Federal Reserve Participation in British Negotiations
September-December 1945

The group designated by the President to conduct the economic and financial negotiations with the British during the months September-December 1945, consisted of the Secretaries of State, Treasury, and Commerce, the Chairman of the Board of Governors of the Federal Reserve System, and the Foreign Economic Administrator. (With the dissolution of the Foreign Economic Administration in the month of October and the transfer of its functions to State and Commerce Departments, the group was reduced to four.) Under this top committee were three subcommittees on finance, commercial policy, and lend lease and surplus property, respectively; Chairman Eccles was a member only of the finance subcommittee. The top committee with its subcommittees on the U.S. side were paralleled by similar groups on the British side, and the U.S. and British counterparts joined to form a "combined" top committee and "combined" subcommittees.

As matters developed, meetings of the U.S. Top Committee (and even more of the Combined Top Committee) were infrequent and most of the work, even in the final stages, was completed at subcommittee level; hence Chairman Eccles, who was assisted by Mr. Gardner and Mr. Knapp, was active principally in the U.S. and combined financial committees. One result was that he had no effective part in the general commercial policy discussions (although a member of the Board's staff attended the meetings of the U.S. and combined subcommittees in this field). However, the lend lease and surplus property settlement was the subject of one meeting of the U.S. Top Committee where the final terms of the offer to be made to the British were reviewed and approved. Also, the method of financing the lend lease and surplus property settlement was determined in the U.S. Finance Committee.

Federal Reserve participation in the British negotiations was therefore concentrated largely on the financial aspects of the matter and in particular on negotiating the terms of the "financial agreement" covering the new money credit of 3,750 million dollars.

The problems involved in the financial agreement concerned the amount of the credit; the financial terms on which it should be extended; the relation of the credit to old sterling balances and to other new credits which the British might negotiate; and the specific commitments as to United Kingdom import and exchange controls which formed part of the consideration for the credit. The State Department, consistently seconded by the Commerce Department, vigorously sought throughout the negotiations to obtain firm commitments from the United Kingdom on its future exchange and import policies, but was prepared to pay a high price for such concessions in terms of the amount and terms of the loan and the other conditions attaching thereto. The Treasury Department and Federal Reserve, while equally anxious to get firm commitments on the former issues, were inclined to bargain much harder on the latter. On one point, namely the conditions of the loan relating to the treatment of sterling balances, Chairman Eccles went further than the Treasury in seeking binding commitments, and was eventually outvoted.

The course of negotiations on the main elements in the financial agreement may be briefly described as follows:

Amount and Terms of the Credit. In the first stages of the negotiations, the British made it clear that they hoped to obtain some 5 to 6 billion dollars as a grant or at least as an interest-free loan repayable over a period of 50 years after an initial period of grace on amortization. However, soon after the financial discussions commenced in earnest in the middle of October, the U.S. side reached agreement that interest would have to be charged at the rate of 2 per cent per annum (sufficient to cover the cost of money to the United States); that, however, some form of waiver or deferment should be worked out for payments falling due in bad years; that there should be an initial 5-year period of grace during which no interest should accrue; and that the amount of the new money credit (exclusive of credits for the settlement of lend lease and surplus property) should not exceed 3.5 to 4 billion dollars. On this last subject, the U.S. Financial Group split at a meeting held on October 17, the State and Commerce Departments supporting the higher figure and the Treasury Department and Federal Reserve recommending the lower.

These proposals were communicated to the British by Mr. Vinson and Mr. Clayton, acting at this stage as the active negotiators on the U.S. side. The British made a counterproposal calling for a credit of 5 billion dollars, of which 2 billion was to be an outright grant and 3 billion a loan on the U.S. terms. This would have called for annual payments by the British of about 95 million dollars and they insisted that 100 million dollars per annum was the maximum that they could afford. This counterproposal was communicated to the U.S. Finance Committee and firmly rejected on the ground that it was tantamount to giving a 5 billion dollar loan without interest.

Thereafter the British accepted the basic U.S. terms outlined above, but sought to weaken the interest stipulation by obtaining favorable conditions in the waiver clause. The discussion of this clause was very lengthy and complex. The issues were: Should payments falling due in "bad years" be waived or deferred to the end of the amortization period? Should the waiver or deferment apply to interest only or to principal payments as well? What criteria should be established for determining "bad years"? Should these criteria operate automatically or should they only establish a prima facie case with final discretion reserved to the U.S.?

In the early stages, the basis of discussion was that both interest and principal payments falling due in bad years should be deferred—without cumulative interest—to the end of the amortization period. But the U.S. side wanted such deferment to be discretionary with the U.S. and wanted to adopt as criteria not only the level of Britain's overseas income (following a British formula based on the volume of pre-war imports), but also on the level of Britain's gross external reserves of gold and convertible foreign exchange.[1] The British, on the other hand, demanded that the deferment operate automatically and consistently opposed any reasonably effective criterion based upon the level of their reserves. To meet the first point, the U.S. side agreed to drop the U.S. discretion if a clause were inserted requiring the British to make up deferred payments in good years, defined as those in which Britain's overseas income exceeded the critical level established by the British formula and Britain's external reserves rose above the critical level envisaged by the U.S. formula. However, this refinement was vigorously rejected by the British.

The U.S. side thereupon altered the basis of negotiations and proposed an automatic <u>waiver</u> only of interest payments (no waiver or deferment of principal payments) if both the overseas income and external reserve criteria were met. But the British continued strenuously to resist any precise formulation of the second criterion. In the end the U.S. side gave in, took the British overseas income formula modified to the basis of a five-year moving average, and accepted some general language on the reserve question. This language simply commits the United Kingdom not to exercise the waiver privilege, even if the overseas income criterion is met, unless in its judgment "a waiver is necessary in view of the present and prospective conditions of international exchange and the level of its gold and foreign exchange reserves".

Certain modifications proposed by the British for the overseas income formula were rejected by the U.S. side. The British were concerned lest their overseas income might be high while at the same time the proceeds were being accumulated in blocked currencies and/or the dollar was a scarce currency, and they attempted to take account of these possible circumstances by amendments to the waiver clause. These amendments were eventually dropped, although by paragraph 12 of the agreement the British retained the general right to approach the U.S. for reconsideration of the terms of the credit if, in their opinion, such reconsideration was justified by "the prevailing conditions of international exchange".

As for the amount of the credit, the British made a "final" offer to accept 4-1/2 billion dollars on the U.S. terms, including the settlement on lend lease-surplus property, for which their figure was 500 million dollars. The State Department, which was holding out for 650 million on the latter item, was willing to accept the British aggregate figure, which would have meant a new money credit of 3,850 million dollars. The State Department

[1] As finally formulated, two alternative formulas were offered to the British on this point: (a) 25 per cent of the average annual value of retained merchandise imports in the previous 5 years; or (b) 15 per cent of such imports <u>plus</u> 25 per cent of Britain's short-term external liabilities. On the latter provision, which was inserted to meet the British insistence that the formula should be based upon Britain's <u>net</u> reserve position, the U.S. side probably would have been willing to make the figure 40 per cent.

continued to be fully supported by the Commerce Department, but the Treasury and Federal Reserve held out for a new money credit of only 3.5 billion dollars. This issue was finally resolved when Secretary Byrnes and Secretary Vinson called upon the President and reached a compromise figure of 3,750 million dollars of new money which, when the U.S. figure on the lend lease-surplus property settlement was accepted, gave the British a total credit of 4.4 billion dollars.[1]

Relation of Credit to Other British Obligations. The British were very sensitive about entering into any commitments which affected their obligations to other countries. In particular, they maintained throughout that it would be "unconstitutional" for them to prejudice in any way the results of the negotiations which they were subsequently to conduct with British Commonwealth holders of old sterling balances. Lord Keynes explained to the U.S. group that the British hoped to make settlements with the holders of these balances, calling for a relatively small cash payment, cancellation of a large fraction of the balances, and funding of the rest for amortization over a period of 50 years without interest. This statement was welcomed by the U.S. side which emphasized (a) that the U.S. could justify cancelling the bulk of its lend lease claims only if other countries which had acquired claims of an equivalent character also undertook some sacrifices; (b) that great opposition would be aroused in this country to any proposal for lending Britain money to pay off old sterling balances ("dead horses"); and (c) that in the interests of protecting the future service on the U.S. credit we would like to see the amount of the service on old sterling balances held as low as possible in future years. However, despite considerable effort, especially by the Federal Reserve representatives, the U.S. side failed to obtain any quantitative limitations on Britain's freedom of action in this field.

The British had initially anticipated that part of the U.S. credit would be earmarked to pay off prior accumulations of sterling balances by other countries. When they were advised that this procedure would be politically unacceptable in this country, they sought general language which would permit the indirect use of the credit for the stated purpose. Agreement was reached early in the discussion upon the language of 6(i) which states that "any amounts required to discharge obligations of the United Kingdom to third countries outstanding on the effective date of this agreement will be found from resources other than this line of credit". However, the British interpreted this language to mean that if--as anticipated--they should raise other credits in the near future (e.g. in Canada and India),

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[1] Up to the last minute the U.S. side was still considering "3c" terms (2-3/8 per cent and 30-year amortization) for the credit extended to cover lend lease pipeline, and surplus property. It had been argued vigorously by the Foreign Economic Administration (before this agency dropped out of the discussions) that Britain could not be offered more favorable terms than other countries on items of this character. This point was disregarded, however, in the final arrangements, which provide uniform terms for the whole credit.

they could repay an equivalent amount on old sterling balances, even though these other credits were specifically tied to exports from the country concerned and even though the actual payments on old sterling balances were made in U.S. dollars. This interpretation was questioned on the U.S. side, notably by the Federal Reserve representatives, and several attempts were made to secure an agreed interpretation stating that during the period of availability of the U.S. credit, payments on old sterling balances would be made from existing British resources. One proposal was to limit the amount of such payments in gold or dollars (or in sterling convertible into the same) to the amount of Britain's existing gold and dollar reserves, providing at the same time that Britain might replenish her reserves by draft against the U.S. credit. It was with this latter point in view that the words "to help the United Kingdom to maintain adequate reserves of gold and dollars" were inserted in paragraph 3 of the agreement. It was believed by the Federal Reserve representatives, supported at times by members of the other U.S. Agencies, that this would be a better way to "dress up" the indirect use of the credit to pay off old sterling balances, and that it would put a ceiling (though a higher one than the British had indicated they would need) upon the amount of such payments during the next few years.

The British resisted any agreed interprepretation of this character, however, and in the end the Federal Reserve was outvoted on the question and the British were left free to place their strained interpretation on the language of paragraph 6(i). From the U.S. point of view, the only safeguard against large scale indirect use of the credit for the purpose of paying off old sterling balances is the fact that the amount of new money has been fixed at the relatively modest figure of 3,750 million dollars, the bulk of which will probably be needed to meet Britain's current deficit in the transitional years.[1]

The question also arose of what relation the future service on the dollar credit should bear to the service on new credits raised by the British in other countries, and to repayments of the old sterling balances. The U.S. side, after examining the possibility of giving service on the U.S. credit some kind of priority, abandoned this in favor of accepting pari passu treatment. This was interpreted to mean that in any year in which the interest portion of the installment due the U.S. was waived, interest on other new credits would have to be likewise waived and payments on old sterling balances would have to be reduced proportionately by waiver or deferment. Moreover, in view of Lord Keynes' declaration of British intentions referred to above, the U.S. side thought it reasonable to insert a provision that payments

[1] At one stage in the discussions the British proposed language which would have committed them not to draw on the U.S. credit a sum exceeding the amount of their current deficit during the transitional period. Since they may finance some 2-3 billion dollars of the deficit from other sources, this would have placed no effective ceiling on the amount of the credit which they might have used to pay off old sterling balances. However, as a method of "dressing up" the arrangements, such a clause would probably have been more satisfactory than the ambiguous language of the present paragraph 6(i).

on the old sterling balances should not exceed the equivalent of 150 million dollars in any year during the life of the U.S. credit.

This latter limitation was vigorously resisted by the British, on the grounds that their acceptance of such a provision would be "unconstitutional" and that Lord Keynes' statement was after all only a "hope". They made a counterproposal that, of the payments made to sterling area countries, only 150 million dollars per annum should rank pari passu with service on the U.S. credit and any further amount should rank "junior". In practice all this meant was that in a year in which there was a waiver of interest on the U.S. credit, payments to sterling area countries in that year of up to 150 million dollars would have to be reduced proportionately by waiver or deferment, while payments in excess of this amount would have to be waived or deferred entirely. The British subsequently agreed to include non-sterling area countries in this provision if the figure were raised to 175 million dollars. The U.S. side thereupon made a new proposal, rejecting the idea of unlimited "junior" payments, but permitting payments on old sterling balances to exceed 175 million dollars per annum if an amount equal to the excess was devoted to acceleration of amortization on the U.S. credit. Although this formulation seemed to escape the "constitutional" question since it placed no absolute ceiling on payments to the holders of sterling balances, the British continued firmly to resist it and the U.S. side, other than the Federal Reserve representatives, chose not to press it. In the end, the U.S. side even dispensed with the "junior payment" concept proposed by the British and simply stipulated that any payments on old sterling balances (except on those held by colonial dependencies or by private individuals and firms) would have to be reduced proportionately in years in which the interest portion of the installment due the U.S. was waived.

Upon Federal Reserve insistence, however, a small safeguard was eventually agreed upon, namely the provision in the waiver clause to the effect that payments in any year on the old sterling balances in excess of 175 million dollars (43,750,000 pounds) cannot be deducted in calculating the United Kingdom's net income from invisible current transactions.

The U.S. side originally suggested a further application of the pari passu principle in the case of accelerated payments by the United Kingdom on other new credits or on old sterling balances. Thus if the United Kingdom made payments to these other creditors in excess of the contractual requirements, it would have been required to devote an equal amount to accelerated amortization of the U.S. credit. Unfortunately, however, such a provision would have contained a wide loophole in that Britain could simply make loans to her creditors if circumstances required, rather than making accelerated repayments on old debts. There was no disposition on the U.S. side to attempt to regulate Britain's foreign lending during the life of the U.S. credit, so the principle of pari passu acceleration was eventually dropped.

Agreement was readily reached on the principle that any new long-term loans obtained by the U.K. from members of the British Commonwealth during the transitional period (notably the proposed loan from Canada) should not be on terms more favorable to the lender than the terms of the U.S. credit. It was believed that countries in the British Commonwealth can and should be expected to be as generous as the U.S. in their assistance to Britain. Interest on such loans would have to be waived, of course, in any year in which interest on the U.S. credit was waived, and the U.S. side sought to extend this principle to any new loans which the U.K. might receive during the life of the U.S. credit. This point was eventually abandoned, however, in view of the British insistence that it was an unreasonable limitation of their future freedom of action.

British Commitments on Exchange and Import Controls. As noted previously, the State Department took the lead in negotiating sections 7, 8, 9, and 10 of the financial agreement, which in general require that the British undertake certain relaxations of their exchange and import controls within one year from the date of the agreement (or later by mutual agreement).

Section 7, dealing with sterling area exchange arrangements, was agreed upon early in the discussions. The only significant point of difference which arose was that the U.S. side hoped that the United Kingdom would relax its exchange controls vis-a-vis each sterling area country as appropriate arrangements with that country were concluded. However, it yielded to the judgment of the British negotiators that it was technically impracticable to dissolve the sterling area piecemeal, and that this had to be done in one stroke when arrangements with all the countries had been completed.

Section 7, when it becomes operative, will remain in effect indefinitely, or at least during the life of the U.S. credit. On sections 8 and 9, however, covering Britain's exchange restrictions vis-a-vis non-sterling area countries and her administration of quantitative import restrictions vis-a-vis the U.S., the British argued that their commitments should be limited to the period of the availability of the credit (i.e. through December 31, 1951), leaving only the general obligations of the International Monetary Fund and the International Trade Organization to govern their action thereafter. This view was accepted by the U.S. side, although it was recognized that after 1951 the British would be free to withdraw from the International Monetary Fund and International Trade Organization and to regain full freedom of action in the matters covered by these sections.

Furthermore, the British were prepared to accept satisfactory commitments on removing exchange and import restrictions vis-a-vis the U.S., and to take such action immediately provided that they retained the right to impose restrictions consistent with Article VII of the Fund Agreement (i.e. if the dollar became scarce). This qualification was acceptable to the U.S. side.

In the case of exchange restrictions vis-a-vis other non-sterling area countries, however, a real issue arose on which the British gave in only at the last moment. The U.S. side readily conceded that in this area the British should be able to impose restrictions consistent with Article VII of the Fund Agreement (scarce currency) or restrictions approved by the Fund under its general powers contained in Article VIII of the Agreement. But the British sought in addition to retain their privileges under Article XIV of the Fund Agreement (providing for the "transitional period"). They recognized that this concession would in fact negate any assurances which they might give in the agreement with respect to the relaxation of exchange restrictions vis-a-vis non-sterling area countries other than the United States. They maintained, however, that while it was their firm intention to do away with such restrictions as rapidly as possible, they could not commit themselves to do so. In particular, they argued that such a commitment would reduce their bargaining power when they came to negotiate a reciprocal dismantling of controls with countries with which they had bilateral exchange agreements.

The U.S. side, on the other hand, insisted that the termination of Britain's bilateral exchange arrangements with Latin American and Continental European countries was one of the most important objectives which the United States sought in making the loan, and that without agreement on this point, the loan would stand no chance of acceptance by the American Congress and public. It was prepared to give the British one year from the date of the agreement to work out the abolition of the exchange restrictions in question, and as a final concession accepted the language providing that the commitment might be modified by mutual agreement in exceptional cases (e.g. if Britain really needed freedom of action to bargain for reciprocal concessions from a recalcitrant trade partner). At this point the U.S. side stood firm, and the British, after vigorous protests which continued up to the morning of the public announcement concerning the agreement, finally gave in.

Section 10 of the agreement contains merely a general statement of British intentions regarding the treatment of old sterling balances in place of the quantitative limitations which the U.S. side had hoped to incorporate there. It also contains, however, a firm commitment by the British that one year after the date of the agreement (or later by mutual agreement), any portions of the old sterling balances which are released or otherwise available for current payments shall be freely convertible for current transactions. In other words, the British forego the privilege of leaving such balances useable only in the sterling area, a form of discrimination which might have had very serious effects upon U.S. trade. The British conceded this point early in the discussions with respect to balances which were being gradually released pursuant to funding agreements. But they resisted for some time the application of the principle to balances not covered by such agreements, pointing out that in effect this would require them unilaterally to block balances held by countries with which they had failed to negotiate funding agreements by the effective date for this Section. They finally acceded, however, finding some consolation in the clause permitting extension of the dead-line in exceptional cases by mutual agreement.