THE BRITISH BALANCE OF PAYMENTS

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TABLE OF CONTENTS

TABLES

INTRODUCTION

In order to understand Great Britain's present economic crisis, a thorough understanding of the long-run trends which led up to it is necessary. Britain's problem has been the necessity of turning the corner from the nineteenth into the twentieth century. She is in her present state mainly because this transition was not accomplished by 1914. For too long a time Great Britain depended upon an economic structure and on methods which often belonged to the previous century.

The era before 1914 was unique in that at no other time has such a combination of economic circumstances existed together. The most obvious of these circumstances were: almost complete free-trade, complete freedom of transfer of funds, an immediately available gold reserve of only 30 to 40 million pounds sterling and yet a confidence in the stability of the sterling exchanges which has not been since 1914. This unrestricted freedom was based upon conditions which have since been lost. It was based upon a fundamental equilibrium in the trade and in the financial relations between the chief countries in the world, a degree of confidence in the maintenance of this equilibrium which we are finding hard to realize today, and in a strength of leadership in the United Kingdom's economic relations which no longer exists.

After 1914 England relied upon these unique conditions which she believed to be permanent but which were actually only transitory. The Victorian Era, which was the high-water mark of British prosperity was based upon an early industrial lead. This start rested upon British coal which was plentiful, near the seacost and cheap. As industrialization spread to Germany, the United States and the rest of the world, Great Britain's leadership began to be challenged. However, the momentum she gained from her early start enabled her to carry on as a great industrial and financial power long after the basis for her supremacy had vanished.

As a result of her special position in the nineteenth century, Britain developed an economic system which was a combination of an advanced stage of industrialization and a deficiency of natural products. She became a great processor, dependent upon an interdependent world economy. The nature of Britain's international trade was, and to a lesser degree is likely to remain, the exchange of manufactured goods for foodstuffs and raw materials with the rest of the world.

The world demand for the type of goods which Britain exported tends to be highly elastic and subject to change. Great Britain could not possibly have maintained her industrial monopoly for ever and yet her economy was based on this monopoly. However, Britain's demand for the type of goods she imports is relatively inelastic. Most of the imports are necessary and cannot be curtailed greatly, regardless of export conditions. Britain's total imports have both a smaller income elasticity and price elasticity than her total exports.

Any decline in international economic activity or any movement towards nationalism will have an adverse effect on such an economy. Both these factors were active after 1914 and Great Britain suffered accordingly. It was a sign of decadence when after the first World War a monetary policy was imposed which strangled industry. The latter, in self-defence, evolved a system of protection which threatened commerce and finance. The fact that some choice had to be made and that someone was bound to suffer, showed that the old economic system was badly out of order. A paralysis was creeping over the British economy and the attempted cures only prolonged or encouraged the decay.

The aim of this thesis is to give an account of the major factors which characterized the decline of Great Britain and the development of the present economic crisis, and to make some predictions as to her possible future. I have called my thesis "The British Balance of Payments" because the strains and deficits in the balance of payments have been the main gauge and obvious sign by which the rate and degree of Britain's decline has been measured. It is significant that one of the greatest economists of this century, Lord Keynes, should be the first to bring a previously seldom used term, "the balance of payments", into the limelight of economic discussion regarding Great Britain.

The present crisis in Britain and the fundamental economic changes which are and will be taking place are evidence that an era of British supremacy has passed and that Great Britain is starting on a new phase in her history, that of a relatively normal and mature economy.

Chapter I - THE DECADE PRIOR TO WORLD WAR I

The period from 1896 until 1914 was one in which international economic competition and tension grew to a position approaching intense equilibrium. Up until this time Britain had stood as the relatively unchallenged industrial baron of the world. She had led the way in almost all political, economic, and social developments. I will not endeavour to explain this prominence except to say that her strategic island position in a world of expanding frontiers and her virile peoples were major aspects. The important point however, is that as a result of her leadership she had come to depend a great deal upon the outside world for her advanced culture and standard of living. Thus any infringement upon her position was of grave concern and was followed by compensating economic policies. I call this a period of equilibrium because these policies tended to keep pace with the disturbances in international trade competition. I do not infer that Britain's policies were always conscious--on the contrary--most of the changes in her economic position were reactions on the part of individuals who were unconscious of the general trends as such. Even today it is difficult for Britain to look at her position objectively. The man inside a tornado cannot see the tornado.

This maintenance, on Britain's part, of international economic equilibrium has great bearing on my main thesis. In order to maintain it she retreated to a less advantageous positions; thus leaving her narrower scope for recovery in later years. As the margin for retreat decreased increasingly important positions had to be given up. However, up until 1914 there was no scar upon Britain's economic face. Her balance of payment was very favourable. There was even a large investable surplus.

For a hundred years the United Kingdom had imported more goods than it had exported. These surplus imports had been paid for by receipts of interest and dividends on investments placed overseas, and by other so-called invisible exports—that is, shipping freights, insurance profits, and the like. Before the first world war these receipts were enough to balance the account and even leave a surplus. In those years Britain was making new overseas loans almost to the full extent it its interest receipts.

However, though this was the apparent economic position of Britain in 1913, the effects of rising foreign nationalism in the economic field, atrophying of certain natural resources in Britain, and the growing obsoleteness of some British manufacturing methods and skills, were having a decidedly detrimental effect upon the economic position of the United Kingdom.

No age is ever conscious of its own position. There were very few economists in England at the beginning of the twentieth century who saw the adverse trend following on the changing economic face of the world. Bowley, for instance; writing in 1904, has this to say:

> Our exported manufactures pay for the manufactures we import and for all the raw material used in our output for the home market as well as the foreign market. At the same time the food we need could be partly paid for by our ships, while most of the rest could come as interest due. Unless then our mercantile navy declined and the capital held by us abroad diminished relatively to our population (which some allege, with very little evidence, is already the case) we could still get the food we need.... 1/

Bowley was right in saying that there was very little evidence. The detrimental effects were not immediately obvious. Some did, however, notice the corner Britain was being forced to withdraw into.

From an economically offensive country Britain had been forced to withdraw to her first line of defense. There were many more "previously prepared positions" she was to retreat to in subsequent years which brought her to her present defense of the inner sanctum.

1/ A. L. Bowley, National Progress in Wealth and Trade Since 1882 (London: P. S. King & Son, 1904), p. 62.

RISE OF GERMANY

The rise of industrial Germany was one of the most important factors which contributed to the fall of Britain's commercial supremacy. In Germany the period of intense development began about 1860, and showed notable rates of increase up until 1910. In Great Britain the process extended over a longer period (1760-1830) mainly because she was leading the way and a greater number of primary inventions were involved. This is a very significant factor in comparing the two because it meant that Germany took over relatively perfected processes thus avoiding the lag of obsolescence. In 1910 Germany had newer and more up-to-date machinery than Britain. In the production of primary heavy products (iron and steel) Germany surpassed the other continental countries and created significant competition for British industry. Although the actual volume was below that of Britain, the rate of increase was greater.

The competitive position of Germany also became greater in certain consumer goods such as textiles, leather, and small metal wares. Germany was recognized as an equal competitor with Great Britain and many even at that time were quick to assume that the "decline" of England had already begun.

Basic to any industrial economy is coal mining. The beginning of modernized industry in Germany begins from the sinking of the first deep pit in the Ruhr field in 1841. This was called the Graf Beust mine. Further discoveries of deep deposits were made in subsequent years and German coal mining was revolutionized. The primitive surface mines of the south were abandoned and production in the Ruhr developed rapidly. Soon with technical improvements and better transportation facilities the Saar and Silesian mines became active.

German coal, however, was somewhat inferior to British coal and much less conveniently distributed. The chief difference is due to the extensive use of lignite in Germany. The highest grade of lignite coal falls just below the lowest grade of bituminous. Anthracite coal averages between 8,000 and 8,600 calories; the poorest bituminous around 6,600 calories. Lignite only yields from 3,000 to 7,000 calories. Most of the British coal is anthracite and bituminous, which along with the better transportation facilities, is a significant factor in determining her supremacy in this field for a longer period than others.[1]

Since German coal was of this inferior quality it did not bear much transportation, and industry tended to be highly centralized around the coal fields. The range of distribution was extended somewhat, however, by additional processing of the coal into "briquettes". The greater part of the true coal was produced in the Ruhr, the Saar, and in Upper Silesia. Thus German production suffered severely by the transfer of a large portion of Upper Silesia to Poland by the Versailles treaties. A similar loss was incurred by the transfer of the Saar to France for a time. Because of the precarious location of these fields Germany was forced to depend more on poorer lignite and as a consequence the industrial districts of Saxony and the Thuringian states grew in importance.

Considering these adverse conditions in such a basic product as coal, the German industrial advance is truly spectacular. Most historians do not do justice to this fact: One reason for this is the fact that the textile industry was used as the basis for estimating industrial advance. Consequently, before 1870 Britain was given undue stress on account of her highly developed textile industry. After the Franco-Prussian war Germany annexed

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[1]/ W. Bowden, Michael Karpovich and A. P. Usher, An Economic History of Europe Since 1750, (New York: American Book Company), p. 509.

Alsace and with it all its important cotton industry. This gave Germany an additional competitive boost. However, Britain continued to export considerable quantities of yarn to Germany. Germany had her main advantage in highly specialized types of woolens, silks, and linens. She had cheap skilled labour which was one reason that the use of power was retarded as compared to America or Britain. However, when power did fully develop, the skilled labour remained and gave Germany supremacy in the production of goods requiring high skills. This supremacy was taken over from Britain.

The development of Germany in the pre-war era was in accord with the mass and quality of her resources. Thus she produced much less coal than Britain (if low heating value of lignite is allowed for). However, she produced much more pig iron and twice as much steel. Germany was thus the leading producer of heavy industrial products in Europe. She was also producing more per capita than Great Britain. By 1913 Germany was producing 16.5 million tons of pig iron to Britain's 10.3 million tons. America was doing better than both of them, producing 31 million tons per capita. A similar reshuffle had occurred in steel production.[1]/

It should be noted, however, that although Britain lost her supremacy in production she maintained it for some time longer as an exporter of these basic products. This was largely due to the fact that the greater part of the production of Britain's rivals was consumed in their own home market. It was not until 1912 that Germany took Britain's place as the chief exporter (by value) of iron and steel. She maintained her leadership as a coal exporter a little longer. In 1913 Britain exported 98 million tons, Germany 47 million tons, and America 24 million tons.[2]/

1/ G. R. Jones & A. G. Pool, A Hundred Years of Economic Development in Great Britain (London: Duckworth, 1940), p. 188.

2/ Ibid., p. 190.

The development of German trade followed on her industrial development. London was the great trading and financial center of the 19th century. This was due a great deal to her strategic position on the primary trade routes. She had a clear predominance in the carrying trade upon which she depended so much for her standard of living. The development of German industry, however, created a volume of trade that could not be handled through London, and the North Sea ports of the continent became increasingly important. The change began as early as 1890 when harbour improvements were installed in Hamburg, Rotterdam, and Antwerp. These improvements in turn attracted more trade and the foreign trade of these ports became greater than that of Britain. "This decline of the transit trade marks the passing of the 'commercial supremacy' of Great Britain."1/

The trade rivalries of the 19th century led to the notable revival of some mercantilistic practices and the extravagances of protection. Germany was no exception. A good deal of her industry grew up under the wing of protection. There was a predominant idea that the greatest economic gain came from trade with the tropics and semitropics, which did not compete in the production of manufactured goods. Germany was a notable exception. The greater part of her trade was with her immediate neighbours and the United States. Her best customers have been her closest industrial rivals. The following figures illustrate this:

1/ <u>Ibid</u>., p. 515.

TABLE I *

The Geographical Distribution of German Current Trade in Per Cent of Total Value

	German Imports			German Exports		
	1893	1903	1909	1893	1903	1909
Great Britain	15.9	13.2	8.5	20.7	19.3	15.4
Other European Countries	44.3	42.5	42.5	48.5	49.0	50.7
United States	11.1	14.9	14.8	10.9	9.1	11.6
Asia	6.0	7.3	8.0	4.8	4.6	4.5

* Bowden, Karpovich and Usher, op. cit., p. 517.

In 1893 trade with the neighbouring countries amounted to 60.2 per cent of the imports and 69.3 per cent of the exports. As contact with the outside world became more direct a portion of the neighbouring trade declined (after 1893). It should be noted, however, that exports continued to find their most important market in the surrounding countries. German shipping records verify the above trade distribution picture.

The industrial rise of Germany then, was relatively quick. She was handicapped by the distribution and quality of her coal deposits, but this was overcome to a great extent by her two main advantages: First, the cheapness of skilled labour; second, the technological advantages gained from following in the wake of Britain, the industrial pioneer. The first advantage gave her the upper hand in products requiring highly trained personnel; the second gave her greater efficiency on account of the lack of obsolete machinery and the relative newness of all her capital equipment.

I do not believe that by herself Germany would have submerged Great Britain as an industrial and commercial baron. She would have probably equaled her but each would have been complimentary to the other. It was the fact that both Germany and America grew to such predominance that caused the eventual downfall of Great Britain. The two main ways in which those countries affected Britain's position and policy were: (1) By taking over their own markets which were the greatest in the world. The nationalistic and isolationistic movements of these two countries led to this move. (2) The encroachment upon other British export markets.

RISE OF THE UNITED STATES

The rise of America as an industrial power was similar to that of Germany only in that it was late in starting (1825-1875). Consequently, America was able to utilize the experience of others to her own benefit. Many American inventors took their inventions over to Europe to try them out before they used them in America. This was partly due to the fact that there was more accumulated wealth in Europe at the beginning of America's industrial advance.

Other than this similarity with Germany, there is little else. America had her main advantage in vast resources and the development of large scale corporate enterprise. This led America to develop along those lines in which she had the greatest advantage--namely, manufactured products adaptable to mass production and not requiring a great amount of skill. The United States was definitely limited in her labour and capital supply in the beginning, which had a great deal to do with determining later trends. Another major factor in American industrial advancement was that she was able to supplement the borrowed European technical knowledge with a great deal of natural inventive genius. Since industry was in the formative stage when a good many of these inventions came into being they could be immediately absorbed while in Europe, and particularly in Great Britain the already mature or maturing industrial structure found it difficult to adjust and supplant aging industries with new ones. This was particularly true in the automotive, sewing machine, and bicycle industries. America went ahead by leaps and bounds while Europe merely dabbled in them and then only in more specialized branches of these industries. This picture was true in many lesser industries, giving America a distinct advantage in these modern developments.

An important aspect of American industrial advancement is its dispersion. This gave it a very broad geographical base on which to grow. The main reason for this dispersion was the fact that settlement and consequently demand tended to grow faster than transportation could keep up to it. Thus each community had to become self sufficient in many enterprises; especially in the production of goods which were bulky and hard to transport. Later transportation caught up with demand and facilitated the growth of these industries. Once transportation gained momentum it grew over the face of America at a phenomenal rate. At first railways merely connected the main waterways such as rivers, lakes and canals, but as the population went further west they branched out on their own.

Another major factor contributing to the growth of industrial America was the Civil War. There is some controversy as to its importance, but all writers agree that the so-called modern era in industry got well under way as a result of the war. Previous to the war the South had been in charge of the country's policy. It followed the English policy of free-trade and was very much against protective tariffs. After the war a protective policy began which has lasted to this day. The influence of the South waned while that of the North increased. Tariffs went up as high as 42% of the value of imports. The history of American tariffs need not be outlined here. It is sufficient to say that they were the shelter under which modern American industry had its birth. The argument for and against tariffs is a long and arduous one in which there is no compromise. I do believe, however, that the earlier American tariff policy was absolutely necessary for the development of America. However, the American tariffs today are one of the major obstacles to world recovery. If America were to lower some of her unnecessary tariffs--i.e., those protecting uneconomical industries--she would provide a means of repayment for her exports and lead towards the solution of the present dollar shortage.

To return to American industrial development, I should like to mention the price rise which occurred between 1860 and 1865. This rise plus the war tariffs were the two main early stimuli to industrial development. The reasons for the rise in prices were numerous--mainly monetary. Paper money began to be used widely and bank credit started to expand. Although these expansions were small compared with those that came later, yet they were very significant in that they came in the industrial infancy when they were most needed. The increase in the quantity of gold coin and bullion is a particularly good pulse of the rise.

Once American industry got under way its momentum kept it going. I have mentioned only a few of the later factors which gave it its remarkable momentum, such as large resources which were cheaply available, the development of efficient corporate enterprise, the wide dispersion of industry and population, and the technical advantages of starting late. There are numerous others which should be mentioned.

The most important of these was the large home market. This market was growing and could absorb anything that America produced. She was in the fastest growing stage of her population development, particularly in the urban sectors. This growth did not begin to slack off until around 1908. It was due to two factors; the natural increase in birth rate because of increased subsistence and better medical care, plus the increased longevity of life for the same reasons, and the immigration movement from Europe.

The profit motive and free enterprise also gave a great impetus to America's industrial growth. This is true of any capitalistic economy but was particularly true of the American economy. The stimulating effects of a vigorous western frontier permeated into the social relations of the American people and had a great deal to do with creating the strong individualism of the American throughout the entire frontier period. Its force is growing weaker today but it has accomplished its job in creating the so-called "American way of life". At least it has endowed the American economy with a strong streak of individualism which may still be found today. This very force--profit making--led to severe and often pernicious competition. Thus, spurred on by some destructive tendencies in competition, there developed the aforementioned corporate enterprises. These in turn drifted into combinations and monopolies until government legislation tried to curb them through the Sherman Anti-Trust laws. These laws did not prove to be very effective.

The growth of transportation had a great effect not only on the growth of the American industrial machine as such, but led to greater competition by opening up markets to all producers. The growing cheap transportation also enabled industry and resources to grow and to develop where they were most efficient. Considerable amounts of British capital went into developing the American railways. I shall go into this further in the following section. To get some idea of thetremendous growth of American railways one should note the difference in mileage between 1860 and 1916. In 1860 there were only 30,625 miles of rail while in 1916 there were 254,000 miles--one third of the world's railroad mileage. The greatest growth occurred between 1880 and 1890. This period also marked the greatest surge in American business activity up until that time. The first obvious repercussions may also be noted in Great Britain in the flare up of imperialism and the tightening of Commonwealth ties.[1]/

American salesmanship and advertising should also be mentioned as contributing factors to the rise of the American economy. Large scale advertising is characteristic of American business technique. In spite of its distasteful character it has become essential to the modern world economy. America is still the unchallenged master of advertising and could not keep her business at its proverbial high pitch without the billboard. Hand in hand with advertising came high pressure salesmanship. The "good old American handshake", the "pat on the back", and "sign here on the dotted line" all did their job in helping to make America what she is today even if a bad taste was left in the mouth of the customer.

There are two more factors which should be mentioned with respect to America's rise. One is the great mobility of American labour, especially in the later part of the 19th century. Immigration contributed greatly to this mobility plus the comparatively weak domiciliary ties in the last century. The slogan, "go west young man", is characteristic of the relative fluidity of American labour at this time in her development. The other factor is the lack of conservatism, characteristic of a young nation, which enabled industry to adapt itself readily to change. In an age of great scientific growth this was a very important factor in enabling the American

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[1]/ See Isaac Lippincott, Economic Development of the United States (New York: D. Appleton & Co., 1933). The statistics for this section were all obtained from this source.

economy to keep up to date. Great Britain was in strong contrast in this respect. By the time that she could convert, America was already realizing the benefits of decreasing costs and could undersell Britain in all but specialties. American adaptability was not just the result of her liberal frame of mind but, to a great extent, of the fact that she came into the industrial field late. It seems almost contradictory that two of America's chief advantages were that she came into the industrial field late and got into most modern industries early.

From this picture of American industrial advance one may suppose that the effect was felt directly by Great Britain. This was not the case, however, as the American home market consumed most of the goods produced. Foreign trade up until 1914 was a relatively unimportant item in the account. It was growing in importance however. From 1860 to 1930 it increased fifteen fold. Yet in 1914 it represented only about 4% of America's income. The greatest effect on Britain was indirect and negative. It was the loss of a market--the largest in the world. America did not come into very great direct competition in merchandise exports and investment until after the first World War. She did not begin to challenge Britain in shipping until very recently, and then only slightly.

In the production of the basic commodities of coal and steel America superseded Britain but most of it was consumed by her home market. The production of coal grew from 13 million tons in 1860 to 670 million tons in 1918. Just before the beginning of the first World War America's coal production was nearly equal to the total of Germany and Britain combined. This has been mainly bituminous coal from the Pennsylvania fields. If coal production is any gauge of the growth and decay of an economy it is significant to note that the 670 million tons produced in 1918 was the highest peak of production, which has steadily declined since. Oil of course helped to maintain industries' fuel supply at a constantly high level. Eventually other sources of power will have to be discovered or the clock will run down as it has in Britain.

As for iron and steel production, the picture is similar. In 1860 the total value of iron and steel was approximately $117,000,000. By 1929 this had grown to $7,137,900,000. worth. Since the production of these basic commodities is considered the epitome of any industrial progress, this increase is very noteworthy. It is pertinent here to mention the fact that the great iron ore beds of Lake Superior are running noticeably short today. North America's hope is pinned on the great new fields under excavation in Labrador. Their development now only requires adequate transportation. Consequently, the significance of the St. Lawrence Waterways project is apparent.

America's position then at the outbreak of the last war was that she was the most self contained large nation in the world and was only beginning to become conscious of her power and international responsibility. (She has not done that fully yet.) She had specialized in mass production. Her main deficiency was in shipping (from lack of foreign trade), and in the manufacture of goods requiring special skills. There were also, of course, those goods which could not be produced in America. For all these she depended on the rest of the world. Britain filled most of the role in shipping and a goodly part of it in specialized products. Germany also contributed a great amount of both, but mainly of the latter. Dyes, ball-bearings, and ground glass were some of Germany's main contributions. The picture changed after the war; America began to grow out of herself and to affect British interests directly. The first World War was a turning point in the world economy.

BRITISH INVESTMENT

I believe that the key to the whole British problem may be found if one traces her investment trend and method through the last one hundred and thirty years. Too little stress has been laid upon it by economists who have been mainly occupied with the analysis of industrial society and with the problem of industrial justice. It has been taken for granted that capital would take care of itself and go where it was most needed. Thus the economic development of the nineteenth century and the early part of this one has followed along the path marked out by the self interest of the investor. Since we live in the short run we cannot be overly anxious about the long run effects of our actions. Consequently, the Cobdenite investment of Britain, with its immediate returns, spelled the doom of the British economy. The economic thought of the Victorian age took for granted that enlightened self-interest of the individual must be the best national guide. At the expense of her own industrial advancement Britain developed foreign industry which became like the crow's egg in the blackbird's nest. It grew bigger and more powerful than British industry with the results we see today. I would tend to disagree with those who say that the present situation was quite inevitable. A quotation from Stephen Leacock in his more serious moments is appropriate here:

> If England is now feeling the cruel pinch of unemployment, the heavy burden of taxes, the drag of worn-out industries whose wheezing and antiquated plants contrast ill with the glittering iron and polished steel of the "rationalized" industries of America and Germany may not the foundation of it lie, in part, in misleading use of British capital in the past. 1/

Let me trace the major trends in this undirected investment. The outflow of capital began after the Napoleonic War. During the first great

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1/ Stephen Leacock, Economic Prosperity in the British Empire (Toronto: The Macmillan Company, 1930), p. 146.

surge of foreign investment from 1815 up until the Crimean War in 1854 the British productive surplus was exported, mainly in the form of producers' goods. Little of this went to the British Empire. Mr. L. H. Jenks says that the total probably amounted to about two hundred million pounds. The United States received about a quarter of this. About half went to investment in Government securities in Europe, while about a third went to the Latin American Republics. The rest was incidental, most of it going to the Australian and Canadian land companies. 1/

The next phase of British investment ran roughly from the rise of the laissez-faire period and Cobdenism in the middle of the last century until the rise of the New Imperialism towards the end of the depression--in 1880. The total foreign holdings at the end of this period are estimated to be 1,200,000,000 pounds. The annual investment ran around 40,000,000 pounds, having had its highest year in 1872 when it was 56,000,000 pounds. I find that British shipping returns at the end of this period were about 50,000,000 pounds a year. The commodity deficit (including bullion) was running at 70,000,000 2/ pounds, leaving an investable surplus when the invisible exports are accounted for.

The geographical division of investments in 1880 differs from that of the previous period. Indian railways and public debt absorbed 160,000,000 pounds. Incidentally, these railway holdings paid off about 14%. The rest of the British colonies took 50,000,000 pounds. Thus the British empire had at this time the benefit of a little more than a sixth of its total investments. The rest went to various foreign government loans and railways in United States and South America. 3/

1/ Ibid., p. 144.

2/ Ibid., p. 130-131.

3/ Ibid., p. 132.

This brings us to the so-called "pre-war" period which has been discussed in this section. The trend towards greater investment in the Empire, which is noted in the last phase, increased markedly. At the end of this period, around 1913, the total British investment was about 4,000,000,000 pounds. Of this 1,780,000,000 pounds was invested in the British Empire outside Great Britain. Of the rest 754,000,000 pounds was in the United States; 764,000,000 pounds in Latin America, and only 200,000,000 pounds in Europe. This is quite a different picture from that at the beginning of the nineteenth century. Where European countries had once represented one-half they now represented one-twentieth. The Empire had become of major importance while the Americas still absorbed a goodly share. 1/

America was also rising as an investing nation although she remained a debtor until after the first war. War loans and reparations represented a good portion of it. Britain still remained a major investing nation well after the war. However, her investable surplus became less and less and home industry had to suffer greater negligence in order to finance foreign investment. The trend towards greater investment in the British Empire continued, leading to more stable securities on account of the political control. The field for good investment, however, was narrowing because of increased supply of funds and because of narrowing horizons. Increased political turmoil added to the instability of investment as a major link in the British chain of security. The cardinal position of investment in the British economy may be seen by the national wealth figures of 1914. The British national wealth was estimated at 14,000,000,000 pounds. Of this 4,000,000,000 was in the form of foreign investment. 2/

What lay behind this random British investment? As I have already mentioned, the stress on individual control in the direction of investment

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1/ Ibid., p. 132.

2/ G. D. H. Cole, British Trade and Industry (London: The Macmillan Company Limited, 1932), p. 110.

was the same. Government directed investment would have been more orderly, but the motivating source was the concept that money talked. That the possession of a security certificate guaranteed the stability of the capital it represented. To her chagrin Britain found that her claim to capital which she had invested in a foreign country could be wiped out with the stroke of a pen. When the American railroads collapsed into the hands of receivers in the middle 'seventies, a great mass of British ownership vanished into nothing. The railways remained. During the American Civil War Britons lost vast sums in selling their securities. The face of America remained unchanged. This same vanishing occurred throughout the field of British investment. The old false idea that six percent returns in Chile was the same as six percent returns in Lancashire had gone. It began to be realized that no matter how the title changes the factory still remained in Lancashire. Did Great Britain realize this too late?

Thus British investment has wandered at random over the face of the globe. It got its start when Britain discovered that a public debt could be a useful thing: Something that could be bought and sold, a repository for investment, a comfort for old age. It became an integral part of the British economy. The custom was very catching and it was not long before Britain would buy anyone's debt or finance anyone's venture. National boundaries did not effect the world of finance.

Indivudual business interest was the sole incentive at first, but as I have noted, Britain found towards the end of the 19th century that she had to follow up her investment with imperial protection. (Thus developed the growth of the empire and the clashes of interests which led to the first World War.)

Everywhere the tentacle of British investment touched it left behind it permanent wealth. It came away having had some of its vitality sapped. It grew weaker and more desperate as the very forces it had created threatened to overwhelm it. Great Britain, which has been the spawning ground for what we call our modern age may be compared to a certain specie of crab. This particular type of crab carries its eggs around inside its abdomen. In caring for these eggs it neglects eating and consequently its shell softens. When the baby crabs hatch they immediately begin to devour the mother crab which has become vulnerable because of its soft shell. Although this is a rather grotesque comparison, the analogy brings out the picture of what actually did happen to Great Britain.

Chapter II--WORLD WAR I AND THE INTER-WAR PERIOD

Economic forces which were reflected through political ideologies, clashed in 1914. So-called "zones of influence" were beginning to overlap, creating great political friction, particularly between Great Britain and her industrial rival, Germany. The United States, although an industrial rival of equal standing, was far away and isolated enough to avoid serious political conflict. World War I was in considerable measure the climax of a struggle between clashing economic interests which had been active for some time previously and had finally come to a head.

Rather than remedying the conditions of conflict, the war only accentuated them. Great Britain went further down the ladder of decline. Wars have a tendency to cover up adverse trends for their duration and consequently to cause an acceleration of these trends afterwards because compensating forces are not active during the war.

The actual physical damage done by the first War was not as great as that of the second. However, the results were very similar. Manpower was expanded in civilian and military activities; there was a large transfer of resources from civilian use to the production of munitions and war equipment; domestic production was curtailed; wages rose; foreign assets were sold to pay for the war, and many men in the prime of their life were killed. There was no significant damage from bombing during the first war, but the manpower losses were far heavier than during the second World War.

These material losses were great, but of even greater significance was the loss of contact with foreign markets and the distortion of international economic equilibrium. For six years Britain was out of touch with her markets (any degree of normality was not reached until 1920). During this time these markets were forced to turn elsewhere or to supply their own needs.

By 1920 many agricultural countries had industrialized themselves, and everywhere Britain turned she met tariff walls. Her search for markets was desperate and she was forced to begin turning slowly into herself. Large areas in Great Britain, which had previously been the location of main exporting industries, became what were called the "depressed areas". Unemployment rose to an unprecedented level. To compensate for this change, new industries, catering mostly to the domestic market, grew up. This slow but sure change in the pattern of Britain's industry entailed much hardship.

Two factors tended to accentuate the hardship. One was the rigidity of wages. Although prices were falling wages tended to be kept up by union activity. The outline of a comprehensive scheme of social security, including unemployment insurance, had been drawn before the war, and this the post-war government extended and developed. Although this socialization is normally a good thing it tended to accentuate Britain's troubles after the first War. Insurance and unemployment schemes tend to reduce the mobility of labour. During the inter-war conversion of industry, Britain sorely needed a very mobile labour force but did not have one. No popularly elected government can be relied upon to enforce by administrative methods the ruthless transfer of labour from one occupation to another, which was what was called for when Britain's export industries were struck by foreign competition. Immobility and inefficiency are characteristic of democratic government and are part of the price we must pay for individual freedom.

The whole world economy was distorted by the first world war. Exchange rates fluctuated widely during the inter-war period. The ill-effects seemed to become cumulative, mainly because of the nationalistic spirit which was rampant after the first war. Each country or group of countries was intent upon saving its own neck at any cost. Financial and commercial policies were followed which caused much strain and chaos to the rest of the world. It is unfortunate that some synchronization of economic policies could not have been evolved. The second World War was directly or indirectly a result of the lack of cooperation among nations after the first World War.

Out of the inter-war troubles there emerged one bulwark. England returned to the gold standard, unfortunately for her, and later became the centre of the sterling area. This sterling area was the greatest single stabilizing force during the inter-war period. The United States, which had acquired great economic and political power, did not maintain stable policies and this fact led to much international economic distress. France showed a similar lack of international social consciousness. It is certain that the depression in the 'thirties would not have been so severe if the United States had used more foresight, established counter-depression policies and refrained from radical isolationist tendencies.

In respect to Great Britain, the inter-war period was the time when her distress ripened. The establishment of the sterling area, accompanied by the temporary prosperity it brought, was the "swan song" of an age of economic prosperity that was passing in Britain.

Britain's commercial policy showed a change during the inter-war period. From the complete free-trade policy of pre-1914 she moved to the protectionist and preferential policies of the 1930's. This change was not sudden. Although the years 1930-32 were when Britain actively changed her commercial policy, the spirit and desire to do so had been built up from before the first War. Changes in commercial policy do not just occur arbitrarily: they are the result of developed circumstances. Great Britain was forced to change her policies, but has she responded too late?

DECLINING INDUSTRIES IN GREAT BRITAIN.

One of the most significant features of the changing British economy has been the shift in industry. Certain staple industries began to wane before the First World War, while other smaller and less basic industries began to rise in the south of England. Britain's power as a great industrial and commercial nation of necessity rested upon the firm foundation of pre-eminent staple industries such as coal, iron, steel, cotton, wool, shipbuilding, and certain branches of engineering. As the pre-eminence of these British industries began to be challenged by the rise of similar but more efficient industries in other countries decay set in at the heart of the British economy.

The industries which have risen to take their place--the expanding industries--have been of the nature which caters mainly to the home market. Thus during the inter-war period there was a decided slump in British exports. These expanding industries include building, road transport, the distributive trades, electrical manufacturing, motor engineering, and numerous other smaller industries.

Unemployment, a yardstick of prosperity, although at a lower level than during the pre-World War One period, nevertheless remained relatively constant as these expanding industries compensated for the decline in employment in the declining industries. The displacement of labour, skilled in obsolete trades, accounts for the general low tenor of employment during this adjustment period. The world's most skilled textile workers found themselves out of demand. Men cannot learn new skills overnight, especially older men and men with dependents who cannot stop supporting their dependents in order to migrate to the south of England to get into the new industries.

However, except for the homes of those who carried the burden of unemployment and of the depressed industries, the standard of living,-- i.e., dress, food, leisure, and pleasure was materially much higher in 1928 or 1931 than in 1914. The rich and the middle classes were poorer than in pre-war days, largely because of heavy taxation, but the poor were much less poor. Few homes lacked what we call the necessities of today, such as radios, phonographs, bicycles, cars, etc. Movies were becoming increasingly popular and refrigeration had improved the British winter diet much above that of 1914.

This mock prosperity was a result of living off capital which could not go on forever. The present crisis in Britain could be seen coming over the horizon but people find it very hard to look to tomorrow if today is sweet.

Since unemployment is such an important criterion of industrial prosperity it is pertinent that a general sketch of unemployment be outlined. The growing pains of industrial advancement in the form of unemployment manifested themselves in Britain, the pioneer of this age, more than anywhere else. The fact that trade unions first grew and were nourished there is ample evidence. Between 1850 and 1914 the average unemployment was about 4½%. It ranged between 1% and 11% from peaks of trade booms to general depressions. Between 1921 and 1937 however, the average unemployment was about 14%. It ranged from 10% to 20% from the best to the worst years. This shows a marked increase over the pre-war era. 1/

The trends on the industrial distribution of employment are a good indication of the changes taking place in British industry during the inter-war period. The following table will illustrate this point:

1/ Jones and Pool, op. cit., p. 295.

TABLE II *

Industrial Distribution of Employment in the United Kingdom, 1923-38

Industry		Percentage Increase (*) or Decrease (-) Since June 1923.
EXPANDING		
Distributive trades	----	* 64.5
Building and Contracting	----	* 63.2
General Engineering	----	* 16.8
Hotel, Restaurant, etc.	----	* 71.7
Road Transport	----	* 73.1
Motor and Aircraft	----	*109.4
Local Govt. service	----	* 49.8
Electrical manufacturing	----	*128.7
Printing, Publishing, etc.	----	* 27.6
Gas, Water & Electricity	----	* 34.2
Tailoring	----	* 8.5
Laundries, Dyeing, etc.	----	* 69.5
Professional services	----	* 61.7
Bread, Biscuit & Cake-making	----	* 15.7
Furniture making	----	* 57.3
Entertainments, sports, etc.	----	*150.5
CONTRACTING		
Coal Mining	----	- 41.5
Cotton manufacturing	----	- 43.2
Woolen and Worsted Mnfg.	----	- 32.3
Iron and Steel	----	- 17.7
Railway service	----	- 14.0
Shipbuilding	----	- 4.8
Dock and Harbour Service	----	- 14.6
Boot and Shoe Mnfg.	----	- 11.9

* Jones and Pool, op. cit., p. 280.

In the most important expanding industries, motor and aircraft manufacturing, electrical manufacturing, and entertainment, Britain did not have any advantage over its chief competitors--America and Germany--and therefore these industries did not help much in filling the export gap. Only now are British films beginning to be produced of such a quality as to be able to compete in the vast American market. The rapid growth of such industries as sports and entertainment in such a short time seems very significant of a declining economy.

The declining industries are mainly comprised of Britain's export industries. Since this gap was not filled by other commodity exports Britain's international trading position was permanently weakened.

The decline in the old staple industries may be attributed to a variety of influences. Most of these influences may be directly or indirectly traced back to the rise of international competition in these and substitute fields, by countries which had a natural or time advantage over Britain. The First World War and the following curtailment of British trade only accentuated her already failing position. Certain hidden weaknesses were brought to the surface in the form of rising costs of production relative to the rest of the world, coupled with falling demand. The growth of economic nationalism closed many important markets. Thus Britain's crippled industries were not able to keep up with changes in fashion or the growing competition of substitutes. Also, some of her best customers were poverty stricken by the depression.

The interaction of all these tendencies was noticeable in different degrees throughout Britain's older industries. Consequently the relative importance of overseas trade with regards to national income fell. This is shown in the following table:

TABLE III *

British Overseas Trade in Relation to National Income

Year	Net National Income (in million pounds)	Merchandise Exports Amount (in million pounds)	Percentage of Nat. In.
1911	2,062	454	22.0
1924	3,600	801	22.2
1929	3,868	729	18.9
1932	3,313	365	11.0
1935	3,960	426	10.8

* Ibid., p. 282.

From 1911 to 1935 merchandise exports fell from 22% to 10% of national income. Thus a much greater strain was put on Britain's invisible exports --shipping and investment. This may account for the relatively small decline in the shipping industry compared to the other declining industries. However, war had crippled shipping in Britain and stimulated it elsewhere. As for investment, this had to be maintained by new additions every year. New additions can only be safely made from the export surplus. After the first war, Britain's export surplus fell but she did not, in these circumstances, reduce the volume of her long term international lending. Between 1922 and 1929 the average annual amount of new issues for overseas borrowers was about 36 million pounds more than the estimated average export surplus on current account. This overlending was only possible because Britain was importing short term capital. The financial difficulties of 1931 had this as one of its principal causes. Short term capital can be called on short notice and is a very dangerous stop-gap. 1/

It is important that I mention the investment problem here since it accentuated the disastrous effects of the slump in Britain's staple export industries. The income from invisible exports was maintained and even ameliorated, but the industrial foundation upon which they rested was crumbling.

Happy was the industry in Britain that had no history. The history of her older ones tells a sad story. Surely and steadily they were atrophying I shall trace the important causes and extent of atrophy in her two largest export industries before 1914. They are coal and cotton, two veritable industrial kings in their day.

1/ Royal Institute of International Affairs, The Problem of International Investment (London: Oxford University Press, 1937), p. 60.

Coal—"King Coal", the acknowledged heart of any industrial economy—has by its decline inflicted the deepest rift in Britain's economy. Britain's coal production has never returned to its pre-World War I peak, reached in 1913, of 287 million tons. Temporary prosperity came on again in 1923 when the Ruhr—Britain's chief rival—was occupied. Since then her output has had a downward trend. As a result coal exports also dwindled and in 1938 were only half of what they were in 1913. The depression caused the coal industry to become sick the world over, yet all coal producing countries except Great Britain increased their production from after the last war. The following table shows the downward trend in the British coal industry:

TABLE IV *

BRITISH COAL INDUSTRY

Year	Output (in millions of tons)	Export (in millions of tons)
1913	287	73
1923	276	79
1929	258	60
1932	209	39
1936	229	35
1937	241	40
1938	228	36

* Jones and Pool, op. cit., p. 283.

Britain's contribution to the total world output fell accordingly. In 1909-13 she produced 25% of the world's total coal. By 1937 this had slumped to 19%. The demand for British coal had fallen in many directions. Coal importing nations were importing from Britain's competitors, especially Germany and Poland. Britain's costs of production remained rigid and even tended to rise on account of antiquated machinery, the nature of British deposits, and the strong labour unions which maintained high wages in the face of falling prices. Competitive fuels, along with fuel economies had also lowered the demand for coal. In 1914, 96.6% of the shipping registered at Lloyds was still coal fired. By 1935 this proportion had dropped to 51%. 1/

British industry, moving south and converting to electrical power, cut down the domestic demand for coal very considerably. There are no satisfactory figures for the period prior to 1914 with regards to electrical power, but statistics for the short period from 1924 to 1930 illustrate the growing importance of electricity. During this period the total power (including coal) available for industrial use grew by 14.3%. The amount supplied by electrical power grew by 39.4%, while that supplied by coal fell by 10.1%. 2/

Similar expansion in the gas industry had the same effect on coal as the electrical industry. Both of these industries used coal to produce their power but the ratio of power produced to coal power consumed was very great. A fivefold increase in the output of electricity was obtained by a twofold increase in coal and coke consumed. The gas output per ton of coal rose from 13.2 thousand cubic feet in 1913 to 16.9 cubic feet in 1936 through technological improvements in methods.

In the other basic coal consuming industries the demand had fallen because of the general slump in industry itself and because of increased efficiency in the use of coal. Valuable coal gases which had formerly been wasted began to be utilized. Also, the increased use of scrap iron in place of pig in steel making greatly reduced the amount of coal used. In 1913 when Britain produced 10,260,000 tons of pig iron and 7,664,000 tons of steel, the iron and steel industries are estimated to have consumed 31.4 million tons of coal. This had dropped to 23.3 million tons in 1937 when Britain produced 8,497,000 tons of pig iron and 12,964,000 tons of steel. 3/

1/ Ibid., p. 284.

2/ Ibid., p. 284.

3/ Ibid., p. 285.

Britain has been very slow in installing mechanical equipment in her mining industry. This has not been solely because of inefficient organization, as some have maintained, but partly because of the nature of the geological structure of the British coal seams. Even at the beginning of the century, when Britain was still industrial baron of the world, one quarter of America's bituminous coal was cut by machinery while only one and one-half percent of Britain's was obtained in this way. By 1924 19% of Britain's coal was machine cut, but America's had risen to 70%. This falling behind on Britain's part, whatever its cause, has had serious consequences as seen today. Her fevered attempts to bring coal production around have come very late--and as yet it is not possible to say whether it is too late. Coal, an integral part of Britain's economy, was allowed to get too weak and was leaned upon too heavily.

If Great Britain's coal industry may be said to be suffering a slow death--then her cotton industry has had a tragic quietus. The causes are not so complex as those which caused the decline of the coal industry. Relatively sudden paralysis set in in Britain's cotton industry as Asia's little giant, Japan, raised its head over the commercial horizon of the world. The great bogey of cheap oriental labor competition became a reality to England's great cotton industry. Japan's dawn song was sung to the tune of the clanking roar of her cotton factories. Cheap cotton cloth was the first probing finger that preceded the flood of Japanese goods which later found their way to almost every retailer in the world and paid for Japan's late war effort.

This prodigious rise of Japan's cotton industry and its disastrous effects upon British cotton trade cannot be more clearly demonstrated than by the following statistics:

TABLE V*

EXPORTS OF COTTON PIECE GOODS
(Indices, 1927 - 100)

From	Great Britain	Japan	Great Britain and Japan
1927	100	100	100
1928	94	114	97
1929	89	131	100
1930	58	115	73
1931	42	104	57
1932	53	149	77
1933	49	153	75
1934	48	189	83
1935	47	200	85

* Royal Institute of International Affairs, op. cit., p. 261.

TABLE VI *

EXPORT OF COTTON PIECE GOODS FROM GREAT BRITAIN

Year	Relative Value (based on Sterling)	Proportion of Total British Exports
1913	97.8	18.6
1927	110.0	15.5
1928	107.3	14.9
1929	99.3	13.6
1930	61.3	10.7
1931	37.3	9.6
1932	43.6	12.0
1933	40.2	10.9
1934	39.8	10.1
1935	39.5	9.3

* Ibid., p. 62.

Between 1927 and 1935 British exports of cotton piece goods diminished in volume by slightly more than 50 per cent. In every year during this period Japanese exports of cotton increased relatively to British exports of cotton. In 1927 Japan's cotton exports were only 1/3 of those of Great

Britain. By 1933 Japanese exports were 3 per cent greater and two years later--1935--they were 40 per cent greater. This market has probably been permanently lost by Great Britain.

Two striking features in this decline in British cotton exports have been the relatively greater decline in value with respect to quantity exported and the persistence of the decline. In 1932 there was a slight rise in exports because of the undervaluation of sterling. This seemed to effect the cotton industry in Britain more than any other industry. The slight gain made on this account was soon wiped out by 1935 and has declined ever since.

Indian tariffs and competition also had an adverse effect on British cotton exports. India was the main importer of British cotton cloth. When Japan began competing in the Indian market and Indian production went up British cotton was undersold and lost the market. In 1927 India imported most of her cotton imports from Great Britain. By 1936, not only was she importing less, but Britain supplied less of the reduced imports. In 1927 total Indian cotton imports were 40,642,000 pounds, of which Britain supplied 79 per cent. In 1935 India's total cotton imports were only 11,835,000 pounds, while Britain only supplied 47 per cent of these imports. (Great cotton manufacturing areas had grown up around Allahabad and Bombay.)[1]/

Cotton exports as a percentage of total British exports fell accordingly--from 18.6 per cent in 1927 to 9.3 per cent in 1936, with a slight rise to 12 per cent in 1932 on account of the undervalued sterling. However, total British exports had also shrunk by 36½ per cent; so that the actual shrinkage in cotton exports was about 64 per cent in 1935 of the cotton exports of 1927. [2]/ This meant a decline of surplus on current account of 30 million pounds a year because of the decline in cotton exports alone.

1/ Ibid., pp. 61-63.

2/ Ibid., pp. 61-63.

As this same picture began to appear throughout the British export industries, the current furplus dwindled from year to year until in 1930 the surplus was replaced by a small deficit. In 1938 the accounts were balanced only by a draft on overseas capital assets. The gap was beginning to grow and was getting harder to fill in. Drawing on one's capital assets is dangerous. The coming crisis was just a matter of time. The gathering war clouds and the accompanying armament race only accentuated and speeded up existing adverse forces. I shall discuss this later stage more fully in the final section.

Chapter III--BRITISH INVESTMENT IN THE INTER-WAR PERIOD (1920-1935).

In the development of the Victorian Age investment played, as has been shown, a very important part. The unique nature of world trade was conducive to advantageous investment on the part of the industrial nations--especially Great Britain. The foodstuffs required by these nations were supplied by bringing into cultivation new foreign lands. These lands in turn became markets for the products of the industrial nations. It was only under such mutual dependence and cooperation that the full fruits of rising industrialism could be realized. International investment was an integral part of this smooth running world economy. However, this smoothness was only relative to the post-war situation and was not uninterrupted. Occasional financial crises, currency difficulties, or periods of default by borrowers entailed losses for British and European investors. They were followed by periods of sharp decline in new overseas investment and consequent depression of industry.

Interruptions of this nature were, however, merely incidental to the powerful forward trend of investment. After the first war the picture was different. Interruptions seemed to become the rule rather than the exception. Foreign investment maintained its good name throughout the war, however, because of the important part Britain's foreign assets played in paying for the war. Britain's accumulated foreign assets have been her mainstay ever since. The last war changed the whole world economy. It accentuated adverse trends in the British economy and left it permanently weaker, although the current balances were soon stabilized and remained so up until a few years before this war. Growing nationalism and the industrialization of certain formerly backward countries such as Japan, along with the effects of the last war's exhaustion of Europe changed the world economic picture. Strain and instability curbed the potentialities of profitable foreign investment.

France and Germany emerged from the war in a very weakened condition. Germany did so because her wealth had been stripped from her by unnecessarily heavy reparation dues; and France, mainly because of the speculative nature of her foreign investments. France had directed her loans to a preponderant degree to financing her ally, Russia. With the advent of the Soviet government these investments became worthless.

On the other end of the scale was the United States who emerged from the war a creditor nation. Her nationals had acquired a large proportion of the American securities formerly held by foreigners. She had accumulated large debts owed her by boreign countries. German reparations had also added to her wealth.

In an intermediate position stood Great Britain. The sale of a large amount of her foreign assets during the war left her with diminished but still substantial claims on the rest of the world. She had contracted a heavy debt with the United States. Against this she had a few shaky investments with her European allies and with Germany. Because Britain had not been able to supply the demand of her overseas customers during the war, some of them had turned to rival producers and so, as has been shown, she lost ground in industry. Thus Great Britain emerged from the last war not only with a weakened capital position, but with a less favourable annual balance of payments--exporting less while continuing to import as much or more than before.

In order to understand Britain's decline in income from foreign investment it is necessary to outline the general post-war conditions in international economic relationships.

On the one hand Europe was badly in need of capital for reconstruction and development. On the other hand America was a creditor nation with a new responsibility. Investment would have to flow along new channels. The United States began to assume the role of a major lending country. It was difficult, however, to induce the American public to put its capital into the international market. They had not been bred into thinking along international lines as the British people had, and besides, the post-war investment field did not look very tempting. A good deal of economic statesmanship was used to overcome the obstacles in the way of the American public.

The obstacles to be overcome were numerous. The budgets of borrowing countries had to be balanced and their currencies stabilized. The Dawes and Young plans were moves in this direction. Most of this was done through the League of Nations in the form of League Loans. Another major problem was the German reparations obligations. International lending was impossible except in an international atmosphere of peace. German reparations involved the problem of war debt and was distasteful to the German people. The solution of European instability and the payment of German reparations meant trying to reconcile two unreconcilable national attitudes.

The Dawes Plan and loan in 1924 alleviated the position considerably and by 1926 it looked as if prosperity was in sight again. Currencies were stabilized throughout Europe; budgets were balanced; the economic life of Europe was revived and international trade began to expand rapidly. Capital began to flow--especially from America--and it began to look as if international investment was going to play as important a part in resuscitating the post-war world as it had done in developing the New World of the nineteenth century.

This did not prove to be the case. From the latter part of 1927 the

American investor lost his taste for foreign bonds, preferring the more exciting possibilities of the rising market in American equities. The process was gradual at first but soon there was a severe drying up of American sources of capital. This hit the debtor nations very hard and there were many defaults in payment. As it became more difficult for the banks of Europe to get short-term loans (to pay the interest on long-term loans), they had to raise their bank rate and restrict international credit. A business reaction set in. Dangerously large stocks had accumulated in primary products through overinvestment in this field. It was all climaxed by the Wall Street collapse of October, 1929, and the world settled into severe depression.

Because of financial difficulties, American civilians and banks began to try and bring home the money they had invested abroad. This confronted the European countries with an impossible exchange position, one which required continuing credits from abroad to make ends meet in the international account. From this followed the financial crisis of 1931 and the fall in the sterling rate which had been at an artificially high level since 1925.

In order to save itself every country endeavoured to cut down on imports. This only accentuated the spiral and world commodity prices fell. Along with the exchange difficulties and internal insolvencies of many countries, this led to growing defaults in international obligations.

TABLE VII *

INTEREST DEFAULTS ON FOREIGN DOLLAR BONDS HELD BY AMERICA

Prior to 1 Jan. 1931	$ 392,226,100
During 1931	521,957,500
" 1932	826,144,200
" 1933	1,145,503,700
" 1934	211,744,100
" 1935	2,787,000

* Ibid., p. 305.

By 1933 the volume of international trade had been reduced to about 75% of its 1929 level, and the system of international investments appeared to have completely broken down.

It is generally accepted that the reasons for the fall in international investment were that they were not handled and placed skillfully enough. The role of international lender had passed from Great Britain to the United States. The issuing of foreign loans is a highly skilled job to which the financial organizations of London and the people of Great Britain had adapted themselves. The United States bungled the job badly by attacking it in the spirit of enterprising salesmanship rather than cautious responsibility. Thus a large share of the responsibility for the disaster which overtook international lending of the post-war period can be attributed to the recklessness and lack of discrimination on the part of the United States.

The heart of the whole investment problem after the war, as Mr. Keynes has pointed out, was the difficulty of transfer of credit. International loans must be paid for in the long run by goods and services. Thus lending must be made with an eye to its use by the borrower and with a realization that appropriate import channels must be opened up for the exports of the borrowing country. Germany failed to use her borrowed capital in the proper places, and the United States failed to import additional goods or reduce her exports accordingly. It may be argued that this was impossible but I do not believe the criticism is sound. Germany certainly did not need parks and swimming pools so badly that she had to use precious foreign capital to build them. Vested business interests in the United States prevented the United States from taking appropriate steps to correct the difficulties.

It was in this chaotic world that Great Britain, who depended so heavily upon her investments, had to carry on. Long years of experience in international affairs had made her cautious and consequently she did not fare as badly as other lender nations.

British post-war investment was affected by two opposing forces. One led to the restriction of investment and the other to its expansion. Among the major factors which led to the restriction of foreign lending was the demand for capital to finance the reconstruction and reorganization of home industry to a sound peace-time basis. This factor was particularly important in the early post-war years. By 1922 the home demand had waned but political and economic instability abroad necessitated the restriction of capital exports. The growth of the New York capital market was another factor which tended to restrict British capital exports. Many found they could obtain capital more easily there. Canada and several South American countries conducted most of their post-war borrowings in New York. The most important single cause of the reduced volume of capital exports by Great Britain was the overvaluation of sterling in 1925. In order to prevent a drain on gold from the Bank of England, interest rates had to be kept at a relatively high level. Certain qualitative restrictions in the form of embargoes were also imposed which tended to restrict the export of British capital. The British economy was in no position to indulge in international lending to the extent it formerly had. The symptoms of disorder, however, were concealed by other factors. The inflow of French and American capital tended to cloud the issue. French short term capital, in search of a safe but temporary resting place, found its way to London in the form of short term loans. French financial trouble--devaluation of the franc--caused this "flight of capital". These short term French funds gave Britain a superficial appearance of economic soundness and allowed her to export capital although her current balance did not warrant it. Because of the current belief of the pre-1931 decade that all economic difficulties would be overcome when the currencies of the world were once more convertible into defined quantities of a precious metal, many unsound European issues were purchased by Britain. Some of these along with a great many South American issues were later defaulted or even repudiated--with the consequent loss to Britain. Another factor which led to maintaining a high level of foreign lending by Britain was the measures used to encourage empire borrowings by giving preference rates. This was the reason there was a shift in British foreign securities from foreign into empire securities. In 1913 Britain had 47% of her foreign investment in the Empire. By 1930 she had 59% in the Empire.

The outcome of these opposing sets of forces was that those which tended to restrict foreign lending prevailed. There has been a substantial decline in overseas lending by Britain since the First War. The amount of new capital raised in London actually increased during the major part of the inter-war period but the proportion of this that went into foreign issues remained constant or diminished slightly. If the price rise is taken into account, there was a marked decline in new foreign investment. Roughly the percentage of total issues raised in London which want into foreign issues fell from 76% in 1910-13 to 11% in 1935. 1/

The imposition of embargoes as a means of controlling capital exports began during the last war. An unofficial embargo was placed upon new issues and was not withdrawn until 1925 when sterling was revalued and the high interest rates obviated the necessity of using embargoes. In 1919 there was

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1/ Ibid., pp. 133-136.

a slight letting up of the embargoes for defense and Empire borrowing purposes. After 1931 a few foreign issues were bought but strict controls were resumed again in 1924 for the eighteen months prior to November 1925, in preparation for the return to the gold standard.

However, the cause of the decline in the importance of overseas investment in the British economy was the general instability of the world capital market. This reflected itself through the controls and the high rate of interest or risk premium. The last was was the major factor which put Britain in a disadvantageous position as an investor and gave the United States the opportunity to take over.

The shift in British overseas investment towards the Empire in an effort to create some sort of economic stability was encouraged by interest rate preferences.

TABLE VIII *

INTEREST RATES AND THE PRICE OF NEW CAPITAL

Year	U.K. Yield on Consols.	Cost to Dominion and Colonies of borrowings from the U.K.	Cost to foreign countries of borrowings from the U.K.
	per cent	per cent	per cent
1921	5.2	6.42	7.49
1922	4.4	5.68	7.21
1923	4.3	5.07	6.96
1924	4.4	5.02	7.57
1925	4.4	4.99	8.00
1926	4.5	5.11	7.32
1927	4.6	5.09	7.07
1928	4.5	5.05	6.73
1929	4.6	4.99	7.20
1930	4.5	5.56	7.14

* Ibid., p. 135.

The long term interest rate as represented by the yield on Consols remained fairly steady around 4½%. The other rates fluctuated considerably. There is an obvious difference throughout the period between Empire and other foreign rates. Between 1932 and 1930 foreign governments had to pay between 1½% and 2½% more than Empire borrowers. This margin may be called the risk premium attached to lending abroad. 1/

The result of this difference in rate was that New York could successfully compete with London in granting loans to non-Empire borrowers. Between 1922 and 1929 the rate in New York was ½% to 1½% cheaper than in London. Canada was one exception in the Empire since her currency was so closely tied to that of the United States'. She found it cheaper to borrow in New York except during 1928-29 when the rates there rose steeply. 2/

It must be stressed that the reason for the high London rate was the overvaluation of sterling in 1925. In order to maintain the gold standard, exports of gold had to be controlled by the high rate. It had a compensating effect however, in that it created a premature depression in Great Britain and consequently numbed the British economy to the disastrous effects of the depression as experienced in the United States. Other factors such as the good distribution of Britain's investments and the maturity of her economy helped her to weather the depression relatively well.

Income from investment, as one of the two most important items in the balance of payments on current account, must be examined with care. Merchandise trade is the other item which vies in importance. Their relative importance with respect to the current balance is illustrated in the following table.

1/ Ibid., p. 136.

2/ Ibid., p. 137.

TABLE IX*

IMPORT SURPLUS AND INCOME FROM OVERSEAS INVESTMENT IN RELATIONSHIP TO CURRENT BALANCE OF PAYMENTS 1913, 1920, and 1922-35.

(millions of pounds)

Year	Commodity Balance of Trade	Income from Overseas Investment	Current Balance of Payments
1913	- 132	210	195
1920	- 380	200	208
1922	- 176	175	144
1923	- 208	200	140
1924	- 338	220	72
1925	- 392	250	46
1926	- 463	250	- 14
1927	- 386	250	83
1928	- 352	250	123
1929	- 381	250	103
1930	- 386	220	28
1931	- 408	170	- 104
1932	- 287	150	- 51
1933	- 263	160	0
1934	- 294	175	- 2
1935	- 261	185	37

* Data based on tables in Ibid., pp. 139 and 140.

The balance on the current account represents the foreign funds in the hands of British persons which are available for lending to borrowers overseas. There is a marked average decline in the surplus which at the beginning of the second World War had declined to a deficit of 70 million pounds (in 1938). Any deficit must be filled by imports of foreign capital, selling of foreign assets, or exports of gold. During four of the years shown in the above table there was such a deficit. In 1926 this was the result of a coal strike and other disturbances which caused an exceptionally large excess of imports of merchandise. In 1931 the overvaluation of sterling was the main cause. Other causes were the sharp decline in the income from certain invisible items such as shipping and short term loans. The payment of war debts to the United States also had an adverse effect.

Between 1920 and 1930 the normal state of the current account was a large surplus. The invisible exports more than made up for the import surplus. Before 1924 the current account surplus was so large that foreign investment could not absorb it all. From 1924 to 1927, however, long term capital exports were so large that foreign capital in the form of short term loans had to be borrowed in order to effect a balance. Most of these short term loans were, as I have mentioned, French capital seeking a safe temporary resting place. The ill effects of this lending long and borrowing short began to be felt in 1929 when a withdrawal of short term funds betan. France had stabilized the franc and began repatriating her balances. High New York rates also attracted funds from London.

Since 1930 Britain's balance on current account has been negative almost continuously. In spite of this Britain remained a net exporter of capital up until this war. This has been mainly in the form of purchases of large amounts of American securities.

Throughout the inter-war period the average balance on Britain's capital account has been negative. This is the true indicator of her economic decay. The last war was the big blow that brought the decay to the surface. However, by 1935-36 the capital deficits began to get smaller and some predicted a hopeful future for Great Britain. Soon after, the armament race between the nations began and the convalescing British economy was again thrown into disorder. The crippling effects of the war itself will be discussed in the last section.

A study should be made at this point of the temporary rebirth of the gold standard and the emergence of the sterling area.

Chapter IV--MONETARY CONDITIONS IN THE INTER-WAR PERIOD

Monetary matters, because of the nature of our world economy, must be viewed in their international aspect. No currency can remain independent of outside economic disturbances if the country to which the currency belongs deals in international trade. Thus world monetary conditions influence the monetary state of affairs of any single country. The more important a country is as a manufacturer and trader, the greater influence its monetary policies exert on international monetary conditions. For this reason a country such as Great Britain cannot follow unstable monetary policies without dire consequences to the rest of the world and eventually to herself. Britain has been notoriously stable in this field---sometimes to her own disadvantage. France is an example of a leading country which did not maintain the stability of the franc, with disastrous results for the world. It is not just a matter of Great Britain having higher moral standards of international responsibility. She stood to gain by pursuing a policy of a stable pound if there was any degree of stability in the world economy. Since this was lacking during the inter-war period Great Britain suffered severely from monetary disturbances. However, she was not as responsive to booms and depressions as the United States because of certain industrial and commercial difficulties.

Since Great Britain has been the leader in so many fields, both cultural and economic, it is not surprising to note that in early searches for international monetary stability she played a leading role. The inter-war period in economic history is notably complicated. In a period between two great wars it is only natural that the disturbing effects of the wars should reflect themselves throughout all international relations. Generally the period was one in which monetary conditions were poor. Many attempts towards stability were made, but the atmosphere of international suspicion and jealousy was a rotten foundation upon which to build any lasting agreements. The seeds for the second world war were sown from the day the first one ended. If there had been international agreement and synchronization of economic policy, Great Britain and the rest of the world might not be in the chaotic state they are in today.

Fluctuating exchanges are the direct or indirect result of secular or cyclical changes in the economic activity of a country or group of countries. Since these changes got more violent after the last war, the relative exchange position of the countries varied rapidly and to a large degree. Any policy which is to lead to stability and international confidence must aim at one of two things or degrees of both. One is to keep the exchanges pegged at an agreed-upon level and to use reserves of foreign exchange or gold to maintain the rates. The other is to let the exchanges fluctuate and to concentrate on stabilizing internal credit structure and economic level of each country so as to modify exchange fluctuations and trends. Both must be pursued, and were, during a time of economic flux such as the inter-war period.

If, however, exchange rates are pegged out of line with the level of a country's economy relative to other countries, the reserves will prove either insufficient or will grow too large, depending on whether the country has overvalued or undervalued its currency. If reserves grow too large it may lead to inflation within the country unless the excess is sterilized as in the excess gold stock in the United States.

Since the pegging of the exchanges depends upon the economic activity of each country, it is necessary to keep these levels stable, within reason. If there is any permanent secular trend in the economy of a country, adjustments must be allowed for (Great Britain in 1931).

I shall trace the historical development in monetary policies followed during the inter-war period and then discuss some particular aspects of the monetary conditions during the period. It is impossible to isolate Great Britain in a discussion of monetary matters, but it must be realized that general world monetary conditions were reflected directly in Great Britain. Through necessity Britain took a leading role in monetary affairs and hence some specific reference will be made to her position.

Special attention must be paid to Great Britain's return to the Gold Standard in 1925. It was one of the most serious monetary blunders in the recent history of Britain. Winston Churchill, who was then Minister of Finance, has proved himself to be a great war leader but lacking in skill in financial administration.

The desire to get back onto the Gold Standard at a Pre-World War I parity was the result of various influences. First, Britain still cherished the memory of her prosperous days before thw war. She had acquired a great faith in the gold standard and the "stable British pound", and failed to realize that the laissez-faire pre-war economy was unique and that the monetary system of that economy was not adaptable to the changed post-war conditions. There was not enough gold in the world to support a Gold Standard. The second influence which led Mr. Churchill and the government to return to the gold standard was a belief that the sterling rate was actually rising to the pre-war rate of $4.83. This rise just before 1925 was not a reflection of an actual rise in British wages and prices, but was the result of an anticipated return to the Gold Standard at the pre-war parity. By contemplating the return, forces were set in action which gave the impression that the return was justified. A third factor which mislead Churchill was that his advisors had miscalculated the maladjustment of money values which would result from restoring sterling to pre-war gold parity, because they used index numbers of prices which were irrelevant or inappropriate to the matter at hand. British wholesale index numbers at the time were based to the extent of at least two-thirds upon raw materials of international commerce, the prices of which necessarily adjust themselves to exchange rates. The wholesale index data should have gathered from the cost of living index, the level of wages and the price of manufactured exports. Since this was not done, the apparent relationship between the British and American exchange rate was not in line with the actual rate. It appeared that the gap to be bridged was only about 2% or 3% when it was actually about 10% to 12%.

The policy of increasing foreign exchange value of sterling to its pre-war value in gold from 10% below this level meant that, whenever Britain sold anything abroad, either the foreign buyer had to pay 10% more in his money or else Britain had to accept 10% less in hers. It was found that the sterling prices of coal, iron, shipping freights, or any other export had to be reduced by 10% in order to be on a competitive level, unless prices rose elsewhere. Consequently, the improving of sterling led to a loss of about 10% in the sterling receipts of the export industries. The direct cost of this reduction fell on labour and unemployment increased greatly. A forced depression of real wages was the result.

Foreign products began to appear cheap to the British importer and imports were greatly stepped up. Exports, as has been mentioned, were greatly reduced, if not in volume then in value.

The balance of payments position was not too steady even in 1925. Mr. Churchill's policy only aggravated this situation at a time when Britain needed a sound monetary policy to alleviate the growing stress. The importance of monetary policy in affecting economic trends and conditions was greatly increased in the inter-war period. As the balance of payments depreciated the Bank of England was forced to act. It put an embargo on foreign loans since these do not bring in current income and are classed as an import. Still more important, however, it raised the bill rate 1% higher in London than in New York and thus attracted American short-term capital. The embargo did not prove effective, so that enough short-term capital had to be borrowed, not only to pay for the deficit in the balance of payments, but also to finance British foreign investment. Since these short-time loans were in demand, London had to maintain the high rate of interest.

The boomerang effect of maintaining a high rate was to restrict credit in the home economy. This was exactly the opposite policy needed in Britain at the time. Cheap money would have been an incentive for British reconversion towards modernizing her industry at a time when this might have meant saving the British economy. John Maynard Keynes believed that the reconversion to the gold standard at the pre-war level in 1925 was the fatal blow which crippled England when she was convalescing from the first World War. History cannot be turned back but I think Great Britain would have been in a far stronger position today if Mr. Churchill had not committed his gross financial faux pas in 1925. 1/

The Gold Exchange Standard was adopted on the continent in the twenties mainly because the total supply of gold was believed to be too small and the free exchange gold standard was not working well enough under the more violent monetary disturbances of the post-war world. In the Free Gold Standard large private funds dealing in arbitrage kept the foreign exchanges

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1/ John Maynard Keynes, The Economic Consequences of Mr. Churchill (London, 1928).

in equilibrium and thus prevented much gold from flowing between countries. This enabled those countries possessing gold to maintain their internal credit structure on a fully backed gold basis. As the fluctuations and trends in the foreign exchanges became more violent private funds proved insufficient stabilizers and the central banks began to be relied upon more heavily to compensate for exchange vagaries by importing or exporting capital. Foreign exchange began to be held more widely by banks, first on top of reserves, and then as part of actual bank reserves. Central banks bought and sold foreign exchange for their own currency on demand and thus developed the Gold Exchange Standard.

This system was not invented after the first war. It had been used in numerous circumstances before. The exchange between London and Edinburgh in the second half of the 18th century had been regulated on this basis. The central banks of Denmark, Norway, and Sweden adopted a gold exchange system in 1885. Russia is a more important example: In 1894 she adopted a policy by which exchange reserves initially acquired by loan were held abroad in Berlin and Paris and the Russian government stood ready to buy and sell exchange on whichever centres the reserves were held at fixed rates of exchange. It proved to be a successful experiment and gained international recognition. Other countries began to hold foreign exchange reserves. By 1913 fifteen European central banks held 12% of their total reserves in the form of foreign exchange. 1/

The first world war accentuated existing exchange disequilibriums and central banks found they were forced to hold larger reserves. There simply was not enough gold in the world, or rather it was too poorly distributed to act as a sufficient stabilizer.

1/ League of Nations, International Currency Experience (New York: League of Nations Publications, 1944) pp. 28 & 29.

The Gold Exchange Standard was officially recommended at the Genoa Conference in the spring of 1922. The reason given was the belief in the shortage of gold supply (current) and the increased demand for it. The Genoa resolutions stressed balanced budgets, fixed gold parities, and free exchange markets. Resolution 2 stated certain provisions necessary for the maintenance of a gold exchange standard. Some of them were: (1) to maintain currency at its gold value an adequate reserve of approved assets must be maintained--not necessarily gold; (2) whenever possible certain countries should establish a free market for gold and thus become gold centres; (3) any participating country, besides its gold reserves at home, may maintain approved liquid assets in the form of bank balances, bills, short-term securities, etc., in any other particular country; (4) a country will buy and sell on demand, exchange held on other particular countries, within a particular fraction of parity of exchange, for its own currency.

These Genoa resolutions had considerable influence although the convention failed to materialize. By 1924 the European countries began to move towards a gold exchange standard. If they had done so simultaneously world history may have been different. It was the fact that each country operated independently in setting its exchange rates and reserve fund ratios that led to a clotting of the gold exchange system and its final breakdown. To see the trend towards the gold exchange standard one has only to look at the ratios between gold and foreign exchange held as reserve by the central banks of 26 European countries from 1924 to 1932 (including France).

TABLE X*

ABSOLUTE FOREIGN EXCHANGE AND GOLD RESERVES OF EUROPEAN CENTRAL BANKS

	1924	1925	1926	1927	1928	1929	1930	1931	1932
Total foreign exchange as % of total	27	28	31	42	42	37	35	19	8

*Ibid., p. 35.

From the beginning the idea was accepted only as a temporary measure by many countries--notably France. This led to the eventual breakdown of the system because these countries withdrew as soon as they found conditions favourable. France was actually on the gold exchange standard for only two years--1926-28.

The means by which countries acquired foreign exchange for their reserves was either by loans or by surplusses in the current balance of payments.

Austria and Hungary received loans amounting to 100 million dollars and 45 million dollars respectively, under the auspices of the League of the League of Nations. Germany obtained 200 million dollars under the Dawes Plan, for stabilization purposes. Belgium obtained one of 100 million dollars, Poland--one of 50 million dollars, and Italy of 125 million dollars. These loans came mainly from the United States or Great Britain.

The second source of exchange reserves, i.e., improving the balance of payments, was done by devaluing the currency or the making known by the monetary authority of the country that the exchanges would be stabilized at a higher level. France is a notorious example of a country which used the devaluation method to its own advantage.

The gold exchange standard functioned normally up until 1931. Gold reserves were kept constant and changes in balances of payments were offset solely by the movement of foreign reserves. This was the only condition under which Great Britain could stay on the Gold Standard. However, during 1931 and 1932 there was a wholesale liquidation of foreign exchange reserves and consequently a total collapse of the Gold Exchange Standard. For instance, Denmark had about 30% of her total reserves in foreign exchange up until 1930. In 1931 this fell to 9% and in the subsequent year to 0%. Similarly with Belgium who maintained about 40% of her reserves in foreign exchange until 1930. In 1931 this was completely liquidated. Others like Germany started to shift as early as 1925 when her foreign exchange reserves fell from 63% to 46% of total reserves. In spite of these individual fluctuations in the proportion of foreign exchange reserves held by the various countries prior to 1931, the average for the 23 countries was remarkably steady. 1/

Since France's monetary policies were one of the main causes of the downfall of the gold exchange standard, some special attention must be paid to her activities. In its annual report for 1931 and 1932 the Central Bank of France declared that ever since 1928 when it had virtually gone off the Gold Exchange Standard, its desire was to convert its foreign assets into gold, and that it had refrained from doing so solely because of the monetary difficulties of other countries. I do not believe this was the reason. I think France would have converted immediately if it had been to her advantage. This was France's attitude from the beginning and since she was a major country of the Gold Exchange Standard, the doom of the system was inevitable. France's unstable policies are illustrated by the fluctuations in the reserve ratios between gold and foreign exchange.

TABLE XI *

PERCENTAGE OF FOREIGN EXCHANGE IN TOTAL RESERVES OF CENTRAL BANK OF FRANCE

1924	1925	1926	1927	1928	1929	1930	1931	1932
2	2	14	47	51	38	33	24	5

Ibid., p. 35.

The effect of France's undervaluation of the franc contributed to putting Great Britain in a difficult position. It remained undervalued until

1/ Most of the statistics for this chapter were obtained from Ibid., Chapters II, III, IV, V, VI.

1930. To a minor degree the favourable French balance of payments added to the forces making for depression in the rest of the world at the turning point of the business cycle in 1929-30.

Thus the fate of the Gold Exchange Standard and the Gold Standard in Great Britain was sealed in 1928 when France declared that she would take nothing but gold in settlement of the enormous surplus accruing to her from the repatriations of capital in the form of current balances of payments. This pressure was felt most in London where the greatest amount of the French capital had lain for safekeeping. London was forced to go off the Gold Standard on September 21st, 1931.

Since the British pound sterling was looked upon as a very stable currency, this depreciation led to an all round scrambling for gold. It became very risky to hold reserves in the form of foreign exchange and many banks included in their statutes, that any reserves held in the United Kingdom had to be withdrawn and kept in gold. Paris became a temporary gold exchange center.

However, the British pound sterling was still the king of currencies. There is no doubt that the chaotic years after 1931 had a telling effect on Britain's international credit. The pound sterling did not have as great international prestige as previously, but it was still the most stable and universal currency.

After Britain was forced to go off the Gold Standard in 1931, there emerged from the international monetary chaos a wide area of exchange stability known as the Sterling area. There were two main characteristics which were pertinent to those countries which were included in this area. First, these countries maintained their currencies in a fixed relationship with the pound sterling. Second, they tended to keep their exchange reserves largely or wholly in the form of sterling balances or other liquid assets in London.

This system did not come about suddenly. Even during the general post-war gold standard regime, many countries preferred to keep some of their reserves in sterling rather than in gold to facilitate trade transactions. When the pound depreciated in 1931 the British Commonwealth of Nations with the exception of Canada tied themselves to sterling. Canada, because of the importance of U. S. trade had to take a middle course. Portugal also joined the sterling group immediately. Others joined later: the Scandinavian countries in 1933, Iran and Latvia in 1936, etc. Several other countries including Japan and the Argentine kept their official reserves in sterling but were not generally regarded as members of the sterling bloc.

In the autumn of 1939, most of the non-British member countries gave up their link with the pound and the sterling area became practically coextensive with the British Commonwealth of Nations. Canada again was an exception. To facilitate the war effort the sterling area became more precise and formal. For instance, the dollar reserves of the sterling area were all put into the "Dollar Pool", so as to insure that scarce dollars were used only when absolutely necessary. I will have more to say about this in dealing with the effects of the second World War.

The rise of the sterling area was unique in history. Stability in a paper-standard system had never been achieved before. The only explanation is that the psychological element gave a faith in the pound sterling. Also, in some countries there was a growing suspicion and skepticism regarding gold. The confidence in the British monetary authorities maintained the prestige of the pound in spite of the fact that Great Britain had severed her century old link with gold.

Among the more specific motives which led to the adoption of sterling as a standard, political ties may have played a part. The fact that the countries in the sterling area were mainly Commonwealth countries bears this out. However, there were more solid economic reasons for the choice. The countries in the sterling area were those which had close financial and commercial relations with Great Britain. This link was strengthened in 1932 by the far-reaching trade agreements made in Ottawa by which certain countries were given imperial preference.

Because of the importance of the British market these countries were desirous of maintaining stable exchange rates on the currency of Great Britain and also of protecting the price of their products on the British market so as to maintain their competitive position. Also, countries which imported a lot from the United Kingdom found that it was preferable to keep their currencies pegged to sterling because sterling balances were more liquid. Another factor which contributed towards the forming of the sterling area was that certain countries had long term debts to the United Kingdom, payable in sterling. Thus sterling reserves were sure to maintain the power to discharge these liabilities.

An important influence in forming the sterling area was the fact that the decline of money incomes and business activity during the great depression was less severe in Great Britain than in other leading industrial nations. The comparative mildness of the slump in the United Kingdom was partly due to the depreciation of the pound sterling and partly to other factors such as the tariff, the cheap money policy of 1932, the improvement in the terms of trade as a result of commercial agreements, the limited extent of the pre-1929 expansion (not solely a matter of choice), and the accumulation of domestic investment opportunities. This reasonable stability of the British economy during the depression is illustrated by the following table.

TABLE XII *

	INDEX OF INDUSTRIAL PRODUCTION			INDEX OF QUANTUM OF IMPORTS		
	U.K.	U.S.A.	Germany	U.K.	U.S.A.	Germany
1929	100	100	100	100	100	100
1930	92	83	88	97	88	90
1931	84	68	72	100	76	75
1932	83	53	58	88	62	69
1933	88	63	65	90	67	69

* Ibid., p. 49.

The United Kingdom was the largest importer in the world. This in itself led to greater stability than in other countries because of the importance of imports to the British economy. Other countries could rely on the steadiness of the British demand. Psychological factors are very important in determining the stability of international economic phenomena. The nature of British imports, being mainly foodstuffs for which demand is less sensitive to cyclical fluctuations than the damand for industrial raw materials, contributed to the steadiness of her imports. This may be contrasted with her exports which consisted mainly of manufactured goods. Here there has been a steady decline, particularly during the depression.

A number of countries maintained the old parity with sterling when they pegged their exchanges to it. These were: Egypt, Estonia, India, Iraq, Latvia, Portugal, and Thailand. The rest of the sterling area countries pegged their rates at a discount from the old parity. None put it higher. This meant that the terms of trade were better all round for Great Britain but her competitive position was weaker in foreign markets. Since Britain's bargaining position as a market was getting weaker as other large markets opened up, her advantage in terms of trade became weaker. This eventually broke down the sterling area and is one of Great Britain's main problems today.

Exchange rates within the sterling area remained remarkably steady. Central banks set buying and selling rates with a very small range between them so that even the fluctuations that used to occur in the gold standard currencies between import and export points were almost wholly eliminated. Some strain did develop as the level of economic activity between countries changed, but no changes in the rates were made until the outbreak of war in 1939. Thus it may be said that the stability of the exchange rates between the sterling area countries, plus the trade agreements, were the two reasons for the rise in the sterling area's share of total world trade during the thirties. [1]/

The reserve funds of the member countries were, as may be expected, held partly in sterling. After 1931 there was probably a greater proportion than before due to the advantage gained by the member countries in pegging their currencies below the old parity. However, a distinct cyclical movement may be noticed in the ratio of sterling to gold in bank reserves. In 1929 the percentage of sterling to gold in fifteen of the major sterling area countries was 61%. This fell to 37% in 1931 largely as a reflection of the fall in the world demand for primary products, of which the exports of these countries mainly consist. The central banks preference for gold was also a contributing factor, particularly when the ratio fell again in 1938 from 55% to 46%. Because of this latter decline in the percentage of sterling held as reserve, the value of the pound fell 6% during 1938. [2]/

A point that should be mentioned here is the effect on Britain's creditor position by the repatriation of bonded indebtedness which went on

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1/ Ibid., p. 53.

2/ Ibid., p. 55.

between 1933 and 1937. The purchase of foreign exchange by the central banks of the various countries broadened the domestic credit base. The resulting decline in interest rates made it possible and advantageous for domestic borrowers to repay foreign debt by issuing new loans at home. Some countries which did this were Australia, Denmark, Egypt, Finland, India, Norway, Portugal, South Africa, and Thailand. These external debts were not by any means all British but the annual amount of capital repayment to the United Kingdom rose from 27 million pounds in 1931 to 107 million pounds in 1937. The grand total of British overseas investment went down from 3,788 million pounds in 1935 to 3,754 million pounds in 1937.

The members of the sterling area held their reserves mostly in London in the form of British treasury bills. Thus there was an influx of capital into the United Kingdom. The effect of this influx on the British economy depended on where the member countries had raised their funds. If they were raised in non-sterling countries and transferred for safekeeping to London, they merged with the general flow of capital and were treated as "hot money". The Equalization Fund had to offset the disequilibrating effects of this movement by the purchase of gold with money obtained from the domestic market by the issue of Treasury bills.

However, if the balances were acquired in commercial transactions with the United Kingdom, they did not give rise to a movement of gold, and their investment in treasury bills was not accompanied by an increase in the supply of bills by the Exchange Equilization Fund. Thus there was an increased competition for Treasury Bills on the London market. This tended to restrict the British credit system as a whole since the London Clearing Banks kept most of their reserves in the form of treasury bills.

In 1938 the volume of sterling area funds held in London declined as a result in the fall in the price of primary products. The sterling area's trade position fell in relation to the rest of the world and a withdrawal of "hot money" from London led to a drain on the gold supply of the Exchange Equilization Fund and a corresponding withdrawal of Treasury Bills from the market.

It is seen then that the operation of an exchange reserve system such as the sterling area involves certain inconveniences to the reserve centre. The United Kingdom could not go off sterling, but the member countries could obtain competitive advantages at the expense of the United Kingdom by pegging their currency to the pound at an unduly low level. The nature of the operation of the sterling area tended to cloud over the adverse trend in the British balance of payments. Any deficit in Britain's balance of payments with the member countries tended to be covered by an equilibrating inflow of funds into London in the form of an increase in the member countries' exchange reserves. The present blocked sterling exchanges are the accumulation of past deficits in the British balance of payments. An initial surplus is of course necessary to start such a system as the sterling area, but if the reserve keeps growing as it did it shows an unhealthy trend in the central economy (Great Britain). Another disadvantage of the sterling area on Great Britain was that she had to keep reserves for the whole area for settlements with the outside world. It was gold that constituted the international reserve of the sterling area as a whole in relation to the non-sterling area. The fact that the sterling area itself was an important producer of gold made the problem easier for Great Britain. However, the fluctuation in the balance of payments of the member countries left Great Britain open to adverse influences she would not normally have suffered from. For instance, though Britain is an industrial country she had to bear some of the strain falling on the sterling area from the fluctuations in agricultural prices. With the adoption of exchange control at the beginning of the war this position was radically altered; but so were the conditions in which the purposes for the whole system were called to answer.

Chapter V—BRITISH COMMERCIAL POLICY IN THE INTER-WAR PERIOD

Great Britain's commercial policy during the inter-war period changed from a slightly distorted laissez-faire policy after the first World War to an Empire preferential system at the approach of the second World War. The commercial policy of a country is the reflection of its internal and external economic position. Thus a study of Britain's policy is very illuminating in showing the general economic trends. A summary of British commercial policy from the beginning of her rise to power follows a clear pattern of rise, peak and slow decline.

British commercial expansion goes back a good deal further than her colonial expansion. Protection and preference were the touchstones of the Mercantilist system and contributed to making Great Britain the eventual commercial and political power in the world. The rise can be dated from the reign of Queen Elizabeth and the defeat of the Spanish Armada at the end of the 16th century. When the power of the Hanseatic League was broken British commercial expansion was assured.

A colonial system grew up centring around Great Britain, the mother country. The colonies produced what raw materials and foodstuffs Britain wanted and they in their turn became markets for British products. It was a closed system.

After 1823 when Great Britain was acquiring a dominating manufacturing ability and the world market was expanding beyond the edges of the Empire, a school of thought grew up in Great Britain which regarded the colonies and the inter-Empire preferences as hindrances in the free expansion of industrial Britain. They were convinced that they could persuade all countries to trade without protection and without preference. Through diminishing marginal productivity the price of British agricultural products was going up. Tariff barriers had to be set up to keep out cheap foreign foodstuffs. Retaliatary tariffs sprang up against British exports and British industrialists who were growing in power and influence began to press for free trade. In 1848 the Corn Laws were repealed and Britain commenced the abolition of import duties and preferences which was completed within the next fifteen years.

However, other countries did not follow suit. This was a direct stimulus for the British government to support commercial expansion. Such companies as the East India Company became more government projects than private companies. Thus when Great Britain launched into free trade at the middle of the 19th century, the forces which finally crippled her were already in existence. She was able to avoid them by developing markets of her own and by leading everyone else in industrial expansion.

These pressure blocks, such as Germany and the United States, grew up under tariff walls. As their power grew they began to control the markets around them, forcing Great Britain to go further afield.

For the last fifty years of the 19th century Great Britain, because of her industrial lead and strategic position was able to operate on a free trade basis. Although a liberal commercial policy such as this led to Britain's eventual weakening, yet, while she was industrially in the lead and the world market horizons were still numerous, her free trade policy was the only condition under which she could expand to the extent she did, and attain the wealth and power as the centre of a great empire. Great Britain gambled to live dangerously---succeeded for a time---and then, because the rest of the world was not willing to play her game, she lost. The crisis in her losing streak came with the second World War.

However, United Kingdom trade did not expand solely because of her free trade policy. One factor which helped to keep expansion on the move was the discovery of Gold in California in 1848, in Australia in 1851, and later in South Africa in 1885. A greater amount of gold was necessary to support the greater trade and without it Britain's expansion and world expansion would have been greatly reduced.

The mechanical inventions of the industrial expansion such as railways, steamships and telegraph also led towards industrial expansion of unprecedented character. Railways were built not only in Britain but all over the New World and there was no country save Great Britain that was capable of financing them and providing the materials required. Nevertheless, under protective systems, foreign countries such as the United States were expanding their trade within themselves at a far greater rate than was Britain.

The first signs of a decline in Great Britain, and hence, a movement towards the abandonment of the tree trade commercial policy, came in 1880 after the economic high-water of 1860-70. It was then that the first serious rivalry began to appear. The report published in 1886 by the Royal Commission appointed to inquire into the Depression of Trade and Industry, leaves no doubt on this score. But Britain, ever sure of her position and of the opinion that she was competing internationally under normal conditions, failed to respond to the changing international picture. She was quite sure that her products were, and always would be superior and that British subjects would not think of buying cheap foreign products. The legendary Englishman who remarked that "the Negroes begin at Calais", was only joking no doubt, but in his heart he meant what he said.

The first movement away from trade had to come from outside Great

Britain. The colonies which had grown up along with the rest of the world did not share the free trade theories of the United Kingdom. Before the turn of the century Canada insisted upon her rights to give British goods preference over the products of foreign countries. Britain at first objected to this and two trade treaties debarred Canada from the rights she claimed. Under Lord Salisbury these treaties were finally denounced and Canada established a system by which she gave un-reciprocated preference to United Kingdom goods. This example was followed within the next few years by New Zealand, South Africa and Australia in turn.

Thus began a new era of preference in the Empire. For a generation Great Britain was dependent upon the four Great Dominions, having a total average population of less than twenty million, for more than seventeen per-cent of her export trade.

It is seen then that Great Britain had no trade policy of her own. The colonies which had suffered from her adoption of free trade in 1848 clung to her with unappreciated tenacity. New colonies were acquired, often with considerable reluctance, and such policy as existed was confined to enabling these colonies to become as far as possible, financially self-supporting. In many cases this was quite impossible and the result was grants, loans and assistances in one form or another.

The first important effort made towards a commercial policy was by Mr. Joseph Chamberlin at the end of the 19th century. He selected the despised Colonial office for himself and put his future at stake by trying to reawaken Great Britain from her apathy towards the world economic changes which were running adverse to the best interests of Great Britain. He tried to stir up the dynamic spirit of the 16th century and failed. His government and that which followed refused to see that the old system of a linked imperial trade policy was the only course that Britain could follow under the circumstances. The 19th century free trade policy ruled until the first World War.

Driven by the instability of a rapidly changing world, to find measures for the restoration of economic equilibrium, and encouraged by its experience of government control in war-time, the British government abandoned most of the cherished notions of the Victorians. A mercantilist re-visiting Great Britain after the first World War would have found himself in familiar surroundings. Free competition was beginning to be curbed and the government was beginning to regulate imports by means of tariffs. Rationalization was the new spirit with which the British authorities began to look at the changing world. The laissez-faire policy of the previous century became discredited. This was no sudden transition. Free-trade lingered on in an adulterated form up until 1930.

The first breach in the free-trade policy was in 1915 when Mr. McKenna imposed duties, most of which were at the rate of 33-1/3% (ad valorem), on certain luxury imports, including private motor cars, musical instruments, and cinemagraph films.[1] These duties were not imposed for any protective purpose but merely to strengthen the British foreign exchange position by cutting certain unessential imports. The duties were not abolished after the war-time emergency except temporarily by the labour government in 1924. These duties proved to be a direct stimulus to the industries concerned; particularly motor manufacturing, which developed under the shelter of the tariffs. Other duties had been applied during the war to save shipping space. Most of these were lifted in 1919 except for those effecting key industries such as dye-stuffs, drugs, scientific instruments, gauges, etc.

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[1] Jones & Pool, op. cit., p. 318.

Great Britain used to depend almost completely on imports for her dyes but by 1927 80% of the requirements were being produced at home. [1]

As duties against foreign imports rose those against empire imports tended to fall relatively. At first no definity policy emerged. In 1919 Lord Milner and L. S. Amery took on the task of persuading the treasury to adopt the tariff reforms of that year. Although these reforms were small in themselves if viewed against the whole background of Imperial trade, yet they were momentous in their effect. Such imports as spirits, wine, tea, cocoa, coffee, sugar, tobacco, etc., were given preference if they came from empire countries. The result was that these industries flourished and prosperity seemed assured.

At the Economic Conference of 1923 the United Kingdom was persuaded to agree to further preferential arrangements. They were not put into effect however, because when Ramsey McDonald's government came into power in 1924 he tore up the agreements. When the conservatives came back after the short stay of the Labour government Mr. Amery was unable to enforce the promised preferences because part of Mr. Baldwin's election mandate had been that he would not allow the preferences to be brought in. The best that could be done was the Empire Marketing Board. Its aim was to stimulate the purchase of Empire goods. In this it did a very good job but the founding of the board cannot be regarded as a definite Britich Commercial Policy. Progress during the first part of the century had been, materially speaking, not very marked; but although those at the head of affairs were slow to respond to changing world conditions, a consciousness had been growing, of the unique nature of the Empire. It was founded mainly for economic reasons and therefore was a self-contained system, or had been. Great Britain naturally

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[1] Ibid., p. 318.

turned towards Empire economic union in her 11th hour.

The strain of international disorder became so bad that with the abandonment of the Gold Standard in 1931 Great Britain once and for all jettisoned free trade and adopted a definite commercial policy of inter-Empire preference. On going off the Gold Standard Britain found to her surprise that the assumption of gold convertibility was not necessary. Great Britain's past prestige stood her in good stead and faith in the stability of the pound sterling did not waver in spite of Britain's monetary changes. It seemed that accidentally, and almost in spite of herself, Britain found that she was in control of the ideal monetary measure of value. A self-contained system of sterling convertibility, enjoying immediate exchange parity with a very large part of the world--the empire. (There were also some other countries which I have mentioned in the previous chapter.) The sterling price level could be freely adjusted to meet the needs of production and trade. It was this adjustable nature of the new sterling system which undoubtedly contributed greatly to the remarkable recovery of the sterling area after the crisis and depression.

However, one must not overestimate the significance of the sterling area. Great Britain did not jump towards Imperial consolidation as something better than the free-trade of her hey-day youth. She followed the line of least resistance in turning towards her Empire. As old age approached she was tempted to rely upon them as an aged father will rely upon his vigorous sons. In line with the same analogy however, the colonies and Dominions did not rely upon England as much as previously. They shared the renewed vigor of the New World and not the senile decline of Europe. Britain has tried desperately since the first War to cut herself free from declining Europe and to find security within the Empire.

The statistics show a picture of decline. Foreign competition has grown since the first War and Britain's markets have slipped from her grasp, yet she has come to depend more upon exports during these years. This paradoxical position has been the real gauge of British decline and has been the key to her changing Commercial Policy. Between 1909 and 1913 Britain produced 59.5% of her food at home, while between 1923 and 1928 she produced only 56.7% at home. The trend carried on in this direction.[1]

To see how far Britain could rely on the Empire to regain economic stability, the following figures are instructive. Between 1913 and 1927 Imperial trade increased by 27%, while world trade increased by only 20%. The Empire's share in world trade increased from 27.75% to 29.48%. Of this total volume of Empire trade 61% was with countries outside the Empire and only 39% within the Empire. These figures illustrate the impossibility of the Empire constituting itself into a closed group. The tendency was for Great Britain to rely more and more upon the Empire and for the Empire to rely more and more upon the rest of the world.

If the relative progress of the various parts of the Empire are considered, the rates are seen to differ greatly.

1/ Andre Siegfried, England's Crisis (New York: Johathan Cape and Harrison Smith, Inc., 1931), p. 181.

TABLE XIII *

INDEX OF CHANGE IN TOTAL IMPORTS

	1913	1927
Great Britain and Northern Ireland	100	114
Canada, India, South Africa, and New Zealand	100	126
United States	100	180
World as a Whole	100	122

INDEX OF CHANGE IN EXPORTS

	1913	1927
Great Britain and Northern Ireland	100	79
Canada, India, South Africa and New Zealand	100	131
United States	100	157
World as a Whole	100	118

*Ibid., p. 183.

This seems to be the very heart of the problem. Any figures which I got for later years showed that these trends continued in varying degrees up until the second World War. It is seen that England has not lagged greatly in imports but has definitely declined in exports. Since exports must pay for imports, the trend has been disastrous. While Britain declined relatively to the rest of the world, the Dominions progressed. This shows the diverging destinies of a prosperous Empire and a mother country no longer prosperous. Like her European neighbours, Great Britain is suffering from old age whereas the Empire shares the youth of the New World.

Comparison of the origins and destinations of imports and exports for the Overseas Empire and Great Britain will also help to exemplify the trends in the world with regard to Britain.

TABLE XIV*

ORIGIN OF IMPORTS INTO THE OVERSEAS EMPIRE

(coming from)	1913	1927
Great Britain and Northern Ireland	44.2%	36.1%
Other parts of the Empire	11.5%	13.1%
Foreign countries	44.3%	50.8%

DESTINATION OF EXPORTS FROM THE OVERSEAS EMPIRE

(going to)	1913	1927
Great Britain and Northern Ireland	41.2%	36.8%
Other parts of the Empire	10.6%	10.7%
Foreign Countries	48.2%	52.5%

ORIGIN OF BRITISH EXPORTS

	1913	1927
Coming from the Empire	20.5%	27.0%
Coming from Foreign Countries	79.5%	79.0%

DESTINATION OF BRITISH EXPORTS

	1913	1927
Going to the Empire	37.2%	43.2%
Going to Foreign Countries	62.8%	56.8%

* Ibid., pp. 184-5.

While Britain's share in the Imperial trade was diminishing, the share of the Empire in Britain's trade was on the increase. Thus England's trade has become less widely distributed geographically while that of the Empire has become more widely distributed. Before 1913 Great Britain shipped about one-third of her exports to the Empire, while since the first War she has shipped over two-thirds.

With this picture in the back of one's mind the commercial policy of Britain during the 1930's may be better understood. The Smoot-Hawley tariff Act of the United States which raised the duties against important British exports, drew together the members of the British Commonwealth in injured indignation; and the injury to their exports was the harder to bear because other foreign markets were also being lost through trade controls. As I have shown, Britain was already leaning heavily towards increased protection before 1930. The effect of the Smoot-Hawley bill was to lead Britain to make major tariff revisions between 1930 and 1932. The extent of these reforms is indicated by the fact that 83% of Britain's foreign imports had entered free of duty in 1930, while in 1932 only 30% did so. This was the turning point in British Commercial policy. I do not believe Britain had much choice. She was fighting a losing battle and the protective lull of the 1930's was only a temporary succor to the British economy before its ills were again brought to the surface by this last war. [1]

Economic nationalism which was rampant in the world also effected Britain and the Empire. In 1932 the major countries of the Empire met in Ottawa and extended the range of preferences. There is no need to outline the details of the conference. Its aim was, not to raise tariffs against foreigners but to lower existing tariffs for Empire countries. Towards this Britain offered certain preferences to the British market, if tariffs were abolished or lowered to major British exports. Any industry in the Dominions or colonies which was assured of a sound future could stay protected even if it competed with Britain. The motor industry in Canada was thus protected. Britain retained the right to revoke certain preferences if necessity forced her to do so. The general opinion is that although Great

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[1]/ Herbert Feis, British Imperial Preferences (Foreign Affairs, V. 24, (July, 1946), p. 662.

Britain benefited from the Ottawa agreements, the rest of the Empire benefited more so.

Many of the tariffs and preferences applied to products in the sale of which the United States was very important. This was mainly in the case of certain types of manufactured goods and wheat. Certain textile quotas were also established in the colonies (mainly India), which were directed primarily against increasing Japanese exports. Around 1935 the structure of preferences and tariffs was at its peak. Empire goods received a preference of from 10% to 33% in the British market and even more for the chief foodstuffs and raw materials. 1/

In 1938 the trade war between the United Kingdom and Eire was ended and an agreement signed establishing reciprocal preference between these countries. But in the same year trade agreements were negotiated between the United States, Great Britain and Canada. Britain lessened or dropped certain preferences that hindered the sale of American farm products, particularly apples and wheat. A similar trend of lowering tariffs between Canada and the United States began. Canada benefited greatly by this since she is so dependent upon the United States for her basic necessities. Canada found that she could not expand and maintain the war effort without more cooperation from the States.

Although the war necessity and American pressure required a change in British Commercial policy, the Imperial preference system has still remained intact. It is not what it was before the war though, and I think I may be safe in saying that we will see it falling into disuse in the future. The United States has played a more and more important part during and since this last World War. Britain's bargaining power as a market has gone down hill a bit while America's bargaining power has risen tremendously. From

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1/ Ibid., p. 662.

the beginning of the preference system the United States has expressed a strong objection and generally rightly so. She is in a better position to voice her objections now and is inclined to be too overbearing with Britain. I believe that she has made England pay too heavily for American help.

Great Britain will have to throw her role in with the United States to a greater degree in the future. The sooner that Britain and the United States can cooperate to extablish a sound commercial policy which is beneficial to both, the better for them. In light of the present Russian crisis it is even more pertinent that this should take place. I believe it is sure to happen sooner or later. The people who are going to suffer are the Dominions and particularly Canada. We will probably lose a large market for our exports. The only answer then will be for Canada to tie herself more closely to the States. Some argue that Imperial preference should be raised and that Canada and Britain should cut themselves free of American dollar diplomacy. Fortunately or unfortunately, depending upon how you look at it, this is economically unsound and practically impossible. Assuming that there is no Russian War in the very near future, I believe we will find that Great Britain will pull through--possibly with the aid of another loan or by further liquidating of foreign assets--; her economy will be internally more stable and self sufficient than ever before, and her commercial policy will be multilateral within the so-called Western Block.

Chapter VI--THE ECONOMIC EFFECTS OF WORLD WAR II ON GREAT BRITAIN

In a general way, the impact upon the economic life of Great Britain of the second World War was similar that of any war. The manpower engaged in military and civilian activities expanded substantially. People who had no need to work or who in normal times would be retired came out because of the national emergency. There was also a large transfer of resources from occupations, such as building, devoted mainly to civilian uses, and to maintaining the war effort. All resources formerly used to maintain and extend domestic civilian capital were greatly curtailed. Britain, because of her great quantity of foreign assets was able to draw munitions of war from abroad by selling assets or creating debts there, to augment her war strength. Also, a large number of persons in the prime of life were killed or incapacitated, and great materila damage was suffered because of enemy action.

The mobilization of manpower in direct and indirect support of the war was relatively large. At the end of the war the armed forces and civilian defence showed an expansion of some four and a half million, and industry a contraction of about one quarter million. Thus the total expansion of manpower due to the war was about four and one-quarter million. The loss in manpower due to the war was not as great in the second war as in the first. There were about 400,000 more killed in World War I. Another factor which tended to alleviate the manpower distortions of the second war was the fact that there was a much larger mass of unemployed persons in 1939 than in 1914. The official figure for mid-1939 is 1.3 million persons. It is estimated by Professor A. C. Pigou that some 20 per cent more manpower was mobilized due to the war. 1/

The direct damages due to the war may be divided into two parts; damage to human life, and damage to capital assets. Two hundred and sixty thousand men in the armed forces were killed and two hundred and seventy thousand wounded. Thirty thousand men of the merchant navy and fishing fleet were lost at sea and sixty thousand civilians died as the result of bombardment. Economically speaking, however, this loss of human life was not the greatest destruction due to the war. The loss in ships and buildings was distrous on Britain's economy.

> The United Kingdom entered the war with a merchant fleet of about twenty-two million deadweight tons. Half of this tonnage was lost during the war. Half of this loss was replaced by new production during the war, but at June 30th, 1945, the United Kingdom Merchant Fleet amounted to less than three quarters of the pre-war fleet. 2/

The destruction of buildings was even more disastrous. In a paper on Housing presented to parliament in March 1945 the following was said:

> In the years 1934-39 the total output of houses exceeded three hundred thousand a year ---. By 1939 the proportion of people still living in unfit or overcrowded houses had been reduced to some 8 percent; and over 30 percent of the population were living in new houses, which had been built since 1919. This progress was cut short by the war. The number of houses built between 1939 and 1945 has not exceeded two hundred thousand. 3/

Besides this negative form of destruction there was also the damage to existing houses by direct enemy action, which was enormous.

> Houses destroyed or damaged by enemy action in the United Kingdom totalled four million. Of these, two hundred and two thousand were totally destroyed and two hundred and fifty thousand were so badly damaged as to be rendered uninhabitable ---. Much of the property destroyed consisted of industrial

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1/ A. C. Pigou, "1946 and 1914", Lloyds Bank Review, (July, 1946), p. 10.

2/ British Command Paper 6707, (London: King's Printer), p. 8.

3/ " " " 6609 " " " p. 1.

plants, which were naturally one of the enemy's main targets. 1/

A third main item was the depletion of British assets abroad. British holdings of foreign securities were reduced by roughly 4.5 million dollars. However, the accumulation of foreign debt was even more significant a loss. The net increase in foreign indebtedness due to the war was about 11.6 billion dollars. 2/

The aggregate loss of assets in monetary terms between 1939 and the middle of 1945 is summarized in the White Paper as follows: 3/

	mn. pounds *
Physical destruction--on land	1,500
shipping (including cargoes)	700
Internal disinvestment	900
External disinvestment	4,200

* the exchange rate was 1:4.03

This omits all private disinvestment such as deterioration of houses, reduction of household inventories, etc. However, a figure of 29.2 billion dollars is about right for total loss. The pre-war United Kingdom national wealth has been roughly estimated as of the order of 120 billion dollars (at 1946 prices), so that the loss of national wealth over the war period was about 25 per cent. 4/ The tremendous loss in foreign assets in significant in reckoning some of the present post-war handicaps in adjustment. Liquidation of foreign assets has continued since the end of the war. The selling of British railways in the Argentine in order to obtain enough credit to buy meat is a notable example.

1/ British Command Paper 6707, p. 13.

2/ <u>Ibid.</u>, p. 10.

3/ <u>Ibid.</u>, p. 5.

4/ <u>Ibid.</u>, p. 10.

Any appraisal of war finance centres around the allocation of national income between the government and the civil population and the effect of government spending on such factors as incomes, savings and consumption. The shift in industrial production from domestic production to war production cannot be discussed apart from the fiscal aspects.

In a free economy where there are few or no controls the effects of increased government spending is to increase incomes and, in the case of war financing, to cut down on the production of consumer goods. This leads to inflation which forces the government to bid for resources at an even higher price and a cumulative inflationary movement is set in motion. In a free economy, rising prices and credit expansions are associated with inflation and are aspects of inflation which most directly effect the individual. Inflation causes forced savings from the public and in peace time leads to an overexpansion of capital goods industries. During war this excess saving is used to finance war industries. Thus the price mechanism, once set in motion by newly created money, results in the cumulative inflation characteristic of the first world war. The picture was very different during the war that has just passed. The British economy in 1939 was not a free economy. In this last war the allocation of resources between the government and the civil population was not left to the free workings of the price mechanism. It was decided, once the framework for control had been erected, by direct restraints on spending, i.e., by rationing, price control, restriction of non-war capital formation, allocation of raw materials, requisitioning of property and direction of labour under essential work orders.

During this last World War Britain was under just such a controlled economy. Consumption was curtailed and prices were prevented from rising.

The distribution of national income as between individuals, and even between broad classes of the community was very different from that produced in an uncontrolled economy. However, as between the government and the public taken as a whole the position was the same as in normal inflation. Instead of forced savings, however, they had what is called "involuntary savings" of a people prevented by direct controls from spending as large a proportion of their incomes on consumption as they wished. Thus the rise in prices in Britain during the war was probably mainly due, not to the inflation factor, but to increased costs of production. These increased costs were the result of wage rises on account of Union activity and of the rise in the price of imported raw materials. 1/

The effect of involuntary savings during the war was to build up what has been termed "suppressed inflationary potential". These funds are called potential because it is assumed that they will be released as soon as controls are lifted and sufficient goods are available to allow these savings to be spent without an inflationary rise in price.

These savings actually consist of two categories--private savings (including private firms) and foreign sterling assets held in London. The latter have been blocked much to the annoyance of the United States and the former are not causing as much post war inflationary pressure as at first supposed.

The direct controls used by the British government in financing the war led to a rise in the proportion of national income spent by the government from 24% in 1939 to 59% in the last two years of the war. The proportion of total cash requirement provided by taxation and other revenues declined from 66% in 1939 to 55% in 1945. 2/

1/ W. Manning Dacey, "Inflation and Its Aftermath", Lloyds Bank Review, (July, 1940), p. 24.

2/ British Command Paper 6783, (London), p. 3.

The rest was borrowed by the central bank from four sources which purchased the issues of government securities. They are: Internal Government funds such as the unemployment fund, Central banks and monetary authorities of countries that had accumulated credits in London by a favourable balance of payments, the British public, the residual buyer, and the commercial banks. Of these, the private persons were the most important source. This includes private companies. The banks only bought that part of the issues that were not absorbed by the other three sources.

Such measures kept the inflation factor down to a minimum. Only in 1940 was inflation an important factor in raising prices. 1/ For example, in this year, the supplies available for public authorities and private consumption rose by 1,086 million pounds, but public expenditure increased by 1,447 millions, reducing the supply of consumable goods by 312 million pounds (1935 prices). If the price of consumer goods were not to rise during 1940, consumption expenditure would have to fall by 362 million pounds at 1935 prices, or 367 million pounds at the current prices in 1939. Actually consumption spending in 1940 rose by 137 million pounds, so that the "inflation factor" in that year amounted to 504 million pounds.

The following tables will help to illustrate some of the changes in the allocation of national income during the war years:

1/ By "inflation" I mean an increase in costs as a result of an increase in the amount and circulation of money in relation to goods and services as against rising prices as a result of increased costs of production.

TABLE XV

AVAILABLE RESOURCES AND THE "INFLATION FACTOR" *

(change on previous year)

	1939	1940	1941	1942	1943	1944	1945
	mn.pd.	mn.pd.	mn.pd.	mn.pd.	mn.pd.	mn.pd.	mn.pd.
Resources available for public authorities and private consumption. (1938 price)	+434	+1,086	+465	+57	+166	+70	-124
Public expenditure on goods and service.	+433	+1,448	+705	+95	+285	-60	-265
Supply of consumption goods. (1938 price)	+1	-362	-240	-38	-119	+130	+141
Indicated change in consumption spending at values of previous year, if rise in price halted.	+1	-367	-281	-47	-161	+183	+209
Actual change in consumption spending at current values.	+57	+137	+43	+171	+ 4[illegible]	+279	+297
"Inflation Factor"	56	504	324	220	157	96	88

* W. Manning Dacey, op. cit., p. 31.

TABLE XVI

AVAILABLE RESOURCES AND THEIR ALLOCATION *

(at Factor cost and 1935 price)

	1938	1939	1940	1941	1942	1943	1944	1945
Gross national product (at factor cost) **	5,085	5,382	5,533	5,863	6,163	6,283	6,360	6,340
Drafts on external capital ***	70	248	688	636	490	482	456	558
Total resources available.	5,155	5,630	6,221	6,499	6,626	6,765	6,816	6,898
Home capital formation (gross)	759	800	305	118	188	161	142	348
Resources available for public authorities and private consumption.	4,396	4,830	5,916	6,381	6,438	6,604	6,674	6,580
Consumption	3,602	3,603	3,241	3,001	2,963	2,844	2,974	3,115

* Ibid., p. 30

** Ibid.—There is some difference in these figures. These may be slightly underestimated.

*** The Bankers' Magazine (May, 1947), gives 875 million pounds drawn drafts for 1945. p. 354.

The drafts on external capital assets represent the deficit in the current balance of payments. American Lend Lease kept this deficit from getting out of all proportion. As it was, the drain on British assets seriously undermined Britain's strength.

It may be said that British war finance was well run. Inflation was kept to a minimum and the internal economy was kept in equilibrium in spite of the heavy strains imposed upon it. It was the cost of maintaining this equilibrium and the war effort that we are interested in. The cost, as has been mentioned, was 25% of Britain's national wealth. As soon as war time emergency controls began to be lifted and war-time concessions began to be withdrawn the full impact of Britain's loss was felt.

In summing up the effects of World War II it may be said that it necessitated the full mobilization of dollar resources, and the need for aid from the United States made it necessary for the United Kingdom to alter drastically its system of international trade and financial controls. The sterling area became one unit for exchange control purposes, and very stringent controls were placed on the movement of funds outside the area. All of the nations remaining in the sterling area pooled and monopolised their resources of gold. Britain also required its citizens to surrender their foreign exchange assets. These were spent early in the war: the net gold and dollar reserves of the United Kingdom, estimated at 4.2 billion dollars in August 1938, were drawn down to 12 million dollars by 1941. These dollar and gold resources increased to 1.8 billion by the end of the war on account of the spendings of the United States forces in the United Kingdom. 1/

In addition to the above mentioned losses, $820 million worth of investments in the United States were sold or repatriated during the war. This drain could not keep up and by the spring of 1941 it was realized that other arrangements would have to be made between the United Kingdom and the United States. These arrangements took the form of lend-lease agreements, which amounted to very large bilateral clearing agreements based on an unspecified trade ratio.

1/ Judd Polk and Gardner Patterson, "The British Loan", Foreign Affairs, V. 24, April 1946, p. 428.

Aid to the United Kingdom under Lend Lease was some $20 billion in excess of reciprocal aid received. This debt is now totally wiped out except for certain goods and services which were not consumed during the war and were available for British use after the war. This amounts to about $650 million which is to be repaid on the same basis as the Interim Loan which I shall discuss in the next section.

The reason the United States wiped out this very large war debt was that she had learned after the first war how difficult and unsuccessful it was to collect war debts. These caused more economic and political friction than they are worth; thus one of the great problems of the 1920's was not repeated. As Mr. Roosevelt put it, "victory and a secure peace are the only coin in which we can be repaid".

Export trade declined drastically, the volume in 1944 being officially reckoned at 30 percent of 1938. More serious still as far as immediate importance was consumed, was the overseas spending during the war of huge sums in maintaining British forces, mostly through the creation of sterling bank accounts. From the outbreak of the war to June 30, 1945, this overseas debt of the United Kingdom, commonly referred to as "blocked sterling", increased from $1.9 billion dollars to $13.5 billion. Britain's total sale or repatriation of foreign assets amounted to $4.5 biolion. The net merchant shipping position declined to 75% of the prewar capacity. 1/

1/ <u>Ibid.</u>, p. 431.

Chapter VII--ECONOMIC CONDITIONS, POST WORLD WAR II

The difference between a war economy and a peace-time economy is that in war-time there is one single all-subsuming objective while in peace-time there is the different, many-headed objective of the greatest good for the greatest number. During the war-time emergency Great Britain was able to postpone many economic disequilibriums because of the all-encompassing war effort. After the close of the war the unifying force disappeared and the actual depreciated condition of Britain's economy began to reveal itself.

This post-war period with its grave economic disturbances is the climax in the long range trend I have endeavoured to outline in my thesis. Consequently it must bear special attention.

In 1946 the deficit in the United Kingdom's balance of payments, amounting to 1,600 million dollars, was much more moderate than anticipated. British exports expanded rapidly to 111% of 1938 volume as compared with only 56% (1945). Receipts from exports totalled 3,560 million dollars. The volume of imports increased from 53% (1945) to 72% of the 1938 level. This would have expanded further if the government had not put deliberate restraint upon it. There was also a world shortage of food at the time which kept imports down. [1/]

Payment for British imports (merchandise) amounted to 4,440 billion dollars in 1946, leaving a merchandise deficit of 880 million dollars. This was reduced to 400 million dollars by the receipts from invisible items. [2/]

However, the large expense item was the British relief program and maintenance in the British zone of occupied Germany. Expenses here ex-

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1/ "The British Crisis", Federal Reserve Bulletin, (September, 1947), V. 33, p. 1071.

2/ Ibid., p. 1072.

ceeded receipts by 1,200 million dollars.

The year 1946 was an exceptionally good year for two reasons. One, large volumes of stock were being used up to carry on the export drive, and two, costs of imports for the Western Hemisphere had not as yet started to rise.

The picture is considerably different in 1947. Prices began to rise drastically in the United States, cutting down the actual value of the American Loan by about 40%. Stock reserves had run out in Great Britain and her economy began feeling the severe pinch of a coal shortage. The mid-winter industrial stoppage in 1946-47, on account of the fuel and transportation crisis, was a very severe blow to British recovery. An economy as tightly geared, function to function, as the British economy now is, finds that it can be very easily stalled if any one of the functions breaks down.

In February 1947, before the full effects of the winter fuel crisis were appreciated the government released a tentative estimate of the current account balance of payments for 1947. It estimated that the deficit would be 1,400 million dollars. After the fuel crisis this estimate was revised and on July 8, Mr. Herbert Morrison stated in Parliament that on the basis of the revised import estimate the balance of payments' deficit for the year ending June 1948 was expected to be around 1,800 million dollars. The total deficit for 1947 actually amounted to 2,700 million dollars. This was an exceptionally bad year. It is hoped that 1948 will not put so much strain on the almost completely exhausted resources of Great Britain. The Economic Survey for 1938 published in England on March 9th of this year gives the following estimates for 1948. [1]

1/ "Economic Survey for 1948", (Ottawa, United Kingdom Information Office), No. 19, p. 3.

If imports continue at the same rate as they have so far this year they would amount to 1,670 million pounds for the whole year. Exports and re-exports have been estimated at about 1,500 million pounds and the net deficit on "invisible" at 80 million pounds. This would give an overall deficit of 250 million pounds compared with last year's 675 million.

An important trend in 1948 has been that of increasing imports from the soft currency areas, and decreasing imports from hard currency areas. Therefore it is of the utmost importance to Great Britain that these soft currency countries become economically stable. Continued dependence upon the American continent is mainly the consequence of the slow recovery of Europe and the Far East. Britain is able to pay these countries and not until they can send her the goods she requires will she be free from the strain of the dollar shortage. This is why the Marshall Plan and the recovery of Europe, or rather of the Western Block in Europe, is of such great importance to Great Britain.

In spite of this lopsided bilateral trade condition Britain has been able to reduce her imports from the Western Hemisphere from 48% in 1946 to an estimated 34% in 1948. This has been done mainly by "doing without" in Britain. British imports are today only about 75% of what they were in 1938. In order to help cover the imports from the Eestern Hemisphere, Britain has planned to export 14% more in 1948 than in 1938. Last year Britain's exports to the Western Hemisphere were 9% below those of 1938. There will still be a large deficit and unless something happens to change current trends Britain will be bankrupt in 1949.

An outline of the means used to pay for the deficit will show the trend of depleting assets.

In 1946 about half of the means used to pay for the deficit will show the trend of depleting assets.

In 1946 about half of the current account deficit had to be financed from gold and dollar resources: about 600 million dollars was drawn from the United States credit, and 540 million dollars from the Canadian credit. However, the United Kingdom added 240 million dollars to its gold and dollar holdings and rapaid nearly 100 million dollars of debts to the United States and Canada, so that the net dollar drain on current account amounted to only 800 million dollars.

The remaining half of the 1600 million dollars deficit was covered by net transactions with other countries, mainly in the form of an increase in sterling balances held for foreign account in London. These blocked sterling balances have been a very sore point with the United States so that one of the conditions demanded of Great Britain in return for the American Loan was that they be released as soon as possible. I shall discuss the loan in detail later in this chapter.

These total figures of the drain on dollar resources do not show the actual trend. The net drain accelerated during 1946 and amounted to as much as 372 million dollars in the last quarter alone. This acceleration continued into 1947, as shown by the following figures, in millions of dollars, cited by Chancellor Dalton in his report to the British Parliament: January (137); February (224); March (323); April (307); May (334); and June (308). 1/

Some of the main factors which led to this dollar crisis were: 2/
(1) The results for 1946 were unnaturally good for reasons already mentioned, and Britain did not have to resort to its gold and dollar resources as much as anticipated in 1945. The drain which began towards the end of the year

1/ "The British Crisis", op. cit., p. 1073.

2/ Ibid., p. 1074.

was mainly due to rising prices of imports, especially those from the Western Hemisphere.

(2) In the first half of 1947, there was a sharp increase in the current balance-of-payments deficit. The important contributing factors were:

(a) A further increase in United States prices.

(b) The serious setback in the British export drive due to the winter fuel crisis. This is estimated to have increased the deficit by 800 million dollars.

(c) The failure of government overseas expenditure to decline as much as expected--mainly in Germany.

(3) The deficit in the balance of payments would have been easier to bear if it had been distributed more among the soft currency countries. Also, if Canada had been able to finance her entire exports supplies to the United Kingdom, and if other countries had been able to provide the same amount of assistance in their capital transactions as in 1946, the drafts on the United States credits in the first half of 1947 would have been only 600 million dollars instead of 1,450 million dollars.

This unforeseen rapid depletion of the dollar credits had left only about 680 million dollars, excluding the balance of the Canadian loan over and above Britain's agreed drawings to the end of March, but including the whole of the South African gold loan. At the present rate these reserves are likely to be depleted by about 222 million dollars by the end of June, 1948. This would leave about 450 million dollars. At this rate Britain's reserves would be only 225 million dollars at the end of 1948 and would be completely wiped out in 1949. [1]

It is pitiful to think what would happen to Great Britain if this

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1/ "Economic Survey for 1948". op. cit., p. 3.

bankruptcy did occur. Unless new loans are forthcoming or prospective plans for Western Europe materialize soon, the end is inevitable. Britain is already importing the minimum amount and any more cuts would bring severe unemployment. Capital development would have to cease. Domestic capital goods would have to be explored for food. The end would be utter poverty. This is unthinkable, and if the Western Hemisphere is to preserve its own interests it must see that Great Britain can fill the gap in her transition from an open trading economy to a normal, relatively self sufficient one.

Along with the dollar shortage, Britain's coal cirsis is the most important item in the economic picture. Coal, which had been a sick industry for decades, seemed to be getting worse in 1945. Drastic measures were necessary since the British economy is based on cheap fuel and cheap food. Coal is Britain's basic industry. She has plenty of it but the pits are deep and the means used to extract it are outmoded. In July, 1946, the Labour government nationalized the coal industry. They set up a national coal board composed of nine members to manage the industry. This board is intended to function as a free agent in the everyday administration of the industry, but under general direction of the fuel minister. This board is also intended to operate as a business corporation, with a balanced budget over a reasonable period of years. Since the industry was as far behind technologically, the government provided the Coal Board with 150 million pounds as ready capital for the earliest possible mechanization of the pits. Mechanization, however, takes considerable time and it is as yet difficult to say whether the Coal industry can be revitalized before Britain's resources are completly exhausted.

One of the major difficulties before the Coal Board is the immobility of labour. The Labour Governments' reconversion plans have that one weakness. The Achilles' heel of central planning is the immobility of labour.

The ability of this Coal Board began to be severely tested in 1947. The Economic Survey for 1947 stated that: 1/

> the 1947 industrial problem is fundamentally a coal problem.... We cannot afford to set a lower production than 200 million tons ....this will meet only the minimum needs.

It soon became realized that this goal would not be reached. The government gambled on average weather, on increased coal production, and on voluntary restraint by the public--and lost. It was also in 1947 that the coal reserves ran out. These had been a bumper to take the economy over any checks in output. After the serious fuel crisis of the winter the British economy slowly came back into full production again. However, all eyes were on the coal production figures. The Labour government was in a paradoxical position. It knew it had to drive for more coal production and yet it had to treat the miners with kid gloves because of the severe labour shortage. It is ironical to think that under such a national crisis, when the British nation depended so much upon greater production in the coal mines, the working week should be shortened to five days and that the Grimethorpe Colliery in Yorkshire should defy their union leaders and go on strike for shorter hours and better pay.

Behind this seeming pettiness, lie much deeper explanations for the labour troubles in the coal industry. The British miner has suffered a great deal in the past and is a very conservative man by nature. He has expected too much from the nationalization of the Coal industry and has been averse to change or renovation of old mining methods and customs.

1/ L. W. Vogel, "Britain's Present Crisis", The Yale Review, (Winter, 1948), p. 306.

The result has been an increase in the price of coal last summer of 2S.6d. This was in direct consequence of the five-day week. It is not an encouraging prospect for the programme of further rationalization of the coal fields. The increased cost of fuel is going to tell very heavily on Britain in the next two very critical years. With the increased costs of producing exports it is going to be very difficult to maintain the high degree of exports necessary when the international market shifts from a seller market to a buyer's market. 1/

The discussion of the post-war economic aspects in Great Britain would not be complete without some mention of the American Loan to Britain. The Anglo-American Financial Agreement, signed on December 6, 1945, and certified on July 15, 1946, provided for the extension by the United States to the United Kingdom of a line of credit of 3,750 million dollars and the assumption by the United Kingdom of certain obligations related to the development of multilateral trade on a non-discriminatory basis. In particular, the Financial Agreement contained specific provisions with respect to the elimination of exchange restrictions on current transactions and on amounts released from accumulated sterling balances. In the light of the difficulties incurred after last July when the restrictions on sterling convertability were lifted, these provisions had to be withdrawn or revamped by the United States. In general, the provisions relating to current transactions were to remain in force until December 31, 1951; thereafter, the rules adopted by the International Monetary Fund will govern the exchange control practices of all members of the Fund with respect to such transactions. The provisions relating to accumulated balances have no terminal date and depend upon how fast the British economy can release the blocked

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1/ Ibid., p. 310.

sterling balances. 1/

The loan proved quite inadequate because of unforeseen developments such as the drain on the dollar reserves after July 15, 1947, the production crisis in England and the rise of prices in the Western Hemisphere.

The conditions which made the loan necessary or expedient to both Britain and America were; first, that Britain was sure that given sufficient time she could restore her economy to an equilibrium position again. It was absolutely necessary that she get assistance from somewhere to weather her over the gap. Secondly, it was important to America that Britain's economy become regularized because Britain is such an important customer and because of her nuclear importance in the creation of a multilateral trading system of the sort hoped for by America. The agreement was made on the basis of these conditions but America having the stronger bargaining power, pressed her demands a little further than Great Britain did.

The actual terms of the financial agreement were that the United States agreed to extend a 3,750 million dollar line of credit to the United Kingdom. This credit can be drawn upon until December 31, 1951, and is to be used "to facilitate purchases by the United Kingdom of goods and services from the United States, to assist the United Kingdom erect transitional postive deficits in the current balance of payments, to help the United Kingdom maintain adequate reserves of gold and dollars, and to assist the United Kingdom to assume the obligation of multilateral trade." 2/ This loan is to be repaid in 50 annual instalments beginning in December 1951, with interest at the rate of 2% per year. If the interest free years up to 1951 are taken into account this will amount to 1.6%. However,

1/ Burke Knapp and F. M. Tamagna, "Sterling in Multilateral Trade", Federal Reserve Bulletin, September 1947, p. 1083.

2/ Judd Polk and Gardner Patterson, op. cit., p. 433.

even this low rate will cover the cost to the United States Treasury. In the light of present developments it is probable that many interest waivers will have to be granted and that the Treasury costs will not be covered. The maximum annual payments of interest and principle would be 140 million dollars.

Britain had actually hoped for an outright grant similar to lend-lease but this idea did not go down so well with the United States Congress. Failing a grant, Britain at least expected that the loan would be interest free. Lord Keynes, the British negotiator, stated: "....I shall never so long as I live cease to regret that this is not an interest free loan. The charging of interest is out of tune with the underlying realities". 1/ However, the provision for interest waiver was inserted so that,....

> interest may be waived in any year in which Britain's average income from home produced exports plus net income from invisible transactions during the five previous years is, after adjusting for price level charges, less than 866 million pounds". 2/

In short, Britain will have to balance her external budget within the framework of a multilateral economy. Consequently, Britain will lose an important source of dollars, namely the dollar pool. The problem, which the loan is intended to try and solve, will also be aggravated by the provisions which will make it necessary for Empire countries to hold balances in other currencies than sterling, causing a flight of capital from the United Kingdom. Thus Britain may have to cover its short-time debts with larger reserves. This would be another strain on the credit and after 1951 Britain may have to rely more and more upon the Monetary Fund for relief from some of the burdens connected with the defense of sterling.

Another stipulation of the loan is that Britain make no other long

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1/ Ibid., p. 435.

2/ Ibid., p. 434.

term financial commitments with any other country. This is to insure that too heavy a burden is not laid on Britain after 1951 and that America gets first choice in payments.

Finally, the United Kingdom promised not to impose any discriminatory quantitative import restrictions. This clause has been very hard on Britain because it keeps her from moving into the soft currency area for more of her imports and thus helping to alleviate the dollar shortage a bit.

Much could be written about the harshness or inadequacy of the American Loan but it all boils down to the fact that America was justified in putting certain stipulations into the loan because of the gamble it was taking in investing in the British future, and that Britain had no choice but to accept. To quote Lord Keynes again, he said to the House of Lords, "Do the Critics really grasp the nature of the alternative? The alternative is to build up a separate economic block which excludes Canada and consists of countries to which we already owe more than we can pay, on the basis of their agreeing to lend us money they have not got and buy only from us and one another goods we are unable to supply".[1/]

The main significance of the American Loan is not so much in its intrinsic value as a life-saver for Great Britain, but that, seen in connection with the International Monetary Fund, the International Bank for Reconstruction, and the recent International Trade Organization, this financial accord may become a crucial part of the general design for an unfettered international commerce. Without these other institutions, it is certain that the loan agreements, except for the credit line, have little significance. This is why it is so important that world stabilization be achieved as soon as possible. Without trade prosperity, none of the mentioned agreements and organizations can function. It is unfortunate that

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1/ <u>Ibid.</u>, p. 439.

Russia has emerged to claim the victory Marx prophesied. The amalgamation of Western Europe and the United States may yet stave off disaster for Great Britain. And it is not only Great Britain that would suffer. Our own Canada would be one of those most effected by economic collapse of Great Britain and Western Europe. Canada would have to become a satellite of the United States.

The future of Great Britain is not just Great Britain's problem. It is a problem which today faces the whole Western World. I would not go so far as to say that we sink or swim with Great Britain, but the United States and Canada certainly will prosper by Britain's recovery, and suffer retardation with its fall.

Chapter VIII--CONCLUSIONS

A doctor seldom pronounces judgment upon the future of a patient when he is still in a critical position. Unforeseen turns and events make sure diagnosis impossible. So it is in the case of Great Britain. She is still in the midst of an historical struggle to determine her future status. However, on the basis of the facts outlined in this thesis, certain predictions of reasonable accuracy can be made.

The whole problem of Britain's economic decline is centred around the unique position she held in the 19th century. Great Britain was the nucleus of a real international economic community which injoyed freedom of movement of goods, funds and men extending the world over. Such a community had not existed since the Roman Empire and is not likely to exist again in our lifetime. It was a system of international specialization. Agricultural countries had specialized before but industrial specialization had never been achieved. This specialization on the part of England in the manufacture and export of industrial goods made Great Britain very dependent upon the rest of the world and upon existing trade relationships remaining as they were.

They did not remain constant. The industries in which Britain had specialized, namely textiles, coal, engineering and shipbuilding, were common to any advanced industrial state. As Britain lost her industrial lead and monopoly, the basis for international specialization was lost. However, Great Britain had already gone so far into specialization and become so conditioned to it that the reconversion to a more normal, mature economy has been gradual and painful. Two wars have accelerated it. The British people failed to recognize and accept the change and consequently made the present crisis worse by putting it off. Post-war reconstruction is a difficult enough process without there being a necessity to reconvert the whole nature of the economy.

The effect of the wars has been to direct demand for British exports to other sources. They have also interrupted the process of adaptation by the British entrepreneur to changing trends in demand. At the end of both wars and particularly of the second, "obsolete" could be written over many British products. Britain's position was also worsened by the protectionist policies in most foreign markets. However, the effect of this closing or redirecting of demand was not always felt immediately in Britain because of expanded post-war demand or because of the opening and developing of new markets.

Great Britain has been forced to concentrate more on domestic agriculture and production. This trend will continue. The present crisis has only speeded up the pre-war shift from an economy based on the expansion of a protected home market. England will probably remain a great industrial and even a great trading nation, but her main industries will never again concentrate on vast exports. The home market will become the primary client instead of the residual client. Exports will likely consist of the surpluses of many smaller industries. The total is likely to remain large but will not effect whole areas as before 1914. Exports must become a luxury and not a necessity.

A shift from imports to domestic sources of supply, effected over a period of years under the pressure of a large adverse balance of payments, is not impossible. Many affirm that because Britain has few natural resources of her own she cannot fall back on herself. She will not have to fall completely back on herself because international specialization will still be active and is likely to grow as natural resources become depleted. Thus, Britain's role as a processor will probably continue but it will probably be a secondary role. No country can be completely self sufficient. For instance, although British agriculture has been rejuvenated by the war and is likely to continue to grow, Britain must always import much of her foodstuffs.

Although it is likely and almost certain that foreign trade will tend to become less important, it is not possible for Britain to balance her payments in the immediate future by equating imports and exports. The gap which has developed can only be temporarily bridged by the current loans. These loans only tend to postpone the self-equilibrating movements of import and export prices. Britain is still an important market and will remain so. This gives her a certain bargaining power which in the long run is likely to lower the price of imports, hence to improve her terms of trade. The present abnormal conditions make this type of adjustment impossible, but when some degree of normality has been achieved it may become active. The present lack of ability to pay for imports on the part of Great Britain will probably cause a world-wide agricultural depression similar to that of 1929-32. This will benefit Britain unless her main customers are those agricultural countries whose purchasing power will have fallen. If Britain can adjust to changing world demand and produce high quality manufactured goods, whe will be able to keep export prices up. The difficulty is in reorganizing the basic industries such as coal before it is too late.

Certain bilateral trade agreements are almost sure to take place in the near future between Britain and those countries (particultrly agricultural) which are short of markets. The United States is not showing much foresight by trying to enforce non-discriminatory, multilateral trade.

Great Britain herself once frowned upon protection of infant industries in the colonies and advocated the same policy which the United States is advocating today, but world conditions were quite different. Britain was dealing with new and relatively undeveloped colonies where today the United States is dealing with mature national economies.

During the war, in order to save tonnage, the United Kingdom diverted to North America a large portion of its demand for imports. This diversion cannot be reversed overnight, particularly in the light of the decadent condition of Europe. Until this distorted dependence upon the United States is diverted to other areas the United Kingdom will find it impossible to pay for its imports. The United States must realize this fundamental fact. It is to her advantage that Great Britain regain stability as soon as possible. Current international political developments are making it all the more pertinent that Britain and Western Europe get on their feet economically. If this is to happen, the United States will have to repeal most of the non-discriminatory clauses attached to the American loans and the International Trade Organization plans, or else Britain will be forced to repudiate them. This would be a very unfortunate necessity and it is hoped that action will come from the United States, not in the form of renewed credits, but by a realization of the basic realities and by acting in their light. Nobody will deny that non-discrimination and multilateral trade are the goal that the world should aim for, but they do not seem to be expedient under present conditions.

Great Britain depends upon three things for her recovery: First, the full reconversion of the British economy from one primarily dependent upon foreign trade to one based on domestic trade. Second, she depends upon the economic revival of Western Europe and the Far East, so that the lop-sided trade balance with the United States can be alleviated. Third, Britain depends upon American help during this critical reconversion period.

Thus the recovery of Great Britain, of Europe, and of the rest of the world are all interrelated. The efforts made in the direction of recovery have been the Anglo-American Loan Agreement, the Bretton Woods Agreement, the International Trade Organization, the nationalization and rejuvenation of many key industries in Britain and in Western Europe, and the Marshall Plan. The plans and organizations are interdependent and must be viewed as one grand plan for world reconversion to sound international and domestic economic conditions. Most of the leadership has been laid in the hands of the United States, and it is with great anxiety that Great Britain and the rest of the so-called Western Bloc look to her for sound administration.

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