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C A B I N E T .

THE FINANCIAL AND ECONOMIC POSITION OF THE UNITED KINGDOM.

Note by the Secretary.

The attached Memorandum by Sir Warren Fisher is circulated to the Cabinet by instructions from the Prime Minister.

(Signed) M.P.A. HANKEY,
Secretary, Cabinet.

2, Whitehall Gardens, S.W.1.

September 14th, 1931.

1. The seriousness of the financial difficulties which are engaging public attention is perhaps not fully realised because of the constant use of technical terms such as the "gold standard", "depreciated currency", "flight from the pound", "inflation", "exchanges" etc.
2. It may therefore be useful briefly to set out the elementary facts.
3. Great Britain is a very small country of under 90,000 square miles with a very large population of about 45,000,000.
4. With the exception of coal the scarcity of natural resources within her own borders is such that she has to rely on other countries for the bulk of the raw materials required for her industries; and the measure of her dependence on other countries for food supplies may be illustrated by the fact that for ten months in the year her bread comes from abroad.
5. In other words Great Britain, in order that her population may live at all, has to obtain from other countries the basic necessities of existence. And in the extent and nature of this dependence on other countries Great Britain is quite unique.
6. These other countries require of course to be paid for the commodities we need from them.

Originally the only method of payment known to man (when he didn't thieve) was the barter or exchange of one person's handiwork or produce for another's; but with the gradual development and therefore increasing intricacy of production and trade at home - and later, as intercourse between different countries grew, of what we now call international trade - this simple system of exchange proved inadequate. So it was found necessary to introduce a special

intermediary which we call money and this token came to be known as coins and later, more comprehensively, as currencies. It served the double purpose of providing a measure of value and of opening up limitless opportunities of exchange (buying and selling); in other words it made possible a generally understood price and easy trading.

In the course of time this special intermediary, or medium of exchange, became identified with the precious metals, gold and silver; and for many centuries purchases were effected with coins made of these two materials. (Other metals like copper - or more recently nickel - circulate internally as a subsidiary coinage). The scarcity of gold gave it the higher and more stable value, and therefore by degrees it came to be accepted as the international measure of values and medium of exchange. Its very scarcity, however, coupled with its weight and bulk made its everyday use as the medium of trade, and especially of international trade, increasingly difficult as that trade developed; and in time it came to be replaced by paper tokens such as bank notes, cheques and other bills of exchange - that is undertakings in writing to pay - which of course have no value as mere bits of paper but only in so far as they correspond with real values in goods (or services) and ultimately in gold. Each country has its own currency - e.g. dollars, francs, pounds - and so long as the currency of a country (whether in the form of bank notes or cheques and other bills of exchange) is accepted internationally as the equivalent of gold or its value in goods or services, as is at present the case with these three currencies, the capacity of that country to purchase abroad on the strength of its paper undertaking to pay is exactly the same as if it had actual gold to ship.

This practice of using pieces of paper like cheques and other bills of exchange - or in the case of small transactions bank notes - for effecting payments must, however, not be allowed to blind us to the fact that the goods supplied to us by other countries are really in exchange for goods which we supply to them or work which we do for them or represent payment for interest due from them to us on our investments abroad. If these goods and services provided by us are not enough, gold has to be paid. Other countries will only supply us with goods to the combined value of these ingredients of purchasing power and no amount of pieces of paper, however binding their terms, will secure anything for us except to the extent that the paper represents real values and therefore commands confidence.

7. Of the work which we do for other countries an important part is to act as a sort of international banker, in which capacity we receive on deposit very large sums of foreign money. This foreign currency is, on receipt by us, converted into English currency and we use the money in just the same way as an ordinary bank or savings bank uses the money of its customers, namely we re-lend it at a profit for the purpose of financing all kinds of commercial and other transactions. This use of foreign money banked here is of great value to us all and is far more than just a means of livelihood for the people actually engaged in the business; for it enables £60,000,000 of our import requirements to be paid for and we should have to do without them if this particular type of business were lost.
8. This "invisible export" as it is called is one of our ways of paying for imports, but its continuance depends on our retaining the confidence of our foreign depositors. This means that they must feel sure that whenever they want their money back in full they can be certain of getting it

(reconverted of course into their own currency). Here again we see the comparison with a bank or savings bank; for, if the institution is sound in itself, no difficulties arise unless the depositors get doubtful or frightened about the safety of their deposits in the bank, when at once a "run" commences and the bank has to put up its shutters, as the proportion of the money which the bank has kept in hand, i.e. does not put to profitable use by lending, is quite insufficient to meet the demands of its customers for immediate repayment of their deposits in full.

In other words the foundation of all banking business is the confidence of the customers in the bank's stability; it is this confidence which leaves the bank free to put most of the money entrusted to its care to profitable use.

The moment that the owners of the foreign deposits in London begin to feel any doubt about the safety of their money, they want to have their money back and a "run" commences. And, as they of course want that money in the currency of their own country, it is no use offering them £1 or 10s/- notes or cheques drawn in our currency, for these are (or may become) from their point of view mere pieces of paper.

9. Now the self-same reason which makes the foreign depositor nervous about the security of his money here makes it difficult for us to obtain the necessary amount of foreign currency (e.g. dollars or francs) to repay him on demand.

That reason is that the combined aggregate of the ingredients of purchasing power (other than gold) mentioned in paragraph 6 above by means of which we pay for the goods we have ordered from abroad is insufficient to pay for the goods ordered, and therefore we have been buying goods "on tick". This means that we owe foreigners on balance more than they owe

us, and that consequently we are short of dollars or francs. Such a state of affairs, if it continues, eventually reacts on the foreign deposits banked with us; for it begins to raise a doubt in the mind of the depositor whether he can get back his money (in his own currency) whenever he wants it. A "run" therefore starts; and as in consequence of our being "down" on balance in our international trade there are no dollars or francs owing to us (but on the contrary we are in debt), we cannot lay hands on these foreign currencies and have to pay out gold to the foreigners who are calling in their deposits.

And as the total of these foreign deposits here is equivalent to several hundred millions of gold pounds, it is clear that, even if we parted with the last ounce of our gold reserve, we should still be quite unable to repay in full the majority of our foreign creditors.

10. Unless the position can be rectified in time so as to stop the "run" the result would be that we should have defaulted and these unfortunate people who had relied on the traditional fair name and credit of this country would have been bilked of at all events some of their money.
11. It will have been seen from paragraph 9 above that the root cause of the "run" on the part of the foreign depositor is the fact of our living beyond our means as evidenced by our ordering from abroad more goods than we could pay for, and therefore our owing to other countries more in dollars and francs than they owe to us in sterling.
12. Closely associated with this fact in the foreign mind is the question of our national Budget. After the war a certain number of countries continued to have difficulties in balancing their budgets and instead of pulling in their belts resorted to the expedient of meeting deficits by printing innumerable bank or currency notes. Whenever this

was done, the national currency lost much or all of its value, i.e., purchasing power, and with the corresponding rise in prices hardship, even hunger, was widespread. At the same time the foreign investor in the country lost most if not all of his money. Consequently, when any of these countries subsequently desired financial assistance from other countries, before the citizens of the latter could be induced to lend, they insisted on the borrowing country balancing its budget. And no one was more emphatic than ourselves in preaching this doctrine.

A national Budget has thus come to be regarded as a touchstone of a country's financial stability second only in importance to its international balance of trade; and if, as is the case at present with us, we are "down" on our balance of trade with other countries, foreigners to whom we owe money automatically turn a microscope on to our Budget. And if the Budget is not really balanced, but is merely dressed up to look as though it were; or again if the national expenditure is of a scope and type such as to involve (by means of taxation) taking people's saved up capital and spending it as if it were recurrent income, the distrust abroad of our soundness would be intensified.

And any expectation that we might continue on a "rake's progress" would complete the destruction of international confidence and thus result in the final collapse of our greatest asset, i.e., our credit.

13.

The picture described in the preceding paragraphs is that of a densely populated country practically devoid of natural resources (except coal) and therefore unable to exist without importing food and raw materials which have to be bought from other countries - and this country ordering from abroad more goods than it can pay for, being called on to repay in full the foreign deposits entrusted to it, and

simultaneously indulging in an unsound Budget.

A country consequently with its international credit undermined.

Up to this time its currency (or medium of exchange as described in paragraph 6 above), viz: the pound sterling, has for international purposes been valued and accepted as the equivalent of a gold pound or of 4.86 dollars or 124 francs.

Once, however, the facts of our international trading position make it clear to Foreign countries that the 17th century taunt

"In matters of commerce the fault of the Dutch

"Is giving too little and asking too much"

is coming home to roost, and that neither as traders nor as bankers are we any longer able to pay in full what we owe to foreigners, there will be a drain on our gold reserves until we cease to be able to supply gold to meet the balance of our liabilities. Then the link between sterling and other currencies will be broken and the value of the pound in relation to those currencies will fall. (This is what is called going off the gold standard). It will not be possible to stop this fall so long as we still have to pay foreigners more than they have to pay us; while its pace will be accentuated by the legitimate desire on the part of foreigners with deposits or other convertible assets in sterling to change them into currencies which have a stable value, such as dollars or francs.

The point or points to which the pound will be written down will depend on a combination of factors; but, if (say) it were to sink to a value of 2.43 dollars (or 62 francs) in effect a nominal £1 will as a measure of value have become an actual 10s/-.

Thus, for example, Americans would find that for every pound that they have on deposit here (at 4.85 to the pound) they would only get back the equivalent of 2.43 dollars, and they would naturally be reluctant to run the risk of a similar experience in future.

15. With the £ sterling reduced by half as a measure of value, its purchasing power over foreign goods is also halved; and therefore, whereas hitherto £25 would secure 120 dollars' worth of goods the same number of pounds would now secure only 60 dollars' worth.

As we are dependent for our existence on imports from abroad the price of such commodities here is doubled and the amount we can buy for a pound is halved. The extent of the drop in the purchasing power of each pound may be influenced by other conditions as well; and one of the most important of these - if the pound is not to sink to nothing - is the readiness on the part of us all to continue working for the same number of nominal pounds as before the slide in its value (called depreciation) had commenced. Now suppose £1 becomes equivalent to 10/- this would mean not only that food, clothing etc: will cost us twice as much; but that everyone who has put his savings in Savings Certificates, or on deposit at Savings Banks or in any other form of security will have been deprived of half its value.

If in an attempt to relieve this position we proceeded to print sufficient additional £ notes so that each of us should have £2 for every £1 which we previously had (a process known as inflation), we should merely make matters worse; the value of the £ might be further reduced in relation to dollars or francs (i.e. the equivalent of gold) and the number of £'s required to obtain goods abroad would be increased accordingly; at the same time the price of articles in terms of the £ would again rise, and consequently the purchasing power

of the pound would sink again (say) to 5/-. And so on.

16. The remedy is to reverse the process which has been responsible for the trouble, and this means that, instead of living at a level which has entailed ordering abroad more goods than we can pay for, we must relate our orders to our capacity to pay. And unless we can produce and sell abroad more goods (including "services") than we have been doing, we shall be forced to cut down our orders abroad, and our standard of living must be reduced accordingly.

17. Provided that we do this - and also abstain from unsound Budgets - the international value of the £ will not deteriorate further; and, although the cost of our imports reckoned in terms of pounds will continue higher than hitherto it has been, this may be offset by the fact that the foreigner may be ready to buy more of our exports than before as instead of having to pay 4.86 dollars or 124 francs for £1's worth of commodities, he will not have to pay more than (say) 2.43 dollars or 62 francs.

This latter result is, however, conditional on foreign countries not raising their tariff walls so as to prevent what they might regard as "dumping".

18. Two very important heads of our export trade (which are included in the expression "invisible exports") will, however, in any event have been crippled, probably for ever.

As already mentioned in paragraph 7 above, London has for many generations been regarded by the world as a sort of international bank (or safe), and in that capacity has received on deposit very large sums of foreign money which have been put to profitable use by re-lending and have earned some £60,000,000 a year towards the payment of our imports.

Obviously if we fail to repay the foreign depositor, or only repay him part of his deposit, he is not in future going to entrust his money to us; and by degrees, and sooner rather than later, he will choose a centre, e.g. New York or Paris, where he can leave his money without the risk of being defrauded.

19. The other part of our export trade just referred to is the interest due to us from our investments overseas. This has helped in the past to pay for some of the imports we need to an extent exceeding £200,000,000 a year. As most of these investments are in the form of sterling, and the interest is therefore calculated in pounds, the immediate result of a fall (say) by half in the international value of the £ would be that we should receive commodities to the value of little more than half what we hitherto have had, perhaps not much more than £100,000,000 worth.

20. Thus our capacity to purchase what we need from abroad would be reduced, under these two heads alone, by about £160,000,000 a year if we failed (and it would have been through our own fault) to maintain the international value of our £ sterling.

Therefore our standard of living - which has been higher than that in Europe largely because of these receipts from abroad on account of our past loans and of our special banking services - would change for the worse, even though we were to succeed by self-denial in diminishing the adverse balance of trade in the sphere of visible exports and imports i.e. of commodities.

21. And our prestige due to the universal belief over the centuries that we are commercially and financially honest will

have been destroyed for ever. The epitaph of us English of to-day will be written by historians to come in Shakespeare's words (Richard II, Act 2, Scene 1) -

"England, bound in with the triumphant sea,
"Whose rocky shore beats back the envious siege
"Of watery Neptune, is now bound in with shame,
"With inky blots and rotten parchment bonds:
"That England, that was wont to conquer others,
"Hath made a shameful conquest of itself."

Treasury Chambers,

S.W.1.

September 11th, 1931.