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CABINET

EXTERNAL FINANCIAL POLICY

Memorandum by the Paymaster-General

In February of this year the Bank of England forecast such a drain on the gold and dollar reserves that there would be a currency crisis at latest in June, but very likely in April.

To meet this they suggested a plan which seemed to me likely to lead to disastrous consequences both economically and politically.

Although the loss of gold and dollars in the last quarter has been negligible, the Bank are again asking for their plan to be adopted. They do this on the strength of vague impressions that pressure on sterling may revive in the Autumn. They say they cannot give any exact reasons for this, though to the outsider the reason seems clear, namely leakages to city financial journals which have been openly canvassing the Bank's proposals.

In March when prospects were bad the Cabinet decided against the Bank's plan. Nothing seems to have occurred since to justify altering this decision.

BALANCE IN SECOND HALF OF 1952

It is reckoned that in the second half of this year the payments of the sterling area will exceed the receipts by £175 millions. It is hoped to redress this balance by expanding exports (coal, defence items, etc.) by £24 millions and cutting imports (oil, machinery, raw materials and food) by £150 millions. Any short-fall in achieving a concrete physical balance of our trade in some such way will inevitably fall upon our gold and dollar reserves. As these have now fallen to about $1,650 millions action on these lines is therefore clearly necessary. Everybody agrees that unless this fundamental condition is fulfilled nothing can save us. Nobody suggests that the Bank's plan will help to cure this deficit.

There is the secondary risk that the outside world may lose confidence in the future of the pound and sell sterling at its present price of $2.8 in the hope of buying it back at a lower price. As we owe about £2,500 millions to the Sterling Area and £1,000 millions to non-sterling area holders this is a real danger.

THE BANK'S PLAN

It is to cope with this risk, i.e. to create confidence, that the Bank proposes:

STERLING BALANCES

1. To persuade the sterling area holders to agree not to draw down their balances rapidly and to publish this agreement.

This seems a very good proposal if it can be arranged.

2. To block 90% of the balances held outside the sterling area whether the holders like it or not.

This seems a very odd way of restoring confidence in sterling. Who is going to put his money in the United Kingdom after such action? What will in fact happen will be that immediately the proposal leaks out, as it will as soon as the Commonwealth and Europe are consulted, there will be a run on sterling held by foreigners, and a drain on reserves by lead-lag methods, etc., such as occurred in 1947 when we lost £300 millions in a matter of weeks. To tide us over it is proposed to borrow from the International Monetary Fund. This recalls 1931 when we also borrowed £50 millions to see us through the run on sterling - and lost it all.

FLOATING RATE

3. To let the rate of exchange "float", i.e. find its own level.

To the banker this seems the obvious way of meeting our primary need, i.e. balancing our trade. If imports exceed exports, he argues, exports will be encouraged while import prices will rise. Hence imports will be choked off, which is what he wants no matter how high food prices rise or how much unemployment is caused. It is the policy which the Socialists have always imputed to Conservatives and which we have always vehemently denied. It is the plain English for the attractive sounding but otherwise meaningless phrase "Take the strain off the reserves and put it on to the rate of exchange".

But anyhow it would not work that way to-day. For our exports are not limited by price. Metal goods are limited by lack of steel; soft goods by the world slump in demand for textiles.

As to imports we are already largely committed for the second half of 1952. Moreover they are cut to the bone. We shall have to reduce them of course. But surely it is better to cut selectively than to face an all-round rise in prices, which would have to be great if it were to have any effect.

But even if everything did work according to plan the fall in the rate of exchange would inevitably widen the gap and increase the drain on the reserves. If the pound is allowed "to float" before sterling is strong, this is bound to happen. That is the over-riding objection to letting the pound slide while our position is weak.

If, as is hoped, some other countries let their currencies float with ours it will to that extent weaken this objection. But this is a gamble. And anyhow the rise in the dollar gap - our principal problem - would remain.

It can be argued that when the pound has fallen low enough speculators will buy in the hope of appreciation. But will they, when 90% of previous holdings have been confiscated? And who can tell what they will consider "low enough" in view of the risk. For some time at any rate they are much more likely to sell expecting (and causing) a further drop. And they will almost certainly be right; and the gap will widen.

Finally, it is said that this is the only way to force Ministers' hands. Nothing, it is claimed, will make them agree to the necessary import cuts save the force majeure of a rise in prices so great as to make further purchases impossible. If this is so it is a terrible reflection on Ministers. Against this pretended advantage we have to set the certain disadvantage that any rise in prices will lead to a demand for increased wages. And this will be much harder to parry if the rise cannot be blamed on world causes but is attributed, not without reason, to a Conservative surrender to "the bankers' ramp".

CONVERTIBILITY

4. It is proposed that apart from the blocked balances foreign residents should be allowed to convert any sterling they hold or earn into gold or dollars at the prevailing rate.

This would certainly be a convenience to bankers, though such an argument would scarcely carry much weight with the public and the Trades Union Congress. Moreover it would stop transactions in cheap sterling which the Bank seems to think can be prevented in no other way. But these are not very important anyhow; indeed they are not mentioned in the Chancellor's paper.

We are told the Commonwealth would welcome it. But would they, if the rate dropped and the value of their sterling balances fell? It would seem far more likely not to inspire confidence but to cause anyone who could do so to convert to gold as fast as possible.

Then we are told Convertibility is a step towards "one world" i.e. multilateral trade. But we are just anxiously considering the extremely complex question as to whether we want to aim at multilateral trade. If we do, which is by no means certain, we are much more likely to achieve it by a step by step approach than by a leap in the dark, which may lead to a complete debacle and force us back to bilateralism in an extreme form.

Against all these dubious advantages stands the incontrovertible fact that Convertibility will be a tremendous incentive to people outside the United Kingdom to send us imports and refuse our exports. For every pound thus earned can and will be converted to gold. This terrible handicap to our exports is probably the strongest long term economic argument against the Bank's plan.

But, of course, there may be a short-term collapse before that, if the foreign holders get wind of the proposals and cash in before their balances are blocked, while lead-lag operations rise inordinately.

Thus on the economic side the Floating Rate and Convertibility, apart from other objections, would make it harder to export enough to pay for our imports and thus increase the drain on our reserves and weaken confidence in sterling.

POLITICAL OBJECTIONS

On the political side the Bank's Plan would be equally disastrous.

At home, as has been said, it operates and is intended to operate, by cutting rations and causing unemployment. Far better to be forced into this, if we must, than to create these disasters by deliberate Government action;

action moreover, which will almost certainly be publicly castigated by leading economists of the Right as well as of the Left.

Abroad the plan will break up the Organisation for European Economic Co-operation and smash the European Payments Union just after we have drawn over £200 millions from it. Could anything create more ill-feeling in Europe or for that matter in the United States? The Americans will hate the free market in gold the plan requires. If on top of that their most trusted ally deliberately sabotages their efforts to build up co-operation in Europe it will strengthen isolationism all over the Union.

As for the Commonwealth, whose Prime Ministers have only just been invited to London in November to concert a common commercial and financial policy, what will they think if we adopt proposals which prejudge all the vital issues? Surely these matters are just the sort of things they were invited to consider.

ALTERNATIVES

The Chancellor invites us to put forward alternative suggestions. On the short-term these are surely being considered by the Cabinet under the headings: Investment Policy, Import Programme, Defence and the Balance of Payments, and so on.

The long-term policy is being considered by the Lord Privy Seal's Committee on External Commercial Policy. It is an immensely complicated problem; it is hoped to hammer out a solution in time for the Commonwealth Prime Ministers' Conference in November.

In the meantime, if we take the necessary measures to redress our trade balance by selling more abroad and buying less, which will have to be done whether the Bank's plan is adopted or not, we shall probably get through the autumn without disaster. If there is difficulty in surmounting the hump we can borrow just as the Bank propose to do if their plan is followed. But there is no mystical significance in $1,340 millions, "the figure at which Cripps devalued". During the war our reserves fell to $12 millions. It would perhaps strengthen confidence if this were stated. It would also help if agreement between holders of sterling balances to refrain from drawing on these beyond a certain limit could be publicised.

TIME SCALE

How long it would be before disaster overtook us if the Bank's plan were adopted is difficult to predict. It might be only a matter of weeks if a leakage that balances might be blocked, and the pound thrown overboard to float where it could, provoked a run on sterling. If we succeeded in turning that corner, the widening gap due to a fall in the value of the pound and to discrimination against our exports, induced by the right to convert a sterling surplus to gold, would increase the drain on the reserves leading to collapse probably in six or eight months.

CONCLUSION

The question is whether, by our deliberate action and by our considered choice, we should ask the country to incur such dangers and bring upon ourselves such odium unless very much stronger evidence is brought forward to prove that the other course would certainly lead to worse disasters. The Bank has been wrong before. It may be now.

C.

Paymaster-General's Office, S.W.1.,
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