946-48 as compared with £345 million a year in 1936-38, representing a decline of over 50 per cent. Even if there were no changes, then, in pre-war import and export values, the British balance on current account might tend to exhibit an annual deficit of about £250 million a year for the next three years.

Imports, however, are likely to be considerably higher than before the war, as a result of the need for reconstruction, repair of damaged property, re-equipment and replacement of plant, restocking of inventories, the expansion and modernization of the pre-war plant generally, and of some increase in present depressed consumption levels. In fact, in the absence of control, the backlog of demand, supported by a high national income and large accumulated liquid assets, would be so huge as to lead to an inflationary spiral at home and to explosive effects on an already deteriorated balance-of-payments position. Although rigid controls must be maintained, some modest increase in the volume of imports in 1946-48, as compared with 1936-38 (which were years of only moderately high activity), seems likely if reconstruction is not to be retarded and consumption unduly restricted. Since import prices will be substantially higher than before the war (though perhaps not as high as their present levels), it becomes doubly clear that the *value* of imports will be much larger, probably by almost 50 per cent, than the 1936-38 annual average of £868 million. Admittedly, the authorities, through the operation of their controls, will not permit much increase in the level of consumption until the balance-of-payments position has improved, and will undoubtedly keep down the rise in the over-all value of imports by substituting, where possible, domestic for foreign goods (notably foodstuffs) and cheaper for dearer goods, by eliminating luxuries and unessentials, by continued economies in the use of raw materials, and by bulk purchases and state trading designed to restrain price rises.²⁴ The sources of supplies, moreover, will be closely controlled according to the availability of foreign exchange, the shipping position, and other factors. Close examination of the structure of British imports,

²⁴ Bulk purchase contracts have already been negotiated, for example, covering imports of sugar, meat, and dairy products over the next three years, and it has been announced that the United Kingdom Commercial Corporation, first set up in 1940, will be continued as a government trading agency for at least another year.

however, strongly confirms informed opinion that, despite war-time expansion in domestic agricultural production and economies in raw material use, the possibilities of additional import reductions, without frustrating reconstruction and restricting living standards, are decidedly limited for a country so heavily dependent upon foreign supplies as Britain.

It is clear, then, that a very great expansion in the value of exports over the immediate pre-war level will be required if a huge deficit on current account, compounded of declines in invisible receipts and increases in imports, is to be avoided. It is widely believed that, in volume terms, exports would have to rise by at least 50 per cent above the 1938 level, or five times above the 1944 level, if even the 1938 volume of imports is to be paid for. (This "target" cannot easily be translated into value terms in view of uncertainty as to post-war levels of export prices.) *Prima facie*, the prospects for so large an expansion of exports in the early post-war years, despite the serious war-time disruption of Britain's export connections, would not appear unfavorable. Throughout the world there will be a huge accumulated backlog of demand for goods of all kinds;²⁵ British export prices will be substantially above pre-war levels (though they will probably not have risen, as compared with 1938, by as much as import prices); and many important potential competitors, such as Germany and Japan, will be temporarily out of the market. The major limitation upon export expansion in the next few years, however, will lie, not on the demand side, but on the supply side. Due to heavy backlogs of domestic demand in the face of over-all shortages of civilian goods accompanying the time-consuming process of reconversion, it will be essential to allocate available resources among the various competing demands of which exporting is only one. Although the government has emphasized that high priorities in manpower, raw materials, and factory space will be given to production for export,²⁶ there will, of necessity, be some relative limitation upon the volume of resources that can be released for this purpose if reconstruction is not to be held up and consumption unduly depressed.²⁷ There is, in addition,

²⁵ On the other hand, it must be admitted that many of the countries most in need of goods, notably the war-devastated regions of central and eastern Europe, of Russia and China, will be among those least able to pay Britain (and other suppliers) in the form of gold, acceptable foreign exchange, or goods.

²⁶ There is a danger, however, that, unless the government takes more active and direct steps to expand exports than by the mere grant of high priorities, industries may find the home market more attractive than the export market. Such measures as the increase early in 1945 in the limit of the government's liability under its export credits insurance scheme are clearly insufficient.

²⁷ This conclusion could be demonstrated by reference to the possible distribution of British national income in the reconversion period as between consumption, government expenditures, private reconstruction expenditures, and the foreign balance. I have experimented with several possible models all of which lend support to the above proposition.

the technical consideration that, even if resources were released in sufficient quantities for export purposes, it would inevitably take time for industries to switch over to their full exporting capacities because of the need for reconversion and re-equipment of plant, transfer and re-training of labor, and the like. Another obstacle to an early restoration of balance-of-payments equilibrium is that British exports require a large fraction of imported raw materials, probably 15 to 25 per cent, and an expansion of exports relative to imports is thus more difficult to achieve than in countries where exports and imports are not so closely tied together. Although it may be presumed that exports will recover rapidly over the next few years, especially if reconversion is prompt, their cumulated total during 1946-48 will unquestionably fall considerably short of the amount that would be necessary to achieve an even balance on current account.

On the basis of the best estimate that the writer can make, the British current account deficit during this three-year period may average about £400 million a year. If any exports are sold abroad on long-term credit terms, or, worse still, if long-term foreign loans not tied to specific shipments of British goods are extended, the over-all balance-of-payments position would be further deteriorated from the capital accounts side.²⁸ Although the government has emphasized that as far as possible goods will be sold on cash terms, it has already granted a £50 million credit to China and similar long-term credits to Russia are contemplated.²⁹ To the degree, moreover, that existing foreign holdings of sterling balances are paid off, whether in the form of goods or free exchange, the total balance-of-payments deficit would similarly be increased from the capital accounts side.

It is frequently argued that a depreciation of sterling would make a substantial contribution towards rectifying the deteriorated British balance-of-payments position on current account. Although some long-run decline in the exchange value of the pound from its present level may perhaps be necessary because of the substantial net loss of invisible receipts and the accumulation of a huge foreign debt (but not because of any crude generalizations based on uncritical comparisons of artificial war-time price and cost indices) a depreciation in the early post-war years would not be very helpful. During this period, as already suggested, foreign elasticity of demand for, and the elasticity of supply of, British exports will be relatively low, and, unless the degree of depreciation is extremely large, the increase in the foreign-currency value of

²⁸ Under the Bretton Woods plan for an International Bank, Britain would be safeguarded by veto powers against having its local currency contribution to the Bank used by that institution for loans to other members and against the Bank borrowing funds in the British market for lending purposes.

²⁹ The government is also committed to extend up to £80 million to UNRRA for relief and rehabilitation.

exports is not likely to be significant. Since the elasticity of British demand for imports will also be low, there would similarly be no significant decline in the foreign-currency value of British imports.³⁰ The net improvement in the trade balance would thus be slight, as compared with that of no depreciation,³¹ and, given the character of the relevant elasticities, is likely to be accompanied by a sharp decline in the terms of trade which would add further to the real burden which Britain will in any case have to undergo in restoring equilibrium in its balance of payments. There is, moreover, the consideration that any depreciation would be likely to be offset, so far as trade with sterling-area countries is concerned, by corresponding declines in the exchange values of the currencies of these countries, and might provoke retaliatory action elsewhere.³² Finally, depreciation would have the undesirable tendency to raise the sterling price of exports and imports, thereby adding to the inflationary tinder and operating, in part at least, to wipe out any export advantages which might accrue from the depreciation. Similar arguments could be presented to show that a policy of export subsidies by Britain would also be unwise.

The British balance-of-payments deficit over the next three years will be compounded of deficits *vis-à-vis* the United States, the rest of the sterling area, Canada, and perhaps all other countries as a group. Of major importance is the fact that the deficit with the United States, which, in view of an unusually large degree of dependence on this country as a source of supply in the early post-war years, may amount to as much as 40 per cent of the total, will be aggravated by pressure from the present holders of sterling balances (most of whom have the bulk of their external monetary reserves tied up in this form) to convert a substantial fraction of these balances into dollars and other hard currencies to meet long-pent-up demands for goods which Britain, for reasons already stated, will not be in position to supply freely for several years. The dollar earnings of many of these countries will be sharply cut with the rapid decline in American military expenditures in their territories and, given the elimination of lend-lease, are likely to be substantially exceeded by their current dollar requirements (even though

³⁰ We assume here that foreign and domestic demand elasticities, while low, are in excess of unity. If, as is not altogether unlikely, their sum is less than unity, the balance of trade would be worsened as a result of depreciation, and an appreciation would theoretically be called for. These technicalities cannot be elaborated here.

³¹ The low elasticity of supply of British exports and the low foreign elasticity of demand for these exports also explains why reductions in foreign tariffs would not be likely to have an appreciable effect upon British exports in the early post-war years.

³² A depreciation of sterling would also doubtless provoke opposition from the present holders of sterling balances since the foreign currency equivalent of those balances would be reduced. Argentina, however, is protected against a sterling depreciation by a gold guarantee.

continued economies are practised).³³ Inevitably, there will be concerted demands upon Britain to turn over dollars in exchange for existing sterling balances and for balances currently accruing. In particular, there will be strong "moral" claims from sterling-area holders of these balances for conversion of at least the part of their balances which resulted from their net war-time sales of dollars to Britain. In view of its tight external position, Britain can presumably accede to these requests to only a relatively limited extent, but at least some degree of convertibility of sterling balances into dollars in the next few years, dependent in large part upon the amount of aid forthcoming from this country, seems "politically" unavoidable.³⁴ Thus, far from being net contributors to the British dollar reserves as they have been during the war, the rest of the sterling area is likely to make net drafts upon those reserves in the early post-war period. To the extent that existing sterling balances are converted into dollars, Britain's overall deficit would be correspondingly increased.

How is Britain to finance this anticipated deficit in 1946-48? Use of existing resources can provide only limited assistance. If the estimates of this essay are correct, Britain may hold at present about £500 million of gold and dollars (part of the latter being in private hands but presumably mobilizable), but the British authorities would undoubtedly be unwilling to draw down these holdings below a certain minimum necessary for working balances and future emergencies, e.g., £250 million. British overseas investments may still have a nominal value of somewhat under £3,000 million, but the present possibilities of liquidation, except at fire-sale prices, seem very restricted since the most marketable investments have already been disposed of.³⁵ Further liquidation, moreover, would accentuate the current account deficit by reducing investment income. If Britain adheres to the Bretton Woods plan it would also be entitled to maximum net aid from the Fund of £325 million,

³³ In the years immediately before the war, according to informal estimates, dollar receipts of the sterling area (excluding Britain) on current account were only moderately in excess of dollar outlays. The restricted dollar earnings of British Malaya in the early post-war period, due to damage and destruction of rubber plantations and tin mines, will tend to add to the factors making for a net dollar shortage on the part of these countries as a group. (Malaya was the largest single dollar contributor in the sterling area before the war.)

³⁴ As will be noted below, moreover, some degree of convertibility into dollars will be necessary if Britain is to be able to induce the holders of sterling balances to scale down the size of these balances. The dollars in question might be turned over to the holders at once in a lump sum, or might be doled out to them in given amounts per year along the lines of the Anglo-Egyptian and Anglo-Iraqi financial agreements of 1945.

³⁵ Already India, Canada, South Africa, Argentina, and Egypt have repatriated virtually their entire public sterling debt, while the most marketable British holdings of foreign corporate securities, notably dollar securities, have been sold or pledged. Apart from Australia and New Zealand, where room for further public debt repatriation still exists, most of the remaining investments fall within the category of direct investments for which no ready markets are available.

but no more than £81 million could be obtained in any twelve-months period. In the first year, however, such aid as Britain might obtain would be partly offset by that country's initial contribution to the Fund of 10 per cent of its gold and dollar holdings (roughly £50 million on the basis of present estimated holdings). Since the Fund is not likely to get into operation, moreover, until the latter months of 1946, and since there is no necessary assurance that Britain's net aid from the Fund can be obtained in full (especially in the form of dollars), it is clear that not much help can be expected from this source in meeting the anticipated deficit in 1946-48.³⁶

It is clear from the foregoing that Britain's over-all deficit in the transition period will have to be financed predominantly by direct aid from foreign countries. With regard to the current account deficit with the rest of the sterling area, it may be presumed that the countries concerned, for want of any better alternative,³⁷ will agree to add to their holdings of sterling balances although they may insist that some fraction of their current surplus with Britain be made convertible into dollars. It may also be presumed that Canada will extend loans or credits on a generous basis in keeping with its war-time performance; the Canadian Government, moreover, has already registered its opposition to further repatriation of Canadian securities now in British hands. Arrangements for the financing of Britain's deficit in the early post-war years with various Western European countries, such as Belgium, France, Sweden, Denmark, and the Netherlands, have already been concluded in the form of bilateral financial agreements with these countries whereby the latter agree, among other things, to accumulate sterling up to given, or unlimited, amounts in return for an equivalent commitment on the part of Britain to accumulate their currencies if need be.

The problem of transition financing, then, largely resolves itself into an American dollar problem. Britain will need dollars, presumably from \$4 to 6 billion, not only to meet its own large current account deficit with the United States, but also to permit some minimum degree of convertibility of foreign-held sterling balances in the next few years. The bulk of these dollars will have to be obtained in the form of direct

³⁶ Britain might also be expected to acquire about £50 to 75 million a year in gold from the Empire, notably South Africa (such acquisitions having been taken account of in our estimates of Britain's anticipated current account deficit).

³⁷ Since most of these countries normally sell an unusually large fraction of their exports in the British market, it may be difficult for them, on the assumption that they will be able and eager to export in substantial volume, to make any major shifts in this trade pattern. Most other potential buyers, moreover, such as war-stricken European and Asiatic countries, will be in no better position than Britain to make satisfactory payment. Finally, it will be in the long-run interests of sterling-area countries to help Britain over the difficult transition period if they are to hope for ultimate repayment of their existing sterling balances.

aid from this country. Since outright American gifts to Britain (for which a reasonably good case could be made out) seem politically out of the question, the aid must take the form of a loan. While the British have frequently expressed pronounced reluctance to assuming a large dollar debt, there seems, in the very nature of the case, to be no *satisfactory* alternative if they are to be enabled to finance their minimum requirements in the transition period. On the other hand, if this aid is not forthcoming on generous terms, the British may choose instead to restrict even further their expenditures in this country (and seek to expand purchases elsewhere as far as possible), to tighten the links within the sterling area, to draw closer to Western European countries on the basis of the recent financial agreements, and to make full use of various defensive trade mechanisms (developed during the war) in an endeavor to exploit Britain's bargaining position in obtaining needed imports on favorable terms. Such policies would perpetuate and even intensify restrictions and discriminations against American exports and seriously compromise our hopes for an eventual restoration of a multi-lateral world trading system. Realistic economic self-interest, and not merely sentimental considerations, point, therefore, to the desirability of generous financial aid to Britain by the United States during the crucial transition period.³⁸

Loans might be extended by this government to Britain in a variety of possible forms which need not detain us here. Since the loan will presumably be made on special terms, it will doubtless require Congressional approval.³⁹ The loan might bear a low, e.g., 2 per cent or even zero, rate of interest, and be repayable over a lengthy period of years on the basis of a flexible amortization schedule, with initial payments to commence not earlier than three to five years from now. Alternatively, the loan might bear a low interest rate with no schedule of principal repayment at all, this to be left to British discretion. Perhaps the best form of loan would be a "line of credit," with a high maximum, to be used only so far as necessary. Confidence, on the part of all concerned, in the resources available to the British to meet any demands on them would go a long way to diminish the pressure which will otherwise be brought to bear. The larger the amount of the loan, of course, the speedier would be British reconversion, reconstruction, and resumption of exports, the greater the degree of free convertibility of sterling that could be permitted, and the sooner the possibility of a relaxation of British defensive trade and exchange controls.

³⁸ A similar case could be made out for generous disposal of our surplus government property in England, notably our stockpiles of foodstuffs and raw materials.

³⁹ There is a possibility that moderate amounts of dollars might be made available to Britain through private channels in the form of an expansion of American branch plants in Britain or of American purchases of internal British securities.

The question of a *quid pro quo* invariably crops up in connection with discussions of American financial aid to Britain. To a large degree this emphasis is misplaced in that the real benefits stemming from such aid will lie in the contribution which it will make towards the restoration of a large volume of multilateral, non-discriminatory, trade in which we have a vital stake. On the other hand, it would seem appropriate to seek certain specific concessions from Britain. We might, for example, insist that Britain take steps to induce its creditors to scale down the amount of their sterling balances, although this seems hardly necessary in that British interests in this matter are at least as great as ours. We might also ask for an early or immediate abolition of the so-called dollar pool. In large part such an abolition would be merely a formal gesture on Britain's part in that the act of pooling, except for India and some of the Crown colonies, has always been voluntary in character, and the various members might still wish, as a form of aid to Britain, to turn over to it any surplus dollars which they might be acquiring. For reasons already suggested, however, the sterling-area countries outside of Britain are likely, as a group, to be making net drafts upon, rather than net contributions to, the pool in the early post-war years. A "breakup" of the pool would, therefore, be largely meaningless so far as its effects upon American export trade are concerned.⁴⁰ More genuine concessions, though of a longer run character, might be sought. We might seek, for example, to extract from Britain a promise to eschew a policy of bilateral clearings and similar practices, and to work, in general, towards an early removal of quantitative import restrictions, especially in so far as they involve discriminations against American goods. We might also seek an early removal or relaxation of Imperial Preference even though the effects of this system in the period immediately ahead will be minor as compared with other forms of discriminations against American goods. These commercial policy matters might, however, be better left to the forthcoming International Trade Conference. In general, unless our financial aid is extended on almost inconceivably generous terms, we cannot hope, nor should we seek, to obtain from Britain, in its weakened condition, a highly exacting *quid pro quo*.

The Problem of Foreign Sterling Balances. In the early post-war years, as already suggested, the British are likely to permit a limited degree of multilateral convertibility of foreign sterling balances (which today total about £3.5 billion)⁴¹ in the form of net releases of dollars

⁴⁰ An abolition of the pool would not, of course, necessarily involve an abolition of the unified exchange-control regulations practised by the sterling-area members nor of their discriminations against American goods.

⁴¹ This total includes foreign loans extended to the British Government, except for the R.F.C. and Indian Government loans for which special payment arrangements have already been made.

to meet only the most urgent needs of the various creditors. In the absence, however, of special measures (such as cancellation of the debts or very large dollar loans) no *net* liquidation of these balances for several years is at all likely, even in the form of British goods; on the contrary, the total, as noted above, will tend to rise and to remain immobilized until the British current account deficit has been worked off.⁴² By the end of 1948, if no special action has been taken, these liabilities may have risen to about £4 billion. Some forward-looking arrangements for the ultimate settlement of this huge dead-weight debt should, however, be made now; the fact that the creditors are primarily sterling-area countries should greatly facilitate the eventual solution.⁴³ The British are committed, to quote Lord Keynes, to "settle honorably what was honorably and generously given," but the former Chancellor of the Exchequer has cautioned that the creditors "must be reasonable and not seek to treat war debts on the footing of ordinary commercial obligations."

Probably as much as £750 million of the balances outstanding represent legal currency reserves and working balances of sterling-area central banks (and currency boards) and are thus not likely to be withdrawn even if exchange controls were removed. During the war the note issues in these countries have greatly expanded, chiefly as a result of active balances of payments with Britain, and a substantial fraction of the sterling thereby acquired is held as legal cover. Higher price levels than before the war will also necessitate larger working balances. Some countries such as Australia and New Zealand, moreover, tended to be chronically short of sterling before 1939 and will wish, for this reason, to hold larger balances. Unless one assumes, then, that countries will no longer be prepared to base their currency systems upon sterling, or that there will be a violent disruption of trade channels from their pre-war pattern, a substantial fraction of the sterling balances now held in London cannot be considered as abnormal or calling for special treatment.

Since the greater part of these balances are, however, clearly abnormal, a concerted effort will undoubtedly be made by the British authorities to induce the various creditors, notably India and Egypt, to scale down the principal of these debts, presumably on grounds of interna-

⁴² It might be noted that under the International Fund scheme no member is obligated at any time to convert into foreign currencies foreign-held balances accumulated prior to the inauguration of the Fund or accruing during the first five years thereafter. Foreign balances accruing thereafter must in general, however, be freely convertible.

⁴³ Of the sterling balances, outstanding on June 30, 1945, roughly £1,070 million was owed to India, £350 million to Egypt, £170 million to Eire, £115 million to Australia, £110 million to Palestine, £100 million to Malaya, £63 million to New Zealand, and £27 million to South Africa. A sizable fraction of the remainder was believed owing to British colonies. In addition, a £140 million loan was owed to the Canadian Government. This was contracted before the Canadians began the policy of gifts, and mutual aid, to Britain.

tional equality of sacrifice, unequal war-time price movements (which in many cases considerably inflated the size of the debts), and long-run self-interest. More tangible inducements will probably have to be offered, however, and in this respect the amount of dollars that Britain agrees to turn over to the creditors immediately, or during the next few years, will be of particular importance. On the assumption that a reasonable amount of dollars is so turned over to meet the "minimum" dollar requirements of the various creditors, e.g., at least an aggregate of £250 million during the next few years, it may be possible to obtain a voluntary cancellation of as much as £500-750 million of the total sterling balances. This will depend upon the cooperativeness of the different holders and the differing circumstances surrounding the balances peculiar to each.⁴⁴ In any case, no single or uniform formula for scaling down debt, applicable to all creditors alike, can be expected, and "deals" will have to be made with each separately.

It is clear, however, that some degree of funding of sterling balances will be essential whereby sterling in excess of the amounts voluntarily cancelled, or paid off in the form of dollars, or held as working balances and currency reserves, or offset against foreign investments,⁴⁵ would be converted into long-term obligations payable over a period of years. Unless some such arrangement is worked out for the orderly liquidation of these balances according to a regular schedule, the existence of a huge mass of unfunded short-term foreign indebtedness would constitute a perpetual threat to the stability of sterling and necessitate the indefinite maintenance of exchange controls, to say nothing of the possible adoption of more objectionable practices. Given funding and the gradual elimination of the British current account deficit, however, the path would be cleared for the eventual restoration of full current multilateral convertibility of sterling.

The precise funding arrangements, which need not necessarily be the same for each creditor, might take a variety of possible forms. The British will doubtless insist upon funding at a low rate of interest and may even be able to extract the concession of no interest payments at all. It is also likely that the debt consolidation process will involve an-

⁴⁴ For example, some of the creditors have legal reserve ratios necessitating large holdings of sterling whereas others have no such ratios; some have large independent holdings of gold and dollars, e.g., South Africa and Argentina, whereas most of them have the bulk of their reserves in the form of sterling; some were neutrals during the war and cannot, therefore, be appealed to on grounds of equality of sacrifice; some have suffered great internal devastation while others have been unscathed; some are sterling-area countries and others are not.

⁴⁵ As already suggested, the possibility of liquidating sterling balances by offsetting them against remaining British foreign investments is limited. Certainly this would be no solution in the cases of India, Egypt, or Eire, the largest creditors, since their sterling holdings are much in excess of British investments in these countries. The British Government, however, has accumulated substantial war stores in India which may serve as a modest offset.

nual amortization payments, to commence at least three to five years from now, with some degree of flexibility permitted depending upon the current state of the British balance of payments. It would also be advisable to spread out payments over a period of at least 25 years; this, on the assumption of a funding of about £2,000 million and no interest charges, would involve an additional charge on the British balance of payments of £80 million a year. From the viewpoint of the creditors concerned, and of the world generally, payment in sterling freely convertible into foreign currencies would be most desirable. This procedure, however, might be unattractive to the British, who may insist that the annual payments be made in sterling to be used predominantly in the purchase of British goods and services (the exact fraction to be made available in free exchange might be variable) until the overall British position would permit full payment in free exchange. Such an arrangement unless coupled with bilateral clearing schemes covering all current account transactions, or devices designed to secure preferential treatment for British exports, could not be considered seriously discriminatory.

Long-run Problems. By the end of 1948 the British balance of payments on current account may have been brought into approximate equilibrium. But such an equilibrium would be based upon continuing close economies, in overseas expenditures, effected by rigid external trade and exchange controls. Whether or not these controls will have to be continued into the longer run,⁴⁶ to say nothing of their possible extension in more objectionable forms, will depend ultimately upon Britain's success in expanding its exports⁴⁷ sufficiently to finance a volume of imports consistent with a high-level-consumption economy and to service its foreign debts including borrowings from this country. Potential import demand will continue at a high and growing level, even after the abnormal requirements of the transition have been met, in view of the government's clearly-articulated plans to strive for full employment with rising living standards. As already intimated, the possibility, even in the long run, of economizing further on imports

⁴⁶ It may be taken for granted, however, that British control over domestic capital outflows, certainly those of the short-term autonomous variety, will be continued indefinitely.

⁴⁷ Including both goods and services. While high income levels throughout the world would cause an appreciable expansion in income from existing foreign (equity) investments, it is unlikely that any great expansion can be anticipated until British foreign investments in general have been rebuilt, and this, in turn, will depend upon the development of an over-all active balance of payments. Some substantial improvement in net shipping receipts might be expected which will vary directly with the level of world trade, the degree to which shipping tonnage is restored, the level of freight rates, and the extent of competition from other fleets. Receipts from financial services, however, cannot be expected to increase appreciably until exchange and trade controls are considerably relaxed.

without frustrating this objective would seem to be narrowly circumscribed; there is, moreover, the consideration that a restrictive import policy would react adversely on those countries which depend heavily on the British market and might thus have a detrimental reflex action on British exports. In the long run no less than in the early post-war period, therefore, high levels of exports will be essential, not so much from the viewpoint of their direct contribution to full employment as from the categorical imperatives of the balance-of-payments position.⁴⁸ Unless the necessary expansion in exports is eventually forthcoming, Britain cannot be expected to return to fully multilateral policies, but will instead attempt to balance its international accounts by resort to whatever other methods are at its disposal. For foreign borrowing, unavoidable during the transition period, cannot be countenanced indefinitely.

IV. THE BRITISH ATTITUDE AND PROSPECTS

There is no question of the alternative which the British, except for a few noisy priests of bilateralism-for-its-own-sake, desire. No country stands to gain more than Britain "by an extension of the rules of the good neighbour in foreign trade."⁴⁹ The British are already committed in the Master Lend-Lease Agreement to work towards the eventual elimination of all forms of discriminatory treatment in international trade (exception being made only for Imperial Preference). The real issue, however, is whether or not the conditions will be ripe in the long run, given Britain's difficult balance-of-payments problems, for that country to enter into a free, non-discriminatory, multilateral framework without excessively compromising its basic twin objectives of balanced international accounts and high and rising levels of employment and real income. The Bretton Woods Agreements would give Britain a period of grace of up to five years in which to continue discriminatory currency arrangements and control over current (and capital) account exchange transactions, and in which to determine whether or not it can safely participate in a multilateral system. Those Agreements, however, do not in and of themselves offer any *necessary* assurance of an ultimately satisfactory solution to the British balance-of-payments problem, or of a realization of the conditions necessary for the eventual removal of controls, although they do provide a framework within which that

⁴⁸ High levels of exports will also be necessary, moreover, if Britain is to be able to rebuild its external reserves and foreign investments.

⁴⁹ Cf. R. F. Harrod, "Full Employment and the Security of Livelihood," *Economic Journal*, December 1942, p. 326. Cf. also R. J. Hitch, "The Controls in Postwar Reconstruction," *Oxford Economic Papers*, April 1942, p. 48: "The freest possible multilateral world trade is so obviously in the long-run interests of a nation of forty-seven million living in a small area that this should be clearly formulated as the *aim* of British commercial policy."

solution will be facilitated. Some informed British organs of opinion take a pessimistic view of the situation, in view of the gnawing fears that the United States will be subject to recurring depressions and the world to chronic dollar shortages, and argue for the adoption, in place of Bretton Woods, of a "regional" or "less-than-fully-multilateral" approach. They would thus expand and strengthen the sterling area through closer trade and exchange arrangements which, among other things, would "assure" Britain of the means of acquiring a volume of imports consistent with domestic full employment and which would tend to insulate the area as a whole from the vicissitudes of American economic life and policies.⁵⁰ The same underlying fears, it might be noted, are at the root of the widespread British hostility toward a somewhat rigid pegging of the exchange value of the pound at a level which might impede the growth of exports and prejudice the maintenance of full employment. In other circles there are fears that Britain will be unable to compete with the United States in world markets, or in shipping and aviation, and that it will be necessary to enter into international cartel or other "share the market" schemes. Still others go even farther in calling for the adoption of an unequivocal policy of outright bilateralism à la Schacht.

In the absence of special measures such as these, the long-run prospects for a sustained high level of British exports on a scale adequate to finance needed imports, and to service foreign debt, are compounded of a wide variety of factors. During the transition period export expansion possibilities, despite heavy foreign demand, will be limited by British ability to release goods for export in the face of pressing domestic demands. In the longer run, however, when "internal" shortages have generally disappeared and the war-time backlog of foreign demand has abated, continued export growth becomes less a matter of ability to make the goods available⁵¹ than one of selling these goods abroad without a sharp deterioration in the terms of trade. Even before the

⁵⁰ The recent financial agreements linking the sterling area with Western European countries and their overseas empires provide a possible basis (as the British authorities undoubtedly had in mind in negotiating the agreements) for a well-integrated trade and currency bloc embracing a substantial part of the trading world within which trade could be reasonably free and stabilized. Complete insulation from the United States would not, of course, be possible in view of the fact that this bloc would not be entirely self-sufficient and American economic fluctuations would still register a strong direct and indirect impact. However, for Britain, such a bloc could provide a workable alternative to a policy of outright multilateralism.

⁵¹ This is borne out by the estimates of Nicholas Kaldor and others of the probable level of British national income in the post-transitional period. These estimates indicate that, despite war-time losses of invisible receipts, national income should be at a level, as a result of higher productivity and a larger employed working force, sufficient not only to make possible over-all balance-of-payments equilibrium but also higher levels of consumption and investment than before the war, provided only that there is not a severe worsening of the terms of trade.

war British export trade had shown a tendency to decline in absolute terms and in relation to total world exports. Among the many long-term factors contributing to this development were: the failure of British industry adequately to adjust itself to altered world conditions and to shifts in the character of foreign demand resulting from overseas industrialization; tariff changes and technological developments undermining Britain's pristine trade superiority which rested on abundant supplies of iron ore, coal, skilled labor, and cheap water-borne transportation; Britain's resistance to cost-reducing innovations and modernization; growing British cartellization; and antiquated sales methods.

The war has intensified many of these longer-run obstacles to British export trade. Overseas industrialization has been speeded up in many traditionally important British markets, notably in the Empire and Latin America, and many of the new industries will demand increasing tariff protection; British war-time restrictions have contributed further to obsolescence and general deterioration of private plant; and cartellization and cost-raising developments have proceeded apace. Coal, long a cornerstone of British industrial might and export strength, is now a definitely wasting asset. Further, Britain may well face a declining trend in its terms of trade which would add greatly to the difficulty of adjusting its balance of payments and would enhance the real burden involved.⁵² Finally, there is every likelihood that British exports will meet increasing competition in world markets from the United States and other countries.

Overseas industrialization need not, of course, involve a relative diminution in demand for imports generally, but might merely cause a shift toward higher-grade consumers' goods, and toward capital goods in general, and might even lay the basis for an expanded rather than reduced volume of world trade.⁵³ Ambitious plans for long-range development programs in many foreign countries may also involve high levels of foreign demand for many years. Whether or not Britain will benefit, however, will depend upon its adaptability to the alteration in the character of this demand. Inasmuch as former leading British exports, such as coal, cotton textiles, and perhaps iron and steel, will probably continue their pre-war declines, increasing attention will have to be directed to capital goods, such as machinery and vehicles, and to specialized higher-grade consumers' goods involving a high degree of

⁵² Such a development appears not improbable because of structural changes in world agriculture and the likelihood of international action to "stabilize" primary product prices generally. High levels of income throughout the world, moreover, would tend to raise raw material prices more than prices of industrial goods, and, given the character of Britain's imports and exports, to worsen its terms of trade.

⁵³ This statement is, of course, a drastic over-simplification. The problem has been recently explored by E. A. Staley, *World Economic Development* (Montreal, 1944).

skilled labor content. It is in such products that British hopes for large and continued export expansion must lie. It is possible, too, that the war-time development in Britain of such "newer" products as rayon and plastics, and of old ones such as chemicals, electrical products, and machine tools, may serve as an increasingly important outlet for British exports. Adaptability, however, is not enough. Britain's competitive position in world markets must be greatly improved. Despite impressive war-time increases in productive efficiency, the productivity of British industry generally, and of many important export industries in particular, is still substantially below American levels. This state of affairs suggests the need for a great over-all increase in national productivity. In actual practice this will call for an expansion in capital-per-head; greater receptivity to cost-reducing innovations; new processes and methods of productive organization; a frontal attack on entrenched monopoly and restrictive practices in general; tax changes to facilitate expansion and modernization of plant; the promotion of industrial research; systematic reorganization of key industries like coal, cotton, and steel; and measures to facilitate labor mobility and industrial relocation. Finally, Britain can do much to overhaul its antiquated overseas marketing machinery. On all these desiderata there is widespread agreement, and there is some evidence that the Government plans to work actively, in cooperation with industry, towards their realization.

V. CONCLUSION

Unless, however, there are high and rising levels of foreign demand in an expanding world economy, no degree of adaptability or of increased productive efficiency will suffice to solve Britain's export problem without the continued resort by that country to some measure of discriminatory trade and exchange policies. Permanent rectification of the war-induced distortions in the British balance-of-payments pattern cannot be anticipated in a depressed state of world employment and trade. In this connection the crucial importance of the policies adopted by the United States, both external and internal, has been so frequently emphasized that no further elaboration is called for here. High and sustained levels of income in this country, coupled with a liberal policy of long-term foreign lending to backward economies, tariff reductions of consequence, and a willingness to acquiesce in downward exchange rate adjustments of foreign currencies if need arise, would go a long way toward making the British problem eventually soluble within a multilateral framework. Such policies would improve the British position not so much directly as by indirectly contributing to high income levels throughout the world, and thus to large and sustained demands for British goods and also to the resulting acquisition by Britain, through triangular channels, of substantial supplies of dollars. It is only

within such a setting of ample dollar flows that one can hope for a gradual removal of Britain's restrictive external controls and for the eventual restoration of genuinely free multilateral convertibility of sterling. In this respect, then, the British problem merges into our own, and the dollar problem as a whole, and calls for the same general therapy. There is, of course, no certainty that well devised American policies, even if accompanied by constructive action from the British side along the lines sketched above, would in themselves suffice, but they are in any case a *sine qua non* of any ultimately satisfactory solution of the British problem.

Whether or not Britain will be forced to continue along the narrow path to bilateralism, state trading, and discriminatory policies in general, or will instead return to the open highway leading to multilateralism, lies therefore, in substantial part, in our own hands. Our national economic interests call, among other things, for a sustained high level of exports (which will contribute to our objective of full employment) and for an early restoration of a multilateral, non-discriminatory, trading system. In view of the importance of Britain in the world economy, its traditional role as the world's greatest importer (and our largest single customer), and its central position in the normal (pre-war) network of multiangular settlements,⁵⁴ we can ultimately hope for neither of these things if Britain's external finances remain unrehabilitated. In this respect we have a special stake in a solution of the British difficulties. As the richest nation in the world we can play a strategic part in this rehabilitation process, and thereby serve our own fundamental interests, by generous financial aid to Britain during its difficult transition period, by pursuing liberal commercial and foreign loan policies in general, and also by not imposing further burdens upon those which Britain will already be bearing. In the latter connection, we must frame a generous lend-lease settlement; we must not subsidize exports or engage in egregiously aggressive export promotional campaigns especially with markets traditionally served by Britain; we must not try to crowd British shipping off the seas by excessive subsidies; and we must not insist upon tying clauses in our foreign loans. Above all, our interests, as well as those of Britain, call for sustained high levels of economic activity in this country. Some trade rivalry, economic conflicts, and dissension will be inevitable in the short run as Britain struggles to restore

⁵⁴ A single example of the importance of this particular factor may be cited. Canada has traditionally had a large balance-of-payments surplus with Britain and a deficit with the United States. If sterling continues to be not freely convertible into American dollars (unlike the pre-war situation), Canada will be forced to keep down its expenditures in this country by restrictive and presumably discriminatory practices. The lack of free convertibility of sterling would thus tend to extend the web of non-multilateral policies to countries other than Britain, with widespread injurious effects upon American exports.

its external position, but by sympathetic understanding of that country's dilemma, and by tangible aid and cooperation, the area of possible conflict can be greatly reduced. Along such lines as these we can not only contribute in good measure to a satisfactory solution of the British problem, but also add ultimately to our own well-being and that of the world. Homely, and lacking in novelty, though these prescriptions may be, their inherent validity cannot be impaired by constant reiteration.

BOOKS PUBLISHED BY INTERNATIONAL
FINANCE SECTION, PRINCETON UNIVERSITY

1. Exchange, Prices and Production in Hyper-
Inflation: Germany 1920-1923. By Frank
D. Graham out of print
2. Governmental Control of Crude Rubber. By
Charles R. Whittlesey \$2.50
3. Monetary Inflation in Chile. By Frank Whit-
son Fetter 2.50
4. The Gold-Exchange Standard in the Philip-
pines. By George F. Luthringer 3.00
5. Railway Nationalization in Canada. By Leslie
T. Fournier out of print
6. The Monetary Experience of Belgium, 1914-
1936. By Henry L. Shepherd 3.00
7. Monetary Experiments: Early American and
Recent Scandinavian. By Richard A. Lester 3.50
8. The Anglo-American Trade Agreement. By
Carl Kreider 3.50
9. Protective Tariffs. By Frank D. Graham 2.00

Order from any bookseller or from
PRINCETON UNIVERSITY PRESS
PRINCETON, NEW JERSEY

Essay Series

1. International Monetary Mechanisms: The Keynes and
White Proposals. Friedrich A. Lutz.
2. Fundamentals of International Monetary Policy.
Frank D. Graham.
3. International Aspects of Wartime Monetary Experi-
ence. Richard A. Lester.
4. Conditions of International Monetary Equilibrium.
Ragnar Nurkse.
5. Bilateralism and the Future of International Trade.
Howard S. Ellis.
6. The British Balance-of-Payments Problem. Arthur I.
Bloomfield.

Order from International Finance Section
Princeton University

