NOTE ON THE FINANCIAL SITUATION.

I.—THE WAR CHEST:

The recent development of events—particularly the growth of the Defence programme and the persistent demand for loans and credits from foreign countries—has added to the problem of finding money for defence a new anxiety as to our ability to defend the £ and to continue to purchase vital necessities from abroad, both in present conditions if they continue, and, above all, in war.

2. Ordinarily imports are paid for by exports or else by gold or the sale of foreign assets. When the balance of trade is adverse as it is now, both increased foreign purchases for defence and equally loans to foreign countries involve within a brief space a loss of gold.

3. The present policy is increasing the pressure on the exchange in three ways.

   Armaments made at home for ourselves involve the import of raw materials from abroad equal probably on average to 25 per cent. to 30 per cent. of the value of the orders, and in these times possibly more.

   Armaments purchased from abroad absorb gold.

   Loans and credits to foreign countries, if expended on the purchase of goods in this country, involve imports on the average of 25 per cent. to 30 per cent. or more of the money so expended; if taken abroad, in the long run they add in whole to our gold losses.

4. Fifteen months ago our gold stock was over £800 million. It looked imposing but, in fact, gave a rather misleading appearance of strength. It had been accumulated in some considerable measure owing to the transfer to London of fugitive short money. In less than 15 months of international tension nearly 40 per cent. of our gold stock has disappeared.

5. The reasons for our gold loss of over £300 million in 15 months (only part of the figures published) are as follows:

   6. The economic set-back in 1937 profoundly disturbed world conditions, the effect being especially marked among the best customers of our export trade.

   7. A great deal of fugitive French money has returned to France; to that extent our loss is France's gain.

   8. The balance of our trade is adverse, but the essential point for sterling is the aggregate balance of trade of the sterling bloc which banks in London. It
is estimated that for a period of 18 months to December last the sterling balances held in London by countries of the sterling bloc were falling at the rate of some £80 million a year.

9. These economic factors leading to a depletion of our gold stocks have been reinforced by the effect of political conditions. A great deal of fugitive money in London has been transferred by foreigners to the United States or other supposedly safe countries, and probably there is a small trickle of British investments to the United States, though the amount is not significant.

10. War preparations have played a part and will play a much greater part in determining the fate of our gold reserves:

Diversion of activities from peaceful enterprise to war preparation leads to a decline in exports, and the intensification of the defence plans leads to an increase in imports, especially of raw materials, but in some cases also of completed goods from the United States. War preparation has come to include the giving of loans or grants to foreign countries on a large scale.

11. The limit of commercial export credits has recently been increased from £50 millions to £75 millions, and the amount of the credits actually granted has increased very greatly in recent months. Sound short-term commercial credits certainly resulting in repayment in not more than two or three years are not so very harmful, but medium and long-term credits are harmful, particularly if repayment is uncertain.

Included in these credits are £10 millions for Russia, more than half of which is unspent, and £10 millions for Turkey, of which £2 millions is already being spent.

12. It is unfortunate that at a time when we shall clearly have to cut down capital expenditure in this country needed to maintain the standard of living we should have committed ourselves to finance capital expenditure for the development and industrialisation of other countries.

13. Apart from these commercial credits, there is a further £6 millions for Turkey, £4 millions net for Czecho-Slovakia, £5 millions for China, a probable £30 millions for India (Army re-equipment).

14. Existing commitments in respect of "political export credits" to various countries amount to £19 millions, plus interest, and suggestions from Government Departments for new promises under this head to cover the cases of Poland, New Zealand, Turkey, Roumania, &c., and to give a margin for further applications, bring the total to £80 millions, plus interest, which will appear in a Bill about to be introduced.

15. The Polish Government, in fact, asked for £60 millions; New Zealand is in difficulties and needs new money both for defence and for other purposes; Roumania and Turkey are both asking for more.

16. The following measures have been taken to protect the exchange. The value of sterling has been let down from 5 dollars to 4.68. The embargo on foreign issues has been greatly tightened up. A very large bloc of gold has been transferred from the Bank of England to the Exchange Equalisation Account for use in active defence. Sweeping measures to discourage and impede speculation have been taken.

17. Very little more could be done even with the most far-reaching powers. A further small depreciation of the £ would be ineffective; a large depreciation, even if it were on balance desirable, is not at present practical politics.

18. Up to the present the disadvantage of our gold loss has been largely political. It must discourage our friends and encourage the Axis Powers.

If it continues swiftly it will soon become also a serious economic anxiety even in peace. But the greatest anxiety is that it may gravely affect our staying power in war. Our gold stock, together with such assets as we may be able to sell or mortgage in wartime to countries overseas, constitutes our sole war chest.

19. The amount of our requirements of foreign exchange in a war of long duration defies calculation. We shall require food and raw materials and maybe armaments in great quantities. What exports we can sell, and to whom, to
offset the imports, is uncertain. It is uncertain, too, to what extent our allies will be financially dependent on us (though it is *prima facie* unlikely that Russia would require financing in a new war to the extent that she did in the Great War).

20. The only prudent conclusion is that we ought to preserve the largest war chest possible. To-day that chest contains some £200 million of foreign securities which we could hope to sell or mortgage, and £500 million of gold rapidly diminishing.

21. The contrast between this and our war-chest at the beginning of the Great War is as follows.

22. On the one hand our gold stock is for the present much in excess of that in 1914.

23. On the other hand, in 1914 by stopping foreign lending we could, other things being equal, improve our buying power by some £200 millions a year. To-day there is no foreign lending and our revenue account is £50 million a year to the bad.

24. In 1914 we recalled some £50 million short money invested abroad; to-day much short money invested in London can be withdrawn from us.

25. In the Great War we requisitioned and sold abroad some £200 million of foreign securities apart from private sales abroad which were probably considerable. To-day we can by requisitioning obtain £200 million of foreign securities and hope to sell these, but no more.

26. In the Great War we did not need to attempt to sell blocks of sterling securities. In the next war, though we could try to do so, the possibility of success on more than a very small scale is exceedingly doubtful.

27. As regards foreign borrowing in war, the contrast with our position in the Great War is as follows:

28. In the Great War we borrowed £250 million from private investors abroad (mostly U.S.A.) all of which was repaid and we borrowed £840 million from the United States Government (not repaid). To-day under the Johnson Act we cannot borrow in the United States either privately or from the Government.

29. Nevertheless, unless, when the time comes the United States are prepared either to lend or to give us money as required, the prospects for a long war are becoming exceedingly grim.

30. It has already been pointed out that it is impossible to frame estimates of the rate at which our resources in gold and foreign securities might be drawn on in the event of war. At the rate, £20 million a month, at which we have been using gold, our reserves would barely last three years and considering the increased demands likely in war, this estimate of the period is very likely much too optimistic.

II.—Money for Defence.

31. The Cabinet review of February, 1938, allotted for defence in 1939, 1940 and 1941, roughly £1,000 million. This had grown by September 1938 to roughly £1,100 million. Subsequent additions, for most but not all of which rough estimates have been given by the Defence Departments, may be put broadly at £1,000 million. Present rough total for three years, £2,100 million.

32. A division between years may be guessed as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>£ million</th>
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<tbody>
<tr>
<td>1939</td>
<td>750</td>
</tr>
<tr>
<td>1940</td>
<td>700</td>
</tr>
<tr>
<td>1941</td>
<td>650</td>
</tr>
</tbody>
</table>

[The figure now estimated to be required in 1939 exceeds by £120 million the figure mentioned in the Budget speech in April.]
33. On the basis of existing taxation, allowing on an optimistic basis for estimated increases of yield and some favourable factors affecting the capital account, the balance of expenditure to be found somehow may be guessed as follows:—

<table>
<thead>
<tr>
<th>Year</th>
<th>Balance of Expenditure</th>
</tr>
</thead>
<tbody>
<tr>
<td>1939</td>
<td>£500 million or a little less</td>
</tr>
<tr>
<td>1940</td>
<td>£360 million</td>
</tr>
<tr>
<td>1941</td>
<td>£350 million or rather less</td>
</tr>
</tbody>
</table>

34. In 1939, but not in subsequent years, £150 million or thereabouts can be borrowed on Treasury Bills, leaving, say, £350 million to be borrowed on long or middle term.

35. The foregoing figures are far beyond anything that can be borrowed by ordinary means without inflation.

36. One remedy lies in increased taxation. The Cabinet note of April last on the growth of Civil Expenditure showed that between 1925 and 1938 the yield of increases in taxation amounting to £245 million enabled us to provide £153 million more for defence. In 1939 £24 million new taxes were added, but the additional amount for defence was lowered to £125 million.

Additional taxation, totalling on a full-year basis some £280 million, has been secured by:
- Increasing income tax and supertax by roughly 40 per cent.
- Increasing tobacco duty by 40 per cent.
- Increasing estate duties by roughly 20 per cent.
- New oil duty at 9d. a gallon.
- New tariff duties.
- Many minor changes, including, e.g., 25 per cent. increase on private motor duties and much heavier increases of duties on commercial vehicles.

37. There must be some limit to new increases of taxation in peace if any elasticity is to be left over for war, when the yield of many customs and excise duties will cease or greatly fall and collection of direct taxes may in the initial stages be greatly delayed.

38. Suppose by way of illustration that in the Budget of 1940 taxation is increased by £100 million (e.g., by a Budget of new taxes similar to the last Budget, plus 1s. extra on the income tax).

The requisite borrowing would then be—

<table>
<thead>
<tr>
<th>Year</th>
<th>Balance of Expenditure</th>
</tr>
</thead>
<tbody>
<tr>
<td>1939</td>
<td>£500 million, of which £150 million would be by Treasury Bills and £350 million on long or middle term.</td>
</tr>
<tr>
<td>1940</td>
<td>£260 million</td>
</tr>
<tr>
<td>1941</td>
<td>£230 million or rather less</td>
</tr>
</tbody>
</table>

39. These figures, which take no account of concurrent requirements of money for loans to foreign countries (and equally take no account of Dominion and municipal borrowings), are up to, if not beyond—and in the case of the current year are certainly beyond—the limit of what can be borrowed out of savings by ordinary means.

40. In the course of time, therefore, and may be a short time, it is likely to be necessary to contemplate a variety of controls, especially—
- Prohibition of new issues.
- Control of advances by Banks.
- Control of advances by Building Societies.
- Control of Companies' dividends and investment of their reserves.
- Possibly also control of prices.

These matters are accordingly being studied at the present time.

41. It has so far been assumed that the programme would end in April 1942. There must at best be an overlap. Even when the normal cost of maintenance is reached, it is likely to require (including the service of the new debt) some £450 million per annum, a figure unattainable on anything resembling the present scale of taxation.
III.—Conclusions.

42. Apart from increased taxation, the following means of arresting the general deterioration suggest themselves:—

43. The primary need is to conserve our resources in gold and foreign exchange, which represent staying power in war.

44. Inflation, with the gold losses it would involve (apart from its other evils), must be avoided. Very heavy increases of taxation are in prospect, and in the course of time general controls are likely to become necessary and the standard of living must be directly or indirectly affected.

45. Purchases abroad of armaments must be avoided to the greatest extent possible. Further expenditure on armaments in this country cannot be undertaken without counting the cost in gold. Indeed, as there is a prospect of the continuance of the present armed peace, if not of the outbreak of war, finality of expenditure (unless for overmastering reasons) should now be declared.

46. If nevertheless substantial new expenditures are contemplated, the Cabinet should be provided not only with estimates of cost, but so far as possible with estimates of the extra strain involved upon the exchanges.

47. In any lengthy war there are types of food and of vital raw materials, the acquisition of which from overseas is essential to our continued existence. It is for consideration whether, bearing in mind the possible lack of means of foreign payment in war, the enhanced prices and the difficulty of carriage in war and the possible losses at sea, the process of acquiring stores of such essentials (now standing in the case of a variety of special minerals, &c., required for war at about six months' war requirements), where they are durable and capable of safe storage, should not be carried further in spite of the immediate gold losses which that course involves.

48. Loans to foreign countries, specially loans not to be expended in this country, must be restricted to the lowest possible limits. The point to be borne in mind here is that every new commitment of this character definitely reduces the period for which we shall be able to finance war.

Treasury Chambers, S.W. 1,
July 3, 1939.