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3rd JULY, 1952.

CABINET

EXTERNAL FINANCIAL POLICY

Memorandum by the Chancellor of the Exchequer.

Since we discussed external sterling policy last February, my colleagues should know that we at the Treasury have not been inactive. The Gold and Dollar Reserves stand at almost the same level as at the time of the Budget. Unfortunately for a variety of reasons the future outlook is unsettled. It is my duty to inform my colleagues that I have recently received a very serious warning from the Governor of the Bank of England in which he says that if we allow our arrangements in the field of external financial policy to remain substantially unchanged over the summer, this "would involve a grave risk to the currency and, therefore, to the economy of the United Kingdom and the sterling area". After deep consideration and consultation, I agree with this view.

2. We should remember that during the second quarter of this year we received no less than \$200 millions United States aid. This is at a rate of \$800 millions per annum, which is much higher than we expected or than we can possibly receive in the future. Despite this, however, we lost some gold from our reserves. The best forecast I can make is that we shall lose, in the absence of any changes of policy, a further £175 millions from our reserves during the second half of the year. This is equivalent to 4% of the total transactions between the Sterling Area and the rest of the world in the period. It will thus be seen that this figure may well be subject to a margin of error of say £125 millions upward or downward. I speak of course for the whole sterling area.

3. We cannot possibly allow ourselves to suffer such a loss when our reserves are only £600 millions. The hard fact of the matter is that our gold reserves have fallen so low, both in relation to the turnover of transactions and in relation to our sight liabilities, that we can continue our present external financial system only at great risk, both to ourselves and to the sterling area. On our present basis, we can never know from one week to another whether some new adverse turn of events will not place the reserves and so the whole system in jeopardy. We are like a boat in mid-Atlantic heavily loaded and almost awash. If we have favourable winds and weather we shall make the crossing, if not, the waves of any appreciable storm will sweep over the gunwale.

4. I have said for some time that we shall have to find a way of running our affairs without taking the whole strain of the balance of payments of the sterling area upon our inadequate reserves. I am not prone to disregard the very weighty and almost unanimous advice which I have received from the world of Banking and Finance that a change in our present system is necessary. However a recent informal discussion with some of my colleagues indicates

that they are not ready to change the mechanism of our external financial system at the present time. It is an understatement to say that we are thus going to take a very grave risk.

5. Given that the existing system must go on substantially unchanged, what advice can I then give? I am expected to carry the sterling area into the winter, after receiving estimates of the appreciable extent to which the Reserves may drop. I do not believe that my colleagues want a further devaluation on the 1949 model, which I would not personally be willing to be responsible for. Nor am I willing to drift into a position in which we are forced by circumstances to make a change of policy, even though it might appear politically easier to explain then than now.

6. As far as I can judge under the circumstances described, the only course open to us which gives us any chance of getting through is to adopt the following bases of policy.

A. The first is that the statement which I made in the House on June 12 after consulting my colleagues, namely that the balance of payments has first priority in all our considerations, is accepted and carried through all our actions. This is vital. I hope that the Cabinet will give a definite direction on which all Departments will act in conjunction with the Treasury. It means specifically that early decisions must now be taken and announced for:-

- (i) definite and effective reductions in the Defence Programme;
- (ii) an adaptation of the investment programme, putting more emphasis on productive industry and less on social investment, including housing;
- (iii) a reduction in imports sufficient to meet the estimated deficit in the second half of this year.

B. The second basis from which we should work is that we cannot continue indefinitely with a system of inadequate reserves supporting an inconvertible currency.

My colleagues will recall that after the meeting of Commonwealth Finance Ministers in January a statement was issued in which we said:-

"... While steps are thus being taken to overcome the immediate problems of the sterling area and to accelerate its development, we agree that its recovery will not be complete until the conditions have been created in which sterling can become and remain convertible".

We have just issued invitations to Commonwealth Prime Ministers to attend a general economic conference in November, and if this is to be a success two things are necessary:-

- (a) that the United Kingdom Government has a definite line of policy to put forward; and
- (b) that the conference is fully prepared at the official level beforehand.

If these conditions are to be fulfilled, we shall require very early decisions on the lines on which our policy is to be prepared. I trust that my colleagues will give me authority to develop a constructive line on convertibility which will interpret our own philosophy as a Government and give cohesion to

the aspirations of the Commonwealth. Some of the preliminary work may well require visits to Commonwealth countries. In any case the utmost secrecy will have to be observed. I have already made some way with certain Commonwealth countries. We must also work to achieve the utmost unity in the financial policy of European countries. Here again I have established the first links. It may well be that certain European countries will not now wait longer for us, before altering their own currency policy.

7. As to timing: our announcements on the physical measures necessary to bridge the gap in our Balance of Payments, and to give confidence, must be announced in time for a debate to take place before Parliament rises for the summer recess. I must make it clear that I refer here to measures other than adaptation in currency policy. I am quite certain that we cannot allow the House to rise without an announcement having been made. What are now required are clear directions so that a wholly adequate programme of action can be announced in the right way and at the right time.

R.A.B.

Treasury Chambers, S.W.1.

3rd July, 1952.