

SECRET

Anglo-American Financial Discussions
Document No. 2
August 19, 1947

MEMORANDUM TO: National Advisory Council

FROM: NAC Staff Committee

SUBJECT: The International Financial Situation of the
United Kingdom

I. Factual Background of the Present Situation

1. In the 18-month period from January 1946 to June 1947, the British drew \$2,750 million on the Canadian and American credits. Of this sum, \$2,050 million was drawn from the U.S. credit, and \$700 million from the Canadian credit. The rate of drawings began to increase rapidly in the second quarter of 1947. In the six weeks following July 1, 1947, the British drew \$850 million from the U.S. credit, and probably made some drawings on the Canadian credit.

2. During the 18-month period ending June 30, 1947, Britain incurred an overall deficit of \$2,900 million in her current international payments. This cumulative deficit was only \$200 million higher than the estimates which the U.S. Technical Committee made in December 1945, and is considerably less than the British at that time expected it to be.

3. However, during the first half of 1947, the deficit was \$1,300 million or at an annual rate of \$2,600 million compared with a 1946 deficit of \$1,600 million. This increase in the deficit was contrary to anticipations.

4. Although the dollar drain during the 18-month period approximated very closely the overall balance of payments deficit, this identity conceals the most important developments.

(a) During 1946, when the overall balance of payments deficit was approximately \$1,600 million, the dollar drain was only \$800 million. The other half of the deficit was largely financed by borrowing from other countries in the form of continued accumulation of sterling balances.

(b) In the first half of 1947, when the overall deficit was approximately \$1,300 million, the dollar drain was approximately \$1,600 million.^{1/} During this period, while Britain received credit from some areas which continued to accumulate sterling balances, she began to repay her accumulated obligations to other areas to a larger extent.

^{1/} Exclusive of a \$205 million draft on British gold reserves to cover the U.K. contribution to the International Monetary Fund.

SECRET

COPY NO. 27

- 2 -

5. During the period beginning about May of this year there began an exceptionally sharp increase in the drain of dollars so that the drain was running perhaps as much as double the overall deficit on current account in the balance of payments. It is likely that this exceptionally large drain is still going on and may continue.

II. Explanation for the Present Situation

1. The increase in the overall deficit on current account was due primarily to the rise of import prices, the impact of the winter crisis on the export drive, and the failure of government expenditures overseas to decrease appreciably.

2. However, the change in the British financial position in 1947 is only partially explained by the increase in the overall balance of payments deficit on current account (an increase of about \$1,000 million at an annual rate) and further explanation is required.

(a) During the first half of 1947 the sterling balances of sterling area countries declined about \$440 million in spite of an estimated capital flow to these countries of \$110 million. Approximately \$200 million of this decline in sterling balances was the result of conversions into dollars for purchases in the Western Hemisphere. Some \$350 million apparently financed the purchase of goods and services from the U.K.

(b) Sterling balances of non-sterling area countries ^{1/}increased \$370 million during the first half of 1947, ^{2/} adding to the very substantial increases which had occurred during 1946. Nevertheless, the deficit of the U.K. with these countries was substantially larger than this amount, and they were able to receive \$120 million from the U.K. by converting sterling in addition to the \$370 million which they accumulated and held. It is likely that this drain has increased substantially during the past weeks.

In other words, the non-sterling area countries, particularly the European countries and the Argentine, continued to help finance the British deficit during this period. However, these countries, pressed by the U.S. dollar shortage, reduced their financing of the British and began calling for dollars.

(The accumulation of sterling balances by non-sterling area countries, which amounted on June 30, 1947 to almost \$3 billion, represents a large potential drain on British dollar resources.)

1/ All countries outside the sterling area except Canada, the U.S. Mexico, the Caribbean countries, Venezuela, Colombia and Ecuador.

2/ Of this \$370 million increase, approximately \$80 million resulted from the sale of French-owned British securities.

- 3 -

(c) In 1947, the British reduced their utilization of the Canadian credits (because of the growing deficit of Canada with the U.S.) and supplied Canada with U.S. dollars to the extent of \$220 million for the first six months.

(d) During the first half of 1947, the British had a deficit on current account with the United States, Canada and Central America ^{1/} (the dollar area) of approximately \$1,300 million. During this period they utilized the Canadian credit to the extent of only \$160 million while the balance of \$1,140 million contributed the major drain on the British resources of U.S. dollars.

3. The foregoing facts illustrate that the present dollar position of the U.K. is not due solely to the increase in the deficit of the overall current balance of payments. Whereas in 1946 other countries, including Canada, financed \$1,000 million of the U.K. overall deficit, in the first half of 1947 they caused a net drain of \$150 million on the U.S. credit, over and above the U.K. current balance of payments deficit. This swing reflects the impact on British resources of the dollar shortage now being experienced by the remainder of the world.

III. The Accelerated Dollar Drain of Recent Weeks

During the first six weeks of the present fiscal year, the British drew \$850 million on the U.S. credit. To explain this rapid rate of expenditure, the following surmises can be drawn:

(a) The British have continued to make dollar payments on behalf of sterling area countries. In this connection the British agreements with Egypt and India provide for making sterling freely available in substantial amounts (potentially more than half a billion dollars for the last six months of 1947) and it must be expected that these countries would be eager to acquire some dollars from their sterling as soon as they obtained the privilege.

(b) (1) The British unfavorable balance of payments with the non-sterling area (exclusive of the dollar area) probably continued at the rate of roughly \$1,000 million a year and, since the bulk of this deficit may be freely used in any currency area, it must be expected that these countries have imposed a drain on the British dollars.

(2) Of the past accumulations of \$2,900 million in sterling held by the non-sterling area countries, a large part has, in effect, been frozen by agreement, but a substantial amount remains freely available in all areas. It is probable that some part of this has imposed a drain on British dollars during the past six weeks. Accurate estimates can only be obtained from the British Government.

^{1/} This area, in British financial terminology, included: Colombia, Costa Rica, Cuba, Dominican Republic, Ecuador, El Salvador, Guatemala, Haiti, Honduras, Mexico, Nicaragua, Panama and Venezuela.

- 4 -

(c) There may have been a drain of dollars on transactions motivated by speculation (or fear of the lapse of convertibility). It is very difficult to assess the volume of such a movement and it is also difficult to trace the channels through which such a movement could take place. However, this is a possibility on which the British may give us further information.

(d) Britain's deficit with the dollar area which is payable only in dollars has probably continued at a rate of roughly \$50 million per week.

(e) The British have continued to supply dollars (or gold) to Canada for part of their purchases of Canadian goods.

(f) A quantitatively minor item is the payment of \$50 million that the British made during this period for civilian supplies for Germany.

IV. The Outlook for British Dollar Needs in the Immediate Future

The Staff Committee reaches the conclusion that the drain on British dollar resources will continue into the immediate future with little, if any, abatement, in comparison with the past few months. The basis for this conclusion is as follows:

1. The overall deficit will continue through 1947 and into 1948 and will have to be met in U.S. dollars. The British estimate (made before the Attlee program was drawn up) called for a deficit of \$1,300 million in the last half of 1947 and for \$500 million in the first half of 1948. This may be overstated, but after adjusting for the effect of the Attlee program, these deficits will probably not be less than \$500 million and \$200 million, respectively. The actual amounts will depend upon Britain's success in expanding exports and curtailing imports, and upon the changing price situation.

2. It is to be expected that during the next few months at least, the dollar drain will be substantially in excess of the overall deficit on current account. The present pattern of British overseas earnings and expenditures is such that there is a favorable balance with sterling areas, for which the U.K. does not receive dollars, and an unfavorable balance with non-sterling areas for which the U.K. must pay dollars. This situation cannot be substantially changed during the coming months. Furthermore, in view of the dollar shortage, the British cannot revert back to the situation in 1946 and the first half of 1947, when the non-sterling areas (exclusive of the dollar area) helped to finance the British deficit. Because of the terms of the present agreements between the U.K. and these countries, and because of the dollar shortages which these countries themselves face, little assistance can be expected from this source.

- 5 -

3. The accumulated balances of non-sterling area countries constitute a highly volatile element in the British financial structure, and even though some liquidation may have already taken place this year, there probably still remains a substantial sum which the British may be called upon to convert into dollars during the coming months.

4. During the latter half of 1947, the British will have to continue to supply dollars to Egypt and India, and to other sterling countries, under agreements or understandings assuring them of availability of dollars.

In conclusion, the Staff Committee is of the opinion that in spite of the Attlee program it is probable that the British will utilize the remaining balance of the American credit, will draw additional amounts of the Canadian credit, and will still find it necessary to dip into their reserves during the next few months.

V. How Can a Permanent Solution of the British Dollar Problem be Achieved?

1. The stabilization of the British foreign exchange position must await the achievement of a balancing of her current international accounts. In addition, if Britain amortizes past debts or engages in other capital exports her current accounts would have to earn a surplus sufficient to cover these payments before stability could be achieved. We judge from the British programs that these goals cannot be reached until 1949 or thereafter.

2. Even after these goals are achieved, there may still be a dollar drain arising out of Britain's deficit on current account with the United States, Canada and Central America, which has always characterized Britain's international payments. The U.K. deficit with South America, which at present must be financed by dollars, may also continue. To achieve a permanent solution it will be necessary for Britain to earn enough gold and dollars from the rest of the world to pay for her deficit with the Western Hemisphere, and also to supply any dollars which the sterling creditors may require in the process of converting their sterling balances. If present conditions of a world dollar shortage continue, the British cannot be expected to earn gold or dollars from most non-dollar countries irrespective of the extent to which they may increase their exports. (South Africa is an important exception, and the deficit with the dollar area should prove manageable if reduced to the value of annual production of gold in that area, about \$400 million, provided that the British obtain this amount through their balance of payments with South Africa.) Even if Britain's current accounts were balanced, therefore, the dollar drain might continue so long as the U.K. could not obtain gold or dollars for its export surplus to non-dollar countries in sufficient amounts.

- 6 -

3. The general balance of payments problem must be approached mainly by expanding exports and reducing the utilization of sterling balances accumulated prior to July 15, 1947.

4. Within the limits established by Britain's ability to export, an approach to a solution of the British dollar problem must take the form of reducing both the deficit with the Western Hemisphere and the surplus with the countries which cannot supply gold or dollars. To some extent this shift can be accomplished by the U.K. and sterling area countries through expanding exports and sales of shipping and other services to the Western Hemisphere, but more progress could probably be made by shifting import sources from the Western Hemisphere to the sterling area.

VI. What Action is Possible and What Would be the Effect?

1. Adjustments of certain obligations under the Anglo-American Financial Agreement

This discussion is limited to an assessment of the benefits which might be expected to accrue to the British from the adjustments discussed below. It does not consider whether, consistently with the terms of the Anglo-American Financial Agreement, any such action may be taken without prior approval of the Congress.

(a) The relaxation of Section 9 of the Anglo-American Agreement. The relaxation of Section 9, without postponement of convertibility, would permit the British to shift purchases from the dollar area to other areas. However, the benefits that would accrue to the British from the relaxation of Section 9 would be limited by (a) the fact that many basic supplies now available in the dollar area are not available in other areas and (b) the fact that there is now a much smaller part of the world which would accumulate sterling voluntarily. It should also be pointed out that some shift in purchases to British non-self-governing colonies and war-disrupted areas can now take place without the relaxation of Section 9. There is also some flexibility in shifting purchases through the Government bulk purchases program.

It is difficult to assess in quantitative terms the magnitude of the possible shift of British imports from the dollar area to other areas during the next few months or year. The British, however, may have specific data on this point which would permit us to make a more accurate judgment.

(b) Postponement of the convertibility provisions. There are two important difficulties that might prevent the British from obtaining extensive benefits from the postponement of the convertibility provisions without the relaxation of Section 9.

SECRET

- 7 -

(1) The British have themselves pointed out that restrictions on convertibility have limited value to the extent that countries are either unwilling or unable to continue to finance the U.K. by accumulating further sterling balances and they might respond to the lack of convertibility by cutting down their exports to the U.K., or demanding dollars in payment for their shipments.

(2) A further difficulty arises from the fact that Britain now has agreements and understandings with a number of countries under which she has already accepted convertibility and these agreements in large part extend to the end of 1947 or beyond.

Within these limitations, the postponement of convertibility might give relief by reducing the dollar drain associated with some areas and with some categories of British purchase. The postponement of convertibility might also assist in maintaining British exports, since some countries may now be curtailing their imports from Britain to make more dollars available for purchases of higher priority in the dollar area. However, the desirability of such postponement must be gauged in light of the fact that any help that Britain obtained from this course of action would be to the disadvantage of the other countries, which themselves are suffering from a dollar shortage.

It is believed that the further postponement of convertibility, if limited to those countries which do not yet have special conversion agreements with the British, would be of relatively minor value during the coming months or year. However, it is difficult to assess the magnitudes involved. Further information should be secured from the British before making a definitive judgment.

(c) Simultaneous Relaxation of Section 9 and Postponement of Convertibility. The combination of relaxation of Section 9 and the postponement of convertibility would, however, probably increase in the long run the ability of the British to reduce their dollar drain, particularly if the British could induce the other countries to waive convertibility rights already granted. The U.K. would then be in a position to enter into agreements with various countries that would (i) stimulate an increase of shipments to the U.K. from these countries and (ii) provide assured markets for Britain's expanding exports. Even more important, this would permit the British to obtain substantial credits from the supplying countries, arising from the purchase of imports for immediate delivery under long-term contracts, against firm commitments for future export deliveries. To the extent that such arrangements proved effective in reducing the dollar drain of the U.K., they would tend to decrease the dollars available to the supplying countries.

The following points may be made regarding this course of action:

- 8 -

(1) There is some doubt as to the magnitude of the benefit which the United Kingdom may derive from these concessions during the first six months or year. The British may present estimates in the course of negotiations which will assist us in assessing the results to be expected from this course of action. However, it is obvious that the gains during the first few months will be on a smaller scale than the U.K. would be able to achieve in the longer run.

(2) Whatever advantage the U.K. might obtain would worsen the dollar shortage situation for the other countries. This would open up the whole field of trade warfare and make it more difficult for the United States Government to resist pressures from groups within the United States seeking discriminatory trade advantages.

(3) The program envisaged above if not restricted to a short interim period, and if carried to its full consummation, would mean the destruction of multilateralism and the defeat of the U.S. post-war economic policy.

The Commercial Policy Subcommittee has recommended that non-discrimination be postponed for one year, or until the ITO Charter becomes effective. (Under the Charter considerable leeway is permitted for discriminatory measures when justified for balance of payments reasons.) However, the Treasury Department legal advisers have pointed out that the program envisaged by the Commercial Policy Subcommittee cannot be carried out without the prior approval of Congress. The State Department legal advisers are tentatively of the opinion that such a procedure might be possible.

One of the considerations necessary to judge the desirability of this course of action is: there is a danger that even if this program is entered into as a short-run expedient, it might be carried to the point where it would make very difficult a return to multilateralism, and would therefore make the U.S. post-war economic policy impossible of achievement.

2. Action which the British themselves can take immediately

(a) Reduced U.K. allocation of dollars to assist Canada and other countries. During the first six months of 1947, the British paid 220 million U.S. dollars to Canada. If it were possible to resume British purchases in Canada on credit, the dollar drain would be reduced. However, the result would be to aggravate the present Canadian dollar shortage which is already acute.

(b) Restrictions on exportation of capital. An important improvement in the British dollar position might be obtained by effective restrictions on the exportation of capital from the U.K. to the sterling area, particularly if this were associated with a definite

SECRET

- 9 -

blocking of accumulated sterling balances. Under these conditions, the goods now being exported from the U.K. as capital exports would in effect be paid for in dollars, or if the purchasers canceled their contracts, these goods would become available for possible sale in other areas against gold or dollars. Even without blocking accumulated balances, a large amount of gold could be obtained from the Union of South Africa, which has a net current account deficit of about \$300 million per annum with the U.K., and possesses only small sterling balances. Most of this deficit would be paid in gold if private capital transactions were prevented from supplying the same amount or more sterling to South Africa through purchasing investments in that area.

(c) Review of Transfers of Sterling by Foreign Monetary Authorities. Consideration might be given to reinforcing the existing exchange controls of foreign areas by reviewing offers of sterling for conversion into dollars with a view to determining that the purpose of the transfer is to effect current payments in dollars. The present system relies heavily upon the exchange controls of foreign countries to prevent movements of capital from sterling into dollars on official or private account. Many of these countries have rather loose controls.

(d) Liquidation of Overseas Assets. In spite of wartime liquidations and the sale of the Argentine railways, the British hold several billion dollars worth of long-term investments abroad. If necessary, some of these investments could be sold for dollars or to finance imports. The British have been reluctant to use this method of acquiring foreign exchange because it would decrease future income of interest and dividends.

(e) Utilization of Gold and Dollar Reserves. The British have gold and dollar reserves of \$2,400 million which can be utilized in part during the present emergency period.

3. Action which the United States can take in negotiation with the British

(a) U.S. Assumption of a greater burden for expenditures for Germany by revising the Fusion Agreement. The British are now paying an estimated \$200 million per year in dollars for the support of the German population.

(b) Revision of the RFC Loan. The revision might involve the postponement of further amortization of the release of a part of the collateral now being held against the loan. During the past 12 months, the British have amortized about \$75 million under this loan. If such action were taken by the RFC it is possible that Canada would be willing to postpone further amortization on her interest-free loan to the British. This amortization is running at a rate of roughly \$80 million per year.

SECRET

- 10 -

(c) Use of the Facilities of the Export-Import Bank. The British may possibly use the resources of the Export-Import Bank to some extent. There may be limited possibilities for assistance by the Export-Import Bank in the form of project loans or exporter credits to the U.K. and sterling area countries.

(d) Amendment of the present arrangements involving exports from Japan which might be of assistance to the British.

(e) Assistance to the U.K. through the U.S. Stockpiling Program. Negotiations between the appropriate agencies of the U.S. and U.K. Governments to eliminate the present price disputes and other impediments which are delaying the U.S. stockpile program and thereby depriving the British of dollars might give some assistance to the British.

4. International Action

(a) Assistance to the U.K. through the International Bank and the International Monetary Fund. Additional assistance might be obtained through the granting of loans for reconstruction and development by the International Bank, both in the U.K. and its Dependencies. The U.S. might assist the U.K. by supporting a request to the International Bank for a long-term stabilization loan.

The U.K. could avail itself immediately of the privilege of drawing dollars from the International Monetary Fund under existing rules.

(b) Assistance through a comprehensive international program for European recovery. The principal means of possible assistance to the British is the adoption of a comprehensive international program for European recovery (the Marshall Plan), and U.S. financing of such a program. This may include substantial direct assistance to the U.K. In addition, a large-scale program for the rest of Europe would be of considerable indirect benefit to the U.K. However, since such a program may well be delayed for a number of months, immediate reliance would have to be placed on the measures above. Nevertheless, assurance of the inauguration of the European aid program would increase the confidence which the British might feel in relying upon emergency financing, and might permit a solution to the British dollar problem without major amendment of the Anglo-American Financial Agreement. Moreover, the assurance of the European aid program would increase the confidence of other countries in sterling and thereby reduce the present large commercial drain of dollars.