

**“A DIFFERENT KIND OF NATION”:
THE POLITICAL ORIGINS OF BRITAIN’S
FINANCIAL AND ECONOMIC UNPREPAREDNESS
FOR THE SECOND WORLD WAR**

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ABSTRACT

This thesis investigates the political origins of Britain's economic and financial unpreparedness for the Second World War.

The thesis contends that new liberal doctrines were formulated in Government for future defence finance in the 1920s, and that these survived and lay dormant after the collapse of the gold standard in 1931. In this context, we argue that the gains made by British and dependent economies after the subsequent victory of protectionism and Imperial preference were very great and invulnerable to outside economic pressure. Consequently, the policy represented by the Ottawa system was, and was known to be, eminently suitable both for rearmament and the economic challenges of the pre-war world.

We argue that an enviable situation was compromised by a liberal revival aimed at bypassing Parliament and steering policy again in the direction of free trade. This movement benefitted from, and was essential to, Neville Chamberlain's policy of appeasement and was articulated through the Government machine. Within it, the American Government became a significant participant in British politics.

This thesis contends that by March 1938 the new political alignment had combined with existing administrative structures to create a thoroughly liberal policy for Imperial defence, and that Chamberlain's Government depended upon rigid adherence to the concept that economic stability was Britain's 'fourth arm of defence'. We argue with particular reference to the drain of Britain's gold reserves that the period of undeclared war after the Anschluss demonstrated the new policy to be reckless, dangerous and harmful to the British Empire's massive war potential.

This thesis concludes that Britain's economic and financial weakness when war broke out was the result of recent political activity; was remarkable rather than inevitable, and in no way reflected the vast material wealth of the Empire and the resurgent condition of the British economy in the 1930s.

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ABBREVIATIONS

PRO	Public Record Office, London
FO	Foreign Office Papers, PRO
PREM	Prime Minister's Office Papers, PRO
CAB	Cabinet Office Papers, PRO
T	Treasury Office Papers, PRO
BT	Board of Trade Papers, PRO
CID	Committee of Imperial Defence, PRO
FDR	Franklin D. Roosevelt Library, Hyde Park, New York
MD	Morgenthau Diary, FDR
SD	General Records of the Department of State RG.59, National Archives, Washington D.C.
<i>FRUS</i>	<i>Foreign Relations of the United States, 1936-1938</i> Various Volumes
<i>DBFP</i>	<i>Documents on British Foreign policy, 1919-1939.</i> Second and Third Series

PREFACE

THE FALL OF STERLING, 1938-39 AND INTERNATIONAL EVENTS

This graph illustrates events described in Chapters 5, 7 and 8 of this thesis. It portrays the concurrence between the international events of 1938 and 1939 and pressure on sterling's rate of exchange with the dollar. The British authorities were in no doubt that a connection existed between the two, and four distinct phases can be observed.

Before March 1938 the pound-dollar exchange and the level of reserves were stable. It should be noted that even at this stage Great Britain was running a substantial current account deficit, thus weakening the argument that subsequent changes were primarily influenced by this deficit, as would be expected according to classical economic theory.

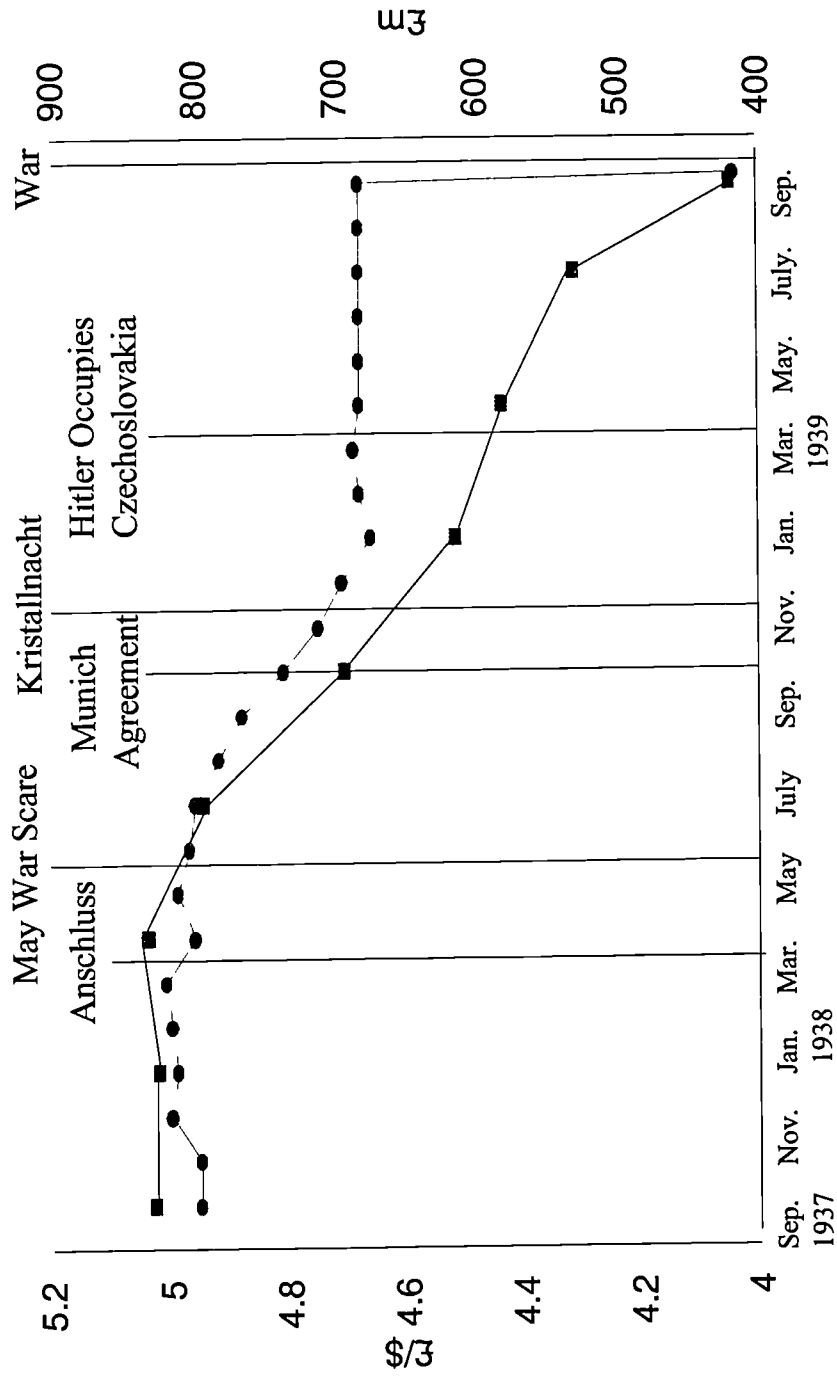
Between March 1938 and January 1939, both the level of gold and foreign currency reserves and the sterling exchange rate against the dollar fell, as reserves were spent to mitigate the pound's decline in preference to the institution of formal exchange controls. These movements began with the Anschluss and gathered pace through 1938. The Munich Agreement afforded scant respite.

Between January 1939 and August 1939, the pound-dollar exchange rate was stable. However, in January the bulk of the gold in the Issue Department of the Bank of England was transferred to the Exchange Equalisation Account for the purpose of supporting the currency. Thus, although the pound was stable, continuing and unabated pressure on the exchanges is indicated by the accelerated decline of gold and foreign currency reserves. The sums involved were more than considerable. The total reserve loss of more than £400 million in the period covered in the graph can be measured against a total budget for the Army of £81 million in the financial year 1937-38.

Finally, as war became imminent, the threat of total loss of reserves forced abandonment of support operations and an instant depreciation of Sterling to \$4.03. Exchange controls were finally introduced on the outbreak of war and this exchange rate became official for the duration of hostilities.

The Fall of Sterling 1938-39

And International Events



E.E.A. Gold & F.C. Reserves —●— £/\$ Exchange Rate

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Back in York but continuing the American theme, I should like to thank Dr. Heidi Schubert for encouragement and support in general and for help with travel arrangements in particular. Ralph Vocke was a beacon of calm and sanity who ensured that I never lost sight of the importance of football. Laurence Brown was a reassuring influence as York's other inhabitant of the interwar period. For unwavering support and help in the final stages of preparation I should like to thank the following future Historical giants, in random order of brains and beauty: Fay Bound, Andy Hopper, Kristel Maxisch, Dave Peacock and Sue Vincent.

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INTRODUCTION

It is generally acknowledged that the British Empire was destroyed by the Second World War, although the process of its disintegration was protracted over subsequent decades. Within this assumption, however, lies the controversial question of the extent to which the War was the root cause of Imperial collapse or simply the agent of the Empire's inevitable demise.¹ It is asserted on the one hand that by "the mid-1930s the British and French Empires were declining as world powers", thus precipitating a scramble to "fill the vacuum".² According to this argument, the structural weaknesses of the Empire were such as to make the most brilliant statecraft an exercise in postponing the inevitable. Conversely, it has also been stated that "until 1936 an Anglo-French alliance would have been the strongest military force on earth, dominant in Europe and easing indirectly Britain's problem of the Pacific". Even allowing for German rearmament, "after 1936 such an alliance would have remained a formidable combination".³ Adherents to the latter view stress the importance of policy in the outcome of history and, following Winston Churchill, seek "to show how easily the tragedy of the Second World War could have been prevented"⁴ had the natural strength of the democracies not been ineptly squandered. The rearmament debate encompasses these extremes, and is the field in which they clash at a fundamental level. Indeed, amongst British historians the debate over the adequacy or otherwise of rearmament is in many ways a continuation of the inter-war political controversy, which echoes the arguments and assumptions of the day.

The resonance through time of the issues of Imperial and national survival demonstrates the critical importance in British history of the events of the inter-war years,

¹ A dissenter maintains that "whatever caused the end of empire it was not the Second World War". However, his conclusion that "in the strenuous conditions of the nineteen-fifties and the nineteen-sixties Britain lacked the economic power, the military fire-power, the expansive thrust for maintaining a world system against the competition of other world powers", seems to suggest otherwise. J.Gallagher, "The Decline Revival and Fall of the British Empire" in A. Seal (ed), *The Decline Revival and Fall of the British Empire: The Ford Lectures and Other Essays* (Cambridge, 1982), p.141; p.153.

² R.J. Overy, *War and Economy in the Third Reich* (Oxford, 1994), pp.32-33.

³ J.R. Ferris, *Men, Money and Diplomacy: The Evolution of British Strategic Policy 1919-26* (Ithaca, 1989), p.186.

⁴ W.S. Churchill, *The Second World War* Vol. 1, *The Gathering Storm* (London, 1948), p.14.

but clouds and distorts historical understanding. This is because the continuing inquest on the performance of Neville Chamberlain draws attention from other significant forces in British public life which had a stake in appeasement, and perpetuates the imprisonment of current debate within the intellectual strictures of British policy-making between the wars. Chamberlain has thus been described as the ‘Guilty Man’ who held back rearmament and then compounded his error with ruinous diplomacy, and conversely as the statesman who frankly appreciated British limitations and bought the time necessary to stave off total disaster in 1940. This curious and continuing dichotomy remains seductive, perhaps because it accommodates many shades of opinion while broadly separating believers in structural weakness from confirmed anti-appeasers. Schmidt remarks that such views, “whether they cast Neville Chamberlain as the ‘villain of the piece’ or whether they attempt to justify his policies - have a part to play in our understanding of the epoch under discussion”.⁵ The effect, however, is unsatisfactory from a historical point of view, as the centre of debate has become fixed in the conflict between the history of Churchill’s victory, which necessarily rests on denigration of Chamberlain, and the work of revisionists who point to its many obvious flaws and untruths.⁶

A.J.P. Taylor, writing in 1961, called for greater objectivity by noting that World War Two “has ceased to be ‘today’ and has become ‘yesterday’”.⁷ It was time to move on from works written of “events while they are still hot”, and although “[n]o one will depreciate such works with the great example of Sir Winston Churchill before him”, Taylor felt that “there comes a time when the historian can stand back and review events that were once contemporary with the detachment that he would show if he were writing of the Investiture [C]onflict or the English [C]ivil [W]ar”. The vitriolic response provoked by these sentiments showed that such a time had not yet come. Although to those born after the appearance of *The Origins of the Second World War* the venom of Taylor’s critics seems more remarkable than his opinions,⁸ we have still not escaped from the controversy. For when a cooler

⁵ G. Schmidt, *The Politics and Economics of Appeasement: British Foreign Policy in the 1930s* (Leamington Spa, 1986), p.3.

⁶ An historiographical account of this phenomenon can be found in M.Cowling, *The Impact of Hitler: British Politics and British Policy, 1933-1940* (London, 1975), pp.2-4.

⁷ A.J.P. Taylor, *The Origins of the Second World War* (Harmondsworth, 1963), p.29.

⁸ See, for several examples, W.R. Louis (ed), *The Origins of the Second World War: A.J.P. Taylor and his Critics* (New York, 1972).

appraisal became possible, revisionists returned to the 1930s, and based their arguments on an archaeological excavation of the case for appeasement, then buried under decades of censure. In effect therefore, both wings of the pre-war political controversy have been recreated, but we have not yet reached the point at which we can “suddenly realise that the [S]econd World [W]ar, like its predecessor, has passed into history”.⁹

If a fresh approach is to be attempted, it is logical that it should begin at the supporting pillar of the existing controversy: the contention that British diplomacy was overshadowed by military weakness, resulting from the inability of the economy to provide and sustain vast armaments. This view was famously encapsulated in Sir Thomas Inskip’s assertion that economic stability could “properly be regarded as a fourth arm in defence, without which purely military effort would be of no avail”.¹⁰ Chamberlain’s modern defenders thus “attempt to turn the tables on the critics by charging them with having adhered to illusions”,¹¹ chief amongst which is a wild overestimate of Britain’s economic capacity between the wars. In the face of this argument, critics of appeasement have been strangely silent. It is reasonable to say, as Chamberlain did, that it is pointless to make threats unless they can be realised, and that the ‘business as usual’ policy pursued by his Government was unavoidable. Therefore, in “judging one policy against another, the historian must know which courses were not open at all, either because of the cost to the economy or the adverse weight of public opinion”.¹²

The relationship between Government and ‘public’ opinion in the 1930s is a recognised area of contention, but the argument that cost determined policy remains largely unchallenged. Indeed, one recent work argues that to ask: “Could more have been achieved if the canons of sound finance had been abandoned?” amounts “[i]n some ways” to “an unfair question”,¹³ although it is not explained precisely why, beyond a brief summary of the fourth arm argument. The logical conclusion of this perspective is that even if Munich was

⁹ Taylor, *The Origins of the Second World War*, p.29.

¹⁰ PRO CAB 24/273, p.268. CP 316(37) Defence Expenditure in Future Years. Interim Report by the Minister for Coordination of Defence, 15th December 1937, p.2.

¹¹ Schmidt, *Politics and Economics*, p.3.

¹² K. Middlemas, *Diplomacy of Illusion: The British Government and Germany, 1937-39* (London, 1972), p.5.

¹³ S. Newton, *Profits of Peace: The Political Economy of Anglo-German Appeasement* (Oxford, 1996), p.69.

a wasted chance to check Hitler, with the diplomatic weaponry of bluff and alliances but without a massive British military contribution, bare survival in 1940 was the best that could possibly be achieved by the rearmament process.¹⁴ Even this meagre return can be credited to the ‘extra year’ gained by appeasement.

Defenders of Chamberlain stress the economic limitations of rearmament in just this way, accusing his critics of ignoring the hard economic facts and adopting anachronistic and bogus arguments. It was, therefore, “untrue that ‘deficit finance’ capable of being applied as if by magic by Keynes, or those who ‘listened’ to him, could have increased the resources available for rearmament”.¹⁵ This linkage of past and present can lead to a singular blurring of tense. A recent example is provided by Hobsbawm, an adult in the 1930s, in stating that: “A Second World War, it could safely be predicted, would ruin the British economy, and disband large parts of the British Empire.”¹⁶ The identification of economic ruin with renewed warfare was central to the National Government’s case for appeasement and remains so, long after the shadow of the bomber has faded away. It would seem, therefore, that the current attitudes concerning the strength of the Empire between the wars rest upon the validity of the fourth arm argument. If it holds good, the case for Chamberlain and believers in structural British weakness has to be recognised as unanswerable, but if it should prove false then a whole range of assumptions concerning the demise of Empire would have to be reconsidered.

No effective counter to the enduring fourth arm argument has yet been attempted. The dated Churchillian thesis rests on “the traditional yardstick of balance-of-power politics”,¹⁷ which criticises Chamberlain’s diplomatic record and simply assumes Britain’s economic ability to rearm. A more recent variant of this theme attempts to turn the tables yet again by demonstrating that economic weakness made still greater the enormity of Chamberlain’s

¹⁴ Ibid., pp.68-69.

¹⁵ R.A.C. Parker, “British Rearmament 1936-9, Treasury, Trade Unions and Skilled Labour”, *English Historical Review* 96, (1981), p.314. This position is also taken in the following influential articles: R.A.C. Parker, “Economics, Rearmament and Foreign Policy: The United Kingdom before 1939: A Preliminary Study”, *Journal of Contemporary History* 10, (1975), pp. 637-647; and G.C. Peden, “A Matter of Timing: The Economic Background to British Foreign Policy, 1937-1939”, *History* 69, (1984), pp.15-28.

¹⁶ E. Hobsbawm, *The Age of Extremes: The Short Twentieth Century, 1914-1991* (London, 1994), p.154.

¹⁷ Schmidt, *Politics and Economics*, p.3.

diplomatic blunders.¹⁸ Such perspectives leave the fourth arm argument untouched as a justification for prudence in policy. Alternatives to appeasement can be made to seem like reckless gambles based on bluff by, logically enough given the terms of the debate, reconstructing the arguments used so successfully by the National Government to keep its critics at bay before the war. Significantly, favourable assessments of the interwar Imperial economy made by economic historians have not been used to effect in the diplomatic and political fields of study.¹⁹ This is perhaps not surprising, as the full importance of Imperial economic potential was deliberately downplayed in the formulation of the fourth arm policy, and this pre-war policy manoeuvre continues to hinder the adoption of a wider perspective.

Middlemas has realised that having “relied most heavily on Government archives, there is a danger that the conclusion might be one which the Government itself would have wished to perpetuate”.²⁰ The most obvious manifestation of this tendency is in the confusing effect on historians of the fragmentary, or departmental, appearance of the British governmental machine and their reliance on the mechanism evolved to overcome this. This was provided by the creation of the Cabinet Secretariat after World War One, which has been praised for introducing a “newer model of streamlined efficiency”. This answered a “formidable intensification of the pressure and strain of public business”²¹ since the beginning of the twentieth century, by delegating many policy debates to a system of inter-departmental and Ministerial committees, thereby saving Cabinet time. The Secretariat was not, however, universally applauded: Sir Frederick Leith-Ross, whose experience of the system of government at this time was second to none, argued that it complicated the process of government and that the “proliferation of committees” led to the administration

¹⁸ C. Barnett, *The Collapse of British Power* (London, 1972), epitomises this approach. Barnett combines contempt for political liberalism with a commitment to liberal financial orthodoxy worthy of Montagu Norman.

¹⁹ For example, B.J. Eichengreen, *Golden Fetters: The Gold Standard and the Great Depression, 1919-1939* (Oxford, 1992); S. Howson and D. Winch, *The Economic Advisory Council, 1930-1939: A Study in Economic Advice During Depression and Recovery* (Cambridge, 1977); and I.M. Drummond, *The Floating Pound and the Sterling Area, 1931-1939* (Cambridge, 1981), are among works indispensable to a serious study of British war potential.

²⁰ Middlemas, *Diplomacy of Illusion*, p.8. The point has recently been repeated by McDonough, though he is apparently unaware of the problem in the field of defence finance, and thus of its scale and wider importance. F. McDonough, *Neville Chamberlain, Appeasement and the British Road to War* (Manchester, 1998), p.7.

²¹ W.K. Hancock & M.M. Gowing, *British War Economy* (London, 1949), p.41.

“becoming Chinese - perhaps I should say Byzantine - in its complexity”.²² Nevertheless, Leith Ross for one possessed the mandarin’s ability to use this apparently unwieldy machine nimbly and to precise effect, as he demonstrated in his nicely timed attack on the Ottawa system at the end of 1936.

The machinery of government seemed more confusing from the outside than from within, a phenomenon which it is hard to regard as being entirely coincidental. Professional civil servants, who worked in the system through their entire careers, could exploit their unrivalled knowledge of its intricacies to great effect, and thereby exert a great and, for contemporaries, nearly untraceable influence on policy. This feature of the interwar system has not lost its potency and historians fall victim to it when, for instance, poring over Cabinet minutes they are confronted by the testimony of a specially called civil servant or the conclusions of an official Committee, and assume, like the Ministers before them, that they have been presented with the last word in technical expertise. An excellent example of this tendency can be seen in the uncritical, and indeed often favourable, reception given by historians to Sir Richard Hopkins’ incredible apologia to Cabinet in July 1939 for the failings of the fourth arm policy.²³ Those sympathetic to the fourth arm argument, though critical of hindsight, neglect to mention that this occasion was something of an ordeal for Hopkins, whose arguments were assailed bitterly and at length by the Secretaries of State for War and Air.

There are other dangers for historians in arguing from the basis of the reconstructed official apparatus than a tendency to absorb the Government line. If it was natural in the formulation of policy to conceal awkward information, policy makers themselves were also misled by the weaknesses and omissions of the system, which could cause them to overlook or undervalue crucial information. This disarming of the critical faculty is particularly evident when the potentialities of Britain and the Empire as economic foundations for the prosecution of war are considered. The effects of determining policy by committee were not necessarily malign, but in matters of great national importance requiring the widest possible

²² Sir F. Leith-Ross, *Money Talks: Fifty Years of International Finance* (London, 1968), pp.52-53.

²³ For example, see D.C. Watt, *How War Came: The Immediate Origins of the Second World War, 1938-1939* (London, 1989), p.307; Parker, “Economics Rearmament and Foreign Policy”, pp.643-644; Newton, *Profits of Peace*, pp.114-117; G.C. Peden, *British Rearmament and the Treasury, 1932-1939* (Edinburgh, 1979), pp.102-103.

consultation, the limitations of the system in terms of democratic accountability were extremely damaging. This was particularly true of Imperial defence, a field which involved many Government Departments in its various aspects. Here, government was guided by the machinery evolved during the First World War which, like the Cabinet Secretariat, was held to be a great administrative success applicable to any future contingency, rather than a product of its time.

Within the Committee of Imperial Defence (CID) and its numerous sub-committees, seemingly every aspect of national organisation for modern warfare was covered, and as the Second World War approached, many of the plans formulated inside the CID on the basis of Great War experience were adopted by the Government. There was, however, a glaring omission in the vital area of war finance, which transcended the scope of military planning. The CID worked on the assumption that Germany would again be blockaded in the event of war, and on the basis of its recommendations the creation of a Ministry of Economic Warfare was approved in 1938. Despite its impressive title, the Ministry would be concerned almost exclusively with the enforcement of the blockade, which would require a considerable period of time to be effective. The other side of the coin was that Britain must be able to finance its own war effort while this attritional process occurred, and the stark fact of the matter, as Government insiders admitted to themselves in private, was that weeks before war broke out in 1939, no effective and coordinated mechanism of war finance had been formulated.

In the 1920s questions of war finance had been explicitly removed from the CID machinery to become the sole responsibility of the Treasury, and this move exerted a coercive influence on official thinking that survived until the Second World War. The Treasury's insistence that it was essential to maintain financial stability in peacetime if a strategy of economic attrition in war was to be effective was nothing more than the application of its normal peacetime ethos to the strategic sphere, which ensured the dominance of a liberal civilian frame of mind. In the First World War, normal financial machinery had been maintained because of the availability of massive credit in the United States, which was used to finance external expenditure and even support sterling on the exchanges.²⁴ When the Treasury gained control of War finance in the 1920s there was no reason to assume that this avenue would not again be open. Even at this stage, therefore,

²⁴ K. Burk, *Britain, America and the Sinews of War, 1914-1918* (London, 1985), provides a comprehensive account of Anglo-American financial dealings in the First World War.

the prospect of U.S. support could be used to justify inadequate contingency planning, and to keep the lid on the dark protectionist forces associated with wartime economics.

When the fourth arm policy was formulated, the Treasury constituted its organisational base and the Department's assumptions endured until remarkably late in the day. In the early years of rearmament the Treasury position appeared to be valid, and thus remained undisturbed. Between 1935 and 1937 it has been argued, "lack of industrial capacity meant that all defence expenditure could be met out of revenue"²⁵ and the £800 million raised subsequently by two defence loans did not destabilise the economy. However, this slowness of expenditure was caused by simply placing orders and letting private firms sort things out for themselves. Direct intervention by the state to push rearmament along was limited to the financing of a number of 'shadow factories' for the R.A.F. and coordinating administrative arrangements, such as the creation of the Treasury Inter-Services Committee. This adherence to 'business as usual' was exposed as inadequate when the pace quickened, but the policy remained unshaken.

The historian who argues from the official record is thus faced with a persuasive argument in favour of financial limitation, based on a dangerously narrow and heavily ideological perception of the interwar economic situation. This is in effect to share the plight of the Chiefs of Staff Sub-Committee of the CID, which felt bound to state that in the conditions likely to prevail in 1937 "only very great military and financial strength can give the Empire security".²⁶ This pessimism has been taken as a tacit acceptance that "such military and financial strength did not exist, and never could".²⁷ However, the Chiefs were bound to the Government's spending limits, and regardless of what they might have thought to be possible they could, in the circumstances, only appeal to diplomacy to remove the threats that the Services would not be equipped to face. The doleful influence of civilian financial orthodoxy on expert military advice meant that Chamberlain could both retard the rearmament process and plausibly argue that "until our armaments are completed we must adjust our foreign policy to our circumstances".²⁸ But what were Britain's circumstances?

²⁵ Peden, *British Rearmament and the Treasury*, p.105.

²⁶ COS 560, Annual Review for 1937, 22nd February 1937. Quoted in Barnett, *Collapse of British Power*, p.440.

²⁷ Ibid.

²⁸ Chamberlain to Mrs Morton Prince, 16th January 1938. Quoted in K.G. Feiling, *The Life of Neville Chamberlain* (London, 1946), p.324.

Before any considered opinion concerning British economic decisions as they relate to rearmament can be reached, a far more searching and intensive analysis of economic 'reality' has to be undertaken than has hitherto been the case.

The British Empire, with a population of 490,000,000 in 1931, "was the source of nearly 60 per cent of the world's rubber, over 50 per cent of the world's chrome, 46 per cent of the tin and 70 per cent of the gold".²⁹ Statistics for food production were equally impressive. Faced with such raw strength, Hitler believed that Germany was faced not with one massive rival in the United States but with two, and "could not in the long run compete with the British Empire and the United States, whose huge internal markets seemed to him to give them insuperable advantages".³⁰ The effective use of the economic weight of the Empire in fact provoked one of the most heated and extensive ideological struggles of the interwar years and one in which the advantage see-sawed according to the international situation. The blueprint of an imperial war economy formulated in 1918 faded with the peace. The orthodox liberal view of international finance then dominated when British defence plans were formulated in the 1920s, before suffering grievous and apparently fatal setbacks with the onset of depression and Britain's ignominious departure from the gold standard in 1931. This was followed by the adoption of extensive protection of the British economy and the formalising of Imperial preference at the Ottawa conference in 1932.

The spontaneous formation of a sterling bloc also followed the departure from gold, when "most of the Dominions and some other countries, all having strong commercial ties with Britain and large sterling holdings, followed suit and pegged their currencies to the pound".³¹ This development further strengthened Britain's position at the heart of the new Imperial economic system. Another reaction to the gold standard disaster was the creation of the Exchange Equalisation Account, a fund to manage the sterling exchange rate and decouple the British domestic economy from the damaging effects of international capital movements. With these sweeping new measures it appeared as if Britain and the Empire were moving towards a form of flexible autarky, whereby the concentration of capital

²⁹ Barnett, *Collapse of British Power*, p.72.

³⁰ D.E. Kaiser, *Economic Diplomacy and the Origins of the Second World War: Germany, Britain, France, and Eastern Europe, 1930-1939* (Princeton, 1980), p.59.

³¹ D. Reynolds, *The Creation of the Anglo-American Alliance, 1937-1941: A Study in Competitive Cooperation* (London, 1981), p.14.

expenditure at home would make Britain the growth engine of the sterling bloc. The results were impressive. In the Great Depression, the British economy did not fall as far as those of the U.S. and Germany, and its recovery from a shallower trough matched Germany's and left the U.S. trailing. The impressive record of recovery and growth manifested by the British economy and its satellites after 1931, appeared to reinforce the credibility of the new system. It was certainly a marvellous basis for a war economy. The liberal cause was not dead, however. The stakes had simply been raised, and with the onset of rearmament they were raised still further.

It becomes clear with consideration of the post-1931 economic record that the formulation of the fourth arm policy constituted something more than a British struggle against the dispiriting arithmetic of power. If it implied that British finance would be organised as in the First World War when "the makers of financial policy throughout the war confined themselves within the orthodox budgetary tradition" and even their critics "appealed, in the main, to the ideas of Gladstone",³² it does not follow that such a policy was appropriate to the very different conditions of the 1930s. In the absence of any contemporary political consensus on the economic possibilities of Britain's situation, it is not sufficient to accept the fourth arm viewpoint as the simple expression of obvious truth.

The argument that the official position concerning British financial weakness was based on the unanimous opinion of experts does not answer the case. Cabinet committees were asked specific, often leading, questions, to which they gave specific answers. Policy remained to be made by those who had the will to assert their views and the power to do so, and indeed control of the Committee system facilitated central political control. The question needs to be asked as to who precisely was in command and what were their motives. If Chamberlain was willing to rest the case for appeasement on economic 'weakness', and the Treasury, supported by a liberal financial press, was willing to play along past the point of recklessness for the sake of fiscal probity, then these actions seem consistent with the forging and operation of a political coalition. The adoption of the fourth arm argument involved the construction of a global economic position and the imposition of this outlook, in alliance with other sympathetic official and public voices, on the political arm of the Government.

The creation of a coalition of political forces, however, implies the existence of an

³² Hancock and Gowing, *British War Economy*, p.9.

opposition, and indeed, the bitter argument over the pace and scale of rearmament cut across party lines. There was more than sufficient hostility to the idea of ‘business as usual’ to form an opposite political constituency based on accelerated military preparation utilising the physical resources of the Empire. The fourth arm argument was far from possessing universal political appeal to the Conservative Party which, though dedicated to the maintenance of existing patterns of business and commerce, was equally and fundamentally wedded to Imperial preference and the protection of the domestic economy. Free trading Liberals were appalled by Hitler’s methods and despite the vocal pacifists of the Labour Movement, the unwavering hostility of the T.U.C. leadership to Nazism and their willingness to rearm provided a more accurate reflection of working class feeling. There was in fact no shortage of support for the idea that Hitler was more dangerous than an unbalanced budget. The failure of these views to overcome the fourth arm policy, however, mirrored the startling reverses suffered by the Ottawa system after 1936. This was no coincidence.

Despite, and paradoxically because of, the success of the sterling bloc and the new policies of protection and Imperial preference, the liberal economic doctrine staged an impressive recovery in the middle of the decade, when powerful liberal forces in Britain declared the economic crisis over and a return to free trade normality desirable. They were aided by a simultaneous American assault on the Ottawa system. These events have received attention but are generally linked as aspects of a failed attempt at the economic appeasement of Germany.³³ It was the case that Britain’s economic preparations for war became the front line in the ongoing struggle between liberal and mercantile ideologies, but in this context, the intervention of the United States is of far greater significance than the effort to accommodate Hitler. This is because Cordell Hull’s intervention in British politics was the springboard for the liberal capture of the official position on the economics of rearmament, which then prevented any development away from the orthodoxy of the 1920s. This could not have been done without American help and it had to be done, for this ground could not be left vacant. Nor could an inch of it be conceded once won, for to let the protectionists into defence would surely turn Britain economically, in Sir John Simon’s words, into “a

³³ Schmidt, *Politics and Economics*, p.131-133. Perhaps because Schmidt’s impressive work concludes in 1937, he underrates the importance of Hull’s intervention in the British debate, the full effects of which were not fully felt before 1938. He also cites apparent Government hostility to Hull’s approach, ignoring the effects on the Civil Service and the concurrent impact of the Tripartite Agreement, both of which took time to work through into the political arm of Government.

different kind of nation".³⁴

A booming economy further strengthened by rearmament, as later was that of the United States, could not have been expected to return to a liberal framework. The inter-war system of defence planning discouraged reappraisal of fundamental concepts, and served admirably as the heart of a rigid policy. Once the fourth arm policy was in place, therefore, no compromise with its critics was possible, and in fact the system was precious to its adherents, who were willing to take risks with national security rather than compromise existing beliefs. The suitability for its purpose of the fourth arm policy can be judged by the fact that its hold was not broken until war came, though the political aspect of appeasement had then been driven back all the way through peacetime conscription to tripwire guarantees of eastern allies.

The German and American influences on British power between the wars are particularly important to an analysis of British war potential. Indeed, the U.S. intervention on behalf of British liberal opinion was based on a knowledge that some action to change the existing British predominance in the international economy was essential. Consideration of contemporary foreign opinion also avoids the damaging effects of Keynesian hindsight. By ascertaining, as far as possible, the scope of political and economic knowledge available to the British protagonists, we can construct a guide in the explanation of why some ideas took root in policy and others did not. From such a perspective it becomes clear that the economic policy assumptions of the British Government were perverse by prevailing international standards. The consideration of foreign attitudes yields another important benefit in that it forms a useful counterbalance to the continuing British tendency to adopt a narrow parochial outlook. This unconscious introspection tends to result in the assumption that perceived British weaknesses were as obvious to potential enemies as they were to the British Government. In fact, the two powers that would exert the greatest influence upon the future of the British Empire, the United States and Germany, were equally prone to take counsel of their fears and it will be argued that they had at least as much reason as the British to do so.

German attitudes towards Britain between the wars were based on the bitter experience of defeat in World War One and the envy of the outsider. Consequently, the

³⁴ PRO CAB 23/93, p.125. Cab.18(38) Cabinet Minutes, 6th April 1938, p.24.

many conservative factions in German political and administrative life each developed policies for German resurgence based on detailed examination of the power that had beaten them. The cause of the German defeat was held to be economic, but the inference drawn was not, as in England, that the classical economic system was the foundation of victory, but that the allies had physical control of limitless resources and possessed the ability to deny them to the Central Powers. The need, therefore was to create a Germany which, in the words of Ernst Bohle, founder of the Nazi 'Auslandsorganisation', "would, in every respect, enjoy absolute equality with England in the concert of world powers".³⁵ This realisation gave new force to a highly developed German economic tradition expressed in the concept of 'Mitteleuropa', which insisted that German security could only be based on absolute self-sufficiency, which could itself be achieved by German domination of east and central Europe. This doctrine, developed in the nineteenth century, was given new impetus when the First World War appeared to demonstrate the need for an imperial economic system which could save Germany from the effects of British blockade.

The Army believed that its prowess on the battlefield had been cancelled out by the inadequacies of the home front, and inspired by the later General Georg Thomas, it developed the idea of 'Wehrwirtschaft', the defence-based economy, and set out to ensure that in future, as in Britain, the economy in war would be made to serve the needs of the armed services. Thomas stated that "the concept of Wehrwirtschaft is a creation of our time", which was "born out of the experiences of the Great War of 1914-18",³⁶ and the lessons of the war were not studied only by the Army. The German Foreign and Economics Ministries were identified with the concept of Mitteleuropa, and the Nazis, whose memories of the privations of war were rather more acute than those of the Wilhelmine elites, radicalised existing conservative notions into the crudest form of imperialism. The drive for autarky and Hitler's direct, though fleeting, achievement of Mitteleuropa demonstrated a basic consistency in German revisionism. It was essential in future to ensure that Germany could not again be undermined by the vulnerability of her economy.

The distance between British and German official thinking is most strikingly revealed in the contrast between assessments of British power. The British were conscious only of

³⁵ R.M. Smelser, "Nazi Dynamics, German Foreign Policy and Appeasement", in W.J. Mommsen & L. Kettenacker (eds), *The Fascist Challenge and the Policy of Appeasement* (London, 1983), p.36.

³⁶ G. Thomas, *Geschichte der deutschen Wehr- und Rüstungswirtschaft (1918-1943/5)*, W. Birkenfeld (ed), (Boppard am Rhein, 1966), p.51.

the limitations of their financial system, and ignored their economic strength. An aim of German policy, however, was to reach after many years a position of 'Weltmacht', equivalent in command over raw materials, the pillars of economic strength, to the United States and the British Empire. Hitler's flouting of British wishes in diplomacy can perhaps be explained by his belief that Britain was governed by incompetents, but the Anglo-German payments agreements of 1934 and 1938 were negotiated on terms favourable to London, reflecting a shrewd German grasp of economic realities. Germany could take no direct action against the British economic system, and indeed the British could have strangled the German economy at any point before 1938 by denying it foreign exchange. Although no such intention existed in peacetime, it was wise not to rock the boat until Germany could secure foreign supplies in her own way.

German opinion in the interwar years, however, shared with British liberalism a tendency not to differentiate between the interests of the British Empire and the United States as great powers. Either of them was potentially overwhelming and the physical reality of Anglo-American co-belligerency for Germany was to be utterly eclipsed by allied war potential, which was effectively limitless. A senior German officer, writing after 1945, noted gloomily that by the end of 1941 "Russia was receiving replacements and equipment from the inexhaustible resources of the British Empire and the U.S.A."³⁷ This perspective obscured the competitive edge to the Anglo-American economic relationship, and the lapse was understandable. This was a struggle that took place largely in secret, with lines drawn both between and within the respective Governments. Though both sides usually managed, for their own reasons, to present an amicable front to the world, until 1939 the Germans were able to reach economic accommodation with Britain, whereas the American attitude, led by the State Department, was far more aggressive.

In the United States, as in Germany, the wealth and power of the British Empire were assumed rather than debated. In 1921 the U.S. Navy Board saw the immediate future of the Empire in terms of continuing "naval supremacy", the "domination of world markets" and the "acquisition and control of oil fields".³⁸ It would be easy to attribute such foreign respect for British power to natural caution and factual ignorance, but between the wars the Americans saw the powerful financial position they had established at the end of World War

³⁷ F.W. von Mellenthin, *Panzer Battles* (London, 1955), p.429.

³⁸ S.W. Roskill, *British Naval Policy Between the Wars* Vol. 1, *The Period of Anglo-American Antagonism, 1919-29* (London, 1964), p.24.

One eroded. The Great Depression hit the United States much harder than Britain, to the latter's relative gain, and shattered American dominance of the international economy. Moreover, as the British made good use of the chaotic situation to create a new economic order, their advantage solidified and went from strength to strength, until a German writing in 1939 could observe that although, after the Great War, "it looked as though London's rôle was going to be taken over by New York", the City of London had "proved stronger" and was "once again the world's banker",³⁹ having regained its pre-eminence within the international capitalist system.

U.S. opinion was keenly aware of these developments and President Roosevelt asserted famously in 1936, the high water mark of the new British system, that "when you sit around a table with a Britisher he usually gets 80% out of the deal and you get what is left".⁴⁰ In contrast to Germany's openly revisionist position, though, Anglo-American commercial rivalry in the years after World War One could be described as a contest conducted according to mutually accepted rules. The collapse of gold as the universal medium of exchange, however, and a cruder form of competition based on physical resources (exemplified by the creation and growth of the sterling bloc) clearly showed that the United States faced a serious economic challenge. Roosevelt warned in October 1937 of the danger that the U.S. could become "a tail to the British kite".⁴¹

By 1934 the domestic orientation of the New Deal had clearly failed to do more than mitigate the effects of the Great Depression, and almost in desperation the U.S. attempted to draw Britain into currency and trade pacts. It had become clear that the resumption of America's economic dominance of the 1920s, and the shifting of the huge post-depression surpluses of primary products, depended on the re-establishment of a liberal trading system or, in other words, American penetration of the Imperial economic system. To this end, the previously marginalised Cordell Hull and the State Department became the spearhead of the American effort. At this stage, as has been noted, Hull became a player in the British domestic fight between liberalism and protection. So, too, did Henry Morgenthau Jr., the Secretary of the U.S. Treasury Department. His initiative led to the conclusion of the Tripartite Currency Agreement in September 1936, which precluded the competitive

³⁹ Count Pückler, *How Strong is Britain?* (London, 1939), p.89.

⁴⁰ D. Reynolds, *The Creation of the Anglo-American Alliance*, p.25.

⁴¹ *Ibid.*

devaluation of the pound, dollar and franc. The agreement gave an impetus to the liberal cause in Britain which was out of all proportion to the significance of its provisions. It is difficult at this remove to comprehend how futile seemed U.S. attempts to influence Britain's economic progress, and the U.S. itself could do little to force its views on London. Yet, by becoming involved in the British domestic debate at a time when the need for rearmament was posing fundamental economic questions, Hull and Morgenthau succeeded beyond Roosevelt's wildest dreams, for the liberal view gained ascendancy and Britain changed economic course of her own free will, with disastrous consequences for her ability to wage war.

The dreadful consequences of 1936 were not immediately obvious but were real nevertheless. Before the Anschluss in March 1938, Britain abandoned her original intention to rely on Imperial and sterling bloc resources for the purposes of rearmament, and commenced negotiations for a Trade Agreement with the United States. At the same time the fourth arm policy for limited rearmament within the framework of 'business as usual' was officially formulated.⁴² These measures effectively meant the victory of liberal economics. Everything was to be staked on the preservation of the liberal international system and, if appeasement failed, dependence on the United States. The assertion of peacetime thinking embodied in the fourth arm policy was thrown into cruelly sharp relief after the Anschluss. At this point, as the Minister for War Leslie Hore-Belisha observed in Cabinet, a period of undeclared war commenced. This was effectively announced by the onset of speculative pressure against the pound and the franc, and a massive flow of gold and currency across the exchanges to the relatively safe haven of the United States.

The fall of sterling was of fundamental importance to British strength for reasons other than the sums of money involved, although these were colossal, because: "Money means command over resources and command over resources means power".⁴³ A threat to British power was reflected by a threat to British currency. This was a fundamental truth of the new

⁴² R.P. Shay Jr., *British Rearmament in the Thirties: Politics and Profits* (Princeton, 1977), and G. Post Jr., *Dilemmas of Appeasement: British Deterrence and Defense, 1934-1937* (Ithaca, 1993), are the best accounts of the explicit formulation of the fourth arm policy within the machinery of Government, though neither considers the American impact on war potential or the important impact of international economic events in 1938-39.

⁴³ R. N. Gardner, *Sterling-Dollar Diplomacy: the Origins and Prospects of our International Economic Order* (New York, 1969), p.xxii.

world of economic blocs, for which liberal Britain had little enthusiasm, and of the new blurring of the distinction between peace and war, which the British authorities simply failed to comprehend. In the economic sphere, this period of undeclared war saw the playing out of the policy positions formulated since 1936, combined with revelation of weaknesses in official British thinking and administration that had become ingrained in the decades since World War One. Shaped by these forces, British actions in 1938 and 1939 possessed a certain internal logic, but in the context of Britain's need to prepare for war they were simply suicidal.

The assault on sterling forms the essential backdrop to the annihilating effects of the fourth arm policy, for at this time the gaps in the system relating to external finance, rather than domestic expenditure, were cruelly revealed. The organisation of defence machinery in the 1920s had failed to provide a financial framework for defence, and in the honeycombed system of British government there was no centre of responsibility or organisational structure concerned with the preparation of the British economy for war. Consequently, the Stamp Survey of 1939 revealed an absolute lack of any preliminary work in this area, and there was, therefore, no voice from the machine which could be raised to alert the Cabinet to the dangers of the prevailing liberal policy. This saw the drain of reserves that would be vital in war as a normal peacetime function of the economy.

During the currency crisis the liberal credentials of the Bank and the Treasury were impeccable, although the Bank's nerve became progressively unhinged by the sheer scale of the assault on sterling. Though there was some voluntary tightening of market freedoms in December 1938, the preferred defence of sterling between March 1938 and August 1939 was to hurl the gold and currency that would otherwise have formed a war chest across the exchanges to bolster the pound. Consequently, in January 1939 "all the gold" deposited in the Bank of England since 1931 was transferred to the Exchange Equalisation Account to provide "the maximum resources with which to combat bear speculation against the pound".⁴⁴

This battle for sterling was, however, a secret fight. The Germans, whose actions created and fuelled the crisis, were unaware of the scale of the problem. In America, the State Department, which had done so much to help the liberal victory in England was not directly involved in the currency crisis. Morgenthau's Treasury Department and the Federal

⁴⁴ Peden, *British Rearmament and the Treasury*, p.99.

Reserve Board looked on like privileged yet appalled spectators of a battle, which might at any moment spread out and engulf them. They wondered, from time to time, why the British did not impose exchange controls of the type they had recommended to the French, that were a fact of daily life in Germany and which, as the British acknowledged, could have stopped the drain at once. The British view, however, consistent with fourth arm thinking, was that the imposition of exchange control was disruptive of normal trade, a measure to be applied only on the outbreak of war. The Bank of England first addressed the matter “in the summer of 1937” and it was “discussed between the Bank and the Treasury during the next eighteen months”.⁴⁵ Even when war broke out and a system of exchange control was introduced, however, it “contained gaps which did not exist in the German system”.⁴⁶

The acceptance of the German economic challenge by the adoption of exchange controls to bring an end to Hitler’s influence on the value of sterling was an option available to Britain, but unacceptable to the National Government. The chances of the issue becoming politically active, though, were effectively reduced by the secrecy of the authorities. The British Cabinet and Parliament were less well informed of the state of the reserves by Bank and Treasury sources than was the American Government, and they had to rely on periodic briefs from the Treasury, read out by the Chancellor. The Treasury’s report to the Cabinet in July 1939 which revealed that “in 15 months of international tension nearly 40 per cent of our gold stock has disappeared”,⁴⁷ and that with the reserves that remained war could not be prosecuted beyond the end of 1941, would have astonished foreign governments. As recently as May 1939, Hitler had expressed the opinion that any war with the British Empire could only be won after “ten to fifteen years”⁴⁸ of struggle. Even after the outbreak of war he was to tell his senior military commanders on 23rd November 1939 that “time is working for our adversary”.⁴⁹ Even the American Government, which was fully informed after November 1938 of the state of British gold and foreign currency reserves, also thought

⁴⁵ Hancock and Gowing, *British War Economy*, pp.108-109.

⁴⁶ *Ibid.*, p.109.

⁴⁷ CAB 24/287 CP 149(39). Unusually, this paper is also appended to CAB 23/100 Cab. 36(39) Cabinet Minutes, 5th July 1939.

⁴⁸ W. Carr, *Arms, Autarky and Aggression: A Study in German Foreign Policy 1933-1939* (London, 1972), p.112.

⁴⁹ B.H. Liddell-Hart, *The Other Side of the Hill: Germany’s Generals Their Rise and Fall, With Their Own Account of Military Events 1939-1945* (London, 1948), p.116.

that Britain could finance the war comfortably by liquidating a fraction of her immense overseas assets, believing as late as November 1940 that Britain possessed \$2.5 billion worth of readily convertible assets in the U.S. alone.⁵⁰ Then, of course, there was always the Empire.

Even here, however, policy had done fatal damage. The buried 1918 report of the Dominions Royal Commission had pointed out that in any future war, Britain would require guaranteed and developed sources of supply. The sterling bloc would have formed an ideal basis for this, and intensification of the Ottawa system in association with exchange control could have made the bloc, unlike Nazi Germany, a self-sustaining economic unit. In November 1938, however, the signing of the Anglo-American Trade agreement made permanent the paralysis in the development of the bloc that had occurred during negotiations, and, worse, undermined its wartime potential by allowing U.S. manufactures into the colonial market. It also strengthened the hand of those like Halifax who felt that America could be relied on to provide all necessary supplies without thought of gain once war broke out, notwithstanding the Neutrality and Johnson Acts which proclaimed that this was specifically what she would not do.

Some idea of the opportunity cost of the fourth arm policy is also provided by the currency crisis, which reflected coincident ideological shifts of great significance. By March 1938 the U.S. was in the grip of the renewed 'Roosevelt' recession, and almost as an ad hoc policy, the Treasury Department decided to feed its accumulated gold reserve into the economy to stimulate credit formation. Gold from Britain sustained this flow and directly supported American recovery, though the U.S. Treasury was slow to realise it. By 1939, having stumbled across the multiplier, the Federal Government was driving to achieve a national income of \$80 billion a year as quickly as possible, from a low point of approximately \$65 billion at the beginning of 1938. This aim would be supported by massive British and French orders for weaponry, to be fashioned in U.S. factories that did not yet exist - further evidence of Britain's decision to avoid the development of its own resources.

The chasm between British thinking in 1939 on the one hand, and German and American perceptions on the other, is here fully revealed. In increasingly desperate circumstances, the British Government became still more fiercely attached to the precepts of liberal economics, equating finance not only with economic strength, but also with

⁵⁰ Reynolds, *The Creation of the Anglo-American Alliance*, p.153.

political freedom. The effectiveness of the German 'Schacht' system was no longer denied but it was interpreted as the economic expression of a repugnant totalitarian ideology, unsuitable for emulation by a free people. However, at the same time the United States had resolved its long struggle between financial orthodoxy and the New Deal, and was grasping the opportunity to climb out of depression provided by the influx of European funds. There is no evidence that the recovery born of this bonanza of credit creation in any way eroded American democratic freedoms, but the decisive United States move towards a more Keynesian attitude to national finance widened the gulf of economic understanding between London and Washington, even as it destroyed the balance of power between them.

In Britain, opportunist Keynesianism of the American variety was utterly rejected in the defence sphere, even though the role of the existing rearmament programme in sustaining Britain's recovery was acknowledged within the Treasury. The impossibility of changing course without revealing shocking deficiencies was a major consideration. When some action in this area was made necessary by political pressure, and Lord Stamp's survey was set up, the stark facts revealed were successfully hushed up by Sir Horace Wilson. Just as the policy of appeasement was indicative of a desire to avoid war at high political cost, the squandering of the gold reserve demonstrated the economic price that Britain was willing to pay to avoid disruption of the liberal financial system. For, in the months before war, dependence on the United States was the only hope: to preserve the international liberal system, to preserve the Government and, finally, to fight the war. Between March 1938 and July 1939 British losses of Gold and foreign currency, at £400 million, were equivalent to more than four times the Army's budget for 1938-9, a comparison which places in context the lengthy and bitter struggle over whether or not Britain could afford to equip five divisions for continental service.

The choice of liberal economic priorities favoured over more appropriate alternatives imposed terrible dilemmas on the British Government, which became enmeshed in a web of paradox. The longer the British operated the fourth arm policy and resisted warlike economic measures in conditions of undeclared war, the worse the economic situation became. The worse the economic situation became, the sooner Britain would have to risk a decision with Hitler, if war were the only circumstance in which warlike economic measures were to be taken. The viability of fourth arm economics was a gamble on the hope that war would be avoided and normal life resumed. Ironically autarkic measures might have

provided Britain with the economic stability required to postpone the fight. But the economic policy predicated on the avoidance of war was actually pushing Britain towards a fight, as well as increasing the perils of the war when it did come. The political stance of the Chamberlain Government, in contradiction to the available possibilities, had been throughout 1938 and 1939 to placate the United States and delay war with Hitler. To this end the autarkic potential of the Empire was weakened to please the Americans, and reserves were permitted to drain away in the hope that appeasement would save the day for 'business as usual'. In the event, Britain entered World War Two with attenuated reserves and a devalued currency, "the worst possible outcome".⁵¹

The economic indignities of the British experience in World War Two and after are well documented. The gold reserves that survived in September 1939 were in no way sufficient to insulate the Empire from American demands for payment in cash for essential imports, especially after the collapse of France, until Imperial autarkic capacity had been developed. This process had in itself been fatally retarded by the liberal victories of 1936-37 and the protracted negotiations for an American Trade Agreement. The consequence was that during the war the "economic cement of Empire"⁵² crumbled away, as the end of the Imperial economic system was the ultimate price of American support. This outcome, though, was far from inevitable: the pre-war National Government was by no means compelled to act as it did, and the policy it pursued after 1936 represented a sharp reversal of the post-1931 course of imperial economic development. It also amounted to an all or nothing gamble. The financial catastrophe of 1938-39 resulted from this change of direction. The real failure of appeasement was not that war occurred, but that it began in a position of artificially created financial weakness sufficient to undermine fatally the fundamental economic strength of the Empire.

The decision taken by the British authorities to maintain normal economic life despite the approach of war was made not of necessity, but in the hope that a measure of rearmament and diplomatic activity would preclude the sort of change unpalatable to the political coalition which constructed appeasement. For although civil servants, liberal internationalists and the politicians associated with appeasement wished to preserve the

⁵¹ R.A.C. Parker, "The Pound Sterling, the American Treasury and British Preparations for War", *English Historical Review* 98, (1983), p.261.

⁵² F. C. Costigliola, "Anglo-American Financial Rivalry in the 1920s", *Journal of Economic History* 37, (1977), p.934.

Empire, they wished to preserve their way of life even more dearly. If appeasement were successful, then both these things would be achieved. If it failed, the escape route would be to throw Britain on the mercy of the United States, the likely benevolence of which as a liberal capitalist power was grossly overestimated. The preparation of the Imperial economy for war would certainly have damaged the transatlantic system of international finance, and it is significant that this survived the Second World War unscathed while the Empire went under instead. It is not true, however, that alternative policies were impracticable or as yet undeveloped. In the chapters that follow, I will attempt to demonstrate the relationship between structural forces and human actions in the context of the British Empire's failure to save itself by preparing its economy for war. In doing so it is my intention to initiate an overdue debate based on the premise that the sound economic structure of the Empire was fatally undermined by political weakness and inappropriate ideology.

CHAPTER 1

NEW RULES FOR AN OLD GAME: THE SHAPING OF FOURTH ARM CONCEPTS IN A FLUID ENVIRONMENT, 1919-1931

The conviction that Britain's economic stability and financial credibility constituted a fourth arm of defence was finally translated into policy in 1938, but it was deeply rooted in liberal intellectual and administrative tradition. That such a purely liberal policy could be adopted at such a late stage, after all the crises and upheavals of the interwar years, is a remarkable testimony to the resilience and cohesion of classical economic ideals. In a State which had supposedly abandoned the doctrine of free trade to embrace economic protection and Imperial preference, a defence policy was adopted which stressed the importance of sound finance as the basic support of Britain's currency and financial credibility. It expressed itself in such phrases as 'business as usual' and sought victory through the strangulation by blockade of enemy commerce.

The implementation of the fourth arm policy was all the more remarkable considering the movement generated during the Great War in the direction of an autarkic Imperial economic system, a view expressed with great force in the compendious 1917 report of the Dominions Royal Commission.¹ The opinions expressed in this document were later held to be extreme: in fact they were at the opposite extreme to the fourth arm policy eventually adopted. Between 1918 and 1938 therefore, a polar transformation of policy took place, the origins of which can be found in developments between the end of the Great War and the collapse of gold in 1931. In these years the relationship between military planning and civilian economic ideology established a particular pattern.

The Committee of Imperial Defence understandably based its planning on the experience gained between 1914 and 1918. Unfortunately for the cohesion of planning, the financial aspect of the war effort, with the partial exception of blockade, had remained in the hands of the Treasury and the Bank of England. The consequence, when post-war plans were formulated, was that defence finance remained exclusively in civilian hands, even

¹ Cd. 8462 of 1917. Dominions Royal Commission, *Final Report of the Royal Commission on the Natural Resources, Trade and Legislation of Certain Portions of His Majesty's Dominions*.

including the non-military financial aspects of blockade. Military planners were thus constrained to assume the financial impregnability of the nation. For their part, the Treasury and the Bank had been able to maintain essentially peacetime financial machinery during the War by the expedient of huge borrowing in the United States. In the 1920s it seemed that such a policy might in future be repeated. Furthermore, civilian control of defence finance effectively meant that the issue was bound up in the bitter controversy between the “familiar shibboleths of protection and free trade”.²

In this debate, war was potentially a major issue. What one liberal economist of the inter-war years described as the “intellectual holiday of the War”³ seemed to reinforce the protectionist case, and it was a concern of liberal thinkers to contain the unwelcome economic concepts of war within tight wartime boundaries, completely excluded from peacetime economic debate if at all possible. In the event, protectionist thinking was not only contained within the sphere of defence planning, but actually rooted out of even this haven, when defence moved to the centre of the political stage.

In respect of both the national debate between internationalism and protection, and the structure of financial planning for defence, the fact that the champions of free trade were entrenched in the Government machine was of deep significance. This was true both in the 1920s and especially after the apparent transformation of policy following sterling’s eviction from the gold standard in September 1931. The steps taken during and after this emergency, though effective measures of crisis management, gave a misleading impression of the ideological conversion within Government. This was reinforced by the initial relief of officials at the economy’s survival, and the silencing of their liberal convictions in the face of the obvious success of a floating pound, protection and Imperial preference.

Even at this stage, however, it was clear that as soon as the crisis passed, traditional modes of thought would begin to reassert themselves. In short, it can be said that although the economic principles behind the fourth arm policy were venerable, the foundations of its triumph in 1938 were laid between the Armistice of 1918 and the crisis of 1931. In the tense atmosphere of that year, the report of the Macmillan Committee noted uneasily as Britain faced eviction from the gold standard that “there are ‘rules of the game’, which, if not observed, will make the standard work with undesirable rather than beneficial

² B.J. Eichengreen, *Sterling and the Tariff, 1929-32* (Princeton, 1981), p.38.

³ W.C. Hancock, *Problems of Economic Policy 1918-1939* Part 1 (Oxford, 1940), p.109.

consequences". It added that: "It is difficult to define in precise terms what is meant by the 'rules of the game'. The management of an international standard is an art and not a science".⁴ The successful maintenance in government of the liberal ideal during and after the crisis demonstrated that powerful forces in British political life had a clear idea what the rules of the game were, and were skilled in the art of playing it. Quiet work done in the 1920s ensured that despite the fragmentation of the world economy in the 1930s, a liberal recovery was possible in Britain, and that domination of rearmament policy would be central to it.

1:1 Peace, War and a New Concept of Financial Control

The British were quick to utilise the experience gained in the Great War. Introducing the Fifth Annual Report of the CID's Advisory Committee on Trading and Blockade, the Chairman, Lord Salisbury, described it as "the latest stage of an Inquiry that has been going on for more than nine years. In February 1920, a number of Sub-Committees were appointed to overhaul the experiences of the late War over a wide range of subjects while the memory was still fresh".⁵ However, the lessons of the Great War were not always reliable guides to the future, and they were not all contained within the field of military planning.

In the economic sphere it was later observed that there existed during the war "two separate torrents of emotion", which "were driving the peoples and their statesmen".⁶ One was "the torrent of war fury", which "carried on its surface the ideas of 'economic defence', - of national or imperial self-sufficiency". The other was "the torrent of peace fervour" which "carried on its surface the theory of an international economic order." Despite the apparent force of autarkic Imperial arguments, officially adopted by the Imperial War Cabinet and the Imperial War Conference in April 1917, internationalists had insuperable advantages in this debate which would become manifest when peace returned.

The technicalities of Imperial economics were encapsulated, also in 1917, in the *Final Report* of the Dominions Royal Commission, which had over five years documented the

⁴ Cmd. 3897 of 1931. Committee on Finance and Industry [Macmillan Committee], *Report*, para.46.

⁵ PRO CAB 47/1. C.I.D. Advisory Committee on Trade Questions in Time of War. Reports and Proceedings 1924-1938. Reports - Advisory Committee on Trading and Blockade. Fifth Annual Report Covering Note by Chairman, 29th April 1929.

⁶ Hancock, *Problems of Economic Policy*, p.111.

extent of Imperial resources and the progress made in their development. Its conclusion was that:

In our opinion it is vital that the Empire should, so far as possible, be placed in a position which would enable it to resist any pressure which a foreign power or group of powers could exercise in time of peace or during war in virtue of control of raw materials and commodities essential for the well being of the Empire, and it is towards the attainment of this object that coordinated effort should be directed.⁷

When peace returned it was easy for liberal commentators to traduce these sentiments as advocating “the economics of siege...as permanent policy on an imperial scale”,⁸ and most damagingly as an attempt by the Empire “to secure exclusive supply for itself”.⁹ This would, of course, have been an absurdity, but the idea was to become a plank of the internationalist case against Imperial self-sufficiency: that it would constitute an incitement to war on the part of the ‘excluded’ powers. This ignored the fact that Imperial defence required guaranteed, not exclusive, supply from the Empire, or as the Dominions Royal Commission put it, “the maintenance and development of supplies of commodities”.¹⁰ In any case, for the Empire to “use its monopoly powers to impose ‘sanctions’ on behalf of its own interests” it would in the first place have to be trading with its potential victim.¹¹ Indeed, where imports were concerned the Commission’s ideas were just as likely to work against monopoly, because “if supplies cannot be obtained from British sources it is clear that in the general interests of the Empire its civil and military industries should draw their supplies from as many sources as possible, and not depend on a single foreign country for their requirements”.¹²

The Committee on Commercial and Industrial Policy After the War was far from seeing Imperial self-sufficiency as a means of excluding foreigners in peace time. Its *Interim Report on Certain Essential Industries* noted that it was “essential to the safety of the nation that tungsten should be manufactured within the Empire after the war on such a scale as to

⁷ Cd. 8462. Dominions Royal Commission, *Final Report*, para. 327.

⁸ Hancock, *Problems of Economic Policy*, p.100.

⁹ *Ibid.*

¹⁰ Cd. 8462. Dominions Royal Commission, *Final Report*, para.333.

¹¹ Hancock, *Problems of Economic Policy*, p.101.

¹² Cd. 8462. Dominions Royal Commission, *Final Report*, para.369.

supply domestic requirements and afford a margin for export so that any sudden increase in our own requirements may be readily met.”¹³ Thus, even extreme selfishness scarcely amounted to the economics of siege. The *Final Report* of the Committee, despite listing first of “[t]he main subjects discussed in this report” its concern with “the manner in which Imperial resources may be further developed and the supplies of raw materials assured”,¹⁴ noted that

any attempt to make the Empire self-supporting in respect of them all would probably be both impracticable and economically unsound. Some selective policy will be necessary, which shall have regard to relative importance, whether industrial or military, and to the sources of supply and the likelihood of their disturbance in times of war.¹⁵

This was far sighted, as assured supply could be expressed essentially in the willingness of suppliers to accept sterling without condition in payment for their goods. The advent of the sterling area would broaden this category beyond the formal empire, and such sources of supply were not necessarily any more prone to interruption than those under direct British control.

Arguments in favour of taking economic measures in peacetime with a view to future hostilities were, however, to be assailed when peace returned by a furious counterblast of liberal orthodoxy. In public this phenomenon was characterised by a demand for economy, pushed hard by, amongst others, the Northcliffe press under the umbrella of an ‘anti-waste movement’. The perspective encapsulated in the slogan ‘back to 1914’ dismissed views such as those of the Dominions Royal Commission as representative of a time “when the spirit of war-time unity in the Empire was at its height”.¹⁶ Peace, it could be argued, required a different set of ideas, and these would assert themselves as soon as hostilities approached a conclusion. From this standpoint, a crucial distinction was drawn between the infringements on a liberal economy necessitated by war, and the requirements of peacetime trade. This distinction was made manifest in decisive fashion by representatives of the

¹³ Cd. 9032 of 1918. Committee on Commercial and Industrial Policy, *Interim Report on Certain Essential Industries*, para.7.

¹⁴ *Ibid.*, para.12.

¹⁵ Cd. 9035 of 1918. Committee on Commercial and Industrial Policy, *Final Report of the Committee on Commercial and Industrial Policy After the War*, para.123.

¹⁶ Hancock, *Problems of Economic Policy*, p.99.

Government, the Bank of England, and selected financiers on the Committee on Currency and Foreign Exchange After the War (the Cunliffe Committee). Its opinion, clearly expressed, was that in time of peace a free trade economy regulated only by the automatic operation of the gold standard was essential.

The *First Interim Report* of the Committee, published in August 1918, asserted that its members were “unanimous”,¹⁷ in their conclusions, chief amongst which was that “it will be clear that the conditions necessary to the maintenance of an effective gold standard in this country no longer exist, and it is imperative that they should be restored without delay”.¹⁸ This was the key to British official thinking, as to express support for the gold standard was implicitly to advocate a return to the laissez-faire economic system of which gold was an integral component. It also meant that the credibility of the financial system would be rooted in *external* financial stability, so deeply in fact that this factor would survive the end of the gold standard itself, with profound consequences as the next war approached.

Although the liberal economic machine would in peacetime be expected to run itself, in 1918 it was clearly in need of repair. In this respect, time was of great importance to the Committee which, eager for its conclusions to be translated into policy, could not “too strongly emphasize our opinion that the application, at the earliest possible date, of the main principles on which they are based is of vital necessity to the financial stability and well being of the country”.¹⁹ This sense of urgency was fuelled by the fact that the gold standard had been effectively, though not officially, suspended during the war.

The refusal of the Government to insure against the risk of transporting gold in wartime had made its export uneconomical. Britain’s gold reserves had thus in effect been protected by enemy U-boats, a situation which self-evidently could not be expected to survive an armistice. It was seen to be imperative, therefore, to restore financial probity as soon as the war ended. There was irony in this point of view, for it was the maintenance of peacetime financial machinery in war that appeared to make urgent the full return of laissez-faire economics at the War’s end. Thus the Cunliffe Committee was able to railroad the Government into policy commitments, to satisfy an essentially spurious requirement for

¹⁷ Cd. 9182 of 1918. Currency and Foreign Exchanges, *First Interim Report of the Committee on Currency and Foreign Exchanges after the War* [Cunliffe Committee], Introduction.

¹⁸ *Ibid.*, para.15.

¹⁹ *Ibid.*, Introduction.

haste. In the event it would prove impossible to reintroduce the gold standard, and it was formally suspended in 1919. However, a commitment to do so in future was sufficient to enforce a liberal economic policy in the interim.

If the eventual return to gold was assumed, a whole raft of further constraints on the structure of the economy could also be taken as read, and applied with immediate effect in the name of facilitating such an outcome. A balanced budget was held to be the most important prerequisite for a gold standard economy, as this would preclude the possibility of inflation and steady the exchanges. In 1918 the main obstacle to a balanced budget in Britain was clearly the war effort, and so in accordance with the demands of the Cunliffe Committee, public expenditure was reduced by means of extraordinarily rapid demobilisation. Lloyd George formed a Finance Committee, in effect a senior inner-Cabinet, and this soon turned its attention to “various suggestions for securing economies in the spending of public Departments, with special reference to the functions of the Treasury”.²⁰ Lloyd George explained that “not only in view of the state of public opinion, but because of the financial situation of the country, ruthless cutting down of expenditure was imperative”. It was the Committee’s problem to “fix on the specific items of waste and extravagance which should be eliminated, and it was here that the Treasury should be able to help the Committee.”

The Treasury was, therefore, instructed “to prepare for the Committee an analysis of the abnormal and temporary expenditure of the chief spending Departments and particularly the War Office, the Admiralty and the Ministry of Munitions”.²¹ This was the sort of task that the Treasury was neither reluctant nor slow to perform, and it quickly formulated an analysis of the “national balance sheet”²² as a basis for drastic economies and the restoration of a balanced budget. This document was duly presented to the Committee and not for the last time in such analyses it painted a “terrifying picture” of insolvency. The Cabinet of 1919 was made of sterner stuff than its successors, however, and elements of creativity in the Treasury’s accountancy were subjected to detailed criticism.

²⁰ PRO CAB 27/71. War Cabinet Finance Committee. Minutes of Meetings, 24th July 1919-31st July 1922. Minutes of Third Meeting, 20th August 1919.

²¹ Ibid.

²² Ibid., Minutes of Eleventh Meeting, 22nd October 1919.

The most obvious cavil was that the figure for debt expenditure included the whole £50 million of annual interest payable to the U.S., but this was not balanced on the revenue side by the £80 million owed annually by Britain's debtors. Also, the planned replacement for the excess profits tax was expected to yield £50 million annually, but not in 1920-1, because of the time lag involved in collection. The Chancellor, Austen Chamberlain, faced with these figures "said in reply to the Prime Minister that if payment of £50,000,000 to America were omitted and the proceeds of the excess profits' tax added, the deficit would disappear".²³ When during further criticism of the Treasury's figures, Warren Fisher was called to upon to defend the high level of expenditure attributed to pensions, the Prime Minister felt it necessary to intervene. He "said that he hoped the Treasury Officials understood that the criticism that had been made in the Meeting bore no reflection whatever on their hard-working Department. It was fully realised what an extremely difficult task they had to undertake."²⁴

Nevertheless, the Treasury was forced to produce answers to the questions raised by the Committee and to revise its report. When these were produced, the Treasury justified its position on the grounds of the hallowed accounting principle of prudence. However, the document produced was supposed to give an impression of conditions prevalent in a normal year, which was hardly the case. Despite this, it was produced as a White Paper, and the Budgetary measures implemented produced impressive surpluses. They enabled "a deficit of £1,690 million in financial 1918-19" to be "transformed into surpluses of £237.9 million in 1920-1, £45.7 million in 1921-2 and £101.5 million in 1922-3".²⁵ Despite the caution in interpretation necessitated by the fluctuating level of prices at this time, these were impressive surpluses, and perhaps indicative of over-zealous economising. Falling military expenditure accounted for much of the gain, but much of this was natural to peace time.

Although there was a continuing world-wide need for British forces, the Finance Committee was told by the Secretary of State for War that daily costs were falling drastically and that, "broadly speaking, it was true to say that the Army had melted away as

²³ Ibid.

²⁴ Ibid.

²⁵ D.E. Moggridge, *British Monetary Policy 1924-1931: The Norman Conquest of \$4.86* (Cambridge, 1972), p.24.

rapidly as available shipping and political conditions had permitted”.²⁶ Whilst the Services were by no means starved of money in these years of still high expenditure, the zeal with which a return to balanced budgets was pursued revealed a clear enough pattern. Expenditure in peacetime, especially on arms, would always come second to economy. This was to be a particular and dangerous feature of financial crises, which could, as in 1938-9, be induced by diplomatic dangers requiring a show of force.

In the immediate aftermath of war, therefore, the policy of restoring a peacetime economy was energetically pursued at the expense of military power, and it soon became clear that preparations for any future war would not be permitted to interfere with normal economic activity. The introduction of the ‘ten year rule’ at the Treasury’s request in 1919 constrained military planners within the arbitrary assumption that no major war should be anticipated for ten years. Although this measure could be taken to mean that the forces should prepare for a major war in 1928, such an interpretation did not gain general currency before the rule was placed on a rolling daily basis. The rule provided, along with the ‘Geddes Axe’ of 1923, the tightest possible definition of the concept that national defence should be organised within balanced budgets. This policy, developed during the adjustment to peace, implied much that would later be explicitly stated when war again threatened, in support of the view that financial stability formed a fourth arm of national defence. For if the measures essential to the operation of a wartime economy were to be strictly contained within the temporal boundaries of the war itself, it followed that the peacetime economic system must of necessity form a solid and stable foundation to offset the budgetary and trade deficits inevitable in wartime.

In 1925 this attitude was embodied in a Treasury memorandum circulated to CID by the Chancellor, Winston Churchill.²⁷ Noting that “[f]ighting departments are always apt to take the standpoint of sons who think their fathers’ purses inexhaustible”, it claimed that Britain was “only qualified to bear” the financial burden of the Great War by

our prudent financial policy in the years before the war. The principal factors were:-

1. A substantial sinking fund.
2. Moderate taxation.
3. A sound currency.

²⁶ CAB 27/71. War Cabinet Finance Committee, Minutes of Ninth Meeting, 17th October 1919.

²⁷ PRO CAB 4/12. CID Paper 599B. Note By the Chancellor of the Exchequer. War and Financial Power, 26th March 1925.

4. Large private savings.
5. Highly organised financial markets (including the stock market, the discount market, the foreign exchange market, the insurance markets, &c.).
6. Large foreign investments.

The memorandum then displayed the true subtlety of the thinking behind it with the observation that the “various factors are related together. The markets and the foreign investments were the result of the savings. The savings were increased by the sinking fund, and were not encroached on by taxation”. There was, though, a foundation to this system of interrelationships: “A sound currency was made possible by a sound budget and was a prerequisite condition of everything.”

This identification of the budget as the essential foundation for the sustenance of war was extensible into peace, because

by being used during the war, all this financial machinery was strained. Now we can only maintain a sinking fund by means of very heavy taxation. Heavy taxation falls on profits, and depletes the fund out of which savings are made. Our currency has been depreciated. Our financial markets have declined, partly owing to the decline in savings, partly owing to the adverse effect of an unstable currency on credit operations.²⁸

This litany of woe, added to a “debt so heavy as to be overwhelming” led according to Treasury logic to an inevitable conclusion: “Recovery from this condition of things cannot be other than slow.” This was because Britain’s “disposable margin of resources...is small”. Disposal of debt “whether in the form of a sinking fund disbursed by the Government or of additional profits left in the hands of traders” could only result, in other words, from the expenditure of a budgetary surplus, or the freeing of profits untaxed because of a balanced budget.

At the heart of the Treasury’s argument, therefore, was the classical precept that all expenditure amounted to the taking of slices from a cake of fixed size. Public expenditure required taxation which reduced the money available for private expenditure and savings. This axiom of the mid-1920s was to have vast repercussions in the future. By 1938 it was known within the Treasury to be false. The concept of the multiplier had been developed in Britain, and national income accounting was being pioneered in the United States. The role of rearmament expenditure in sustaining Britain’s recovery during the Roosevelt recession was acknowledged, yet nevertheless the belief that resources were fixed in size was to

²⁸ Ibid.

remain the basis of fourth arm policy until it was disintegrated by war.

This message to the CID, that any requests for additional funds on their part would upset even the prevailing glacial pace of financial recovery from the previous war, was reinforced by implications for the future. The sum available annually for financial redemption was “small in proportion to the total debt, but it accumulates at compound interest, so that *the rate of progress increases* [Italics in original]. Therefore, the effect of any additional burden placed upon this country’s finances is itself cumulative; it prolongs the period of recovery to an extent disproportionate to the amount of money involved.”²⁹ This was a stroke of genius, sufficient to justify the most pettifogging exercises in budgetary control.

This was not the birth of the fourth arm concept but it was the first articulation of it, for excessive military expenditure was not only a threat to economic recovery: “even if the question of the material welfare of the people be left on one side and nothing be taken into consideration except the prospect of this country winning the next war, expenditure on armaments in excess of what is absolutely necessary would be highly injurious”. Although the Treasury stated that “[t]his conclusion is quite independent of any psychological reaction of armament expenditure on financial markets”, nevertheless it was “a matter on which City opinion has become very sensitive”, as evidenced by the ‘fact’ that: “Foreign Governments which spend money on increases of armaments find great difficulty in borrowing in London”.³⁰ The memorandum’s concluding sentence neatly combined the threats that military expenditure would pose to both peacetime prosperity and preparedness for war: “Any suggestion that this country would take part in a new competition in armaments would have a most disastrous effect upon confidence, and greatly weaken the progress of the financial recovery necessary before we can face another war.”

This statement of Treasury policy in the defence sphere was a confident exposition of the doctrine which had arisen from the post-war ideological triumph of the Cunliffe Committee and the concomitant success in reestablishing budgetary orthodoxy. The Treasury was now seeking to establish the firmly liberal doctrine that the economic conditions of war and peace were distinct, and that it was dangerous to attempt to combine them. Peacetime prosperity was the bedrock of the economic ability to sustain war. If, as war approached, the classical economy were perceived to be in difficulties, this foundation

²⁹ Ibid.

³⁰ Ibid.

would be jeopardised and doubts cast in British minds upon the advisability of undertaking any risk in foreign policy that might lead to war. Finance was the tool with which this distinction would be physically realised.

The logical bases of this argument, which accounted for the success of its coercive power have, however, been misinterpreted. It has recently been argued, accurately, that in the early 1920s, statesmen's "views were similar to the later doctrine that finance was the fourth arm of defence, although this argument was not specifically adopted until 1926. The government regarded finance as a more important element of power than armed force."³¹ These views were not only similar to the fourth arm doctrine, but the foundation of it. The inference has then been drawn, however, that such an attitude "misunderstood the relationship between economic strength and military power"³² as components of national strength to the detriment of the latter, and "overrated the strategic value of Britain's economy" by "assuming that whenever necessary this could sustain whatever rearmament its security might require".³³ This analysis is itself rooted in misunderstanding. The conflict that damaged British military effectiveness was not between the "distorted... importance of financial compared to military factors in power as a whole", but as the documents quoted specifically state, between financial and economic factors.³⁴

The two terms are distinct and not interchangeable, a fact understood in Germany which traditionally maintained separate financial and economic departments of State, with the latter as the senior partner. In Britain, the relative importance of the two factors was reversed. As will be seen, the inability of the British Empire to create and sustain massive military power was to be the result of a determination, in the name of sound finance and the restoration of the international trading system, to ignore great economic possibilities in the rearmament field. The Treasury memorandum quoted above was quite clear in seeing 'financial power as the basis of economic power'. While it conceded that in the war "economic power had to be pushed up to the maximum and maintained there", nevertheless "economic strain was felt above all as a *financial* strain." This was orthodoxy, which stated

³¹ J. R. Ferris, *Men, Money and Diplomacy: The Evolution of British Strategic Policy, 1919-26* (Ithaca, 1989), p.34.

³² Ibid.

³³ Ibid., pp.34-35.

³⁴ Ibid., p.34.

the “supreme importance of financial power as the basis of economic power, and of economic power as the base of military power”.

As war plans were formed in the 1920s, the official stranglehold on policy became increasingly apparent in the relationship between the twin pillars of economic war strategy, blockading the enemy into submission and ensuring British ‘staying power’ while this policy took effect. Together, the offensive war winning strategy of blockade and the defensive concept of finance as the foundation of national subsistence formed an essentially attritional concept appropriate to experience in World War One. Britain’s finances would sustain her while blockade strangled the enemy economy and secured victory. The blockade aspect of this concept had an obvious military dimension and was covered by the CID’s Advisory Committee on Trade Questions in Time of War. This Committee busied itself with largely technical questions relevant to blockade, such as the legal aspects of treatment of neutrals and the provision of bunkering facilities for warships, based on actual experience in World War One. However, it did consider the financial implications in the reports of its Advisory Committee on Trading and Blockade

In the Committee’s Third Annual Report in 1926, Ralph Hawtrey at the Treasury³⁵ set forth his views on these matters in the context of war against Japan. His views were later given general application to all potential enemies and appeared in the Financial Section of the Fifth Annual Report in 1929, remaining unchanged thereafter as the basis of official policy. The gist of this advice was that the function of finance as a weapon was:

To employ the dominant position of the London financial market with the objects of :-

- i) Diminishing the financial resources of the Enemy
- ii) Putting pressure on undesirable firms
- iii) Preventing undesirable trade³⁶

This action would, however, pose risks. Under the heading “*Remarks*”, Hawtrey noted that:

³⁵ A contemporary, P.J.Grigg, observed that “Hawtrey was ‘Director of Financial Inquiries’ at the Treasury, which meant that he was a sort of economic consultant”. Grigg, Principal Private Secretary to successive Chancellors in the 1920s, noted that Churchill “used to accuse us of giving Hawtrey too little scope. I remember his demanding from time to time that the learned man should be released from the dungeon in which we were said to have immured him, have his chains struck off and the straw brushed from his hair and clothes and be admitted to the light and warmth of an argument in the Treasury board room with the greatest living master of argument.” P.J. Grigg, *Prejudice and Judgement*, (London, 1948), pp.81-82.

³⁶ CAB 47/1, p.76. Advisory Committee on Trading and Blockade, Fifth Annual Report, April 1929, p.27.

Control of the London Market to influence neutrals may drive business from the London market and seriously affect our dominant position both during and after the war. The whole question must be carefully balanced before any control through the London market is exercised. The situation would be studied in the first place by the Advisory Committee on Trading and Blockade in conjunction with the Treasury, who would be instrumental in the formation of the Committee, subject to the directions of the Minister.³⁷

Hawtrey's comments revealed clearly the division between military and financial problems, and at the same time suggested a limit to the authority of the Committee of Imperial Defence, beyond which lay the Treasury's domain. For to interfere with the London market was to raise concerns about Britain's own financial position, or 'staying power', and this was the Treasury's ground.

The Treasury's appropriation of all the financial aspects of defence, save some unnamed eventualities relating to blockade which could be sub-let in a controlled way to the CID, was to have many implications for defence policy in the 1930s. Chiefly it meant that there was an aspect of Imperial defence that was no business, in terms of advising the Government, of military experts, and thus the strategic implications of many financial actions were later to be inadequately appreciated or wholly unappreciated. Even in the blockade sphere, the strictly technical nature of the CID's planning was stressed. In his introduction to the Advisory Committee on Trading and Blockade's Fifth Annual Report, Lord Salisbury took pains to "emphasize, however, that the report is entirely without prejudice to the question of policy, which would, of course have to be decided by the Government of the day in accordance with the circumstances of the moment".³⁸ If this was not clear enough, Salisbury refined his argument to define his report

as being in the main a work of codification, and, upon the analogy of the codification with which we are familiar in legislation, implies no judgement on the merits of the thing codified, but merely assembles in a convenient form the experience of the late war. Further than this it would not be right for the Committee to go. It is not for the Committee to determine policy...³⁹

The Treasury, of course, felt no squeamishness about recommending its advice to successive Governments as the basis of national policy. Related to this was the fact that

³⁷ Ibid.

³⁸ Ibid., p.62. Fifth Annual Report, Covering Note by Chairman.

³⁹ Ibid.

civilian control of defence finance and thus, according to the logic of the day, of defence economics, meant that Imperial defence was more than a little dependant on the prevailing fashion in general international trade. Thus, defence needs were never likely to drive economic policy, even in conditions of some danger. In the turbulence of the interwar years, therefore, the prospects of defence, in more than a strictly budgetary sense, would depend on the outcome of the protracted intellectual struggle between the defenders of free trade and the advocates of national economic protection and Imperial preference. The only hope for the full exploitation of Imperial military-economic potential would come from a decisive victory for the latter. Such, however, was the institutional strength of economic internationalism that even when protection and Imperial preference did carry the day in national politics, the formulation of a corresponding economic strategy for the defence of the Empire was by no means assured.

The Advisory Committee on Trading and Blockade expressed succinctly the clean division that existed in official reasoning between the wartime and pre-1914 worlds. In its Third Annual Report it noted that the 206th meeting of the CID approved the view of its Standing Sub-Committee on the Co-ordination of Departmental Action on the Outbreak of War:

‘That all Sub-Committees enquiring into matters connected with War preparation plans should be instructed to bring their work up to a stage not less than that existing before 1914 before the submission of their next annual report, and, in that report, to indicate a statement showing in what respects their work is in advance of or behind that in existence on the outbreak of war.’⁴⁰

It was pointed out in the Report that:

No similar organisation existed in 1914 and the blockade machine had to be developed as the war proceeded under the stress of war conditions. The present organisation is based on a study of the blockade machine as it functioned when fully developed during the war; and it has been possible for representatives of all Departments concerned to think the problem out beforehand, as a whole and under peace conditions, in the light of experience gained in a war of the first magnitude.

Simply stated, the British planned to fight a future war with the same economic organisation as they had the First World War. But although the blockade machine had been developed from scratch after 1914, the next war would be paid for on the assumption that

⁴⁰ Ibid., p.29. Advisory Committee on Trading and Blockade. Third Annual Report, December 1926, p.9.

financial conditions would match those that prevailed before 1914. Crucially, however, the official image of the pre-war financial world was nostalgic and idealised, and the British war plan would be rooted in the premise of the model classical economy. The structure founded on this belief was to survive until the outbreak of war in 1939, and would be defended fiercely even when pressing and obvious circumstances laid bare the absurdity of its assumptions. In consequence, an analysis of British defence capability between the wars must consider how the official perception of economic well-being was shaped after the Great War, and how this survived the crises of the 1920s and early 1930s to become an integral component of the fourth arm argument as a new war approached. It is a narrative best shaped in terms of gold.

1:2 British Attitudes to Gold Between War and Crisis.

At the outbreak of World War One Great Britain was the hub around which the international financial system revolved. Although new industrial competitors were making a nonsense of the idea that Britain was the workshop of the world, there was no disputing the fact that she was its banker. Thus, although “Britain’s share of world income in 1913 was only about 13 percent[sic]”,⁴¹ the British held “nearly one half of the total international investments”,⁴² and had “the highest ratio of foreign trade to national income”.⁴³ These facts, along with the financial impartiality implied by Britain’s commitment to free trade, and the convenience of settling international accounts in sterling, helped to ensure that the pound sterling “provided a very close substitute for gold”.⁴⁴ In these circumstances the British influence on the operation of the international gold standard could not be other than great, but the British perspective was that the gold standard worked automatically, according to a theoretical model.

During the nineteenth century all the world’s major currencies had become convertible into gold at fixed prices and their values were thus pegged in relation to each other, within narrow limits. According to the gold standard model, inflationary expansion in any one

⁴¹ H. Van B. Cleveland, “The International Monetary System in the Interwar Period” in B. M. Rowland (ed), *Balance of Power or Hegemony: The Interwar Monetary System* (New York, 1976), p.18.

⁴² D.H. Aldcroft, *The Interwar Economy: Britain, 1919-39* (London, 1970), p.244.

⁴³ *Ibid.*, p.243.

⁴⁴ *Ibid.*, p.244.

economy would attract imports, increase the price of exports and lead to a deficit in the balance of payments that would be paid for in gold. The drain of gold would contract the money supply, force prices down and raise the cost of money as expressed in interest rates. These effects would discourage imports, increase the competitiveness of exports, and thus bring an end to the adverse balance of payments. An inflow of gold would then reverse the contraction of the domestic money supply and restore a situation of monetary equilibrium.

This mechanism, based on Hume's price-specie flow model,⁴⁵ was accepted in its most simplistic form by the Cunliffe Committee, and it has been suggested that this was because of Lord Cunliffe's limited but happy experience of buoyant pre-World War One financial conditions, beginning in 1911 as Deputy Governor and then from 1913 Governor of the Bank of England.⁴⁶ However, the Cunliffe Committee's stress on the intellectual purity of the mechanism was inappropriate to the actuality of its operation. Before World War One the gold standard was not an intellectual concept translated into reality, but an effective system that had developed and expanded as the nineteenth century progressed. It has been observed that it could "properly be called a 'gold standard' system, in so far as the arrangements of the several countries fitted together in a reasonably coherent way, even though no one had consciously designed it, and even though no international agency administered it, assisted it, or brooded about it".⁴⁷ At that time, the Bank of England, because of the sheer scale of international holdings of sterling and London's position as "the world's premier money, capital and commodity market",⁴⁸ could exert an enormous "pull on the exchanges"⁴⁹ and ensure that movements in the British balance of payments responded directly to rises and falls in its discount or 'Bank' rate. This meant that in British eyes the gold standard appeared to work as perfectly as the model suggested, it being "thought at the time, and afterwards, that Bank Rate was a weapon of immense power, able to pull gold from the ends of the earth".⁵⁰ The model, however, was simplistic in the extreme

⁴⁵ B. J. Eichengreen, *Golden Fetters: The Gold Standard and the Great Depression, 1919-1939* (Oxford, 1992), p.32.

⁴⁶ *Ibid.*, p.37.

⁴⁷ I.M. Drummond, *The Gold Standard and the International Monetary System 1900-1939* (Basingstoke, 1987), p.9.

⁴⁸ Moggridge, *British Monetary Policy*, p.7.

⁴⁹ Cleveland, "The International Monetary System", p.17.

⁵⁰ Drummond, *Gold Standard*, p.21.

and took no account of the potentially dangerous limitations of actual British reserves of gold and foreign currency, which were disguised by London's ability to command assistance from other central banks in times of financial crisis.⁵¹

The success of the British monetary authorities in getting by on low stocks of gold at a time of international monetary cooperation, was to prove unsustainable in the fractured world after 1918. But equally importantly for British War potential, low stocks of gold and foreign exchange in pre-war Britain, when measured against London's power to attract funds, revealed a disinterested attitude to the metal itself. In the British official mind gold was valued because it made the system work, not for its intrinsic monetary worth, and from a position of monetary equilibrium the accumulation of gold was no more to be desired than its loss. Experience appeared to teach that the true value of gold lay in its utility or even its symbolic value, as monetary adjustments often occurred in the mere expectation of gold movements, before they had a chance to occur. At this stage, the gold standard was held to be a practical device that would inevitably function while all currencies were fixed in terms of gold and thus in terms of each other. It achieved its mythical status over years of operation until, as Ralph Hawtrey, writing in 1926, observed: "Economists have been inclined to teach that this usage is so firmly established that it approximates to a moral principle, as if the use of a metallic currency were somehow essential to honest dealing."⁵²

It was acknowledged that the circumstances of World War One, which obviously disrupted normal trading, had also affected the monetary utility of gold for the duration. A fact of critical importance for the interwar years, however, was that Britain was not forced to use its gold as a hoard of wealth during the war, because of the availability of loans in the United States. These were used to help finance the war effort of Britain and her allies and support sterling. The last of these uses of credit was not well regarded by the Americans, who made "frequent and urgent requests that the British find some other way to support the rate than through the use of American advances".⁵³ Such requests fell on deaf ears and the use of American money, together with the fact that the cost of insuring gold for shipment became prohibitive with the growth of the U-boat menace, ensured that Britain's reserves,

⁵¹ Eichengreen, *Golden Fetters*, p.31.

⁵² R.G. Hawtrey, *The Gold Standard in Theory and Practice* Second Edition (London, 1931), p.1.

⁵³ K. Burk, *Britain, America and the Sinews of War, 1914-1918* (London, 1985), p.177.

actually smaller than in 1939, remained in situ.

This peculiar set of circumstances would not recur, as Britain's war debt default of 1933 provoked the Johnson Act forbidding U.S. loans to war debtors. The subsequent Neutrality Act restated this policy, along with the prohibition of arms sales to all belligerents, but none of these developments could be foreseen in 1918, and it seemed that the best way to secure supplies from the U.S. in future war was to pay the colossal debt and restore Britain's international financial reputation. No precedent existed to suggest that Britain's gold reserves might actually be needed for their intrinsic worth, to buy where sterling was not accepted. There was also the attraction that dependence on U.S. supply did not involve any compromise of liberal ideology. With the return of peace the undamaged prestige of gold dwarfed the concept that Imperial resources should be developed to the point where a vast dollar debt need not again be incurred. This, as we have seen, was safely dismissed by peacetime liberal doctrine as a wasteful restraint of trade. The successful argument that free trade and the gold standard should be restored when peace returned could be made without regard to the influence of war past or impending. Indeed, the economic chaos in the post-war world seemed to reinforce this view.

The attitude of 1918 to the gold standard was a strange parody of the pre-war perspective. A functional mechanism had been raised to the status of a law of nature, whilst the cheerfully utilitarian attitude to gold as a metal was retained.⁵⁴ The grisly consequences of this attitude would be revealed in 1931, but during the sterling crisis of 1938-39 another manifestation of the 1918 mental framework, the inherited tendency to equate sterling with gold would become significant. Confidence in the pre-war status of sterling 'as a close substitute for gold' meant not just that it performed some of the same functions by proxy, but that it possessed as well many of the attributes that made gold universally convertible. The sheer presence of sterling as the currency of the largest Empire in human history, ensured that it had to be used for the convenience of world trade, and was desirable to hold because it was in itself backed by obvious and enormous physical wealth.

Sterling was not a complete substitute for gold because its value depended on the strength it was seen to represent, while the intrinsic value of gold was of course the result of its scarcity. This fundamental distinction was most obviously manifest in times of crisis.

⁵⁴ In other words: "The symbolic character of the monetary unit has emerged into the foreground, while its relation to some actual physical material has receded". Cmd 3897. Committee on Finance and Industry [Macmillan Committee] *Report*, para.20.

Whereas the value of gold would naturally increase during a crisis that threatened British power, that of sterling would naturally fall, unless determined political steps were taken to preserve that power and control the exchanges. World War One did not make this fundamental relationship clear, although the cost of its concealment was the mountain of dollars borrowed to support sterling.

In the 1920s, the basing of economic war plans on the 1914-18 experience and victory by blockade rested on staying power, which in itself rested on the unchallenged validity of the gold standard. It had seemed that the system could be suspended but not destroyed by war and it was still assumed to be the only practical mechanism which could guarantee the effective operation of international trade. Moreover, the emotional appeal of such a system was great, as it went without saying that Britain in the world economy was of unique importance, a nation whose well being was almost indissolubly linked to the economic health of the world, and which alone had the will to restore it. The Cunliffe committee, in rejecting the appeals of its witnesses to consider economic practices current in other countries, stated that “we would point out that these countries have not in practice maintained the absolutely free gold market which this country, by reason of the vital importance of its position in international finance, is bound to do”.⁵⁵

In the years before 1931 the weaknesses of the gold standard as a regulator of international trade would be revealed fully, and its collapse in September of that year left ample time for an economic system to be evolved, which was more closely fitted to the core economic strength of the Empire and more able to face the challenge of the multi-polar world of the 1930s. Unfortunately, the grave danger of employing liberal ideology as a basis for War finance remained hidden in the government machine for far longer, and this lacuna would itself exert an influence on policy.

1:3 American Attitudes to Gold and the Onset of Crisis.

The British authorities were not blind to the fact that the post-war world was much changed, and the emergence of the United States as the dominant economic power was the most obvious new feature. However, the U.S. prized the gold standard as highly as the British and was equally keen to see its restoration worldwide. The accident of war that had left the Americans dominant in the world economy of 1919 had effects, however, that were

⁵⁵ Cd.9182. Committee on Currency and Foreign Exchanges [Cunliffe Committee], *First Interim Report*, para. 31.

less obvious than the fact of American power, but equally significant, especially in terms of gold. The price of gold at \$20.67 an ounce was too low to induce gold producers to sell to central banks, so that the amount of gold available to back the currencies of the world economy was essentially fixed at a level inadequate for the purpose.⁵⁶

This scarcity led to the development of a ‘gold exchange’ standard, pushed hard by the British and disliked by the Americans, whereby the reserves of many of the world’s central banks were held in currencies legally convertible into gold, a means of economising on the metal that would suffice unless holders of these currencies exercised their right to convert. If this happened, as it eventually did, the monetary authorities of gold standard countries would be deluged with demands for gold that had nothing to do with the state of their own economies but which, according to gold standard theory, would have to be met by contraction of their money supplies to match the loss of gold and, hopefully, reverse the process.

The inadequate supply of monetary gold was compounded by its maldistribution at the end of World War One. The British were aware that the United States had captured a sizeable proportion of the world’s gold during the war. The Cunliffe Committee was told that the Federal Reserve’s holdings increased nearly tenfold from \$48,264,000 in December 1914 to \$415,798,000 in December 1918,⁵⁷ and though large movements of gold in and out of the U.S. occurred between the wars the legal reserve requirement of the Federal Reserve ensured that a vast amount of gold remained consistently in America as backing for the huge American money supply. In addition, post-war international conditions favourable to American finance ensured that: “In the 1920s the United States thus became a gigantic sink for the gold reserves of the rest of the world.”⁵⁸

These structural restrictions on the amount of gold circulating in the international monetary system were compounded by another product of the war: a tendency of national governments to pursue economic policy as an aspect of their political system. This led to competition, and “the attempt of each of the main powers to secure for itself a

⁵⁶ Eichengreen, *Golden Fetters*, pp.198-201, dissents from the view that world gold stocks in the 1920s were too low in total, but acknowledges that progressive maldistribution of reserves, especially in favour of the U.S. and France, meant that gold in circulation was inadequate to satisfy demand worldwide, enforcing reliance on the risky gold exchange standard.

⁵⁷ PRO T 185/1, p.26. Committee on Currency and Foreign Exchanges After the War [Cunliffe Committee], *Proceedings*.

⁵⁸ Eichengreen, *Golden Fetters*, p.194.

disproportionate share of the world's limited stock of monetary gold".⁵⁹ Throughout the 1920s the tendency of the Americans in particular to pursue their financial affairs strictly in terms of national interest, with insufficient regard for their new financial responsibilities, was a fundamental cause of strain in the international economic system. The accumulation and sterilisation of gold in the U.S.A. were bound to result in a deflationary contraction of the money supply amongst its debtors. They could only circulate as much paper money as was backed by gold or convertible currency, unless further loans of dollars were forthcoming. The United States, however, lacked the experience as arbiter of international trade necessary to perceive these dangers, and believed by the mid-1920s that in the "three interlocking components" of the "Dawes Plan, the debt settlements, and the gold standard"⁶⁰ it had established lasting machinery for "European recovery on an open-door, capitalist basis, conducive to U.S. economic penetration".⁶¹ In Europe, the coining of the nickname 'Uncle Shylock' reflected an unappreciative attitude to American efforts.⁶²

The British, experienced in the international repercussions of their actions, recognised the dangers inherent in the pursuit of a nationalistic monetary policy by the dominant economic power, and were conscious of the U.S. Federal Reserve's "slim qualifications for the world monetary leadership that fate had thrust upon it".⁶³ The return to the gold standard in November 1925, therefore, gave London every chance to prove the thesis developed in 1918, that the influence of British finance and the effectiveness of the gold standard mechanism could restore order to the world economy. Indeed, the return to gold

⁵⁹ C.H. Feinstein, P. Temin, and G. Toniolo, "International Economic Organisation: Banking, Finance and Trade in Europe Between the Wars", in C.H. Feinstein (ed), *Banking Currency and Finance in Europe Between the Wars* (Oxford, 1995), p.12.

⁶⁰ F.C. Costigliola, *Awkward Dominion: American Political, Economic, and Cultural Relations with Europe, 1919-1933* (Ithaca and London, 1984), p.112. Costigliola's work is amongst a number by American authors which earn a blistering rebuke from R.W.D. Boyce for adopting a position which "seriously misrepresents British policy" in the 1920s, by neglecting the fact that British policy makers "remained committed to multilateralism and strenuously resisted a retreat into Imperial protectionism." Boyce contends that American work fosters the view that "anything Britain did in the international arena is regarded as self-evidently designed to regain Britain's 'financial leadership', while any American initiative is seen as a contribution to an 'open world economy'". Costigliola is actually more even-handed than this attack implies. R.W.D. Boyce, *British Capitalism at the Crossroads, 1919-1932: A Study in Politics, Economics and International Relations* (Cambridge, 1987), p.375, fn.1.

⁶¹ Costigliola, *Awkward Dominion*, p.56.

⁶² For example, see B.D. Rhodes, "Reassessing 'Uncle Shylock': The United States and the French War Debt, 1917-1929", *Journal of American History* 55, (1969), pp.787-803.

⁶³ Cleveland, "The International Monetary System", p.43.

was held initially to be a success, at least in terms of the immediate objectives of the British authorities, which were the “attainment of sterling parity, the reversal of the gold flow to the United States, and the realignment of United States and British prices”.⁶⁴ The deflationary effect of the overvalued parity of \$4.86 on the British economy was not as immediate or as obvious as the boost that was given to confidence in London as a centre of international trade. The events of the late 1920s, however, would expose the structural weaknesses of the gold standard system and test beyond endurance the British belief that their economic health depended upon its operation.

While the U.S. exercised an irresistible pull on the world’s capital through its gold holdings, trade surplus and creditor status, British finance could do little to compete, and this became more true after 1928, when the effects of the stock market boom in America and the de jure pegging of the French ‘franc Poincaré’ below its real value made themselves felt. These events led to a drain of the world’s capital to the U.S. and much of its remaining gold to Paris, where French reserves increased by £80 million in 1929 alone, a figure “the equivalent of the world’s output of new gold for a year”.⁶⁵ This situation was sustainable only as long as the U.S. was willing to lend further funds to its debtors in order that they might remain on a gold exchange standard and avoid a catastrophic contraction of their currencies.

When the Americans perceived in 1929 and 1930, under the influence of their own accelerating financial crisis, that their debtors were in an increasingly poor position to repay further loans, they simply stopped lending, and in 1931 the United States actually imported a net \$756 million of capital.⁶⁶ The consequences of the situation created by the wartime capture of the world’s gold supply by the U.S.A. and its subsequent policy were now revealed in the form of an unstoppable collapse in world prices, as the currencies of U.S. debtors imploded. As many of these nations were primary producers, the approaching crisis manifested itself in a sharp decline in world agricultural prices.

The consequences of the American withdrawal of credit for primary producers were

⁶⁴ S.V.O. Clarke, *Central Bank Cooperation: 1924-31* (New York, 1967), p.92.

⁶⁵ Hawtrey, *The Gold Standard in Theory and Practice*, p.125.

⁶⁶ D. Williams, “London and the 1931 Financial Crisis”, *Economic History Review* Second Series 15, (1962-3), p.518.

grim, as they had to “repay, rather than fund, earlier borrowings at a time when their foreign exchange earnings were beginning to decline”.⁶⁷ In the absence of American credit a “large and sustained outflow of gold from the debtor to the creditor countries”⁶⁸ occurred, with South America alone losing \$369 million, more than a third of its stock, between the end of 1928 and the end of 1930.⁶⁹ By April 1930 nine countries had been forced off the gold standard to prevent the immediate collapse of their currencies, but by now the world economic crisis was feeding on itself.

In world agriculture, “prices fell by about 50 per cent between late 1929 and mid-1931”,⁷⁰ and a series of bank collapses in Europe and the U.S. led to a huge demand for short term funds in order to stabilise the world economy. Before the Great War, any such development would have been offset by advances of short term credit from London balanced by British borrowing from creditor nations. At this time, however, only Great Britain was willing to extend credit and conduct normal financial business, and consequently the whole burden of rescuing the world economy from a disaster of Biblical proportions fell on London, which despite apparently total failure was ultimately, though accidentally, successful.

1:4 A Chance to Rebuild.

In the crisis of 1930-31, London was called upon to play its traditional role of alleviating the forces of world depression by providing short term funds to tide struggling nations over their time of crisis. On this occasion, however, the scale of the problem was unprecedented and the British financial position was weaker than it had ever been before. The British response to pressure for credit was usually automatic and involved separate processes, whereby long term foreign investment would be reduced in favour of short term investment, while interest rates were raised to attract foreign capital which was then lent in turn to those demanding credit. The first of these processes was accomplished as before, but the attraction of sufficient foreign investment proved impossible.⁷¹

⁶⁷ Ibid.

⁶⁸ Ibid.

⁶⁹ Ibid.

⁷⁰ Aldcroft, *The Interwar Economy*, p.269.

⁷¹ Williams, “London and the 1931 Financial Crisis”, p.519.

In the first place foreign capital was hard to come by as creditor nations were not lending, and banking crises were freezing British claims abroad, for example in Germany, where the closure of the banks immobilised £70 million of British short term assets.⁷² Secondly, British interest rates could not be raised to a level sufficient to attract such foreign capital as was available. The British domestic economy had been badly hit by international events, and as more British capital was now invested at home a rise in interest rates would do further damage to the economy. In the absence of foreign capital the international demand for credit fell on existing British reserves which were in no way adequate to bear the burden. These stood at £430 million in June 1930, but between this date “and December 1931 London lost £350 million of foreign funds,”⁷³ and in the summer of 1931 the rate of loss was phenomenal: “Between July 15th (the last phase of the sterling crisis) and September 1st 1931 about 200m. of funds were withdrawn from London.”⁷⁴ This was unsustainable, and on 21st September, “[w]hen the gold standard was suspended, the Bank was holding only £134 million in gold and £16 million in foreign exchange.”⁷⁵ It was also faced with the repayment of emergency credits worth £130 million at gold standard rates of exchange, received from the United States and France.⁷⁶

The abandonment of the gold standard was perceived, when it happened, to be an unmitigated disaster, an impression fostered by the harsh domestic consequences of the 1931 crisis budget, which aimed to restore confidence in sterling by balancing the Government’s finances through cuts in expenditure. In fact, by apparently failing to preserve the order of international finance, the British authorities had stabilised the system and created a new basis for the conduct of international trade. The sense of doom that accompanied sterling’s departure from gold dissipated with remarkable rapidity when the immediate economic collapse that had been expected failed to occur. On 15th October 1931 the Prime Minister was informed by the Treasury that there was “absolutely no sign of either inflation or

⁷² Ibid., p.524.

⁷³ Aldcroft, *The Interwar Economy*, p.270.

⁷⁴ Williams, “London and the 1931 Financial Crisis”, p.527.

⁷⁵ S. Howson, *Sterling’s Managed Float: The Operations of the Exchange Equalisation Account, 1932-39* (Princeton, 1980), pp.4-5.

⁷⁶ Ibid., p.4.

hoarding”,⁷⁷ and in addition to this heartening domestic news the P.M. had been told as early as 6th October by E.R. Peacock, a Director of the Bank of England, that “on the whole, since we had come off the gold standard, the £ had behaved much better than had been expected” and that sufficient foreign money “was returning to keep things steady”.⁷⁸

A month later, despite the uncertainties produced by a general election, the Controller of Finance and Supply Services at the Treasury, Sir Richard Hopkins, was able to tell MacDonald that during the campaign, “the pound had kept remarkably steady & on the whole surprisingly high”. He concluded that “there does not appear at the moment to be ground for worry.”⁷⁹ This unanticipated optimism was not exclusive to Britain, as the departure of sterling from the gold standard presented an opportunity to those economies whose earlier distress had already forced them off gold. A 30% devaluation of the pound against the dollar and the removal of the pressures that its defence had caused, stabilised the currency and improved the competitiveness of sterling relative to the dollar, a benefit that was not exclusively British but common to all holders of sterling against holders of the dollar and gold.

The rewards of remaining with sterling were not limited to immediate competitive advantage, for there was also an effective guarantee of maintained competitiveness within the enormous British market. India and the British colonies had no choice but to follow sterling, and the Dominions, with the exception of U.S.-influenced Canada, were too intricately connected with the British economy to follow any other course. Apart from Canada, “Australia and New Zealand had already suffered exchange depreciation, and needed to link to sterling to maintain competitiveness in the British market”,⁸⁰ although the independently minded South Africans suffered a period of economic agony before “being forced to devalue and peg to sterling for similar reasons”.⁸¹ These factors made it attractive for economies outside the Empire, which held sterling as their foreign currency reserve, to peg the value of their currencies to the pound.

⁷⁷ PRO PREM 1/97, p.70. Note to Prime Minister’s Office from Treasury, 15th October 1931.

⁷⁸ Ibid., p.8. Note of a Conference Held in the Prime Minister’s Room at 10 Downing Street, 6th October 1931.

⁷⁹ Ibid., p.3. Memorandum from Hopkins to P.M., 4th November, 1931.

⁸⁰ Feinstein, Temin, and Toniolo, “International Economic Organisation”, p.55.

⁸¹ Ibid.

In addition to the benefits of remaining with sterling there were grave risks in pursuing alternative courses of action: Portugal alone had £50 million of Government money in London when sterling came off gold and was typical of a number of smaller independent states in that it pegged to sterling, “because it was trapped”,⁸² and unable to bear the losses that any other policy would inevitably have brought. In this piecemeal way, the sterling bloc was created, as separate authorities entered a common system to alleviate their common difficulties.

The British authorities were quick to perceive these consequences of sterling’s float. In January 1932 Hopkins responded to a question from the new Chancellor of the Exchequer, Neville Chamberlain, about “the possibility of a revival of prosperity starting here (rather than in the United States) spreading to other countries as a prelude to a general revival”.⁸³ Hopkins’ attitude was positive: “The specific effects of depression in the United States are mainly felt in countries whose currencies are closely linked through the gold standard to the dollar”. Because of this he felt that “depression in the United States might exist with a very fair degree of general prosperity in the rest of the world”. The agency of this world prosperity could only be Britain, which was “off gold” and “to a large extent insulated from depression in the States. Greater prosperity in this country would be shared by the countries from whom we purchase and with whom we are closely linked, especially the Empire, South America and the East.”

British abandonment of the gold standard had wrested the economic initiative from the U.S.A. and was perceived to have done so by the British authorities. British policy seemed to have been pushed, albeit inadvertently, in the direction advocated by right wing German economists whose views were beginning to exert a decisive influence on Nazi economic policy. In connection with British rearmament it has been stated that “the days of Keynes’ ‘General Theory’ were not yet”.⁸⁴ The 1930s, though, were quintessentially the days of Keynes before and after the publication of his most famous work, and not just in Britain. He “was widely respected in Germany by virtue of his well-known position

⁸² I.M. Drummond, *The Floating Pound and the Sterling Area, 1931-1939* (Cambridge, 1981), pp.7-8.

⁸³ PRO T 172/1768, p.6. Memorandum from Hopkins to Chamberlain, 18th January 1932.

⁸⁴ M.M. Postan, *British War Production* (London, 1952), p.13. This quotation is used approvingly by Parker in defence of the Government’s rearmament policy. R.A.C. Parker, “British Rearmament 1936-1939, Treasury, Trade Unions and Skilled Labour”, *English Historical Review* 96, (1981), p.306.

concerning the treaty of Versailles. The Nazis and their entourage were also fond of quoting him at current economic discussions.”⁸⁵ Despite Keynes’ influence in Germany, a number of German economists were keen to stress an independent and traditional development along the same lines. It has been observed that: “In 1932 Ernst Wagemann emphasized the independent development of German monetary theory in a reference to Keynes: ‘Keynes would drop his eyes in shame if he had the opportunity to look into the important writings by Adam Müller, Adolf Wagner and others; with Knapp’s writing he seems to be acquainted at least in translation.’”⁸⁶

The independent development of German economic theory was of great significance, because while Keynes’ ideas went hand in hand with such thinking on the domestic level, in matters of international trade Keynes was a liberal, and his German equivalents very definitely were not. Known as the ‘German reformers’ this school in fact drew upon a venerable tradition in German thought which perceived economic policy to be inextricably linked to the political power of the state. They advocated an end to the free trade economy, whilst rejecting the communist alternative. Extreme nationalists, they felt that a national economy should serve the state within a capitalist domestic framework based on private property. From their ideas the Nazi policy of Autarky developed, whereby strictly regulated foreign trade, together with imposed price and wage controls, would bring an end to the free convertibility of the state currency in international markets and shield the domestic economy from external pressures.

This policy depended upon the existence of sufficient economic potential within the currency area, and the British already had this on the grandest possible scale. The pound sterling, as its recovery in late 1931 demonstrated, possessed great natural strength as the medium of exchange for a massive global empire which contained much of the world’s population and natural riches. The smoothly functioning sterling bloc, the largest and most dynamic of the world’s new currency areas, can be compared with Hitler’s early attempts to create Mitteleuropa. Initial Nazi efforts at “the opening up of new markets while hoping to prevent the industrialisation of agrarian countries”,⁸⁷ were received with an

⁸⁵ A. Barkai, *Nazi Economics: Ideology, Theory, and Policy* (Oxford, 1990), pp.55-56.

⁸⁶ *Ibid.*, pp.104-105.

⁸⁷ W. Michalka, “Conflicts within the German Leadership on the Objectives and Tactics of German Foreign Policy, 1933-9” in W.J. Mommsen & L. Kettenacker (eds), *The Fascist Challenge and the Policy of Appeasement* (London, 1983), p.51.

understandable lack of enthusiasm by primary producers supplying Germany who “quickly grew tired of having to accept typewriters, aspirins and mouth organs in return for their grain.”⁸⁸ Despite the enviable success of the new system formed after the abandonment of the gold standard, the British Government and financial authorities had in effect developed a response to prevailing circumstances which, while being perceptive and in many ways technically brilliant, left their core beliefs completely intact.

The autarkic potential of the Empire was to be exploited not as the foundation of political and economic hegemony, but as the basis for the restoration of worldwide free trade. Hopkins’ memo to Chamberlain concluded with the hope that economic revival within the British economic orbit “might, I think, communicate itself later, through reviving confidence, to the gold standard world”.⁸⁹ In an apparently emphatic condemnation of the gold standard, Ralph Hawtrey, the head of the Treasury’s Financial Inquiries Branch, wrote in a 1931 appendix to his earlier book on the subject that “we should absolutely refuse to return to gold till there is some adequate safeguard against undue fluctuations in the purchasing power of gold”.⁹⁰ Hawtrey’s job made him in effect a spokesman for the Treasury view, and his combination of apparent hostility to gold with the hope of an eventual return to it is reflected almost exactly in a statement made by the Chancellor, Neville Chamberlain, before the Ottawa Conference of 1932. He stated that “we must make it clear that we have no intention of returning to the gold standard unless we can be thoroughly assured that a remedy has been found for the maladjustments which led to the breakdown of that standard last year”.⁹¹

The British Government accepted that the post-war gold standard had been fatally flawed and would not, therefore, seek to re-establish the old system while a handful of nations sought to hoard the world’s gold supply, but still they looked forward to a day when gold convertibility might be resumed. As in 1918 the breakdown of the gold standard was attributed not to any intellectual flaw in the gold standard system but to the uncontrollable force of circumstance and regrettable human weakness. This argument was purely technical,

⁸⁸ W. Carr, *Arms, Autarky and Aggression: A Study in German Foreign Policy, 1933-1939* (London, 1972), p.41.

⁸⁹ T 172/1768. Hopkins to Chamberlain, 18th January 1932.

⁹⁰ Hawtrey, *The Gold Standard in Theory and Practice*, p.151.

⁹¹ *Parliamentary Papers* Vol.10 (1931-2): Cmd. 4175, p.167. Quoted in Drummond, *The Floating Pound and the Sterling Area*, pp.26-27.

and true as far as it went. There was no suspicion, however, that the correctly identified maladjustments that had wrecked the gold standard may have been expressive of a fundamental change in the relationship between economics and the state.

Shortly after the return to gold in 1925 Hawtrey had rejected without ceremony Keynes' ideas for the establishment of a sterling bloc as an alternative to gold: "At the present time the logic of facts has disposed of Mr Keynes's proposals. Gold is *de facto* the international currency, and this country must do as others do and adhere to it."⁹² In 1931 he acknowledged that the government was responding to the departure from gold with "precisely the plan advocated by Mr Keynes".⁹³ This did not mean, however, that the sterling area as an end in itself should be accepted. Hawtrey stated that "sterling might really become a rival standard to gold, as Mr Keynes hoped", but continued "we cannot count on that".⁹⁴ He went on to advocate an eventual return to gold in association with a suitably contrite United States.

As in 1918 the British felt able to reconstruct the international economy, this time on the basis of the sterling area, which had developed unexpectedly as a microcosm of the ideal world economy. A floating pound embodied all the advantages of the pre-war gold standard within the area, and as ever it was the system rather than the metal itself which mattered to the British. Gold itself had been brought into disrepute by American behaviour since the Great War, and in 1932 a minority report of the League of Nations Gold Delegation advocated a return to gold only if certain preliminary measures were taken. In Britain: "Treasury Officials remained skeptical about Britain's power to reflate the world economy either by effort or by example, but they took this list of preconditions to their hearts".⁹⁵ Not least among these was the traditional British opinion that, in peacetime, "gold mattered only as a way to settle international obligations, and it should be freed for this use".⁹⁶ Until this became possible, however, current problems were to be acknowledged frankly and dealt with in a pragmatic manner.

⁹² Hawtrey, *The Gold Standard in Theory and Practice*, p.106.

⁹³ *Ibid.*, p.144.

⁹⁴ *Ibid.*, p.151.

⁹⁵ Drummond, *The Floating Pound and the Sterling Area*, p.132.

⁹⁶ *Ibid.*

The experience of the 1920s had taught Britain that her commitment to gold and free trade was in no way appropriate to the circumstances of the post-war world. The lesson had been absorbed, however, that after the fall from the gold standard the sheer size of sterling holdings around the world and recovery in Britain would help to restore some of sterling's status as an equivalent to gold, which had become largely irrelevant as a regulator of trade. The inhabitants of the new sterling bloc had to believe in the pound or acknowledge that their currencies were worthless. Sterling was thus seen to have its own specific gravity, which was sustained by the responsible attitude of the British financial authorities. The British had in fact begun unconsciously to realise their power, which was based on the size and natural wealth of the Empire, not the particular financial system that had arisen during its acquisition.

The events of the 1930s would demonstrate, however, that although Britain's superb technical response to the world collapse left her relatively strong and financially well placed, the retained belief in the ultimate restoration of the gold standard provided a rallying point for British liberals. There was an ambiguity in the concept of sterling as a replacement for gold in peacetime. Whilst protectionists might think that sterling's impressive solidity after the collapse of gold proved their point, liberals could imagine this to be a survival of the pre-war system when the two were synonymous. This would ultimately prove to be a fatal flaw in the seemingly complete triumph of protectionism and Imperial preference in 1932. It was a weakness that would manifest itself to decisive and appalling effect in the defence and strategic spheres after the disciples of internationalism, paradoxically benefitting from the success of protection, staged an impressive recovery on the grounds that Britain's economic crisis was over. This riposte would be facilitated by the influence of internationalists in Government, their intellectual cohesion in public life, and perhaps most importantly, the help they would receive from the United States, as Cordell Hull began a propaganda offensive in support of his trade agreements programme.

CHAPTER 2

“ON THE UPGRADE”: BRITAIN’S UNWELCOME RECOVERY, 1931-1936

The fundamental restructuring of the world economy which took place after the British departure from the gold standard in 1931 created, to the surprise and delight of British politicians and officials, an opportunity to re-establish London’s leading role in international finance. This position was left vacant by the spectacular economic collapse of the United States, which having pursued policies likely to bring on a depression, had succeeded only in undermining that gold-based financial structure so congenial to its domination of world markets. When this crashed down, “leaving wreckage strewn across the world”,¹ a situation was created in which many outcomes were possible. If it were true that the collapse of the international economy promoted political extremism and made war more likely, it could also be said that more than ever in the harsh and anarchic new climate, material possessions and political order were essential ingredients of power. The British possessed both, and in the early 1930s they used these assets to impose their will on the international economy.

The shattering experience of World War Two and its legacy of Imperial decline have combined to create a powerful retrospective image of the 1930s as a time of doomed British efforts to defend a scattered Empire against multiple threats. It should be remembered, however, that the extent of the Empire also ensured a powerful economic presence across the globe. The parlous American position after 1931, reflected in mass defaults on war debts, was an aspect of this reality. It has been argued recently that the weight of American economic strength as an ingredient of power has been overrated by ‘economic determinists’ in comparison with Britain’s global presence and existing forces, and “that the reality of British power was more important and more effective than was American potential”.² This is true but to express the scale of British power in terms of “a

¹ P. J. Cain and A.G. Hopkins, *British Imperialism: Crisis and Deconstruction 1914-1990* (New York, 1993), p.75.

² B.J.C. McKercher, “‘Our Most Dangerous Enemy’: Great Britain Pre-eminent in the 1930s”, *International History Review*, 13 (1991), p.757.

superiority of two to one in cruisers over the United States”³ in 1939 is to overlook the fact that the worldwide British presence was of great economic, as well as military, significance. The growth potential of the United States, though vast and concentrated, was by the same token confined within its own borders and, given its matching diplomatic and military introspection, the nation required a functioning global financial system to exert its influence across oceans. The significance of America’s gold hoard as a regulator of international trade diminished after sterling, the world’s major reserve currency, went off gold. In economic as well as military terms, the isolationist, disarmed and geographically remote U.S.A. was little more than a regional power without, in the 1930s, the physical power or financial leverage even to collect its debts, either in Europe or the British Empire.

The benefits conferred by the post-1931 international system can be seen in Britain’s dynamic economic performance and the recovery of the Empire before the outbreak of World War Two. Not least amongst these gains were the possibilities created for Imperial defence. Economic growth was of great strategic importance, as it increased war potential and was of profound significance as a basis for British rearmament. It was imperative for British security, as well as British prosperity, that nothing should undermine this new international system. Professor Kennedy reminds us that in the international arena all progress is relative, and the United States realised with a clarity born of harsh experience that Britain’s gain was its loss, both relatively and absolutely. In the years between sterling’s departure from the gold standard and the outbreak of war, therefore, the Americans sought to bring sterling back into a fixed relationship with the dollar, do away with the Ottawa system of preferences and the sterling bloc, and thereby regain their lost advantage of the 1920s.

In pursuit of these goals, however, the United States was initially powerless, and could only appeal to Britain’s liberal conscience. While memories of 1931 were fresh, such proposals were rejected scornfully, especially by the Chancellor of the Exchequer, Neville Chamberlain, who thought “that we have the misfortune to be dealing with a nation of cads”.⁴ Had he known of the work of the State Department’s British Empire Committee, it is unlikely that his opinion would have changed. In 1934, this body sought ways of disrupting the new British system but found none in existing circumstances. By 1936 the

³ Ibid., p.766.

⁴ Neville Chamberlain Papers 18/1/819, Chamberlain to Hilda Chamberlain, 4th March 1933. Quoted in I. M. Drummond, *The Floating Pound and the Sterling Area 1931-1939* (Cambridge, 1981), p.140.

American authorities were coming to realise that the British position could only be undermined from within, and Cordell Hull's propaganda offensive against the Ottawa system, which began in January of that year, was perfectly timed to assist those forces within the British establishment and public life which had never been reconciled to the new economic order of the 1930s.

Hull's campaign for an Anglo-American trade agreement gave tremendous impetus to liberal idealists in Britain. They were able to use its deliberately vacuous declarations in favour of international economic cooperation as ammunition in a drive for moves against protection and especially Imperial preference. Their influential position in the machinery of British government then became of crucial importance, but ever since 1931, although quiet, they had been busy.

2:1 The Economic Foundations of Strategic Strength

The failure of the 1931 crisis to undermine the British economy was, as has been seen, greeted with relief by the National Government, which was quick to adapt to changed circumstances. A new emphasis on stimulating the domestic economy was underpinned by a determination to provide consistently cheap credit. The maintenance of an interest rate of 2% was facilitated in 1932 by the introduction of the Exchange Equalisation Account, which managed the floating pound through the manipulation of gold and foreign currency reserves.⁵ This was the reverse of the gold standard mechanism which had maintained a stable currency by adjusting Bank Rate. The British economy was further reinforced in 1932 by the introduction of comprehensive protection for industry and agriculture in the Import Duties Act and the Horticultural Products Act, which introduced a global 10% tariff on imports into the U.K. along with import quotas on agricultural products.

The moderate tariffs and quotas provided for in the Acts could be raised, and frequently were, on application by interested parties to the Import Duties Advisory Commission, but the interests of the Empire and the emergent sterling area as essential components of the new system were safeguarded. Empire imports into the U.K. were temporarily exempted from the Acts until the negotiation of the Ottawa Agreements in August 1932 formalised privileged access for Empire producers into the British market. Subsequent agreements with the other members of the sterling bloc, such as the Roca-

⁵ An excellent account of the origins and management of the E.E.A. is provided in S. Howson, *Sterling's Managed Float: The Operations of the Exchange Equalisation Account, 1932-39* (Princeton, 1980).

Runciman agreement with Argentina in 1933, completed the new economic order of the British world.

These measures answered British and Empire needs perfectly, and the excellent economic performance which followed was enhanced in both absolute and relative terms by the economic catastrophe which had overtaken Britain's chief trading rival, the United States. In this context it is surprising that when rearmament is mentioned, the economic factor is not set against the aggressive designs of the 'have nots' among the results of depression, but is added to the list of British weaknesses. A partial explanation lies in the state of Britain's balance of payments, but one of the many and forcefully expressed concerns of Treasury Cassandras which has nevertheless gained amplification over time, especially in the context of rearmament.⁶ The continuing perception of Britain's interwar 'weakness' in international trade, has overshadowed the resurgence of British economic growth after 1931.

Economic 'balance' formed the cornerstone of the fourth arm argument as it was explicitly articulated in 1938, defensively by politicians in their memoirs, and subsequently by historians. The aspect of this argument which began with the balance of payments held that a consistent deficit on current account would result in the drain of gold and foreign currency reserves essential to the prosecution of a long war, the collapse of sterling and an inevitable explosion of price inflation. Such thinking is curiously reminiscent of the fears expressed in 1931 of the likely effects of the departure from the gold standard and, it must be said, equally unfounded in fact.

It has been seen that the competitive benefits of sterling's 1931 devaluation were common to those substantial areas of the world economy which were linked to the currency, and were not limited to the United Kingdom. Similarly, the newly fragmented state of the world economy and the formulation of tariff walls against British goods, even within the Empire, were unquestionably harmful to British exports. With the exception of 1935, the current account of the balance of payments was consistently in deficit in the 1930s, as the demand for imports in the expanding British economy first remained steady in value and then

⁶ A recent summary of this viewpoint, incorrect in all points of fact but accurately representing the fourth arm argument as it was constructed by the Government in 1937-38, argues that "from 1931 the country ran persistent peacetime balance of payments deficits [presumably this refers to current account], reflecting both its weakening competitive position industrially and the reduction of its invisible earnings. Frequently it was pressure on the balance of payments and especially on sterling which hobbled defence policy - retarding rearmament in the 1930s". D. Reynolds, *Britannia Overruled: British Policy and World Power in the Twentieth Century* (London, 1991), p.17.

grew during the decade as international prices recovered. Before the Great War this would indeed have constituted an alarming state of affairs, but the British economy had changed.

In 1913 imports had accounted for 31.1% of national income, but by 1929 this figure had declined to 26.7% and in 1938 stood at only 17.6%. In the same period exports declined from 23.2% to 9.8% of national income.⁷ Thus it can be seen that between 1913 and 1938 the gap between imports and exports expressed as a percentage of national income was virtually unchanged. This was because the decline of exports relative to imports took place within the context of a declining percentage share of both figures within national income.⁸ In other words, the influence of the balance of payments on the United Kingdom was declining in relation to the size of the domestic economy. This fact reveals a central truth of the interwar years, that the British economy was experiencing transformation rather than decline.⁹ Redirection of investment was hardly surprising in the troubled trading conditions of the interwar years. In the 1920s, high rates of interest and official discouragement of foreign lending concomitant with the return to gold¹⁰ attracted funds to London, and after 1931 it became safer to invest capital at home rather than abroad in a world of defaulting debtors.

The effects of the restructuring of the British economy visible in the balance of payments figures were also evident in the figures for capital formation and growth of national income, especially after 1931. Net domestic fixed capital formation, including investment of funds in British industry that might before World War One have gone abroad, increased steadily in the interwar years. In the 1920s this reflected the imposition of controls on foreign lending designed to prop up sterling, but after 1931 domestic investment was a

⁷ D.H. Aldcroft, *The Interwar Economy: Britain, 1919-39* (London, 1970), p.245.

⁸ It has been noted that: "In the thirties, as the British economy somewhat disengaged itself from its long involvement with external markets of all kinds, all export markets became sharply less important - in spite of devaluation and of the Ottawa agreements." I.M. Drummond, *British Economic Policy and the Empire, 1919-1939* (London, 1972), p.19.

⁹ The economist Colin Clark produced a paper for a 1931 Cabinet Committee on international trade containing both Prime Minister and Chancellor, of which he was secretary, which argued that "it was possible to think of shifting resources towards industries producing for the home market, if only because a smaller volume of exports now sufficed to purchase Britain's food and raw material imports". S. Howson & D. Winch, *The Economic Advisory Council, 1930-1939: A Study in Economic Advice During Depression and Recovery* (Cambridge, 1977), p.84.

¹⁰ A detailed account of this pre-Ottawa willingness to interfere with markets is provided in J.M. Atkin, "Official Regulation of British Overseas Investment, 1914-1931", *Economic History Review* 2nd Series 23, (1970), pp.324-335.

central pillar of economic recovery. In the years 1934-38, net domestic fixed capital formation reached its highest levels of the interwar years, and exceeded £200 million (at 1938 prices) in each of the years 1936-38.¹¹

This level of investment made possible extremely impressive economic growth and, despite the deficit on the balance of payments current account, the decline in national income caused by the depression was more than reversed by 1934. In that year the net national product (gross national product minus capital depreciation) grew by more than 7% (at 1938 prices) before settling to an impressive average of 3.45% growth between 1935 and 1939.¹² This was a virtuous circle as growth made possible further investment which made possible further growth, and British figures are still more impressive when contrasted with those of the United States, which ran a surplus on current account. It has been argued that having “cast off the gold standard”, Britain “enjoyed a rate of economic recovery that far surpassed that of the United States”.¹³ Comparison of growth figures shows this to be no overstatement. Gross domestic product in Britain grew by an average 2.3% per annum between 1929 and 1937, whereas that of the United States was no higher in 1938 than in 1929. Between 1929 and 1937, British industrial production grew by 3.4% per annum compared to 0.4% for the U.S. economy in the same period.¹⁴ On the basis of these figures¹⁵ it has been justly asserted that “[d]uring the 1930’s (1929-37) the tide ran strongly in Britain’s favour”, and that compared with “different time spans...the interwar years and especially the 1930’s were more favourable to this country than periods either before or after”.¹⁶

¹¹ C.H. Feinstein, *National Income, Expenditure and Output of the United Kingdom, 1855-1965* (Cambridge, 1972), T.14. Table 5, Gross Domestic and Gross National Product by Category of Expenditure at Constant Prices 1870-1965, ii) 1913-48 at 1938 prices.

¹² *Ibid.*, calculation from Table 5.

¹³ F.C. Costigliola, “Anglo-American Financial Rivalry in the 1920s”, *Journal of Economic History* 37, (1977), p.934.

¹⁴ D.H. Aldcroft, “Economic Growth in Britain in the Inter-War Years: A Reassessment”, *Economic History Review* Second Series 20, (1967), pp.313-314.

¹⁵ The figures quoted are conservative. It has been noted with regard to Aldcroft’s article that: “Even those who have sought to question the more exaggerated claims for the thirties as a period of rapid economic growth have conceded that the annual growth rate for the decade averaged between 2.3 and 3.3 percent, depending upon the indices of production taken.” J. Stevenson & C. Cook, *The Slump: Society and Politics During the Depression* (London, 1977), p.9.

¹⁶ Aldcroft, “Economic Growth in Britain”, p.313.

Strong growth helped Britain's international position by increasing the attractiveness of sterling for foreign investors which, allied to the advantages of the sterling area, ensured that foreign currency and gold continued to flow into London. It was this movement of money that spoke of the new British strength, as it occurred against the background of an adverse balance of trade, a situation that was completely contrary to classical economic theory and indicative that a new logic was dictating international economic developments. The seemingly paradoxical increase in the strength of sterling as Britain's trade gap widened demonstrated the fundamental strength of Britain's economic position in the 1930s. The British economy could afford to run a current account deficit as long as this amounted in absolute terms to a fraction of the growth in national income, and the figures quoted above, which take account of the external position show that this was very comfortably the case.

Such a situation in effect meant that Britain was sharing a proportion of its increased wealth with its overseas trading partners at no risk to domestic economic stability, and in fact a current account deficit contributed to the steadiness of the economy by preventing demand-pull inflation. This would be a particular problem for Germany, which lacking Britain's access to overseas supply, was to experience severe 'overheating' of its economy by 1938, as demand outstripped productive capacity. In Britain, the fear of classical economists was that a balance of payments deficit would drain gold and foreign currency reserves and thus devalue the currency. The emergence of the sterling bloc and the system of tariffs introduced in early 1932 and at Ottawa had the effect of preventing any such development.

Although it was often pointed out that the short-term foreign capital which was entering Britain might well disappear in a crisis, if this were permitted by the British authorities, the reserves of sterling area economies were predominantly held in sterling in London. Sterling could not depreciate against these currencies, which were pegged to it, and a trade deficit with them as Hubert Henderson observed in 1932 would have the effect of increasing these London balances and strengthening the pound on the international exchanges.¹⁷ The U.S., furthermore, had made it clear in 1933 that it would use its reserves to prevent any significant decline of sterling relative to the dollar. The move towards greater trade within the sterling area, as against the dollar-based economies, was therefore of great

¹⁷ Cain & Hopkins, *British Imperialism*, p.86.

benefit to British financial strength. Although depression had the effect of reducing international trade generally after 1929, British imports from the Empire remained constant in value between 1929 and 1936, while imports from the rest of the world declined and imports from the United States more than halved.¹⁸ In the same period Britain's exports to non-Empire countries were more than halved in value, but exports to the Empire, which fell by less than a quarter,¹⁹ spared Britain from the full effects of the depression.

During the recovery an increasing proportion of the current account deficit was incurred with the sterling area in pounds, and the economic strength of the area as reflected in level of the sterling relative to such currencies as the dollar and the franc, continued to grow.²⁰ The new intra-imperial trading bloc based on British growth was, therefore, of mutual benefit to its members not only during the depression but also during the ensuing period of growth. This was by no means an invisible phenomenon and it became increasingly obvious over time, embarrassingly so to economic liberals who reacted instinctively against the idea that the Ottawa system might prove permanently beneficial to Britain, but who could not deny its evident success. In a report to the Cabinet in 1936, the Government's Chief Economic Advisor, Sir Frederick Leith-Ross acknowledged that the growth of the economy was the prime cause of the balance of payments deficit and tacitly admitted what the move of international capital into sterling was openly demonstrating, that the former was of greater significance than the latter: "in practice the effect of the balance of payments on the exchanges may for long periods be outweighed by the influence of more powerful factors".²¹

The self-reinforcing economic strength of the sterling bloc has now been perceived by

¹⁸ *The Economist*, 26th November 1938: Supplement "The British-American Trade Agreement" pp.2-3.

¹⁹ *Ibid.*

²⁰ In 1913, 80% of Britain's imports had come from foreign sources. In 1938 this had fallen to 61%, a 'foreign' total which of course included non-Empire members of the sterling bloc, significant exporters to Britain who were bound to accept payment in sterling. Drummond, *British Economic Policy and the Empire*, p.21.

²¹ CAB 24/265, p.230. CP339(36), Memorandum on the Balance of Payments by the Chief Economic Advisor to His Majesty's Government, 18th December 1936, p.9. Leith-Ross, in addition to his independent rôle, was a senior Treasury official, and his paper does not chime with more recent orthodoxy which claims that: "Throughout the 1930s the Treasury and the Bank were haunted by 1931", and that: "For the Treasury the payments position was its prime economic concern for most of the 1930s." Reynolds, *Britannia Overruled*, p.125.

economic historians, but not the implications for Britain's great power status in the 1930s. As the significance of the balance of payments figure in the defence debate has overshadowed more relevant information, so economic historians have not fully considered the strategic implications of Britain's economic resurgence in the 1930s. It has been noted that British 'gentlemanly capitalists' encouraged tariff discrimination against British exporters within the sterling area so that local production could generate the revenues necessary to continue debt repayments to London.²² The figures quoted above, however, demonstrate that British production was not sacrificed to benefit city financiers, but redirected to the domestic market. While such a development was in the interests of rearmament, especially in industries at the 'cutting edge' of technology, it was also no bad thing in this context that industrial development should occur in the Empire, and thus reduce the need for supplies from the U.K. in the event of hostilities.

Industrialisation outside the United Kingdom should be considered as a logical organic development of the Imperial economy.²³ The notion that the metropolis should forever provide manufactures in exchange for the raw materials of the underdeveloped world was a most brutal and dated form of imperialism, associated at this time with the United States and expressed repeatedly in the free trade sermons of Cordell Hull, who complained to Sir Ronald Lindsay that British policy "was every week rapidly driving all food and raw material producing nations to a policy of industrialization and that no matter how cruel this might be it was wholly and hopelessly uneconomic from everybody's standpoint".²⁴ In Britain, on the other hand, Leo Amery, often caricatured as the worst type of exploiting imperialist, made the telling point that: "Cordell Hull really represents mid-nineteenth century vision on economics, coupled no doubt with the desire to create an American export hegemony in the world."²⁵ Amery shared with his mentor Lord Milner a belief "in the 'natural harmony' between the colonies and the metropole and refused to acknowledge that any conflict could arise because of development." Amery stated plainly that "we cannot develop them [the

²² For a detailed development of this argument see: Cain & Hopkins, *British Imperialism*, Chapters 8 and 10.

²³ The point has been made that if the British were intent on the imperialist exploitation of their colonies, their methods in this respect left much to be desired. I.M. Drummond, *Imperial Economic Policy 1917-1939: Studies in Expansion and Protection* (London, 1974), pp.427-446.

²⁴ *FRUS* 1936, Vol.1 (Washington, 1953). Memorandum by the Secretary of State, 20th July 1936, p.677.

²⁵ Amery to Lord Linlithgow, 25th January 1941. Quoted in W.R. Louis, *In the Name of God, Go! Leo Amery and the British Empire in the Age of Churchill* (New York & London, 1992), p.25.

colonies] and help them without an over-spill of wealth and prosperity that would be an immense help to this country....”²⁶ A desire “to develop the Empire and break decisively with the prevailing orthodoxy of *laissez-faire*”²⁷ could therefore be seen from a moral as well as economic perspective. Churchill’s free trading principles were combined with a crudely derogatory attitude towards the coloured peoples of the Empire, and this also created friction with Amery, especially when the latter was Secretary of State for India during World War Two.

It has also been argued, again in an echo of contemporary thinking, that the sterling bloc was sufficient to ensure the economic stability of the Empire but “was simply not big enough or influential enough to offer a cure for an ailing world economy in the 1930s”.²⁸ This view ignores the fact that such an endeavour was in no way relevant to Britain’s needs. Britain’s task was to reconstruct its defences without wrecking its economy or sacrificing its international economic position to the United States, as had happened in 1914-18 and would happen again between 1938 and 1945: in short Inskip’s idea of the fourth arm. The post-1931 economic measures provided the necessary framework for this task, and the actual development of the world economy up to 1936 demonstrated their success, if the complaints of the U.S. authorities are any guide.

2:2 American Problems

The United States was at the heart of the depression and had no means of insulating itself from its effects. The collapse of the U.S. export position after 1929 was of grave political significance, and the composition of U.S. trade with the British Empire exacerbated American difficulties. Although the physical self-sufficiency of the United States economy has often been stressed, it should also be noted that overcapacity in primary production actually meant that dependence on foreign markets, and the British Empire market in particular, was a fact of American political life in the 1930s. This situation was by no means new: Andrew Mellon, then Secretary of the Treasury, had “observed in 1923 that with a ‘balance’ among industries, the United States could do without exports. He admitted,

²⁶ Ibid., p.81.

²⁷ Ibid.

²⁸ Cain and Hopkins, *British Imperialism*, p.94.

however, that such a balance did not exist”,²⁹ and when depression came it still did not exist.

A balance did exist, though, in trade between the United States and the British Empire,³⁰ although the composition of this trade was of little help to the U.S. Government. The United Kingdom itself ran a continuous deficit on visible trade with the United States, but this reflected the privileged position occupied by the exports of U.S. manufacturing industry during the depression in comparison with agriculture. Protected manufacturers purchased raw materials from the British Empire and exported finished goods to the U.K., which in turn exported its manufactures to parts of the Empire enjoying a trade surplus with the United States. This triangular pattern of trade meant that American manufacturers were in a sense part of the British system, and between 1929 and 1936 their exports to Great Britain maintained their value, although this was by no means sufficient to ease the position of the entire American economy.

American farmers and primary producers had to export their surpluses to the United Kingdom, which in the mid 1930s imported “more than a third of the world’s exports of wool, motor spirit, iron and steel, wheat and maize; more than half of the world’s exports of eggs and cheese; three-quarters of the beef exported; and very nearly all the mutton, bacon, ham and pork”.³¹ The protection of the British market for such undifferentiated products, along with devaluation of sterling, hit American exports hard at a time when the position of American primary producers was already desperate. The difficulties experienced by the United States in adjusting to this situation were of great domestic political importance, especially after the election of Franklin D. Roosevelt, as New Deal politicians saw the American depression squarely in terms of a collapse in agricultural prices and sought the salvation of the farmer as the key to U.S. recovery.

In 1933, however, the American economy was entirely incapable of absorbing its agricultural production and politicians were alarmed by the seriousness of the situation. On 9th May, Roosevelt was told by the Governor of Minnesota that “unless something were done at once farmers in his state would resist any attempts at foreclosures. In Iowa they

²⁹ F.C. Costigliola, *Awkward Dominion: American Political, Economic, and Cultural Relations with Europe, 1919-1933* (Ithaca and London, 1984), p.67.

³⁰ *The Economist*, “The British American Trade Agreement”, p.1.

³¹ *Ibid.*, p.1.

already had”.³² Henry Morgenthau Jr., at this time head of the new Farm Credit Administration recalled that “the smell of revolution was in the air” and that “we had to do something about farm prices...and we had to act fast”.³³ Practical solutions, however, were not easy to find. Attempts to provide loans to China and the Soviet Union with which to buy cotton came to nothing, and massive purchases of primary products by the Government did not permanently raise prices. To dispose of its farm surplus, the Roosevelt Administration was forced to address the fundamental realities of its trading position, namely “the dominating commercial problem of the United States--our relations with the British Empire”.³⁴

Roosevelt’s task in finding agreement with the British was not helped by his early actions as President, when the domestic aspects of the New Deal took priority. In March and April 1933 the President executed a series of measures which temporarily removed the United States from the gold standard and devalued the dollar. There was great domestic pressure to take these steps, but largely on the grounds that they would raise U.S. prices, aid exports and thus end the agricultural depression. Such considerations were not foremost in British minds, however, and when the export of U.S. gold was prohibited on 19th April 1933, the Prime Minister and a team of senior civil servants were on their way to the United States to discuss currency stabilisation with Roosevelt prior to the World Economic Conference.

Sir Frederick Leith-Ross saw the American action as an attempt at “a competitive depreciation of the dollar with the pound”, and when asked by MacDonald how to respond recommended that “our best course would be, on arrival in New York, to transship to the *Mauritania* (which was due to leave New York the same day) and go home, as the American action made nonsense of all the plans for the Conference”.³⁵ His advice was not taken and the visit went ahead, but the incident was significant for a number of reasons. In ‘torpedoing’ the Conference, Roosevelt angered all shades of British opinion, including

³² Quoted in J. M. Blum, *From the Morgenthau Diaries Vol.1, Years of Crisis, 1928-1938* (Boston, 1959), p.45.

³³ *Ibid.*, p.52.

³⁴ SD 611.4131.115½. Memorandum. Functions of a British Empire Committee, 12th September 1934.

³⁵ Sir F. Leith-Ross, *Money Talks: Fifty Years of International Finance* (London, 1968), p.160.

liberal idealists, whose support the U.S. would need in the future. It was the first occasion on which the post-depression economic system was challenged openly by the Americans and it was clear that although Roosevelt was willing to act ruthlessly and quickly to gain an advantage, he had used the only American weapon to little effect.

The sheer scale of U.S. gold and currency reserves meant that the President could choose any pound-dollar rate he pleased, but could only really prevent competitive British devaluation. Forcing the pound down would simply improve British and sterling area competitiveness against U.S. goods, a senseless act and suicidal in terms of U.S. politics. Pushing the pound above a certain level by devaluing the dollar again would, as the reaction of the confirmed internationalist Leith-Ross demonstrated, be regarded as a hostile act. Roosevelt had only to compare the moderate levels of existing British tariffs with those of his own country to know that a considerable tightening of these, along with an extension of Imperial preferences, was possible and indeed likely if it were felt that U.S. exports were being 'dumped' in the Imperial market.

Within the Empire, the situation was clearly perceived as a struggle for supremacy between the pound and the dollar. Sir Ernest Oppenheimer, speaking in the South African Parliament made the position clear: "There is no such thing as financial independence, and there is no such thing as a natural currency system".³⁶ He concluded that South Africa faced a stark choice "between one managed currency - sterling - and another - the gold dollar". There was very little that the Americans could do to influence such decisions except to ensure that the dollar was as competitive as it could be against the pound and to hope that the British would come back to a system of fixed exchange rates and in some way modify the new tariff system. The Roosevelt administration's devaluation in 1933 demonstrated the limits of unilateral U.S. action, having as its most significant consequence the cessation of British war debt repayments, gamely maintained until that time.

The development of the world economic system after the British abandonment of the gold standard and free trade exacerbated the American depression and created problems that were beyond the power of U.S. politicians to solve by their own efforts. Worse, the same developments had reduced dramatically the American capacity to influence international economic developments in their favour. The U.S. could match foreign devaluation, but not gain a competitive advantage against sterling-based currencies. Furthermore, given its

³⁶ House of Assembly, *Debates* Vol.18, 28th January 1932, cols 429-430. Quoted in Drummond, *The Floating Pound and the Sterling Area*, p.91.

desperate political need to export, and its already prohibitive levels of protection, the U.S. was likely to suffer more than an opponent in any tariff war. The consequence of these factors was that economic concessions on the part of the British Empire were essential if the American economy were ever to recover. No weapon existed to force such concessions, and so the U.S. resorted to propaganda.

The Secretary of State, Cordell Hull, had been marginalised and indeed scorned by his government as the American delegate to the World Economic Conference, but his rehabilitation after this point revealed Roosevelt's change to a more internationally minded policy.³⁷ Having steered his Trade Agreements Act through Congress by June 1934, Hull was encouraged to take it to the world, and as an accord with Britain would be the most valuable of all possible trade agreements, Hull became the spearhead of American attempts to negotiate a revision of British trading practices to American advantage.³⁸ In September 1934, preliminary studies of the issue were made in the State Department by a specially constituted British Empire Committee. Its language did not evoke the comity of nations.

The Committee speculated that in the long term "if a successful attack can be made upon the Ottawa Agreements, the strategic point of attack would be Canada".³⁹ In the short term a "program for immediate action should explore the possibilities of bilateral treaties with the British Empire countries under the limitations imposed by the Ottawa Agreements". To this end, it was thought best that "the Country Committees contemplate bargaining item by item, with a minimum of national planning and a maximum of opportunism".⁴⁰ Despite these aggressive intentions it was realised that overtly threatening behaviour carried risks. The possibility of threatening Canada during negotiations was raised. This

method of attack would be to offer concessions, but to back these up with the threat that if the Ottawa agreements are not renounced in the interest of a satisfactory trade agreement with the United

³⁷ Hull's treatment during the conference and his subsequent return to favour are described in T. McCulloch, "Anglo-American Economic Diplomacy and the European Crisis, 1933-1939" (Unpublished D.Phil. thesis, University of Oxford, 1978), pp.67-68; p.87.

³⁸ He was well suited to the task. On the successful passage of the Trade Agreements Act through Congress it has been noted that: "Hull, whose abiding interest was trade policy, as had been evident at the London Economic Conference, was delighted. It made up for all the disappointments he had suffered since March 1933 and before". *Ibid.*, p.123.

³⁹ SD 611.4131/115½. Memorandum on Work of British Empire Committee, 12th September 1934.

⁴⁰ *Ibid.*, Memorandum, Functions of a British Empire Committee.

States, this country would enter upon a policy of counter-discrimination against Canada. It could be argued that the imperial preference system amounts in reality to unfair discrimination against foreign countries. It could be argued that the whole imperial preference system has no standing in international law, particularly in view of the fact that the Dominions have in recent years achieved a status in international law as independent nations. Thus, the Dominions are recognised as separate countries by the League of Nations and by the Statute of Westminster.⁴¹

Canada's special measures against the U.S. "would appear to be a clear case of discrimination which might well justify retaliatory treatment". In this case: "The program of retaliation might be extended and include the United Kingdom. This would involve the denunciation of our treaty of 1815, requiring a year's notice. Action proposed against Canada might be applied against all the Empire countries." However,

any threat of trade war on the British Empire would react unfavourably on the immediate program of domestic and world-wide recovery. The very denouncement[sic] of our treaty with England or the threat of a trade war with Canada would be likely to strengthen deflationary tendencies. In the third place it is more than questionable whether a threat of discrimination on our part would be adequate to bring results. Indeed, there is a danger that such a proposal would inflame and strengthen jingoistic and nationalistic and protectionistic[sic] sentiment in Canada and the various British Empire countries, thereby solidifying and increasing the British imperial system.⁴²

The outlook for the U.S. in 1934 appeared to be bleak. The British Empire Committee had appraised the situation with complete accuracy. It wished to destroy the British Imperial economic system, but the U.S. possessed no power of coercion and any attempt to do so was only likely to strengthen the Ottawa agreements. Negotiation also seemed unpromising as there was no obvious sense for the British in making concessions, and no prospect at all of American producers making such reciprocal gestures as would tempt even British liberals in the direction of a trade agreement. The Committee's impressions were reinforced by a conversation between U.S. Under-Secretary of State Phillips and Lord Lothian on one of the latter's frequent visits to the United States.

⁴¹ Ibid., Memorandum on Work of the British Empire Committee, 13th September 1934.

⁴² Ibid.

Lothian expressed himself, according to the evidence of Phillips' report, frankly.⁴³ MacDonald, as a result of Roosevelt's actions in 1933, "was now the 'laughing stock of the British public', wholly discredited. It was natural, therefore, that he should be sore and not well disposed to this country." Baldwin, after his attempt to renegotiate Britain's American debt in 1923, "had been tainted by failure ever since. He was, therefore, not well disposed towards this country." Lothian characterised the most significant developing partnership in Cabinet in equally unflattering terms. "Sir John Simon he characterised as a 'fish'" who, despite not being "so hopeless as he would appear on first impression...was not a man on whom cordial relations could rest". The heir apparent, "Chamberlain represented a purely local point of view; he was not internationally minded and, although a brilliant man, could not be counted upon to favor cooperation with the United States".

Clearly, Lothian's reputation as a catalyst for improved Anglo-American relations was not earned by fostering mutual ties at the level of the elected political elite. Indeed even at the political grass roots Lothian was not enamoured of his countrymen. "Englishmen", though interested in the New Deal, "were not convinced, however, of its ultimate success; they felt that the United States was still on the downward spiral, and that until the bottom was reached and the movement upwards begins, there was no disposition to join hands with the United States in any economic program". However, British society and her governmental system being what they were, the opinions and actions of men such as Lothian and those of like mind mattered.

Lothian stated, almost regretfully it seems, that "present British policies towards international trade were still effective and conditions throughout the British Isles were still on the upgrade". However, "Lord Lothian thought that this upward movement would cease before many months and that thereupon and thereafter the British Government would be more favourably disposed to discuss ways and means with other countries to do away with barriers to international trade". Unfortunately for Lothian, British conditions continued on the upgrade, with no end in sight. However, Hull's campaign for a trade agreement, which began in earnest shortly after Lothian's interview with Phillips, provided a much needed rallying point for economic internationalists within the British establishment and made possible the argument that, in the deteriorating diplomatic climate, the very success of British economic policies proved that their remedial work was done and that the time was

⁴³ SD 711.41/280. Note of Meeting between Lord Lothian and Under-Secretary of State Phillips, 11th October 1934.

ripe for a return to freer trade in cooperation with the United States.

When political conditions did turn in favour of the United States, the British Empire Committee's blueprint proved to be ideally suited to the changed situation and it was adhered to with remarkable consistency, from the Trade Agreement with Canada in 1935, which failed to unsettle the Ottawa framework, to the final achievement of the Anglo-American Trade Agreement of 1938. The clear cause of this transformation was the deteriorating diplomatic situation after Hitler's renunciation of Versailles and the advent of open rearmament in 1935, which provided an obvious British interest in friendly relations with the United States. There were clear reasons on both sides for bargaining to take place, the British offering economic accommodation in return for substantial U.S. diplomatic and political commitments.

Bargaining was one thing, however, capitulation another. There was nothing in the situation to justify the string of unreciprocated British concessions following the Tripartite Agreement of 1936, the negotiations culminating in the Anglo-American Trade Agreement of 1938, and the suicidal British attempt to defend the sterling-dollar parity between 1938 and 1939. These concessions severely weakened the strength and cohesion of the British economic system as war approached, and were made simply in the hope of creating a more favourable American attitude, without any compensating material gains. It is widely assumed that this situation was the unavoidable consequence of Britain's diplomatic plight. This is not so. In 1936, on the contrary, the official British reason for treating American approaches with caution was that the deteriorating diplomatic position of the British Empire made it essential for Britain to strengthen the Ottawa system and move away from any liberalisation of her international economic situation. Viewed from this position the subsequent British volte-face was remarkable, and the causes of transatlantic appeasement must clearly be sought elsewhere than in explanations of inevitability.

2:3 Limiting Factors in the Perception and Consolidation of British Strength

In May 1931, the Prime Minister was shocked to discover that the League of Nations Agricultural Credit Scheme, which required a British financial contribution, had been approved by the Treasury and the Foreign Office together and the necessary credit arranged. Alerted to this development, the P.M. in a strongly worded reply to a memo from Sir Robert Vansittart expressed his surprise that the matter "appears to have been under consideration for some time & has not been brought up to the Cabinet". MacDonald "knew nothing of

this”, and went on to describe how he had seen “the Chancellor at once & heard that he had just approved though with hesitation, & had wired Geneva. Up to then I had seen no papers.” The Prime Minister then asserted that the matter was “an issue of first class importance” which “cannot be decided between Departments”⁴⁴ and must be addressed by the Cabinet. Although the Prime Minister, on this occasion, exercised his authority, the incident revealed several themes which would be of importance in the course of finance and diplomacy in the 1930s. The difficulty of exercising political control over departmental ideology was particularly significant. As the Dominions Secretary, J.H. Thomas, pointed out, the Agricultural Credit Scheme so swiftly approved by the Foreign Office and the Treasury sought by creating a “convenient geographical bloc” to “range Europe economically against the rest of the world”,⁴⁵ and that “while as an individual State the United Kingdom is part of Europe, she is also, as a member of the British Commonwealth of Nations a part of the rest of the world”. Thomas asserted that for Britain to have adopted such a scheme would have been to “lay us open to the charge of having thrown over the Empire in the interests of Europe just at the time when we profess ourselves as anxious to develop a scheme of Imperial economic co-operation”.⁴⁶

The Treasury attitude to Imperial unity was expressed in a letter sent by Sir Frederick Leith-Ross to the Foreign Office, before MacDonald got wind of the scheme. Speaking on behalf of the Lords Commissioners of the Treasury, Leith-Ross stated that:

In their Lordships’ view it would be better from every point of view that His Majesty’s Government in the United Kingdom at the appropriate moment should take a definite decision, on the merits of the scheme as they affect the interests of this country and leave the Dominion Governments to express any views which they may hold on the subject as independent members of the League of Nations.⁴⁷

Unfortunately for their Lordships, ‘every point of view’ did not coincide with their own, and with the political mood of the country swinging so heavily in favour of Imperial economics, such a brazen attempt to bypass Parliament and Cabinet on a prominent issue was asking for trouble.

⁴⁴ PRO PREM 1/105, p.13. MacDonald to Vansittart, 15th May 1931.

⁴⁵ Ibid., p.8. Minute, J.H. Thomas to MacDonald, 16th May 1931.

⁴⁶ Ibid., p.12.

⁴⁷ Ibid., p.29. Letter, Treasury to Foreign Office, 8th May 1931.

The incident concerning the Agricultural Credit Scheme was not, however, an isolated attempt by officials to drive policy: its singular features were the clumsiness of the manoeuvre, its openness and the effective opposition it provoked. In fact, the affair was illustrative of developments in the British system of government in the twentieth century and the effects that these had on the process of political decision making. The changing shape of the governmental machine, in conjunction with developments in party politics, gave rise to a situation between the wars in which the true power-political interests of the British Empire were inadequately recognised, and in which the lack of an effective political voice to define and defend these interests resulted in the success of an opposite view almost by default.

The pre-First World War Liberal reform programme and the enormous demands upon government caused by the War created an unprecedented administrative machine, uncomfortable to a professional Civil Service that had been schooled in the essentially legal functions of a State dedicated on 'laissez-faire' principles to "three classic activities - the maintenance of internal law and order, the defence of the realm, and the conduct of external relations".⁴⁸ This view was reasserted after the Great War when a press campaign against the 'bureaucracy' of the war years, and the recommendations of various Command papers in favour of budgetary and trading probity, added momentum to the swing of the 'Geddes axe', which restored a balanced budget and in the process swept away most of the administrative machinery created in the war. Ironically, however, that which survived was to prove of enormous assistance to civil servants in the assertion of their traditional opinions. Official opinions were also preserved by the division of Civil Service into an elite Administrative Class closely concerned with the formulation of policy, and a subordinate Executive Class which dealt with the technical work of departments.

Much remained that could not be undone by the 'back to 1914' attitude. Even the 1914 State had been far more complex than that of 1900, and many wartime innovations became permanent features of government. This was reflected in the survival of the Cabinet Secretariat, which had developed from the War Cabinet Secretariat, and was sustained by its Secretary, Maurice Hankey, "despite opposition in certain quarters - notably the Asquith

⁴⁸ D.N. Chester and F.M.G. Willson, *The Organisation of British Central Government, 1914-1964* (London, 1968), p.19.

liberal press - to the idea".⁴⁹ The Secretariat constituted a response to the rapidly increasing volume of government business, and by delegating much of the policy making process to a system of sub-committees it sought to ensure that the scale of work that reached Cabinet was manageable and to prevent "Cabinet time being taken up by matters of minor importance".⁵⁰ This rather begged the question of who precisely should decide what was, or was not, a matter of minor importance unworthy of Cabinet attention.

A consequence for Ministers of the increased work load was that their departments could no longer be run like offices, a situation which caused them to depend increasingly upon the advice of their senior civil servants and on the information prepared by them. In 1937, for example, Frank Ashton-Gwatkin at the Foreign Office sent a draft to Sir Frederick Leith-Ross of a memorandum to be circulated under Eden's name calling for a wholesale revision of the Ottawa system.⁵¹ Although this document was framed in the first person singular, Eden had not yet seen it.

Leith-Ross, assuming it to be the work of Ashton-Gwatkin, queried whether the request it contained for a Cabinet Committee to consider trade policy revision was intended to be composed of Ministers or officials. Leith-Ross felt that only a Ministerial committee would do. Later when Eden approached Chamberlain with the final memorandum he stressed that he wanted a Ministerial committee to consider the issue. Upon considering a memorandum from Leith-Ross, Warren Fisher added in his own hand the opinion that a committee of officials should in fact precede that of the Ministers in order to present the latter with a considered view of the technicalities of the matter. Shortly afterwards Chamberlain replied to Eden that he thought it best for a committee of officials to precede the Ministerial committee. Thus an approach to a major question of policy, apparently decided in a Ministerial exchange of views was in fact the sole work of the Chief Economic Advisor to H.M.G. and the Permanent Head of the Civil Service, although the systematic normality of such practice was such that of all the parties involved, perhaps only Leith-Ross was aware of the fact.

Also, the proliferation of sub-committees reflected the fact that departments had to cooperate on complex issues such as in the foreign, economic and defence spheres, and most

⁴⁹ Stephen Roskill, *Hankey, Man of secrets* Vol.2, 1919-1931 (London, 1972), p.125.

⁵⁰ *Ibid.*, p.129.

⁵¹ For this Correspondence see the Leith-Ross papers, PRO T 188/175

liaison of this nature on the policy level would take place between civil servants of the Administrative Class. Lord Bridges, a future head of the Civil Service who served in the interwar Treasury, noted that the “experience of anyone who has worked in Whitehall is that there is an early stage in any project when things are fluid; when, if you are in touch with those concerned and can get hold of the facts, it is fairly easy to influence decisions”.⁵² The influence of politicians, therefore, would be diminished if officials combined to shape policy before Cabinet had a chance to consider alternatives.

Even if an alert and determined Minister were to reject the advice that resulted from collaboration between officials, such a stand would be futile if other ministers concerned with the same issue were to combine in Cabinet and overrule him. On the other hand, if a politician found himself in accord with Civil Service opinion in the formulation and prosecution of policy, the active assistance of the administrative machine would greatly enhance his political influence. It was much easier to swim with the tide of expert advice than against it. To carry their views against officials, politicians had to be vigilant, determined and united. This combination was also necessary to drive policy forward and prevent civil servants from making the most of a political vacuum. These qualities were lacking in the field of Imperial economics for a variety of reasons, and with melancholy results.⁵³

Between the end of the World War One and the separation of sterling from the gold standard in 1931, political interest in Imperial economic development became increasingly

⁵² Lord Bridges, “Whitehall and Beyond”, *The Listener*, 25th June 1964, p.1016. Quoted in G.K. Fry, *Statesmen in Disguise: The Changing Rôle of the Administrative Class of the British Home Civil Service, 1853-1966* (London, 1969), p.60.

⁵³ The hierarchical British Governmental structure of this time has been contrasted favourably with the apparently chaotic American and German systems, and in many ways the two resembled each other more than either did the British system. It has been said of Roosevelt that: “By pitting Welles against Hull, political envoys against career diplomats, Treasury against State, Stimson against Morgenthau, and a host of other official and personal representatives against each other for influence over foreign policy, he became a court of last resort on major issues and kept control in his own hands.” This is more than suggestive of similar descriptions of Hitler’s methods, for example Speer’s comment that Hitler “did not like establishing clear lines of jurisdiction. Sometimes he deliberately assigned bureaus or individuals the same or similar tasks. ‘That way’, he used to say, ‘the stronger one does the job’.” Perhaps the contrast with British practice is illusory. The political infighting in the American system particularly, to which British condescension is encapsulated by Keynes’ bafflement at “how decisions are ever reached at all”, was at least conducted in public by elected representatives. In Britain, the same horse trading took place behind closed doors amongst civil servants, and the public was presented with a facade of good order and streamlined efficiency. R.F. Dallek, *Franklin D. Roosevelt and American Foreign Policy, 1932-1945* (New York, 1979), p.532; A. Speer, *Inside the Third Reich* (London, 1970), p.210; J.Charmley, *Churchill’s Grand Alliance: The Anglo-American Special Relationship, 1940-57* (London, 1995), p.45.

detached from government. In the immediate aftermath of the war sufficient of the wartime spirit of Imperial unity and national planning survived to ensure the abandonment of the pure concept of free trade. The introduction of some preferential duties for Imperial produce and the Safeguarding Act of 1921, which provided a degree of protection for British industries struggling in the postwar climate were, however, measures taken very much against the tide of national opinion, both popular and expert, and “in 1921 and 1922 nobody had any doubt that the path of wisdom lay in promoting the return of gold, as recommended by the Cunliffe Committee”.⁵⁴

The intellectual dominance of the ‘back to 1914’ movement led to a general acceptance of the Cunliffe Committee’s view that Britain’s economic ills would be cured by the restoration of international free trade, which would restore foreign markets, and a return to gold, which would impose the measure of deflation necessary to restore British competitiveness and the financial dominance of the City of London. Of the main political parties, the Conservatives had most instinctive sympathy for Imperial preference and protection. The issue had split the party before the war, however, and had apparently cooled the 1923 General Election after it when Baldwin championed the protectionist cause. The Tories could thus be forgiven after their restoration in 1924 for accepting expert advice and being content to see if the gold standard could do all that orthodoxy claimed.

The Labour Party, under the influence of Philip Snowden, was committed to a return to gold, and free trade was “a powerful unifying factor” for the schismatic Liberals.⁵⁵ In this climate, the paralysing situation developed whereby “Liberals realised that the classical precepts no longer applied to the home market but...insisted on their application to the international market”, while the Tories “realised that they no longer applied to the international market but insisted on applying them to the home market”.⁵⁶ Before 1931, therefore, there could be no coalition between the Conservative and Liberal parties, and any grouping between Labour and the Liberals would, as in 1924, commit the Government to free trade.

A curious feature of the 1930s was that after the defeat of classical economics in 1931, the newly created economic structure which worked to Britain’s benefit was not

⁵⁴ P. J. Grigg, *Prejudice and Judgement* (London, 1948), p.94.

⁵⁵ R. Skidelsky, *Politicians and the Slump: The Labour Government of 1929-1931* (London, 1967), p.6.

⁵⁶ *Ibid.*, p. 79.

brought forth by, and did not create, any concomitant ideological movement from which a base of political support could grow in Britain itself. Advocates of an Imperial economic structure, such as the Empire Economic Union were dissatisfied with the post-1931 state of affairs which they saw as being at best an anaemic step in the direction of Imperial economic federation. Only a single Imperial currency and a far more rigorous tariff structure than that introduced in 1932 could satisfy them, although such measures would have robbed the prevailing situation of much of its self-sustaining flexibility and alienated those parts of the sterling area that were not inside the Empire.

An appeal to the Chancellor of the Exchequer, Neville Chamberlain, by Leo Amery calling for a single Imperial currency was rebuffed by reference to precisely these arguments. Chamberlain summarised the position shrewdly: "The more I see of this difficult and complicated question the more I am convinced that it would be wrong to lay down rigid rules in conformity with theoretical considerations. There are too many factors in the case which do not lend themselves to theory."⁵⁷ The political philosophy of other protectionist pressure groups, such as the Federation of British Industries, was not broad or deep and was satisfied with the new framework of protection. The Federation in particular could only be relied upon to resist specific attacks upon existing tariffs and quotas or to agitate for new additions. British opinion in the 1930s was to become trapped within an ironical paradox: ardent imperialists sought to realise their goals by impractical and inappropriate means, while the financial authorities were operating an extremely successful imperial economic policy for which they had little liking and which they would seek to abandon as soon as circumstances permitted.

Advocacy of Imperial economic unity was left to individual politicians such as Leo Amery, publicists such as Beaverbrook, and officials of pronounced conviction. In the context of the failure of protectionist ideology to coalesce, the political groupings which had grown out of Lord Milner's 'Kindergarten' were particularly important. This has been described as being "for nearly forty years Toryism's only effective doctrinal body",⁵⁸ yet many of its most influential adherents were connected with the Liberal party, for instance Lord Lothian, the future Ambassador to Washington, who resigned from the National

⁵⁷ Neville Chamberlain Papers: Chamberlain to Amery, 10th March 1933. Quoted in Drummond, *The Floating Pound and the Sterling Area*, p.19.

⁵⁸ D.C. Watt, *Personalities and Policies: Studies in the Formulation of British Foreign Policy in the Twentieth Century* (London, 1965), p.29.

Government over the Ottawa Agreements.

Lothian, as a founder member of the 'Round Table' group, had a decisive influence on the economic philosophy of the former Kindergarten, which was entirely liberal, and he was reinforced by the activities of his friend Lionel Curtis, who founded the similarly internationalist Royal Institute of International Affairs and "became the prophet of Chatham House".⁵⁹ The economic views of Lothian and Curtis developed from an Imperial vision which for the Kindergarten had been formed before World War One, and has been described as being influenced by "Joseph Chamberlain's imperial tariff movement and the movement for an imperial federation".⁶⁰ This was not quite the case after World War One but contains truth. As the economic soul of the Kindergarten became liberal and left the Chamberlainite aspect of imperialism behind, the Imperial political vision remained, and the two strands became fused together.

At this time it was possible for ardent imperialists in the Conservative Party to be equally enthusiastic free traders in the manner of Winston Churchill, and after the debacle of 1923, and the return to gold in 1925, the Round Table and Chatham House incursions into Tory economic ideology were not obtrusive.⁶¹ But as 1931 approached and the political inconsistency of such a position became increasingly exposed by circumstances, the liberal stranglehold on Conservative Party ideology, as opposed to policy, was not relinquished. The stifling of any coherent protectionist doctrine in Conservative economic thinking, and the obvious incompatibility of such views with the Labour and Liberal positions effectively precluded the adoption in the public life of the 1930s of advanced protectionist theory such as that existing in Germany. In addition, the fact that the views of protectionists were remote from the process of government in the 1920s led to a situation in which the Imperial economic argument became frozen in time, and restricted to a polemical wilderness irrelevant to a changing international economy.

The protectionist solutions advocated by Empire free traders drifted further and further from the contemporary mainstream of political action, with the result that when their

⁵⁹ Ibid.

⁶⁰ Ibid.

⁶¹ Boyce notes shrewdly that one of the Round Table movement's "contributions was the subtle one of diverting imperial sentiment away from aggressive economic policies". R.W.D. Boyce, *British Capitalism at the Crossroads, 1919 1932: A Study in Politics, Economics and International Relations* (Cambridge, 1987), p.26.

views again became relevant in 1931, after the discrediting of classical economics, they were ill equipped to perform as a doctrinal body unifying the range of pressure groups, such as the Farmers' Union and the Federation of British Industry, and protectionist individuals such as Amery, who might have forged an imperial economic ideology capable of consolidating the advantageous developments of the early 1930s and realising the full potential of the sterling area. The practical result of liberal domination of the Round Table group was explained in Lothian's 1933 pamphlet *Liberalism and the Modern World*: "The great weakness of the Liberal Party and the great strength of Liberalism is that, thanks to their own work in the past, two-thirds of the Conservative Party and two-thirds of the Labour Party are in fundamentals still Liberally minded."⁶²

The crash of 1931 and the formation of the National Government modified the political position, but consolidated rather than changed its essentials. Conservative dominance and the catastrophic failure of classical economics made a return to gold and free trade inconceivable in the short term, but although the introduction of the Import Duties Act and the Ottawa tariffs provoked a resignation of National Liberals, these policies had been introduced as a technical response to the emergency rather than as a conscious application of ideology. The National Government's position was of necessity consensual and its policies of protection and Imperial preference essentially negative. Figures in the Government, politicians and administrators, were happy to see them remain as crisis measures, but the political advocates of Imperial economics remained fragmented and lacked an intellectual driving force which might have enabled them to perceive the possibilities of the developing sterling bloc, and around which they might have coalesced as an effective grouping.

This was reflected in the one area where intellectual drive and the administrative system combined. The success of wartime planning had led to a feeling that some form of 'economic general staff' might provide an alternative to the vagaries of the free trade system. The problems encountered after the return to gold saw this idea regain its appeal, and in 1929 Ramsay MacDonald instituted the Economic Advisory Council to be "according to the Labour Party's election manifesto" his "eyes and ears on economic questions".⁶³ The

⁶² Quoted in J.R.M. Butler, *Lord Lothian (Philip Kerr) 1882-1940* (London, 1960), p. 170.

⁶³ Howson & Winch, *Economic Advisory Council*, p.1.

Council was a disappointment but after its effective demise in the 1931 crisis it produced an influential offshoot in the Committee on Economic Information, which produced reports on the national economy for consideration by the Cabinet and had a notable influence on policy. The Committee included leading Treasury officials such as Phillips and Hopkins and eminent economists like Keynes and Henderson.

It has been suggested that the Committee was largely responsible for the Treasury's increasing sympathy for the advanced economic thinking represented by Keynes.⁶⁴ Unfortunately for the Empire, however, such thinking was almost exclusively concerned with the domestic economy. Whilst Keynes and Henderson were not Tories, neither were they socialists, and both were closely associated in the late 1920s with the radical economic thinking contained in the Liberal 'Yellow Book'.⁶⁵ Keynes had been a longstanding critic of exchange rate policy in the 1920s, but crucially this was because of the grave effects of the return to gold on the domestic economy. Once the direct link between sterling and Bank Rate had been severed in 1931, his interest in international economics was as dedicated as the Treasury's to creating conditions in which international free trade could be re-established or at least approached.

This situation can be contrasted with developments in Germany. The ideas of German economists in relation to domestic policy were remarkably similar to those of Keynes, but they saw an autarkic attitude to international trade as a logical extension of such policy, whereas Keynes did not modify his internationalism until the eve of the Second World War. Thus it was, that the most advanced British economic thinking gave no backing to a British development of the policies of economic nationalism practised overtly by Germany and hypocritically by the United States. The intellectual reach of liberal economic views in Great Britain at this time was impressive. The beliefs of economists like Keynes and Henderson were well represented in the press. Their Cambridge colleague Walter Layton, founder of the Liberal 'Next Five Years' group, went one better and edited *The Economist*.

Although the liberal views of economists tended to be conventional in the international sphere, the influence of liberal thinking was not limited to the disruption and exclusion of protectionist thinking. At the core of the Round Table group's ideology, political as well as

⁶⁴ Ibid., p.157.

⁶⁵ For an excellent summary of Keynes' involvement in Liberal policy formation see J.Campbell, "The renewal of Liberalism: Liberalism without Liberals" in G. Peele & C. Cook (eds), *The Politics of Reappraisal, 1918-1939* (London and Basingstoke, 1975), pp. 88-113.

economic, was a belief inherited from the 'Kindergarten' that Britain and the United States "shared a common culture and a common purpose".⁶⁶ This romantic view had been deftly coupled with political acts appeasing the United States in the diplomatic arena before World War One, and in the 1930s the association of this thinking with the appeasement of Germany would also have devastating consequences for the economic base of British rearmament. While the thinking of protectionists atrophied, that of economic liberals adapted, and a group of thinkers centred around Lothian, and Gladwyn Jebb and Frank Ashton-Gwatkin of the Economic Section of the Foreign Office began to push for the economic appeasement of Germany based on British concessions. In this endeavour they were to be unsuccessful, but the dated 'pan-Anglo-Saxonism' of the Kindergarten fitted well with the usefulness for their purposes of American help, and was encouraged by new and determined American attempts, led by Cordell Hull and presented in liberal terms, to undermine the Imperial economic system.

It can be seen, therefore, that in the interaction of the British State and British politics with contemporary events and modern economic thinking between the Great War and collapse of gold, no effective constituency developed that would be able to comprehend fully the benefits that chance had dropped in Britain's lap, to realise their potential uses as the likelihood of war grew, or to protect the gains that had already been made. British Imperial interests would be sacrificed when the requirements of appeasement created a community of interest between Chamberlain; the Civil Service, which had retained the liberal attitudes of the previous century; well-connected liberal theorists and those in the Government whose affinity for the United States made them anxious to sacrifice the Ottawa system.

The complex system of government administration by sub-committee produced by the Great War had blurred the distinction between administrative and political issues and led to a situation where the influence of civil servants upon policy was very great. We have seen that as early as 1931 Foreign Office and Treasury Officials had on their own initiative attempted to direct the economic future of the Empire in flat contradiction of Government policy. Although the grand scale of the infringement on that occasion had been bound to provoke the Prime Minister's rage, it was true that in smaller ways politically important decisions could be taken and presented as part of the daily work of departments, whereas

⁶⁶ Watt, *Personalities and Policies*, p.30.

the views of Ministers had to be fought for in Cabinet, often against arguments drawn up by the officials of other departments and presented by their Ministers.

To resist the arguments of officials required constant vigilance and the repeated exercise of political will, the difficulties of which were increased after 1931 by the emergence of the National Government and the need to forge consensus amongst politicians from all the major parties. This state of affairs was in contrast to the Nazi and U.S. systems, in which the growth of competing political and administrative empires, each seeking the favour of the head of state, precluded the development of a monolithic official machine with the capacity to direct political thought. The consequences of the British system were revealed as the deteriorating diplomatic system made necessary a response to the threat from the totalitarian states.

In the early months of 1936 Cordell Hull launched in earnest his campaign for a trade agreement with Great Britain, and the measure of his success was to be seen after concurrent but separate negotiations culminated in the Tripartite Agreement on exchange rate cooperation between Britain, the U.S. and France. This accord represented more than a chance taken to restore some measure of international economic cooperation. From its conclusion liberal opinion in the British Government began to gain ground and voices were raised in support of an Anglo-American trade agreement based on a mutual reduction of tariff barriers between the United States and the British Empire. No single person or group could claim to be the driving force of this movement and the motives of those involved differed widely, yet the coalition of forces in favour of an accommodation with the United States became so powerful that it not only swept aside all opposition but gained sufficient momentum to triumph over the ultimate doubts of many of its supporters.⁶⁷ The process was aided by the swift appreciation in the United States Government of the opportunity that was being presented to undermine the Imperial economic system and regain the advantage that had been theirs before 1931. The State Department's skilful handling of this process was based on the solid groundwork of the 1934 British Empire Committee, which facilitated a clear understanding of U.S. needs, and the sheer perseverance of Cordell Hull. American success was made possible by the peculiarities of the British political system, which magnified the influence of a handful of liberal economic thinkers against the express wishes of people and Parliament.

⁶⁷ I.M. Drummond & N. Hillmer, *Negotiating Freer Trade: The United Kingdom, the United States, Canada, and the Trade Agreements of 1938* (Waterloo, 1989), pp.4-5.

CHAPTER 3

“THE DESTINY OF TOMORROW”: A TRANSATLANTIC ALLIANCE FORMS AGAINST OTTAWA, 1936

In January 1936, the American Secretary of State, Cordell Hull, approached the British Embassy with his scheme for a liberalisation of international trade. “Anxious for Anglo-American rapprochement, and somewhat unversed in economic matters”,¹ the Ambassador, Sir Ronald Lindsay, listened as Hull outlined his grandiose plan for the restoration of international free trade and stressed his belief that British commercial policy was hampering his efforts. Hull had utilised the powers he had gained under the Trade Agreements Act of 1934 to pursue a “program” based on the negotiation of a number of bilateral trade agreements with foreign countries. He believed that this programme was the only one “that could either consistently or safely be considered, especially by important commercial nations like Great Britain and the United States”;² and informed Lindsay of “certain methods and practices in trade on the part of his Government which...were seriously handicapping the prosecution of our international trade recovery program”.³

His specific objection was that bilateral agreements negotiated by the British, such as that with Spain, had the effect of diverting the “increased exchange” made available under the corresponding U.S. agreement “to Great Britain under her clearing arrangements and at the loss of the United States”.⁴ In addition to the Spanish example, Hull complained, “a number of similar clearing arrangements on the part of the British Government were understood to have like obstructive and handicapping effects upon the efforts of this Government to carry forward its broad program with the favored-nation policy underlying it”. Hull summed up with reference to a number of these examples that “the British, by unusual and objectionable methods were forcing the bilateral trade practice at the expense

¹ I. M. Drummond and N. Hillmer, *Negotiating Freer Trade: The United Kingdom, the United States, Canada, and the Trade Agreements of 1938* (Waterloo, 1989), p.37.

² *FRUS*, 1936, Vol.1 (Washington, 1953). Memorandum by the Secretary of State, 22nd January 1936, p.629.

³ *Ibid.*, pp.629-630.

⁴ *Ibid.*, p.630.

of healthy triangular and multilateral trade”.⁵

American anger at British practice could in part be explained by a complete lack of the physical means to influence the situation. As Lindsay pointed out, “the effect of the British Government’s action in the instances mentioned, not to include others, was more or less natural, due to the unfavorable balance of trade on the part of the British Government”,⁶ a position which meant that nations covered by British agreements had to deal sympathetically with British demands under the implied threat of being excluded from a market in which they traded at a profit. The United States which traded smaller volumes of its output to the credit of its balance of payments had no such leverage in world markets. Even worse for the Americans was the knowledge that they were as dependant as any other nation on their ability to export to the vast British market. Their difficulties in competing with Britain in relatively small third markets such as Spain simply emphasized the fact that Hull’s trade initiative fell massively short of both U.S. requirements and his own all-encompassing vision.

To make any practical difference to the U.S. depression it would be necessary to conclude an agreement with Great Britain, which was not only by far the world’s largest importer, but was in contrast to other nations increasing its imports to fuel a growing domestic economy. Britain, however, remained committed to protection of domestic industry and Imperial preference, and though its tariffs were low by world, and especially American, standards, Empire producers were by 1936 gaining an increasing share of the vital British market. British policy was clear, successful and domestically popular. It held no special place for the United States, and Hull’s prospects appeared to be bleak. The American trading position relative to Great Britain was in fact weaker than any of the nations which had negotiated clearing agreements with Britain, for largely the same reasons, and the commercial logic of the situation dictated considerable American concessions to British exporters, if the British Government were to be induced to reverse its successful policy and absorb the American surplus at the expense of its Imperial trade.

3:1 *Opening Shots*

Hull’s tone in his early diatribes reflected the weakness of the American position and his lack of effective bargaining counters. He “stated that of course the British Government

⁵ Ibid., p.631.

⁶ Ibid.

had a perfect right to take these shortsighted steps as we considered them, wherever practiced and by whom”,⁷ and later “that of course the British Government could go along with the expectation of a more or less favorable development in their domestic economy, sitting behind tariff walls and Empire preference”.⁸ His reasons for not doing these things were that the prosperity gained was in some unspecified way “artificial” and “temporary”, and more importantly that the system as practiced by Great Britain would be the direct and sole cause of war, in defence of which point of view Hull noted the “astonishing development in world affairs” of “a million heavily armed men on the march from Italy to Ethiopia”, and that the “British Government had felt obliged to prepare a huge budgetary increase of 1½ to 2 billions of dollars for heavily increased armaments”.

The deteriorating international situation was to become the main lever with which the U.S. Government transformed its bargaining position with Britain, but in early 1936 this lever was not yet to hand. The view that likely war inevitably made concessions to the United States desirable had not yet gained primacy in Britain. In fact the British assumption was that crisis would entail a move away from the United States and towards a further strengthening of the post-1931 system, for reasons of economic logic and military necessity, and because of the political unreliability of the United States. In the course of the next year this perception would begin to change, but in early 1936 Hull’s task was formidable, his complaints to Lindsay peripheral to the central question of access to the British market, and a long way from even raising the possibility of a major trade agreement. It would be necessary to proceed with caution.

In a further meeting with Hull on 5th February, even the sympathetic Lindsay was forced to warn the Secretary of State that his method of approach might be counter-productive. The Ambassador reported to Eden⁹ that “I dared say that there might be some features in British policy which were displeasing to him - some British rats which were eating his corn; but if in his contemplated communication he began to throw rats at us, we might answer by throwing back hippopotamuses at him, and the only progress we should

⁷ Ibid., p.630.

⁸ Ibid., p.631.

⁹ PRO BT 11/589, pp.278-279. Enclosure, 26th February 1936: F.O. A1505/890/45. Lindsay to Eden, 8th February 1936.

make would be along the path of recrimination.”¹⁰ Such a development was “something to be avoided above all things, and was my reason for speaking to him as I did”.

Despite the surrealism of Lindsay’s metaphors, Hull comprehended his message. In contrast to his vehement tone in conversation with Lindsay, but wisely in view of America’s position, he told Ray Atherton, the Chargé at the U.S. Embassy in London, that he did “not think it desirable at the present stage to address a note on this subject to His Majesty’s Government” but to “ascertain first whether Mr. Eden and Mr. Runciman were aware of the divergent trend of policies of the two Governments”.¹¹ Hull instructed Atherton to approach Eden first and “endeavor to obtain his interest and support without, however, burdening him with the technical details”.¹² Atherton interpreted Hull’s instructions by refraining, on his own initiative, from handing Eden a copy of Hull’s memo, “to avoid its passing into the hands of the Foreign Office experts who would merely write a technical appraisalment”.¹³

Eden was thus forced to take “extensive notes” and form initially a purely personal impression of the situation from American information. He was “obviously unaware of the extent that British practice had deviated” from the American conception of fair trade practice, and upon making the point that “in determining the British course of action in this matter there were many other allied considerations for discussion with the United States” he was told that “the essential first and foremost was that the two countries as the two great trading nations should agree in principle to work for the abolition of trade barriers”. Expressed in this way the argument sounded reasonable and “Eden said he agreed with this and felt it was vital for the economic welfare of the world we should endeavor to accord our two views”. Eden expressed his appreciation of Hull’s personal approach and told Atherton “that from the notes he had made he would at once proceed to take the matter up with the Foreign Office experts” and “discuss the matter with Runciman”.

The Foreign Office, though, had already been in contact with the Board of Trade, which on 14th February had received Lindsay’s report to Eden on his January meeting with

¹⁰ Ibid., p.279.

¹¹ *FRUS* 1936, Vol.1. The Secretary of State to the Chargé in the United Kingdom (Atherton), 13th February 1936, p.636.

¹² Ibid., p.635.

¹³ Ibid. The Chargé in the United Kingdom (Atherton) to the Secretary of State, 26th February 1936, p.644.

Hull.¹⁴ The latter would have been encouraged by the Ambassador's tone, for despite his warning to Hull concerning the manner of his approach to the British Government, he revealed himself to be in accord with the Secretary of State's sentiments. After noting the increase of U.S. interest in cooperation with Britain, and criticising the "characteristic fashion" in which the Americans, having made "fervent appeals" in this area "offer no concrete proposals and are aggrieved when they receive none",¹⁵ Lindsay made an unambiguous plea for a positive British response to Hull's overtures. He encapsulated the diplomatic argument in favour of accommodating the U.S. in stating that:

If the other questions are treated as incidental and the real issue on which Mr. Hull wishes to elicit the views of His Majesty's Government is 'the wider measure of economic cooperation between the two countries', I should like to suggest that the events of the past year have largely eliminated the obstacles to any such discussions which were pointed out in Sir Robert Vansittart's letter and enclosures of 23rd July last, viz:

Stabilisation
Imperial Preference
War Debts
Trade Agreement.¹⁶

Lindsay's advocacy did not embody any fervent espousal of free trade, but in line with the tradition of British officials who were not professionally concerned with economics he assumed it to be a good and natural thing. To those of this inclination, any economic consideration was secondary to the overriding diplomatic aim of securing U.S. support in a deteriorating political environment. There was no thought of the preferential system as a fundamental support of British power in times of crisis. The four items listed in the Ambassador's memorandum were seen not as central points of issue in an ideological struggle but inconvenient impediments to the wider purpose, to be removed as quickly as possible on almost any terms.

As U.S. commercial policy seemed to be designed to encourage a British move in the direction of a desirable liberalisation of trading conditions, the lack of movement in this direction seemed infuriating and baffling. Lindsay closed his memorandum by appealing to these arguments explicitly. With reference to his view that it was "very clear that the

¹⁴ PRO BT 11/589, pp.282-288. Enclosure, 14th February 1936: F.O. A 6260/890/45. Lindsay to Eden, 23rd January 1936.

¹⁵ Ibid., p.286.

¹⁶ Ibid., pp.286-287.

political situation in Europe is far more involved and perilous than it was a year ago”,¹⁷ he stated that if the promised memorandum from Hull “turns out to be a plea for closer cooperation, Mr. Hull’s initiative may partly be accounted for by the greater imminence of European War which, in his view, is so largely due to economic causes. What I fail to find any convincing reason for is the seeming fact that he should desire Anglo-American cooperation more keenly than His Majesty’s Government”.

Lindsay’s frustration on this score reflected the fact that the voice of the Foreign Office was not dominant in the formulation of the British Government’s policy. To capture the Foreign Secretary and his officials was by no means to win the war. The ‘economic’ departments of the British Government were unlikely to be impressed by arguments criticising the technical aspects of British commercial policy, especially given the American record in this area which was anything but a testament to the virtues of free trade. The encouraging tone adopted by Eden was balanced almost immediately in a speech by Runciman to the Bradford Chambers of Commerce on 27th February, in which he forcefully affirmed British commercial policy, and was directly critical of American practice, doubting the ability of “the United States to throw down her tariff barriers so long as she maintains her present fiscal system”.¹⁸

He went on to say that it was “not for me to teach the Americans how to do their business but I have no hesitation in saying that the rapidity and volume of their trade would be vastly increased if the United States would release some of her stores of gold and if her attitude towards the borrowing nations was a little more adventurous as her own home policy”. Atherton, reporting to Hull, added that the “best available press report of Runciman’s references to his trade agreements” was that: ““We hope to get into foreign markets by reason of these agreements and I intend to pursue this policy as long as I am where I am.”” The speech provoked an immediate telegram from the Secretary of State, asking Atherton whether he thought Eden had talked to Runciman before it was made. Hull described himself as “very anxious to have any information which might become available

¹⁷ Ibid., p.288.

¹⁸ Quoted in *FRUS* 1936, Vol.1. The Chargé in the United Kingdom (Atherton) to the Secretary of State, 28th February 1936, p.645.

to you relating to this subject".¹⁹

Atherton's investigations into the matter, while not wholly reassuring, suggested possibilities for the United States. He discovered that the Foreign Office "had communicated with the Board of Trade" concerning Hull's approaches, but that Eden had not contacted Runciman personally. Atherton had also ascertained that, because of the question of sanctions against Italy, Eden's "relations with Runciman are not too easy", and that regarding Runciman's remarks "he was obviously somewhat taken back when they were first brought to his attention".²⁰ This passage of exchanges revealed to a discerning eye the most profitable line of approach when dealing with the British. Any attempt to argue against the technical details of British commercial policy would be rebuffed, as the Treasury and the Board of Trade did not take kindly to attacks upon their professional expertise and held that of their American opposite numbers in particularly low esteem. Eden's response had revealed, however, that in the first place the British Government was not wholly united behind its policy and secondly that there was a strain of British thinking, at least in the Foreign Office, that was keen to reach agreement with the United States and which was responsive to a liberal message.

3:2 A Different Tack

Hull had a chance to consider these points while the German reoccupation of the Rhineland put all other thoughts from the minds of the British Cabinet, and when he finally handed the British Ambassador his original memorandum, another was attached which struck a much more moderate tone. It specifically retracted his previous appeal on technical details, stating that he regretted "to learn that the British Government construed my proposal, which was in the nature of an inquiry, to embrace minor and other subordinate questions of a controversial nature. This was entirely foreign to my purpose."²¹ He simply wanted to know whether the British "Government could see its way clear to pursue virtually the identical course the United States Government has pursued under the Trade Agreement Act of 1934".

¹⁹ Ibid. The Secretary of State to the Chargé in the United Kingdom (Atherton), 28th February 1936, p.645.

²⁰ Ibid. The Chargé in the United Kingdom (Atherton) to the Secretary of State, 29th February 1936, p.646.

²¹ Ibid. Memorandum, in The Secretary of State to the Chargé in the United Kingdom (Atherton), 28th March 1936, p.648.

Hull then aimed for the moral high ground, stating that the “mere announcement by the British Government” of such an intention would have a considerable “moral effect” throughout the world. Hull’s message was amplified by his Special Assistant, James Clement Dunn, when the memoranda were handed to Lindsay, who “called the Ambassador’s attention” to Hull’s “particular wish” that his initiative should “not become involved in technical discussions as to the exact methods of its execution” and that a declaration of the type Hull sought “would not obligate the British Government to any immediate or specific steps, but would have the effect of giving assurance generally that it was the intention of the British Government to carry out such a program”.²² This shift of emphasis proved to be a master stroke and the Secretary of State’s perseverance began to be rewarded. His appeal to a liberal spirit in trade and his association of increasing international tension with its absence appealed to a broad spectrum of British opinion, both official and individual, from those who cared little about trade but valued U.S. political support above all else, to those for whom the restoration of free trade was the essential foundation of a better world.

In communicating with Lindsay and Eden, Hull was also sending his message through the line of least resistance. Upon receipt of Hull’s second memorandum, Lindsay “expressed himself as very much relieved to know that no particular steps were intended for adoption at this particular time and said that he hoped the whole matter would be kept on a plane of policy and declaration until such times as the different phases could be successfully dealt with”.²³ Lindsay was enthusiastic as well as relieved and told Dunn that “he would make every effort to explain the matter again to his Government particularly along the lines of the Secretary’s new memorandum and hoped that from the policy viewpoint it could be accepted and put into effect by his Government”.

On 1st April, the Ambassador remarked to Hull that his memorandum had “lifted all the problems relating to international economic affairs to a higher and clearer level”.²⁴ This level, free of wrangling over tariffs and quotas was clearly more congenial to the Diplomatic Service and the Foreign Office. Eden, upon receiving the memorandum himself hinted why: he told Ambassador Bingham that “while he was not an expert on the technical side of this

²² Ibid. Memorandum by the special Assistant to the Secretary of State and Chief of the Division of Western European Affairs (Dunn), 30th March 1936, p.649.

²³ Ibid., p.650.

²⁴ Ibid. Memorandum by the Secretary of State, 1st April 1936, p.650.

subject, he was fully aware of its importance and its political implications and that it was his intention to make every effort to avoid a conflict of trade policy between Great Britain and the United States".²⁵ Eden's attitude was similar to Lindsay's in that they both felt that close relations with the United States were essential to counteract a deteriorating diplomatic situation and that all possible obstacles to such an understanding should be removed. Economic matters, especially in the eyes of those with no understanding of them, formed simply a technical issue, which should not be allowed to constitute such an obstacle. These opinions were sufficient to begin a shift in British policy.

Despite his enthusiasm for Hull's views, Lindsay had felt it necessary to warn him that "it might seem to the British Government more or less difficult to reverse its present definite course and attitude" and make the announcement Hull sought, and that "their country was moving forward fairly well in the present situation and the disposition might be to so continue".²⁶ Other sources emphasized this note of caution. On 7th April, Bingham reported to Hull that he had dined the previous day with the "permanent Assistant Secretary to the Board of Trade" who described Runciman as "far more liberal in his views and policies than any successor was likely to be" and characterised him as "a good man struggling against an adverse tide of events".²⁷ This unpromising information was reinforced when Bingham talked with a "high Treasury official", and "he too stressed the urgency of European political situation as the primary factor dominating British policy in all fields which compelled, reluctant as they were to admit it, a policy of expediency in economic and financial international questions".²⁸

These British responses would seem to indicate that Hull's noble ideals had no likelihood of adoption in the tense international climate created by Hitler's reoccupation of the Rhineland. In other words, the British policy of protection and Imperial preference was seen to be more logically suited to a time of crisis than one of free trade. Hull had received enough encouragement to continue, however, and he seemed to have engaged Eden's

²⁵ Ibid. The Ambassador in the United Kingdom (Bingham) to the Secretary of State, 7th April 1936, p.655.

²⁶ Ibid. Memorandum by the Secretary of State, 1st April 1936, pp.650-651.

²⁷ Ibid. The Ambassador in the United Kingdom (Bingham) to the Secretary of State, 7th April 1936, p.655-656.

²⁸ Ibid., p.656.

enthusiasm completely. Importantly, all Hull's communications to this date had reached the Board of Trade through the Foreign Office, which had the first opportunity of presenting its views to the rest of the British establishment. Although Hull thought the British attitude "disappointing",²⁹ he saw "a chance that fuller consideration may produce a change in their present judgment, and induce them to undertake the step I have suggested".³⁰ To this end he would "continue the effort here to secure full consideration from them for the wisdom of some such step. I desire to do likewise in London." Hull instructed Bingham to "take advantage of all opportunities to present these views to the British Government" and, at "a suitable and propitious opportunity", to "talk again with Eden and Runciman, and leave with them an informal memorandum in summary of your remarks", which Hull had thoughtfully provided.

Eden received the latest memorandum on 28th April, and on this occasion he brought an official response, asking Bingham to tell Hull that "his Government has taken great satisfaction in the views you have expressed in your communications and is giving them active sympathetic consideration".³¹ Furthermore, the British Government was preparing a memorandum for Hull, which Eden hoped would "show that the aims and methods of his Government are substantially similar to those of our own". This promised little, but after months of effort Hull was on the verge of establishing an official dialogue with the British Government. The Secretary was not, however, about to rest on his laurels, and having gained Eden's support he attempted to establish a direct line of communication with Runciman. At a lunch appointment, Bingham handed the new memorandum to Runciman and was asked to convey the latter's "acknowledgement" of the message which Hull had conveyed to Runciman "through his son".³²

Although Runciman's defended his policy along familiar lines, his "attitude did not remind" Bingham "in any way of his remarks" to the Bradford Chambers of Commerce, and he felt that Runciman was "at pains to give me the palatable interpretation of British

²⁹ Ibid. The Secretary of State to the Ambassador in the United Kingdom (Bingham), 11th April 1936, p.656.

³⁰ Ibid., p.657.

³¹ Ibid. The Ambassador in the United Kingdom (Bingham) to the Secretary of State, 28th April 1936, p.660.

³² Ibid. The Ambassador in the United Kingdom (Bingham) to the Secretary of State, 29th April 1936, p.660.

commercial policy within the limits of what they conceived to be their greatest self interest”.³³ Runciman told Bingham “that in his speech before the [A]ssociation of British Chambers of Commerce” on the following day “he would make occasion to set forth anew the Government’s viewpoint”. The tone of this speech, though, was far from warm. Bingham reported that Runciman “referred to the fact that I was present and added: ‘The American Ambassador is the representative of a Government which has again and again stated that it wished to see a much freer flow of international trade. In so far as it lends itself to that ambition, they will find us ready to cooperate.’”³⁴

If this was an uncompromising statement, it should perhaps be understood in terms of the British business audience which Runciman faced. On 30th April, Hull had received a telegram from the American Consulate in Birmingham explaining the attitude prevalent in Britain’s industrial heartland.³⁵ The Consul, James R. Wilkinson had

heard a discussion being carried on by a group of important businessmen in this City...There seemed to be among these men a general agreement that by and large the British business public is extremely hostile toward any move involving the lowering of British customs duties on American goods or involving the loosening up of any measures now restricting their introduction into this country...This attitude, it was stated, is attributable to a widespread belief that, in no circumstances and despite the declarations of our Federal Administration to the contrary, will the United States ever give any substantial quid pro quo in exchange for British tariff favours.

British industrialists were probably more aware than their Government that, as Runciman said in a rhetorical flourish concluding his speech: “The turn which economic issues take today in large part spells the destiny of tomorrow.”³⁶

On 26th May 1936, Bingham was given the British Government’s memorandum to Hull, which asserted British credentials on free trade, referred to Ministerial statements on the issue, and assured the Secretary of State that such deviations as had occurred from the most favoured nation principle were temporary measures designed to ensure the payment

³³ Ibid., p.661.

³⁴ Ibid. The Ambassador in the United Kingdom (Bingham) to the Secretary of State, 1st May 1936, p.662.

³⁵ SD 611.4131/139. American Consulate, Birmingham, to Secretary of State, 30th April 1936.

³⁶ Quoted in *FRUS* 1936, Vol.1. Bingham to Hull, 1st May 1936, p.662.

of debt owed to Great Britain. The British Government also expressed its willingness to reaffirm its attitude along the lines suggested by Hull.³⁷ The latter would have derived more encouragement from a report by Atherton, summarising “a luncheon conversation with senior officials of the Board of Trade and Treasury regarding certain economic and financial questions”.³⁸

The sentiments of these officials differed sharply from those of the businessmen overheard by Wilkinson. They doubted the practicality of a trade agreement, but asserted their liking for freer trade:

As regards the general question of a more liberal and enlightened commercial policy, both the Board of Trade and Treasury official [sic] emphasized the pressure which the departments concerned and the Government came under from Members of Parliament and special interests, and took the line that since the disease of protection had come on this country when it was advanced in age it was all the more violent in its initial stages. They both felt that the present House of Commons was essentially a protectionist body, which saw the immediate objects of attainment, especially as regards specific products, and tended to disregard the eventual results and the broader national interests. Furthermore, ‘the war mentality’ arising out of the international situation was playing its part. In the circumstances those ministers who had a liberal trade outlook, as well as permanent officials of the same conviction, had to content themselves with attempting to check the excessive zeal of the protectionists until such time as opinion began to move in the opposite direction, which would then give them the opportunity for a frontal attack.

An example of the prevailing climate was provided:

Captain Wallace, Parliamentary Undersecretary at the Board of Trade, who was sufficiently new at his job to consider himself more a member of the Conservative party than a Government official, stated in private only yesterday that he would just as soon have the Argentine negotiations fail, for such a failure, far from reacting adversely on the Government, would be popular in the House of Commons.

In addition to the British Government memorandum, contacts were underway at the official level with regard to the negotiation of a trade agreement. Sir Frederick Leith-Ross, the Chief Economic adviser to the British Government, and Oscar Ryder, a member of the

³⁷ Ibid. The Ambassador in the United Kingdom (Bingham) to the Secretary of State, 26th May 1936, pp.663-666.

³⁸ SD 611.4131/177. The Chargé in the United Kingdom (Atherton) to the Secretary of State, 12th June 1936.

U.S. Tariff Commission, met in London and agreed that the Americans should produce a list, both of the concessions they sought from the British and those that they were willing to give in turn.³⁹ This rather shadowy procedure had the effect of leaving the impression that interest remained entirely on the part of the United States and also of handing an early initiative to the Americans.

Shortly afterwards, H.O. Chalkley, the Commercial Counsellor of the British Embassy was called to the State Department's Division of Trade Agreements, ostensibly "for the purpose of discussing the progress of the exploratory studies of trade relations between the United States and the United Kingdom"⁴⁰, but in fact to receive American demands. Chalkley was told that the Americans "believed that a comprehensive trade agreement of great value to both countries could be consummated provided the British Government would be prepared to consider modifications of imperial preferences affecting a very substantial portion of our export trade with the United Kingdom".⁴¹ In the absence of such modifications "it was pointed out that only a very limited agreement, if indeed any agreement at all, could be negotiated".

Although Chalkley "was assured that this did not mean that we would request the abolition of imperial preference", the American aspirations had leapt from a desire for revised British commercial practice in third markets to a demand for the wholesale revision of the trading system of the British Empire. The Americans made it known "frankly" that they were "somewhat concerned about the preliminary negotiations" between Britain and the Dominions concerning measures to replace the Ottawa agreements, which were to expire in August 1937. It would be "unfortunate" if any new agreements should "preclude the possibility of a really worthwhile agreement with the United States". Chalkley, perhaps unsurprisingly, "did not show much enthusiasm in regard to these suggestions", and doubted the basis for an agreement.

Chalkley's lack of enthusiasm continued at his next meeting with the Division of Trade Agreements. He presented the Americans with a short list of British requests for tariff

³⁹ Drummond & Hillmer, *Negotiating Freer Trade*, p.38.

⁴⁰ *FRUS* 1936, Vol.1. Memorandum by Mr William A. Fowler of the Division of Trade Agreements, 17th June 1936, pp.666-667.

⁴¹ *Ibid.*, p.667.

reductions which, he said, was “one year old, unofficial and subject to revision”,⁴² and which was sufficiently modest to include golf balls as a separate category. In return he stated that the United States could expect ““very little indeed, in the way of reductions in duties””, and argued “to the effect that there was very little proof that imperial preferences are of themselves effective in diverting American trade”. He was “emphatic in suggesting that the words ‘abolition of preferences’ be not used in negotiations”,⁴³ and even stated “that effective argument against them was difficult except in very exceptional circumstances”. Far from considering concessions, Chalkley “stressed the value to the United States of securing stability of the *status quo* both with respect to import duties and to preferences while pointing out the necessity for the increase in some of the existing import duties”.

This position was in fact all that the United States could have expected, and after Hull dispatched another memorandum asking when the British Government was going to make the declaration it had promised, Atherton gained the impression in conversation with Chamberlain, who had not seen it, and Runciman, that the attitude of both men, “was based on Cabinet consultation and decision to play for time”.⁴⁴ There remained Eden, who on receipt of the latest memo had “said he wished to continue to handle this matter personally”,⁴⁵ but the political response from London was frankly discouraging. Hull’s achievement in cultivating Eden and persuading the British to even talk about an agreement had been impressive, but his only real bargaining counter was the worsening diplomatic situation, and current British commercial policy could be argued to be appropriate to that situation as well. Hull could only keep up the pressure and hope that movement within the British establishment itself would work in his favour.

Another memorandum expressing regret at the delay in the British Government’s declaration in favour of Hull’s policy was followed by a visit from Lindsay, who brought with him an extract of a speech by Runciman in the House of Commons on 15th July. This was obviously designed to convince the Americans that Great Britain had no dark motives. Runciman’s speech had pointed out Britain’s tremendous power to influence world trade in its favour, which it was not exploiting. In fact: “The British import market, which is by

⁴² Ibid. Memorandum by Mr. Richard Eldridge of the Division of Trade Agreements, 24th June 1936, P.670.

⁴³ Ibid., p.671.

⁴⁴ Ibid. The Chargé in the United Kingdom (Atherton) to the Secretary of State, 26th June 1936, p.672.

⁴⁵ Ibid. The Chargé in the United Kingdom (Atherton) to the Secretary of State, 19th June 1936, p.669.

far the largest import market in the world, has been kept open for the goods of all nations on fair and equal terms.”⁴⁶ The clearing arrangements entered into by the British Government abroad were the minimum required for “self-defence”, given that “[u]pon certain countries and for a certain period we could no doubt force the greater quantity of United Kingdom goods”. Despite this, the British had “used the power of our huge import market with great caution to promote the sales of our goods abroad rather than to compel artificially changed purchases”.⁴⁷

Hull may have had cause to be grateful for British restraint in its trading practice, but he knew that he could take this for granted, and furthermore the British tone, which showed every sign of taking his liberal sentiments at face value, held the promise of further concessions. He told Lindsay, therefore, that “in the abstract” Runciman’s statement was “excellent and encouraging”⁴⁸ and that he wished to “express...appreciation of the tone of Mr Runciman’s remarks, especially as viewed from the abstract standpoint”, but he “would not be quite frank if I did not express a little disappointment in the failure of Mr Runciman to indicate a single step or act or utterance” in favour of “a liberal commercial policy”. Hull went on to say that “unfortunately the inert or static attitude of the British government in this respect was pointed to both at home and by most of the capitals of Europe”,⁴⁹ and that “the British Government was not moving one fraction of an inch in the direction of either carrying forward any kind of a program or furnishing any kind of leadership”.

In addition to his usual debating points, Hull mentioned “the desultory conversations between the British Government and the United States Treasury Department” and wondered “why it would not be possible”⁵⁰ for the two Governments, in addition to their announcement of common purpose, to “undertake to keep the pound and the dollar within certain ranges”. Summing up, Hull elucidated his latest bargaining position that “the British Government was almost absolutely static with reference to its economic and commercial policy; that it was seemingly settling and falling back to a two-fold major objective of large armaments and Empire preference; that it was in these unfortunate circumstances that I was

⁴⁶ Ibid. Memorandum by the Secretary of State, 20th July 1936, p.679.

⁴⁷ Ibid., pp.679-680.

⁴⁸ Ibid., p.675.

⁴⁹ Ibid., p.676.

⁵⁰ Ibid., p.677.

finding it difficult to induce other countries in Europe to move forward in support of the liberal economic program”.⁵¹

Hull’s position was a far cry from his initial complaint about bilateral trade agreements. It was also an outright appeal to liberal sentiment in Britain, characterising the British Government’s protectionist policy as both the direct cause of fascist aggression and the main obstacle to movement in the direction of peace and prosperity. Perceiving that Lindsay “seemed much interested and entirely sympathetic with these inquiries in the nature of suggestions”,⁵² Hull proposed “a purely oral conversation for the benefit of our respective Governments which he could carry home with him” in the event of there arising “such facts or developments as would afford an occasion and a basis for such oral conversation”.⁵³

Despite his comments, Runciman’s speech had encouraged Hull and he instructed Bingham not to hand on his previous critical memorandum until it had been revised.⁵⁴ Also, Eden informed Bingham that the speech would have gone further towards the American position but for time pressure.⁵⁵ If Hull had hoped for some immediate move in the British position, however, he was to be disappointed. There followed a period of apparent calm, and after a month of delay, the irascible Secretary of State sent a further memorandum bemoaning a lack of progress, which Bingham was to use in meetings he was instructed to arrange with Eden and Runciman.⁵⁶ Eden defended himself by reference to his recent and impeccably internationalist speech at Geneva, and complained that the difficult political situation was holding up the sort of movement that the Americans desired. He said that Lindsay had “strongly presented the view of the American Government on the general subject” to him and “expressed his deep interest, in which I have no doubt he is sincere, in doing everything possible to maintain the best relations with the United States and said that he would give this matter more time and effort and would take it up with Runciman and

⁵¹ Ibid., p.678.

⁵² Ibid., p.677.

⁵³ Ibid., p.678.

⁵⁴ Ibid. The Secretary of State to the Ambassador in the United Kingdom (Bingham), 25th July 1936, p.680.

⁵⁵ Ibid. The Ambassador in the United Kingdom (Bingham) to the Secretary of State, 28th July 1936, p.680.

⁵⁶ Ibid. The Secretary of State to the Ambassador in the United Kingdom (Bingham), 3rd September 1936, pp.680-684.

Neville Chamberlain”.⁵⁷

In keeping with the current American pessimism, however, Bingham expressed the opinion that although Eden was “no doubt...sincere”, he must “doubt his ability to influence his colleagues sufficiently to modify their views”. This opinion would seem to be supported by Eden’s failure to raise American demands formally in Cabinet until October 1936. Also, while Bingham was talking to Eden, Under-Secretary of State William Phillips, on a visit to Britain, took the opportunity to talk to the Foreign Secretary’s principal officials, Cadogan and Vansittart. Phillips explained the Hull Program to the former, but “[a]t this point Mr Cadogan admitted his ignorance in regard to the entire subject.” He “had evidently not given much consideration to this whole question. Again and again he pleaded ignorance”, but

stated that for forty years the British Government had taken up the cudgels in favour of the lowering of tariff barriers but that the world had not followed them in this respect. He also reminded me that the United States had been one of the principal champions of the high tariff policy and that in present circumstances the British public had come to believe that their interests were best protected by the present commercial policy of the Government. Politically, therefore, it would be very difficult for the British Government now, to seem to go back to its former freer trade policy and, in fact, this could not be done without serious political complications. Commercially, the British were doing well under the present system of specialised agreements. They had the approval of the British public.

Phillips summarised:

In brief, while it was apparent that Mr Cadogan was not responsible for, or particularly in touch with the new British trade agreements, he was in entire sympathy with them and was not particularly concerned with the fact that the continuation of the present British policy might lead the British and American Governments in opposite directions.

Talking to Vansittart, Phillips “had very much the same impression that Sir Robert was not particularly interested in or concerned with commercial matters.” Phillips concluded that “after my conversations with both Vansittart and Cadogan I feel that, unless the approach can be made through higher channels, these two men in the Foreign Office at least will not go out of their way at the present time to meet our desires”.

This time appeared to be the low point of American attempts to engage British interest

⁵⁷ Ibid. The Ambassador in the United Kingdom (Bingham) to the Secretary of State, 19th September 1936, p.685.

in an agreement, but appearances were deceptive. Cadogan's ignorance would not always tell against the U.S., Vansittart's influence was already overstated and would decline, and despite Eden's shortcomings from the State Department's point of view, a variety of information would be presented to Washington towards the end of 1936 to suggest that opinion in the British political establishment was moving the American way, and that Bingham was probably overestimating the importance of individual Ministers in the British decision making process. When Chalkley was summoned to the State Department for discussions on 21st September, the Americans gained the impression that he was under instructions to broach the subject of trade negotiations in such a way as to stress the urgency of the matter.⁵⁸ Forces had been at work which supplemented Hull's efforts, but of which he could have been but dimly aware.

3:3 Morgenthau Tips the Scales

Hull had referred to the "desultory conversations" taking place between the British and the U.S. Treasuries concerning currency stabilisation. The occasion for these talks was the impending devaluation of the French franc and the general desire that this should not cause chaos on the foreign exchanges. While Hull had been pursuing his reciprocal trade agreements program Morgenthau, in the traditionally disjointed manner of American policy making, had on his own account been pressing hard for a currency stabilisation agreement between the franc, the dollar and the pound, with the active support of Roosevelt. His motives were complex and in part rooted in his fierce anti-Nazi convictions, which he felt necessitated agreement between the western democracies. On the other hand, if this produced the long hoped for pegging of sterling to the gold dollar so much the better, and this outcome was certainly close to Roosevelt's heart.

In 1935, when the franc was merely under pressure, and the memory of Roosevelt's behaviour during the World Economic Conference was still fresh, Morgenthau's efforts were greeted "with derision by the British authorities".⁵⁹ A year later, however, after the election of Blum's Popular Front and the subsequent flight of capital from Paris, it became evident that the franc was about to be driven from its gold parity, along with the other

⁵⁸ Ibid. Memorandum by Mr. John R. Minter of the Division of Western European Affairs, 21st September 1936, pp.685-686.

⁵⁹ S.V.O. Clarke, *Exchange-Rate Stabilization in the Mid-1930s: Negotiating the Tripartite Agreement* (Princeton, 1977), p.18.

currencies in the European gold bloc. The British then became interested in some form of cooperation to manage the situation and after much haggling an accord to manage the French devaluation was reached. However, there seemed at first little cause for specifically American jubilation. The Tripartite Agreement in bald terms was a fig leaf designed to disguise the French devaluation as merely part of a general international rearrangement of currencies.

The now traditional American attempt to peg sterling to the dollar at a high parity - on Roosevelt's insistence, Morgenthau advanced the figure of \$5 - met with the traditional rebuff, the British simply promising in line with their own policy to avoid competitive devaluation. This response did not surprise the American authorities. John H. Williams, the Vice-President of the Federal Reserve Bank of New York, told Morgenthau that "the British are not planning to play with us in this matter at all..." and that "it would clarify the situation if we would recognize that we have no real power over them at this stage...."⁶⁰

Morgenthau's excitement during the negotiating of the Agreement was largely confined to the effect he imagined it would have on the dictators,⁶¹ and the main concern of the British was to ensure that the French did not come entirely off gold as the ability to exchange francs for gold greatly facilitated the operations of the Exchange Equalisation Account. The compromise agreement creating the '24 hour gold standard' gave the French some flexibility in managing their currency but allowed the British to sell Francs for gold at a price to be renegotiated each day. Indeed Morgenthau found himself forced to accord similar facilities to the British, as he was unable to prevent any devaluation of sterling, and "[w]ithout discussion, he dropped his request for an explicit commitment by Britain on the sterling-dollar rate"⁶² in return for convertibility facilities.

This was a major concession, as the U.S. had previously only sold gold for currencies that were on a full gold standard. If Morgenthau tried to buy gold with pounds in the international market, rather than from a central bank, he only raised the price of gold and depreciated sterling still further against the gold dollar. Morgenthau found that "I am

⁶⁰ Ibid., p.50.

⁶¹ Morgenthau clarified this point in conversation with his advisers on 18th September 1936: "This is a notice to Japan, Germany and Italy that we won't stand any monkey business...This is a notice to the boys - *Achtung!*" Quoted in J.M. Blum, *From the Morgenthau Diaries Vol.1, Years of Crisis, 1928-1938* (Boston, 1959), p.166.

⁶² Clarke, *Exchange Rate Stabilization*, p.52.

buying sterling and I can't convert the damn stuff.” Believing that: “No country wants to sit and hold paper”,⁶³ he agreed “[i]n the spirit of the Tripartite Agreement”⁶⁴ to sell gold to the British at \$35 an ounce, an arrangement that was eminently satisfactory to London.

Hull's lack of interest in the Tripartite Agreement was not surprising as he had not been a party to the negotiations, and the results seemed inauspicious in terms of U.S. trade policy. He would have been much more pleased, however, had he but known the effect that the Agreement had had within the British establishment. In the closing months of 1936 the movement for a modification of the Ottawa system was becoming firmly rooted. Hull's propaganda offensive during 1936 had provided support and encouragement to like-minded elements within the British establishment, the most prominent of whom were in the Economic Section of the Foreign Office.⁶⁵

Frank Ashton-Gwatkin and Gladwyn Jebb, candid enemies of the Ottawa system, planned for the economic appeasement of Germany through concessions designed to draw that country back into the international financial system, which it would then have a political stake in maintaining. They moved in June 1936 after a dinner party organised by the Economic Adviser at Australia House, at which a number of economic liberals were present, including Jebb and Leeper of the Foreign Office. As a result of the discussion which took place, Professor Noel Hall of London University was prevailed upon to write a memorandum detailing a scheme for the economic appeasement of Germany.

The idea of making unreciprocated concessions to Germany never excited much enthusiasm outside the small circle of its proponents and when, before the memorandum had “taken final shape”, Jebb “presented the substance of it privately to Mr. Waley of the Treasury and Mr. Brown of the Board of Trade, neither were very encouraging”.⁶⁶ When the memorandum was finally prepared, however, Germany was not its only focus, and it made the specific point that: “It should be noted that the policies which are advocated here fit closely with those which Mr. Cordell Hull has been following under the Democratic Tariff

⁶³ Ibid., p.53.

⁶⁴ Ibid.

⁶⁵ For an interesting account of this attempt to establish an economic voice for the F.O., see D.G. Boadle, “The Formation of the Foreign Office Economic Relations Section, 1930-1937”, *Historical Journal* 20, (1977), pp.919-936.

⁶⁶ FO 371 19933 C4758/99/18, p.171. Minute by Jebb. Origin of the Hall memorandum, 25th June 1936.

Legislation”; and further: “A development of British Empire Policy that is compatible with more generous international policy in the United States has much to commend it.”⁶⁷ Hull had thus become, unknown to himself, a player in the debate within the British governmental system on the course of economic policy. Jebb maintained that “neither Mr. Leeper nor myself take any responsibility for the Hall memorandum, but ... we are both impressed by the desirability of its being subjected to the most sympathetic consideration by the experts of His Majesty’s Government”.⁶⁸

Despite the introduction of an American dimension, the Hall scheme could not gloss over the unattractive features of unilateral concessions to Germany. As Vansittart noted in conversation with Ashton-Gwatkin, the scheme “certainly had attractive features”, but if it caused “unemployment in this country, the chances of getting Ministers to agree to it were the reverse of bright”. Ashton-Gwatkin replied that any unemployment resulting from the scheme would “most likely be temporary” and intriguingly “that there were great possibilities of camouflaging the scheme by representing it as primarily designed to encourage trade within the Empire”.⁶⁹

Little came of the Hall Scheme’s main aim of the economic appeasement of Germany. The obvious costs were sufficient to defeat any attempt to make the scheme appear beneficial to the Empire, although Eden became and remained enthusiastic about it. Such failures to carry the whole package of economic appeasement measures have been taken as evidence that the ‘economic’ departments within the British Government which had constructed the post-1931 system would always defend it successfully against the schemes of liberal idealists.⁷⁰ This is too simplistic a conclusion. If one takes a departmental view, the Treasury and the Board of Trade certainly resented Foreign Office encroachment on their territory, partly for political reasons but chiefly because, as Cordell Hull had discovered, they were extremely sensitive to any attempt to denigrate or compete with their professional expertise. Sir William Brown at the Board of Trade summed up this attitude when considering an early draft of Runciman’s July speech to the House of Commons in response

⁶⁷ Ibid., C4759/99/18, p.191. Hall Memorandum, p.8.

⁶⁸ Ibid., C4758/99/18, pp.171-172. Origin of Hall Memorandum.

⁶⁹ Ibid., p.180. Record of a Conversation Between Sir R. Vansittart and Mr. Gwatkin.

⁷⁰ G. Schmidt, *The Politics and Economics of Appeasement: British Foreign Policy in the 1930s* (Leamington Spa, 1986), pp.221-222.

to Hull's urging: "I attach a draft which was originally prepared by the Foreign Office, but has been modified here in order to reconcile it with some actual features of our commercial policy."⁷¹

Such asperity did not mean, however, that the Treasury or the Board of Trade were immune to a liberal message, in terms either of departmental ideology or as individual civil servants. The 1931 economic changes had never been presented in either of these departments as anything other than crisis measures, and after a period of recovery it was inevitable that they would be called into question. For the Ottawa system to be undermined it was not necessary for a full-blown scheme of economic appeasement to succeed, merely for aspects of such thinking to be accepted in the Government. Indeed, the more stridently the whole package was promoted, the more moderate individual aspects of it would come to appear.

3:4 A Decisive Shift

The effects of the changing climate of British opinion promoted by Hull came to be seen towards the end of 1936, when various papers were presented to the Cabinet in the wake of the Tripartite Agreement which stressed the liberal message with varying degrees of candour. On 28th October 1936, the Cabinet considered a memorandum from the Board of Trade⁷² prepared after a meeting "under the Chairmanship of the Financial Secretary to the Treasury, at which Sir F. Leith-Ross and officials of the Treasury, Board of Trade and Foreign Office were present".⁷³ This stressed that the Tripartite Agreement concluded in September had stated that the governments involved "attach the greatest importance to action being taken without delay to relax progressively the present systems of quotas and exchange controls with a view to their abolition".⁷⁴

This policy was "strongly" endorsed by the League of Nations Assembly in a resolution calling for "all States to organise, without any delay, determined and continuous action to ensure its application". Having established the credentials of a liberal programme,

⁷¹ PRO BT 11/589 p.29. Minute by W.B.Brown, 14th July 1936.

⁷² CAB 24/264, p.311. C.P. 277(36) International Action Towards Relaxation of Obstacles to Trade. Board of Trade, 23rd October 1936.

⁷³ Ibid., pp.1-2.

⁷⁴ Ibid., p.1.

the memorandum noted the difficulties involved but concluded that “the present seems the ‘psychological moment’ for attempting some action in the international sphere, and it is felt that the possibility of a multilateral agreement ought to be explored”.⁷⁵ Indeed some work had been undertaken already. Leith-Ross had already met M. Rueff, the Financial Attaché at the French Embassy, and the good offices of the Belgian Government were being sought to take soundings for a move in the European context concerning which the “United States Government would need to be kept informed at all stages and given the opportunity of participating should they desire to do so.”⁷⁶

In this paper, liberal civil servants appeared to be making an effort to feel their way round the flank of Cabinet opposition to their views, and hustle through a change in the Government’s outlook under the cover of a concerted international move towards freer trade. The unpopular idea of German economic appeasement was dropped, along with the politically charged question of agricultural preference. Instead it was mentioned that Leith-Ross had supposedly been told by Rueff before he left for home “that some agreement might be reached between the ‘free currency’ countries to abolish their industrial quotas as between themselves”.⁷⁷ The paper then attempted to generate a sense of urgency. It noted that Reuff would shortly return from Paris, and “it is desirable that before then H.M. Government’s attitude in the matter should be settled as far as possible.”⁷⁸ In fact, the whole impression of international movement for change, culminating in the Van Zeeland Mission, was generated by Leith-Ross through his extensive network of international financial contacts.⁷⁹ Nor had the Chief Economic Advisor been idle on other fronts.

Shortly afterwards, Leith-Ross presented a report to the Cabinet on the Balance of Payments⁸⁰ which suggested reasons and remedies for the existing deficit on current account. He attributed the primary cause of the deficit to the fact that “greater industrial

⁷⁵ Ibid., pp.3-4.

⁷⁶ Ibid., p.5.

⁷⁷ Ibid., p.1.

⁷⁸ Ibid.

⁷⁹ The Belgian Premier was prevailed upon to contact governments with a view to arranging an international conference. The central role of Leith-Ross in this initiative can be traced from the extensive correspondence contained in PRO CAB T 188/175.

⁸⁰ PRO CAB 24/265, p.275. CP 339(36) The Balance of Payments of the United Kingdom, 18th December 1936.

activity and purchasing power in this country has led to a greater volume of imports of foodstuffs, raw materials and manufactured goods, the principal value of which lies in their raw material content".⁸¹ For the same reason, goods had been diverted from export to the domestic market. The demands of rearmament were also mentioned, along with a rise in import prices. Leith-Ross expressed no alarm at the deficit and pointed out that a run on the pound and a rise in interest rates were unlikely to follow from it. In fact, British money rates were "lower than those of any European country", and attempts to "discourage the investment of British capital abroad by the control of new capital issues", allied to a general "absence of credit-worthy foreign Borrowers", created conditions which "have tended to increase the plethora of funds seeking investment at home, and thus to give an additional stimulus to domestic trade production, while, at the same time, strengthening the value of sterling".⁸²

He listed a number of ways in which the deficit might be eliminated, rejecting import control and deciding that: "The preferable course seems to be to meet the adverse balance of payments by other means, and, in particular, by allowing the exchange to adjust itself as it may be expected to do, to a slightly lower level".⁸³ This "has the advantage of operating on a very wide field, Viz., the trade of the whole sterling area; so that a relatively small deviation in the balance of payments can be corrected by a small change in the level of the exchanges".⁸⁴ Almost as an afterthought Leith-Ross then stated that "[f]or the rest" some means might be found of stimulating exports and at this point the tone of his paper changed radically.

The whole second part of the report was devoted ostensibly to the stimulation of exports but in reality to a veiled attack on Imperial preference. Leith-Ross's earlier praise of post-1931 policy was qualified by the assertion that, successful as this had been: "Recovery has by now reached a high level within the sterling area, and the scope for further expansion of trade is consequently greatest in the countries outside the sterling area."⁸⁵ He argued that Britain's "policy, by establishing a preferential or favourable position

⁸¹ Ibid., p.277. CP 339(36), p.2.

⁸² Ibid., p.3.

⁸³ Ibid., p.4.

⁸⁴ Ibid., p.5.

⁸⁵ Ibid., p.6.

for our exports to the Empire and to the countries with which we have negotiated Trade Agreements, has accentuated the competition which we have to face in other countries, particularly in South America and the Far East, where the scope for expansion of trade is now most marked".⁸⁶

Leith-Ross reinforced these questionable assumptions by quoting "an interesting article"⁸⁷ in the Liberal publication *Political and Economic Planning*, which in November 1935 claimed that its June issue of that year "showed that the primary producing interests of the overseas Empire must inevitably be far wider than the British market, and that the industrial and commercial interests of Great Britain are far wider than the market provided by the overseas Empire". It also appealed to the consciences of its readers: "We expressed fears concerning the ultimate wisdom of a policy which, in face of the traditional British conception of imperial trusteeship has sought to exclude from the Crown Colonies cheap manufactured articles which the United Kingdom cannot supply on competitive terms and which, by reason of their low standard of life, Colonial populations urgently desire." A copy of this publication was also placed in the Foreign Office records, with a note by Jebb that it "may be used in connection with the Hall memo."⁸⁸

Leith-Ross's paper was an elegant exposition of the developing liberal arm of the movement towards accommodation with the United States. Instead of denigrating the post-1931 system, it simply argued that a policy designed as a crisis expedient had succeeded, could no longer be justified and should now be supplanted. The argument in favour of freer trade was based on supposition, but played on fears of possible stagnation and economic aggression and so directly echoed the statements of Cordell Hull. There was also a calculated appeal to the conscience of the Cabinet in an assertion that Imperial preference was morally as well as economically flawed.

The Twenty-First Report of the Committee on Economic Information expressed itself bluntly in its concluding paragraph: "The recovery which has taken place both in the United Kingdom and in the Empire as a whole has involved a considerable dislocation of trade with the rest of the world. It is gradually becoming clear that full recovery, both in the Empire and in the rest of the world, cannot be expected without some resumption of trade along its

⁸⁶ Ibid., p.9.

⁸⁷ Ibid., p.12.

⁸⁸ PRO FO 371 19933 C4760/99/18, p.204. Note by Jebb, 2nd July 1936.

old channels.” The conclusion was reached that “changes in British policy since 1931 have probably caused the main alterations in the channels of trade, and therefore it rests largely with us now to do what is possible to restore the situation”. To this end, “in our opinion the objective of policy should now be to seek to expand trade, wherever possible, between the United Kingdom and the Empire, on the one hand, and the rest of the world, on the other”.⁸⁹

By the end of 1936, therefore, the policy of Imperial preference was under concerted attack within the British establishment. Runciman in the Cabinet was increasingly well disposed to a U.S. trade agreement, but the most powerful backing came at the official level. Leith-Ross had made his opinion clear and the presence of Hopkins and Phillips on the Committee of Economic Information indicated their compliance. That Keynes and Henderson were on the Committee was also an indication that the views of professional economists were in line with more liberal trading practice. Such thinking was naturally encouraged by the Americans, who under the influence of Hull constantly hammered the same successful message at the British, that world crisis was based on protection, that a liberalisation of trade was essential and that Great Britain was responsible for much of the problem and furthermore presented the main obstacle to a solution.

For those likely to be influenced by this argument, the motives of the United States in presenting it were immaterial, as was any question of the sincerity of the professed American desire for mutual concessions. Powerful British interests and voices, as well as those of the Dominions remained wedded to Imperial Preference, but their opponents were coordinating their efforts and, with the ability to influence the Cabinet, had direct access to the main policy making body of the Empire. 1937 would see them continue to gain ground beginning with Runciman’s visit to the United States, during which he would meet Hull and Roosevelt directly.

⁸⁹ PRO CAB 24/265, p310A. CP 341(36) Economic Advisory Council. Committee on Economic Information, Twenty-First Report. Survey of the Economic Situation, December 1936, p.32.

CHAPTER 4

THE DEVIL IN THE DETAIL: A NECESSARY CASE FOR ECONOMIC DANGER AND THE FORMULATION OF THE FOURTH ARM POLICY, 1937-1938

Walter Runciman visited the United States in January 1937, having first “had a talk with Anthony and with Leith-Ross”, by whom he was “appraised of the worst rocks, which I hope to have the good fortune to avoid”.¹ Neither Eden nor the ubiquitous Leith-Ross could have objected to the impression made by Runciman’s less famous mission. In conversation with Cordell Hull he defended his record as a liberal in difficult times, which compared favourably, he noted, with that of the Secretary of State.² He did not, furthermore, rule out some loosening of the Ottawa system, concerning which “the details were always capable of discussion and readjustment”,³ a message he repeated in Parliament on his return, and more strongly in a letter to Baldwin. He told the Prime Minister that he had defended British policy but noted: “On the other hand, a certain degree of elasticity in the tariff undertakings which we gave at Ottawa would undoubtedly have facilitated negotiations with the United States of America.”⁴ He also suggested for the first time a direct link between Imperial defence and the economic appeasement of the Americans: “If we are able to reach a trade agreement with the present Administration, there is no doubt that it will make much easier their co-operation with us in case of trouble in Europe.”

This attitude must have surprised Hull greatly, as a memorandum he had prepared for Roosevelt⁵ prior to their meetings with Runciman described him as “an old time Liberal and free trader”, who was “at present extremely nationalistic, as has been evidenced by his

¹ PRO PREM 1/291, pp.43-47. Letter from Runciman to Baldwin, ‘Secret’ 6th January, 1937.

² Ibid., p.55. Memorandum by Runciman. Conversations with President Roosevelt and Mr Hull. Runciman met Hull on 23rd January, 1937.

³ Ibid., p.53. Runciman to Baldwin, Secret, 8th February, 1937.

⁴ Ibid., pp.53-54. Runciman to Baldwin, 8th February.

⁵ Cordell Hull, Secretary of State to Roosevelt, January 22nd, 1937. In D.B. Schewe (ed), *Franklin D. Roosevelt and Foreign Affairs*, Second Series, January 1937 - August 1939, Vol. 4, January - March 1937, pp.85-88.

promotion of and subscription to policies calculated to gain unfair advantage over American interests in many parts of the world". Hull speculated that Runciman's assumed "unfriendliness" to the United States might be the result of "indifference, supreme nationalism" or his family connection to shipping. In return, Runciman spoke less than warmly of Hull who "appeared to ignore our agreements, being so proud of his own 13 that he scarcely listened to the fact that we had made 23".⁶ Given this mutual petulance, Runciman's willingness to assert a liberal view and embark on negotiations for a trade agreement seems all the more remarkable. His comments clearly belied Hull's caricature and revealed possibilities for the United States. He suggested to Hull that it would be desirable to "draft expressions of principle to which the United Kingdom, as well as the United States of America, adhere". If this were done, "we could both put ourselves in a position to instruct our officials".⁷

Runciman's manner, shifting between firmness and conciliation, spoke of the transitional point at which British policy stood. Complaining of the recent Neutrality Act, he told Roosevelt

that the natural result would be to make countries like the U.K. turn away from the U.S.A. to other sources of supply, because we could not run the risk of finding ourselves choked off some day, perhaps in our time of greatest need. As a simple business precaution we would deal now with countries which would be our supplier in the future and we would avoid countries which might cut off our supplies at the behest of the Senator Nyes of the day.⁸

These remarks might be considered the high water mark of Imperial self-sufficiency in the defence context. Thereafter, the alternative argument that American support must be bought with economic concessions in a more liberal international system, became dominant. Roosevelt asked Runciman if he felt his trip had been worthwhile, to which he "replied that one did not cross the North Atlantic in the winter merely for a holiday".⁹ Against this background of a drive towards the liberalisation of British trading practice, the doctrine that economic stability must be considered a fourth arm of defence was established as the basis

⁶ PREM 1/291, p.60. Conversations with President Roosevelt and Mr Hull. Meeting with Hull and Roosevelt, 24th January, 1937.

⁷ Ibid., p.56. Meeting with Hull, 23rd January.

⁸ Ibid., p.62. Meeting with Hull and Roosevelt, 24th January.

⁹ Ibid., p.63. Final talk with the Premier, 26th January, 1937.

of policy in the domestic financing of rearmament. This all-encompassing liberal organisation of defence policy was firmly entrenched by March 1938, when circumstances changed decisively for the worse with Hitler's march into Austria. The victorious ideals of the British liberal resurgence would then be given the opportunity to prove themselves in the place between the twin threats of Nazi aggression and American avarice.

4:1 *Breaches in the Dam*

The new year of 1937 saw London blessed with a bountiful supply of American sermons on the economic and political benefits of free trade. In January, Hull renewed his propaganda offensive against the Ottawa system with a lengthy memorandum reiterating his arguments of 1936.¹⁰ In February, Henry Morgenthau, fresh from the successful conclusion of the Tripartite Agreement, delivered a similar message to Chamberlain through the British Embassy.¹¹ This stated that the burden of armaments was bringing the world to financial ruin and the risk of war. He told T.K. Bewley, the Financial Adviser at the British Embassy, that "if Mr. Morgenthau could do anything to help to prevent such a war he would (in his own phrase) die happy: he was inclined to think that the situation might be saved by a bold initiative by the United States and Great Britain".¹²

The message echoed Hull's argument that protection, by denying universal access to resources, made war to gain them more likely. A heavy burden of armaments could be taken to represent an advanced stage of this process and Morgenthau's argument stressed not only the desirability of an Anglo-American attempt to liberalise trade but also its urgency. To this end he raised the possibility of sending Bewley to England immediately on an American destroyer. When the British reply eventually came, however, it consisted largely of carefully phrased platitudes, and the correspondence was passed over to Cordell Hull, who simply continued his campaign.¹³ From this point, negotiations were conducted solely with the State

¹⁰ *FRUS*, 1937, Vol.2 (Washington, 1954). The Department of State to the British Embassy, 17th January 1937, p.1.

¹¹ *DBFP*, Second Series, Vol.18 (London, 1980). Record by Mr. T.K. Bewley (Washington) of a Conversation with Mr. H. Morgenthau, 23rd February 1937, p.278.

¹² *Ibid.*, p.279.

¹³ The shuttle of draft replies and amendments between Eden and Chamberlain can be followed in *Ibid.*, pp. 348;381;415 and 428. The British were puzzled by Morgenthau's motives, and felt the Treasury level inappropriate for such dialogue. However, in absorbing the attention of the two most influential Cabinet ministers, Morgenthau's initiative kept the pressure on London.

Department, and there followed a series of seemingly negative exchanges which disguised the fact that the Americans now had a foot firmly in the British door. Not for the first time or the last, the wholly ingenuous British style betrayed them. The tone of Hull's statement to Chamberlain had been completely intransigent, but the British response was one of disappointment rather than irritation and based its objections on points of practicality rather than principle. It was becoming evident to the political leaders of the United States that forces were at work in Britain which might present them with enormous gains at the lowest possible cost.

In mid-1937, the State Department was sure enough of its ground to present the British with an extensive list of demands which had to be conceded before the beginning of negotiations for a trade agreement could be announced. Once again a blunt attempt at coercion did not receive the brisk rejection it merited, for by this stage the Foreign Office was united on the need to conciliate the United States. In March, Eden, in a memorandum originally drafted by Ashton-Gwatkin, "asked Chamberlain for a ministerial committee on tariff policy".¹⁴ This request, which crystallised the accumulated wisdom of the higher Civil Service, asserted that as it was not possible to "be certain of peace in our time" it should be seen whether "the policy of 1931 now should be modified in the circumstances of 1937".¹⁵ The momentum generated at the end of 1936 was consciously maintained with specific references to the Leith-Ross paper on the balance of payments, and the Twenty-First Report of the Committee on Economic Information, along with a more general assertion that "many authoritative and independent persons have suggested for quite different reasons that the time has come to call a halt to, and if possible to moderate, both the development of the Ottawa principle and the progressive protection obtained by British industries in the U.K."

The minimal impact of the Hall scheme and obvious political hostility to the economic appeasement of Germany faced Foreign Office activists in this direction, such as Ashton-Gwatkin and Jebb, with the fact that in such a climate only the American aspect of their scheme could be retained. Initially, this was because American appeasement appealed to those in the F.O. who mistrusted the Hall Scheme. The deteriorating diplomatic situation of the mid to late 1930s lent urgency to the belief of 'anti-appeasers' such as Vansittart that

¹⁴ S. Howson and D. Winch, *The Economic Advisory Council 1930-1939: A Study in Economic Advice During Depression and Recovery* (Cambridge, 1977), p.143.

¹⁵ PRO T 188/175, p.26 et seq. Letter and Memorandum, Eden to Chamberlain, 24th March 1937.

closer ties with Washington could only enhance British prestige in dealings with potential aggressors, especially Japan, and that if hostilities should occur the Americans could be induced to lend support, despite the raft of neutrality legislation that was then in place. Vansittart, anticipating in 1933 the need for U.S. support against Germany, asked: "How would that square with a sterling bloc? Ill, I should say."¹⁶

Vansittart's position was shared by other important officials, like his successor Cadogan who "freely admitted his ignorance of finance",¹⁷ and held such matters to be outside their area of competence. They had no conception of the dangers of tampering with the Ottawa system but felt that it cramped diplomacy and should not be allowed to do so. Thus it was that in March 1937, Sir Ronald Lindsay replied to a suggestion from Eden as to "how the attitude of America can be most favourably predisposed towards us for the contingency of a European war", with a letter saying he had actually been about to make "the strongest plea I possibly could", advocating "a trade agreement with America on the broadest possible basis". Although claiming that he had always been in favour of such a move for economic reasons, Lindsay now thought that "on political grounds I have come to the conclusion that a trade agreement is the only important active measure that we can take to predispose America favourably in the manner we desire".¹⁸

The Foreign Office drive towards a trade agreement gained surprising impetus with Chamberlain's accession to the office of Prime Minister, when his policy agenda proved amenable to cooperation with Eden and his officials. At meetings of the Cabinet's Foreign Policy Committee in 1937, held concurrently with the Imperial Conference of 1937, none of the Departments or their Ministers much shared Chamberlain's enthusiasm for the economic and colonial appeasement of Germany. Given the Reich's economic and military policies and stated philosophy, the chances of enticing Hitler into a liberal system with bribes seemed absurdly slim. The idea of employing of similar tactics to win the support of the United States, though, met with much greater success. This was both the cause and effect of a formidable consensus between the previously warring factions within the Civil Service,

¹⁶ PRO FO 371/17318, pp.133-134. Memorandum, January 1933. Quoted in Drummond, *The Floating Pound and the Sterling Area, 1931-1939* (Cambridge, 1981), p.21.

¹⁷ David Dilks (ed), *The Diaries of Sir Alexander Cadogan O.M., 1938-1945* (London, 1971), p.19.

¹⁸ PRO FO 954/29. Anthony Eden, Private Office Papers, U.S. 37/1, pp.1-2. 17th March 1937.

and the political leadership of Government.

The Interdepartmental Committee on Trade Policy, which Eden and the Civil Service had called into being, reported, unsurprisingly, in favour of more liberal British trading practice. When a prospective statement on the report was discussed in the Foreign Policy Committee, discussion centred round Section IV, which called for an 'open door' in the Colonies. Eden advocated "acceptance of the recommendations in principle because this would contribute to the improvement of our relations with the United States, the Oslo group of countries and Japan".¹⁹ In response, the President of the Board of Trade, Oliver Stanley, warned of a "widespread suspicion, both at home and overseas, that the Government might be contemplating a general abandonment of the whole system of Imperial preference".²⁰ Supporters of the Imperial economic system, however, had already been outmanoeuvred comprehensively. The Lord Chancellor, Viscount Hailsham, complained that he had expected the matter under discussion would be limited to the German issue. "He had never thought that the Enquiry would be extended to questions such as the abolition or relaxation of Imperial preference in the Colonies."²¹

At the next meeting, however, which considered the text of a statement on the Interdepartmental Committee's report, Eden said that he "would like to see some reference to economic and political appeasement included in the first sentence of the statement".²² The new Prime Minister was clearly in support of this sentiment and later told the meeting that he "hoped that the Committee would not forget that this question had become a much wider one than the return to Germany of her former colonies. There was no doubt that the United States would greatly value a gesture".²³ This intriguing comment is at odds with Chamberlain's reputation for hostility to the United States and his jealous resentment of Roosevelt's attempts to broker European peace, which indeed provided the occasion for his break with Eden in early 1938. His unwillingness to tolerate U.S. interference in the diplomatic sphere did not, however, appear to preclude attempts to draw the U.S. closer to Britain. These, if successful, could only strengthen Chamberlain's hand in his dealings with

¹⁹ PRO CAB 27/622, p.162. Cabinet Committee on Foreign Policy, Twelfth Meeting, 11th June 1937.

²⁰ Ibid., p.165.

²¹ Ibid., p.175.

²² Ibid., p.180. Thirteenth Meeting, 16th June 1937.

²³ Ibid., p.187.

the dictators.

Equally surprising, considering Chamberlain's role in constructing the Ottawa system, was his willingness to sacrifice some degree of protection and Imperial preference to gain American support. However, as Hankey shrewdly noted: "The truth is that Chamberlain, while at the Treasury, absorbed many of the ideas of that Department."²⁴ A former Chancellor might be expected to approve of any measure that could be thought of not as a concession but as a move in the direction of free trade, to which "the United States would attach importance...out of all proportion to its real significance".²⁵ In the context of the Prime Minister's dream of a general European settlement, the economic cost of American appeasement seemed well worth paying. His grave underestimate of this cost served only to facilitate the effective bonding, through the Treasury and Foreign Office, of the domestic and international wings of liberal orthodoxy in rearmament. As Prime Minister, Chamberlain was able to neutralise the professional jealousies of the two departments in the sphere of economic policy and unify their efforts, which achieved greater political effect than could have been expected had they been operating separately.

Chamberlain's arrival as Prime Minister was the pivotal event in the disastrous course of British defence finance. The Foreign Office move against Ottawa was conducted with his support and he pushed the Dominions hard towards acceptance of a reduction in their preferences, in pursuit of a quick settlement with the United States.²⁶ This, though, was no easy task, as the Secretary of State for the Dominions, Malcolm Macdonald revealed, rather drily, to the Foreign Policy Committee: "The discussions with the Dominion Delegates [to

²⁴ Hankey to Phipps, 11th November 1938. Quoted in R. Douglas, *In the Year of Munich* (London, 1977), p.80.

²⁵ CAB 27/622, p.187. Committee on Foreign Policy, Twelfth Meeting.

²⁶ For Example, on 25th November 1937, the High Commissioner in Australia passed on a telegram from London stating "that negotiations should proceed as rapidly as possible" and that it was "therefore necessary for the United Kingdom Government at once to invite the Commonwealth Government to give a definite assurance that they will, in connection with a United Kingdom-United States Agreement, be prepared to waive their rights under the United Kingdom-Australia Trade Agreement of the 20th August 1932". Chamberlain followed this up on 30th November with a personal message to Lyons, the Australian Prime Minister, in which he said that: "I am particularly sorry to have to ask you for an early decision on a matter of considerable difficulty at a time when you have so many pressing domestic preoccupations, but as I explained in my earlier message on this matter it is essential that our negotiations with the United States should now proceed rapidly." A trade agreement "would have an importance in world affairs far beyond its intrinsic provisions", and Chamberlain concluded that "I confidently hope you will be able to let us have the formal consent of the Commonwealth Government at a very early date". PREM 1/291, p154; pp.146-147.

the Imperial Conference] had been as helpful as we had expected, though perhaps not as helpful as we had hoped.”²⁷ There was also powerful opposition in Britain to any relaxation of the Ottawa system, and tortuous wrangling with the Americans ensured that more than a year was to pass before the trade agreement was successfully concluded.

The important fact, though, was that the issue was now above the counter in Cabinet and the official object of policy. This meant that Britain must implicitly abandon any prospect of an independent defence policy based on the financial resources of the Empire, for despite the British Government’s statements of 1936 that it must rely on Imperial resources and guaranteed lines of supply in a dangerous world, this position was in fact being abandoned even as it was professed. As Chancellor, Chamberlain had been busy in this area too, and the energy which he put at the disposal of the F.O. had earlier benefitted the policy position of Treasury officials.

The interest shown by the Foreign Office in the diplomatic benefits of an economic settlement with the Americans complemented the enthusiasm of the Treasury and the Bank of England for such a policy that had been demonstrated by the Tripartite Agreement of 1936. Unlike the Foreign Office, however, the financial establishment was motivated primarily by ideology. British financial officials were first and foremost skilled administrators, and the intellectual dimension that existed for them did not really extend beyond a model of the perfectly functioning system of international finance, any move towards which was desirable. It was therefore quite possible for them to take action with enthusiasm that was directly contrary to immediate British interests.

Sir Frederick Leith-Ross followed up his subtle advocacy of 1936 by stating baldly in 1937: “The time seems to me to have come when we ought to reconsider our general attitude towards stabilisation and work for a general agreement.”²⁸ This, he explained, meant a return to gold. His thinking was entirely consistent with his earlier view of 1933 that future prosperity depended on “securing international agreement for the relaxation of tariffs, the adoption of more liberal monetary policies, and the abrogation of exchange controls, and so on”.²⁹ This view chimed with Vansittart’s opinion in 1933, despite the latter’s implacable

²⁷ Ibid., p.161. Twelfth Meeting.

²⁸ PRO T 160/840/F13427/8. Leith-Ross Memorandum, 31 May 1937. Quoted in Drummond, *The Floating Pound and the Sterling Area*, pp.227-228.

²⁹ PRO DO 35/266/9223F/1. Leith-Ross to E.H. Marsh (Dominions Office), 28th February 1933. Quoted in *ibid.*, p.159.

hostility to Germany and his advocacy of great armaments, and it is thus possible to see why, after 1936, British international financial policy began to move away from the needs of Imperial defence as these had been identified towards the end of World War One, rather than towards a strengthening of the Ottawa system as the logic of a deteriorating international system would have suggested. As has been noted, the conclusion of the Tripartite Agreement with France and the United States, whereby the British took their first visible step away from the system that had served them well since 1931 by agreeing “to abstain from competitive depreciations or deliberate devaluations”,³⁰ was taken by civil servants to be a milestone on the road to a new liberal world economy.

4:2 The Home Front

The Treasury was naturally well-disposed to the liberalisation of the international economy, but the political aspect of the move against Ottawa was also significant. The Foreign Office view that war could best be avoided by securing some form of diplomatic commitment from the United States, rather than embarking on the undiplomatic task of developing British war potential, held obvious attractions for the Treasury in its goal of maintaining a balanced budget at low levels of taxation. In 1936, under Chamberlain, the Department had found itself at odds with the political pressure for increased defence expenditure. The Chancellor had been helped in this conflict by the instinct of Baldwin’s Government to recoil from the financial implications of a defence effort appropriate to Britain’s deteriorating diplomatic situation.

Despite the commonly held view that public opinion in 1936 was a brake on rearmament, in effect the domestic political situation demanded a minimal level of spending which was from the outset distasteful to the Government.³¹ The Defence Policy and Requirements Sub-Committee of the CID, in its report to the Cabinet on the Third D.R.C.

³⁰ Ibid., p.225.

³¹ Baldwin’s caution concerning the electoral aspects of rearmament appears to have been personal to him. Even Chamberlain, who was making every effort to limit expenditure on weapons, wished to play up rearmament at the 1935 General election but was restrained by the Prime Minister, who wished to stress the continuing relevance of the League of Nations. Chamberlain’s aim to divert the lion’s share of such additional expenditure as would take place on a showy deterrent bomber force can be understood in this context. M. Cowling, *The Impact of Hitler: British Politics and British Policy, 1933-1940* (Cambridge, 1975), pp.91-94; U. Bialer, *The Shadow of the Bomber: Fear of Air Attack and British Politics, 1932-1939* (London, 1980).

Report of October 1935,³² considered the financial implications of rearmament. The issues faced by the Committee in compiling its report spoke of a situation unlikely to be relieved by the revival of liberalism in international trade.

Lord Weir, at the Committee's first meeting, briefly and bluntly encapsulated the economic implications of the worsening diplomatic situation:

There were bottle-necks at the moment and if expansion was commenced these bottle-necks must unavoidably get worse. He was, therefore, bound to state that the programme recommended could not be carried out in the period envisaged unless a definite turn-over to a semi-war organisation was undertaken. The scheme was unrealisable in the time considered necessary unless this semi-war organisation was introduced or, alternatively, a reduction was effected in normal civil activity and our export trade.³³

Weir's last sentence explicitly raised the possibility that given the correct thoroughness of effort, rearmament would not damage the civilian economy and that more disruption would occur if the rearmament programme were to be carried out in competition with the normal peacetime activity. Hankey added his support and "said how glad he was that Lord Weir had raised this aspect of the problem". He added: "The position in Germany was different; she had already gone to semi-war conditions."³⁴

None of this was satisfactory to Chamberlain, who pinned a superficially authoritative Weir down to details. He "referred to a statement made by Lord Weir that the programme envisaged in the Defence Requirements Report could not be carried on except by adopting semi-war conditions and asked what these conditions were".³⁵ Weir attempted to elucidate and

said that although he had had experience of production under war conditions, he had never considered the question of semi-war conditions in relation to this country. It was well known that these conditions existed in countries such as Germany and Russia where there was central control. He did not consider such a system, i.e., peace production with a war type of control could ever be carried out in this country.³⁶

³² PRO CAB 16/123, p.5. D.P.R. (D.R.9) CID Sub-Committee on Defence Policy and Requirements. Programmes of the Defence Services, Report, February 1936.

³³ Ibid., p.87. First Meeting of the D.P.R.C., 13th January 1936, p.7.

³⁴ Ibid.

³⁵ Ibid., p.89. First Meeting, p.9.

³⁶ Ibid., p.89-90. First Meeting, pp.9-10.

Weir then retreated from his earlier implication that economic controls would ease the burden of rearmament on the civilian economy and said that he “considered that semi-war conditions would necessitate interference with existing civil and export trade”.

The Prime Minister, Baldwin, seeing that Weir had retreated under Chamberlain’s fire from his original view, followed the logic of the revised position. He “referred to the question of estimating the time necessary to carry out the programme without semi war conditions which Lord Weir had stated could not be effected without interfering with private industry”.³⁷ Weir “said this was a very difficult question and the estimate would depend on the quantitative character of the programme”. Baldwin persisted in a fruitless search for facts and “asked whether Lord Weir, on the material in the papers already submitted to the Committee, could calculate the productive capacity of the country - a matter on which the Committee had little knowledge. It was a matter of vital importance to ascertain what could be produced and in what period of time.”³⁸

These exchanges implied a fluid situation, in which knowledge was slight and a number of policy options available. The views of Chamberlain and the Treasury, though as usual forcefully expressed, represented only one such option. Characteristically, Baldwin seemed unwilling to impose an opinion, and the Committee’s Report in February 1936 incorporated Weir’s view, as the Government’s most respected outside expert, in the context of the existing fiscal orthodoxy represented by Chamberlain. The main text of the Report went so far as to quote³⁹ a statement on financial control made by Lord Weir, in a Memorandum included as Annexe C, that

the conditions are in some measure akin to War conditions. The word of the man responsible for Supply must carry, and the spirit and enthusiasm which he has evoked in the contractor’s mind must not be chilled by delays of approvals, caused by financial control. I do not mean that any loose disregard should prevail on the financial side, but the keynote must be that ‘the job must go ahead.’⁴⁰

Despite the note of restraint adopted at the end of this statement, its repetition in the main Report showed that it was nevertheless controversial to the Committee, which noted

³⁷ Ibid., p.93. First Meeting, p.13.

³⁸ Ibid., pp.93-94. First Meeting, pp.13-14.

³⁹ Ibid., p.10. D.P.R.C. Report, February 1936, p.11.

⁴⁰ Ibid., p.15. D.P.R.C. Report, p.20. Annexe C. Industrial Production. Memorandum by Lord Weir.

emphatically that:

We are at one with Lord Weir in agreeing to the urgency of the matter, but it would of course be impossible to adopt any unconstitutional methods of financing whereby the Treasury loses control over expenditure. We have no reason to believe that Treasury control, adapted to meet the particular circumstances, is incompatible with rapidity; the machinery lies to hand in the existing Inter-Service Treasury Committee which has proved most effective during the crisis caused by the Italo-Abyssinian dispute.⁴¹

It was further stated that “under Lord Weir’s proposals, the supplies called for in the 3-5 years’ programmes are to be secured without interference with or reduction of production for civil and export trade”.⁴²

These conclusions are revealing of the state of British thinking at a crucial juncture. In the field of defence finance, the course of development since World War One was reiterated. There was to be no interference with the peacetime economy, despite the situation, openly recognised by a key Government adviser and discussed in the D.P.R.C., that existing conditions constituted uncharted territory in which the dividing line between peace and war was becoming indistinct. In addition to its hindrance of war preparation, this attitude precluded the consideration of economic defence needs in a wider policy context than that of a balanced budget, and enabled the issue of wooing the United States through economic concessions to be viewed from a predominantly diplomatic perspective. This worked to downplay the fearful strategic consequences of accommodating Cordell Hull. However, in worsening diplomatic circumstances the struggle to impose a budgetary limit on rearmament was to be every bit as tough as negotiating a trade agreement with the Americans, and, in contrast to the shadowy world of economic diplomacy, the consent of Cabinet and Parliament would be required. Chamberlain would need all his enhanced power as Prime Minister as well as the support of the Civil Service to impose his policy on the country. Great skill and perseverance would also be required, but he possessed these qualities in abundance.

4:3 *Manoeuvres*

In the field of British economic diplomacy, where the voice of democracy was heard

⁴¹ Ibid., p.11. D.P.R.C. Report, p.11.

⁴² Ibid., p.11. D.P.R.C. Report, p.12.

only in the far distance, liberal policies could advance through the concerted action of officials, acting with the Prime Minister's blessing. The requirements of defence, however, might make themselves felt regardless of sharp official manoeuvres. This problem did not immediately become manifest, because British policy makers were not forced to defend the D.P.R.C. decision to finance the Services without disruption of normal trade until the beginning of 1937. When this point was reached, the liberal economic view was in the ascendant, and it was therefore natural that the 'business as usual' policy established by the D.P.R.C. would prevail within the Government machine, especially as such work as had been done in this area in the 1920s specified such a policy until the actual outbreak of hostilities. Under the pressure of political circumstances, however, the effectiveness of traditional financial methods could not simply be assumed, and if these were to be imposed on the existing situation a doctrine for the rationing of defence expenditure would have to be formulated as a political weapon. Thus, the financial policies of World War One, as interpreted in the 1920s and restated in the D.P.R.C. in 1936, were appealed to and given an ideological coherence they never possessed at that time, when they were ad hoc responses to crisis in a world that no longer existed.

The assumptions of what would become the fourth arm policy, that defence expenditure should take place within a balanced budget and without disruption of the civilian economy, matched those of liberal internationalists in their assault on the Ottawa system, and added weight to Chamberlain's policy of appeasement. It was also true that if defence expenditure broke its chains then the necessary changes in Britain's international financial policy would sweep away the American negotiations along with cherished liberal freedoms, such as free movement of capital across the exchanges. An examination of this issue reveals that in the sphere of finance the development of the fourth arm policy, far from providing validation for appeasement in the hard cold light of reality, was constructed to serve political ends and was finally pulled apart by unforgiving circumstance. It was in fact the reverse of a realistic policy. As finally accepted by Cabinet in February 1938, its explicit hope was that through the diplomacy of appeasement, physical circumstances could be adjusted to match its assumptions and crown it, retrospectively, with success.

During 1937 Chamberlain, as Prime Minister, was better able than before to act on his belief that the cost of rearmament would overstrain and thus undermine the economic strength of the nation. His impact on the international economic debate has been noted but

his new office, allied to his native determination and drive, gave him greater power to impose his, and the Treasury's, position on the financing of defence. It has been observed that "Chamberlain upheld normal trade with reasoning that gave his doctrine the powers of both admonition and salvation"⁴³ and that he "acted upon these principles with a tenacious consistency that could only be inspired by faith - that war would not come to pass".⁴⁴ True though this is, Chamberlain's concern for limitation of defence expenditure had support in circles which felt that war might indeed occur, but whose commitment to financial probity was nonetheless total. Even with such support, the task facing him was formidable.

Chamberlain was convinced that defence spending had to be constrained by the normal functioning of a peace time economy, and as the alternative made Ottawa seem mild he should have been able to rely on the support of the Civil Service and the powerful voices which had coalesced around Cordell Hull's drive for a trade agreement. However, not all of these forces were in a position to be helpful, and when it came to arming against Germany rather than enticing America, elements of the F.O. such as Vansittart were likely to prove hawkish. Chamberlain could rely on his Chancellor, Simon, and Treasury civil servants, who shared his concerns and were guided in Sir Richard Hopkins' words, by the "assumption that we shall not, and cannot afford to, allow ourselves to slip quietly into American or French budgetary methods but shall strive, at any rate till disaster overwhelms us, to keep within the limits of decent finance".⁴⁵ Throughout 1937 they devised means of quantifying and then controlling the cost of the rearmament programme. At the end of the year Sir Thomas Inskip, Minister for the Coordination of Defence, gave voice to the new doctrine, and by February 1938 the concept of the fourth arm was firmly established as Government policy. This success, however, was by no means as easily accomplished as a brief summary of the process implies.

In January 1937, during a meeting of the Cabinet, "a request was made that in this critical year the Cabinet might be given information at rather shorter intervals as to progress

⁴³ G. Post Jr. *Dilemmas of Appeasement: British Deterrence and Defense, 1934-1937* (Ithaca and London, 1993), p.312.

⁴⁴ *Ibid.*, pp.312-313.

⁴⁵ PRO T 161/783/48431/02/1. Hopkins on Defence Finance, 14th May 1937.

with the armaments programme”.⁴⁶ The result in February was Inskip’s paper “Progress in Defence Requirements”, which introduced the Cabinet to themes of production limited by inadequate capacity with which they would soon become familiar. Bottlenecks of this type were endemic to an economy undergoing forced rearmament and were a feature of German and later American experience. However, commenting on Inskip’s account of shortcomings in the provision of machine tools and anti-aircraft equipment for the Navy, Chamberlain “wished the Cabinet to realise that these two instances showed that even the present programmes were placing a heavy strain on our resources. Any additional strain might put our present programmes in jeopardy. The Minister for Coordination of Defence agreed.”⁴⁷

This statement was revealing of the way in which Chamberlain’s thinking was moving and was the kernel of the fourth arm argument. In fact, bottlenecks in production were simply evidence of the inadequacy of existing plant in the defence industries. The test of resources would be whether or not new plant could be created and maintained. This was as yet unknown but it had become necessary to make a political decision whether or not a determined effort to rearm would be made. In this debate the artificial correlation of existing productive capacity and the totality of national resources was to become an essential component of the executive’s developing tendency to highlight dangers to the general ‘balance’ of the economy. It was an argument likely to impress the uninformed with the apparent evidence of their own eyes, and despite seeming to be rooted in objective reality it was usefully vague about numbers. This was particularly important, as the Treasury’s calculation of the maximum sum available for the rearmament programme consisted of the uncorroborated guesswork of a single official.

Also in January, Sir Richard Hopkins, now Second Secretary at the Treasury, concocted a maximum figure for defence expenditure which the Department was prepared to finance from taxation, of £1100 millions, and realising this to be politically inadequate decided to sanction a loan to boost the total to a figure of £1500 millions, which might be acceptable to Cabinet but which nevertheless came down firmly in favour of ‘business as usual’. Early in February, therefore, Chamberlain informed his colleagues that “as the Cabinet must long have realised, it was not possible to finance the whole of our Defence

⁴⁶ PRO CAB 23/87, p.38. Cab. 1(37) Cabinet Minutes, 13th January 1937, p.7.

⁴⁷ Ibid., p.155A. Cab. 5(37) Cabinet Minutes, 3rd February, p.15.

Requirements Programmes from revenue”,⁴⁸ and he thus requested authorisation to seek borrowing powers from Parliament before the Budget. This may have given the Cabinet the impression that the money would be found for the programmes they had agreed. In fact this measure simply authorised spending up to the Treasury’s then secret ceiling, and in the ensuing months a plan was prepared to enforce this limit.

In a dangerous world, however, limitations on rearmament would need to be justified. Chamberlain’s comments concerning strain on national resources prefaced the alarmist line that a determined rearmament drive would destroy the economy, but a convincing case for this view had yet to be drawn together from the various strands of Treasury thinking. An attempt at such a synthesis was presented to the Cabinet at the end of June in Sir John Simon’s paper “Defence Expenditure”. In the preamble Simon acknowledged that the work was largely Chamberlain’s, and as Chancellor he was to prove a like-minded and supportive successor to the new Prime Minister. The report was, in fact, largely the work of Hopkins, whose heartfelt determination to avoid fiscal laxity had resulted in a long initial draft which defeated Chamberlain’s attempt to work through it in the small hours, and had drawn his criticism that it had to be shortened for Ministerial consumption.⁴⁹ The streamlined report put before the Cabinet stressed the exponential growth of ‘capital’ expenditure, that intended to remedy deficiencies, on defence between the first and third D.R.C. reports and the figures revealed during the Treasury’s work in January on the defence loan. The report stated that:

Figures such as these indicate the pace at which the cost to be met continues to grow and show that there is at present no trace of finality. We are running the gravest risks if we do not resolutely insist on correlating the rising total burden of Defence liabilities to the whole of our available resources. Indeed, the means of correlation is, under existing practice, rapidly breaking down.⁵⁰

The report introduced the Cabinet to the maximum figure of £1,500 millions to be spent on defence in the five years 1937-42, which “must be regarded as a maximum” and stressed that in the event of “a set-back in trade - indeed, if prosperity does not increase -

⁴⁸ Ibid., p.220. Cab. 7(37) Cabinet Minutes, 10th February, p.20.

⁴⁹ T 161/783/48431/02/1. Hopkins to Chamberlain, May 1937. Marginal note by Chamberlain.

⁵⁰ PRO CAB 24/270, p.272. CP 165(37) Defence Expenditure. Memorandum by the Chancellor of the Exchequer, 25th June 1937, p.2.

the sum available is likely to be less and even very substantially less”.⁵¹ Perhaps anticipating trouble in enforcing this figure, which was after all “based on a general examination by the Treasury of the cost of the programme as revealed in January 1937”,⁵² and which took no account of international dangers, the authors of the report stressed in conclusion the basis of their argument in external finance. There was good reason for this, because as long as the debate remained in a domestic context there were too many counters to Treasury reasoning.

If production was slow then a Ministry of Supply could be put forward as an answer, a move which the Government was determined to resist. Similarly, if resources were stretched then measures of compulsion might be employed on labour and capital, and taxation might be increased. The Government could not argue that resources were stretched to the limit until such measures had been employed. The external position, however, provided a logical answer to this problem as no precedent for its control by formal machinery existed from the previous war, and no political constituency existed which would press for such control. This state of affairs would endure. In January 1939, with the war crisis, as reflected in loss of reserves, already underway, *The Economist* launched a severe attack on the Government’s unpreparedness for war, and it almost got to the point. It noted that:

There is an important point of principle involved. The Prime Minister has told us that he will not introduce a war-time regime until an emergency actually arises: there can be, for instance, no Ministry of Supply and no compulsory register until war is actually in sight. And on Tuesday Sir Auckland Geddes [adviser to the Lord Privy Seal] revealed that, although a Ministry of National Service already existed in skeleton form, with a ‘young and active man’ already earmarked to be a Minister, neither would be produced until the day of disaster dawned. Perhaps the best comment on the doctrinaire position which the Government have taken up in this matter was made by Sir Auckland himself:-

As an island nation (he said) we have been accustomed to wars which allowed us a period to make the necessary arrangements after the beginning of the war. That position is now past.

That is precisely why, in Mr Eden’s words, ‘The nation would welcome the greatest possible national effort in every sphere of defence’ - even in peace-time.⁵³

⁵¹ Ibid., p.1.

⁵² Ibid., p.3.

⁵³ *The Economist*, 21st January 1939, p115.

The Economist's sentiments were close to the mark in general but were well contained within Government policy. In focusing its attack on the Ministry of Supply it was neglecting larger issues. The true basis of the 'business as usual' policy, by then established in the stability of the currency, was untouched, and indeed in its previous issue the journal had warmly approved of the Government's action in transferring the gold in the Bank of England's Issue Department into the Exchange Equalisation Account to be squandered in support of sterling. If the most widely-read journal dedicated to financial and economic matters did not recognise that the damaging effects of the Government's sharp division between conditions of peace and war extended equally to its own field, then it is not surprising that the fact was not more generally remarked upon. Simon's report to Cabinet concluded with a statement, redrafted by Sir Warren Fisher to read more emphatically,⁵⁴ that:

While in this note I have confined myself to a brief exposition of the relation of the programmes to our Exchequer resources available out of taxation or loans, this is only one aspect of the problem. Ultimately our resources have to be measured in terms of man power, productive capacity, and the maintenance of the balance of our general trade, without which our imports of essential raw materials and food could not be obtained. These matters cannot be excluded from any review of the problem.⁵⁵

Simon's paper, which in the light of its arguments called for a review of Service programmes to fit the new financial ceiling, was approved by the Cabinet. Service Ministers, however, were rightly concerned that commitments already agreed in Cabinet would be reneged upon. Simon drew a distinction between programmes agreed by both Cabinet and the Treasury Inter-Services Committee and those simply agreed by Cabinet which could be reviewed. The Home Secretary, Samuel Hoare, commented on the logic of the Treasury's scheme when he "pointed out that if the figures of Defence expenditure had increased rapidly, this had been by deliberate decision of the Cabinet on a review of the whole international situation".⁵⁶

This rebuke from such a senior political figure reflected the fact that despite the authority of the Prime Minister and the Treasury, the Cabinet could not be trifled with and

⁵⁴ T 161/783/48431/02/1. Handwritten alteration to Fisher's proof copy of CP 165(37).

⁵⁵ CAB 24/270, p.273. CP165(37) Defence Expenditure. Memorandum by the Chancellor of the Exchequer, p.4.

⁵⁶ PRO CAB 23/88 p.333. Cab 27(37) Cabinet Minutes, 30th June 1937, p.9.

might turn. The 'balance of our general trade' in the narrow sense of the balance of payments would not suffice to scare Ministers, as it was impossible to thread a needle from trade gap to currency collapse. Trade was already evidently in deficit and had been for some time, yet the chief difficulty experienced with sterling was actually to keep it below an exchange rate of \$5. Foreigners continued to compete for access to the British market, and essential imports showed no signs of drying up. The Cabinet might, however, be outmanoeuvred and Simon set his mind to a more surreptitious way of advancing policy.

After the Services' estimates had been duly despatched to the Treasury, and a new Treasury paper prepared on the basis of the figures they contained, Simon wrote to the Prime Minister concerning the best method of translating the exercise into policy.⁵⁷ He considered that a "slightly varied" D.R.C. Committee would be appropriate, although the effect of the variations would be anything but slight. He stated that "I do not think the Foreign Office need be represented, and it would be well that in addition to Sir Warren Fisher, who was an original member, Sir Richard Hopkins and Sir Horace Wilson should be added". This body, newly packed with the Treasury architects of the rationing concept and cleansed of their rivals from the F.O. "would then, in the light of these documents, consider the comparative claims upon the resources of the country in the widest terms, including the necessities of overseas trade, manpower, etc., with a view to making a report to the Cabinet as soon as may be".

If this committee came down on the side of the Prime Minister and Treasury, which given its composition was more than likely, its conclusions would be presented to the Cabinet with the authority of the considered opinion of a Cabinet Committee, rather than as the simply departmental view of the Treasury, and would thus stand a greater chance of being pushed through by the Prime Minister's supporters. Or as Simon put it, "it seems to me that it is likely to be a quicker and more effective way of getting to a definite result than the alternative method of the Treasury coming forward now with a maximum global figure which will at once set everybody disputing".

The Committee so constituted duly assembled, but even without the Vansittart wing of the Foreign Office, the idea of rationing was by no means universally welcomed. The main intellectual weaknesses of the Treasury position were again that its figures did not

⁵⁷ PRO CAB 64/30. Minister for the Coordination of Defence. Defence Preparations, Estimates and Expenditure. Letter, Simon to Chamberlain, 22nd October 1937.

reflect complete national mobilisation for defence and that consequently it could be accused of taking risks with national survival to save money. The simple concept of rationing could not answer these criticisms. Hopkins conceded that the total five year figure for rearmament of £1,500 millions was by no means the maximum that could be raised. He revealed that: "Generally, in regard to our financial capacity, he felt that looking only at the period 1937-41 we should be able to obtain £1,500m. *or rather more from revenue and borrowing without a great increase of taxation* [italics added]." ⁵⁸

At this stage, his justification for rationing was that "looking beyond 1941 the expenditure of £1500m. would lead to a higher cost of maintenance than we can afford without a great increase of taxation. On the whole, therefore, he put the figure over five years at £1,500m." Hopkins had adhered to this position, despite at a previous meeting having seemed less than horrified by the prospect of an increase in taxation. Inskip had asked whether

the Treasury had made an estimate, possibly an arbitrary figure, of the amount which it is within our capacity to provide for defence in the next 3-4 years. He felt that without guidance on this point the Cabinet could scarcely reach decision on the programmes. He invited discussion on his suggestion that we should not look too far ahead. If measures deemed necessary for security can be taken presently, should we be deterred by doubts as to what we may be able to maintain in five years time? ⁵⁹

Hopkins stated his view that, considering future costs, £1500 millions was the maximum available without an increase in taxation but added curiously: "The purely economic effect of a rise might not be too serious. The danger is rather psychological". Ministers would thus be invited to constrain defence policy within a global budgetary figure specified according to rule of thumb by Hopkins, though even he felt that more could be raised without taxation and that taxation itself could safely be raised. Inskip was torn between his own instinct to press ahead and his respect for the Treasury view, which led him to accept the Treasury's idea of maximum current expenditure. Criticism of Hopkins' reasoning came from Hankey, who "suggested that if, to give security and avert war, the needs of defence were predominant in the next four years, some heroic measures would be justified on grounds of defence analogous to those taken in 1931 on grounds of economic

⁵⁸ Ibid., Inskip Committee, Minutes of Seventh Meeting, 2nd December 1937.

⁵⁹ Ibid. Minutes of Sixth Meeting, 25th November 1937.

stability”.

This statement intriguingly linked ‘1931’ and ‘stability’, terms that would come to be repeated continuously in Government up to the outbreak of war. Hopkins took it to be a plea on behalf of sacrificing social spending for defence within the global limit, perhaps unwisely in view of Hankey’s subsequent forceful advocacy of the placing of defence before finance. He stated that: “A major consideration was expenditure on unemployment assistance which, in contrast to a figure of £20m. in 1929, does not now fall below the level of £65-55m. at best owing to the block of permanently unemployed. It is capable of rising to £100m.” He did not explain how, according to his hypothesis, unemployment could rise steeply in an economy that would supposedly be straining itself past the danger point to produce weapons.

It was clear that given the doubts expressed by Hankey and Inskip, at this time considered supporters of the Prime Minister, the Treasury could not hope to sell rationing to a Cabinet containing its confirmed critics, on the grounds either of current or future strain on productive capacity or the tax system. This was reflected in the tone of two papers written by Inskip and Hankey and circulated with proof copies of the former’s “Interim Report” to Cabinet. Inskip expressed himself in a forceful but contradictory manner, reflecting his personal uncertainty. He believed that “expenditure on re-armament for the next four years ought to depend on what we need now to make us secure and on what we can afford now and not what we can afford in five to ten years time”.⁶⁰ On the other hand: “The husbanding of our financial resources is almost as much a matter of defence as the provision of material and personnel. I suggest that this should never be forgotten.” For Inskip, therefore, defence finance was a balancing act: “I suggest that expenditure should not be contemplated on a scale which is likely to exhaust our financial resources. The question is how we are to reconcile the two desiderata, first to be safe, secondly to be solvent.” This was in fact a succinct statement of the Government’s problem: how could it remain safe while imposing its idea of solvency on the Cabinet in dangerous times?

4:4 Tying the Knot.

The provisional nature of the estimates provided by the Service Departments meant that Inskip was compelled to produce an “Interim Report” to the Cabinet in December 1937

⁶⁰ PRO T 161/855/48431/01/1. Cost of Defence Requirements. Memorandum by the Minister for the Coordination of Defence, circulated 23rd November 1937.

which, in the absence of hard figures, “was less a detailed examination of actual and prospective Service programmes than a statement of the general principles upon which such programmes should be based”.⁶¹ However, the paper, largely drafted by Treasury civil servants, managed finally to knit the various themes that the Treasury had pressed upon the Cabinet into a winning political formula, or as Simon put it: “A classic statement of the elements that make up our strength for national defence”.

The Report was named “Defence Expenditure in Future Years”, and it recapitulated to Cabinet the Treasury’s line that, contrary to previous experience, the costs of rearmament were upsetting the balance of normal trade. Incremental demands for the funding of agreed programmes were beginning to outstrip the existing defence budget, and the likely cost of major new programmes was threatening to exceed that which could be provided within the context of a balanced budget and the existing defence loan of £400 million. The levels of expenditure envisaged by the Services were now described as a threat, not to any one economic indicator, but to the general ‘stability’ of the entire economy. The concept of stability gave the argument its internal logic, and made possible the famous assertion that:

Seen in its true perspective, the maintenance of our economic stability would more accurately be described as an essential element in our defensive strength: one which can properly be regarded as a fourth arm in defence, alongside the three defence services, without which purely military effort would be of no avail.⁶²

This argument was a triumph of logical manipulation, and the basis of the Treasury’s attempt to “justify” limited rearmament “as a positive force in the emergent rearmament policy”,⁶³ for it removed the rock on which earlier Treasury appeals for economy had foundered, that defence and fiscal economy were in opposition. It asserted that defence costs must be curbed to strengthen the economy for defence. Guardians of the existing financial system could claim, according to the logic of the argument, that any risks that were being taken with national defence were being incurred by expenditure on arms, not by the control of such expenditure.

This argument was an eloquent rejoinder to allegations of unpreparedness. Critics of this view could be confronted with the word ‘stability’ and asked to disprove its validity

⁶¹ N.H. Gibbs, *Grand Strategy* Vol. 1, *Rearmament Policy* (London, 1976), p.282.

⁶² PRO CAB 24/273, p.268. CP 316(37) Defence Expenditure in Future Years. Interim Report by the Minister for Co-ordination of Defence, 15th December 1937, p.2.

⁶³ R. P. Shay Jr., *British Rearmament in the Thirties: Politics and Profits* (Princeton, 1977), p.166.

within the framework of the existing financial system. The vulnerability of economic stability was substituted for the more limited threat to the balance of payments, as the most likely cause of a fatal sterling collapse, and had been hinted at as a concept when Simon's earlier report had spoken less broadly of dangers to 'the balance of our general trade'. The phrase was repeated four times in Inskip's report, in a passage reproduced almost verbatim from a Treasury memorandum prepared by Bridges;⁶⁴ first as one of "our real resources" alongside "our power to maintain our credit"; then as being "closely connected with our credit"; and then as synonymous with Britain's credit, after any substantial disturbance of which "savings would be reduced and confidence would at once be weakened." Finally, "the maintenance of credit facilities and our general balance of trade" introduced as prerequisites a synopsis of the blockade policy, from which they emerged condensed as "sufficient economic strength" before attaining final form as "economic stability". The idea had thus been developed over consecutive paragraphs to the point where the definition of 'balance' as the result of matching debit against credit was replaced by the sense of balance as if on a high wire, in which circumstance stability was of critical importance. Which Minister would care to be held responsible for tipping the economy over the edge?

However, for the argument to function as anything but an elegant debating point, the horrors of instability had to be credible to the Cabinet. The successful amendment was to link in a general sense the idea of an overstrained economy with a threat to the external value of the currency. If the Cabinet was discussing expenditure, an unbalanced budget would be the agent of doom; if the balance of payments, then that would suffice; if industrial capacity, then inflation would hasten the end. The need to assert a consecutive causal chain of disaster from unbalanced budget to inflation to trade deficits to currency depreciation had been broken and now any one of these factors could pose a fatal threat to economic stability unaided. The political utility of the fourth arm argument lay in the fact that it was vague as to causes but absolutely emphatic as to effects, and this was made possible by its theoretical basis in the external position. Anti-appeasing Cabinet members lacked the knowledge and the financial data to challenge its rather hazy precepts and had for the same reason to accept the Government's assertion that more comprehensive rearmament would destroy sterling.

The domestic and international aspects of the 1937 drive for liberalism in policy, had, through Chamberlain, achieved effective mutual support. The Treasury's success in

⁶⁴ T 161/855/48431/01/1. Memorandum by Bridges, 8th December 1937.

constraining defence expenditure made possible a liberal stance in economic diplomacy, while in turn the supposed threat of rearmament to the external position made feasible the same limitation of the Service programmes. Thus: “The amount of money which we can borrow without inflation is mainly dependent upon two factors: the savings of the country as a whole which are available for investment, and the maintenance of confidence in our financial stability”.⁶⁵ Britain should “avoid at all costs any action at the present time which would affect our stability. Nothing operates more strongly to deter a potential aggressor from attacking this country than our stability”.⁶⁶ Obvious military weakness, it was acknowledged, might tempt an aggressor despite Britain’s stability, and Inskip tendered to his colleagues the revised formula that: “The problem before the Cabinet is, therefore, to strike a proper balance between these factors” and provide adequate armaments “without making demands on our resources which would impair our stability, and our staying power in peace and war”.⁶⁷

In effect, the domestic and external aspects of defence policy had first been coordinated by Chamberlain’s policy and then fused, in a way that was politically effective and served his purpose. The defence of the Empire, like its economic well-being, was to be openly subordinated to the survival of the international financial system and Britain’s position within it. The argument was familiar enough to appeal to the disproportionate number of National Liberals in the Cabinet and unanswerable by the rest, to whom the intricacies of international finance were a closed book. The political effect of the fourth arm argument was confirmed when Inskip presented hard figures for future expenditure in his February 1938 Report and was able to impose them without difficulty on the Cabinet.

Inskip’s “Further Report” imposed a limit of £1,650 million on defence expenditure over five years, and even this figure amounted to only £1,570 million for the Services, when A.R.P. and interest on the defence loan were subtracted. Inskip nevertheless gave the appearance of seeking a compromise with the defence Departments by agreeing to spend as much immediately as he believed industry could cope with, to ensure the full utilisation of existing plant in 1938 and 1939. Money for new projects, therefore, could not yet be

⁶⁵ CAB 24/273, p.268. CP 316(37) Defence Expenditure in Future Years, p.2.

⁶⁶ Ibid., pp.2-3.

⁶⁷ Ibid., p.3.

spent. This formula has been taken as evidence of Inskip's concern for actual defence as opposed to the Treasury's obsession with finance, but if this was dissent it was of a limited kind, and his views are more revealing of the inadequate scale of the existing effort.

The Services' inflated estimates for 1938-9 amounted to slightly less than £2000 millions over five years. Inskip's rejection of this figure as certain "to definitely impair that economic stability which is an essential part of our defensive armour", reveals that his idea of the full employment of industry did not differ markedly from that of the Treasury. He noted that even the approved sum would "involve maintenance costs on the conclusion of the programme of no less than £255 millions a year. The Treasury cannot see any prospect of any sum approaching this figure being made available on the basis of existing taxation and £400 millions of borrowed money". Inskip was far from advocating expenditure at a level likely to exceed the Treasury ceiling or challenge their logic, and his hope was that "before this point is reached the position may have changed, and the need for great armaments disappeared". Moreover, his statement that defence expenditure for 1938 at £345 million would match existing productive capacity referred only to the current organisation of the economy. In the event that "heavy excess expenditure over such a figure were contemplated, it would appear that we must envisage war measures of compulsion on industry and labour, not only most difficult politically, but threatening the maintenance of that stability which it is an essential defence interest to preserve".⁶⁸

This statement indicates the distinction that was drawn in Government between the political and financial effects of rearmament with the clear assumption that the latter acted primarily on the former. It specifically separates politics on the one hand and stability on the other, with the implication that the latter was largely an economic consideration. Although stability was mentioned elsewhere in the sense of domestic political tranquillity, this was usually in the economic context of industrial relations rather than the rights and wrongs of rearmament. Therefore, the stability of the existing political system, and its preservation involved the prevention of those destabilising economic events that might threaten to bring it down. In terms of fourth arm logic these factors could appear from any direction as a result of uncontrolled rearmament, and would be followed directly by the disintegration of the currency, itself symbolic of the British way of life.

This was a much more powerful and aggressive political argument than had yet been

⁶⁸ PRO CAB 24/274, p.322. CP 24(38) Defence Expenditure in Future Years. Further Report by the Minister for Co-ordination of Defence, 8th February 1938.

deployed in favour of orthodoxy. It covered dissent like a blanket and permitted continuous attack on the Government's critics, especially Conservatives who could now also be reminded that economic collapse would bring with it political upheaval, possibly of a revolutionary nature. In this context it has been argued, for example, that "[i]nflation's adverse effect on Britain's international credit position, and consequently on trade, was but one element of the Treasury's concern."⁶⁹ This was true but is simply to say that inflation was as good as any cause in the collapse of Britain's credit, and thus the social unrest likely to result from such a failure would in fact be a secondary effect of a breakdown in the fourth arm policy.

Thus, "the problem of balancing Britain's security against her international solvency"⁷⁰ was in fact the answer to the Government's policy dilemma. The plausible contention that Britain's international solvency was threatened by rearmament was the one essential component of the fourth arm policy, without which demands for greater and more rapid improvements in British security could not be resisted and a case against massive expenditure sustained in Cabinet.

In terms of fourth arm policy, therefore, all roads away from the righteous paths of 'business as usual', and financial stability led immediately to the downfall of sterling and the collapse of Britain's credit. If this were to happen, British life as the Chamberlain Government knew it would cease, and it was axiomatic that Britain could not fight a war in such circumstances. If victory depended on wearing the enemy down economically, the only viable policy was to sacrifice rearmament expenditure for economic stability, itself the fourth arm of defence. This was an elegant argument of the sort that betrayed a classical education, and which possessed an internal logical symmetry designed to exclude the possibility of alternatives, and rationalise contradictory evidence. It resembled the gold standard theory, proved similarly resistant to calamitous reality, and was equally reliant for its existence on a foundation of dubious assumptions. These, when challenged, reveal that economic stability, as the term was understood by Inskip, was essential not to defence but to the maintenance of the existing financial system. The actual maintenance of economic stability for war would require the establishment of an entirely different financial system, which would involve the measures of compulsion that the Government was pledged to

⁶⁹ Shay, *British Rearmament*, p.161.

⁷⁰ *Ibid.*, p.168.

avoid.

4:5 Available “weapons from the authoritarian armoury”

The importance and extremism of the move towards a purely liberal policy in defence finance can be judged by the sharply contrasting advice given to the Economic Advisory Council’s Committee on Economic Information by the economist P.K. Debenham in October 1937. His paper, entitled “Notes on armament expenditure, the foreign exchanges and Government finance”,⁷¹ summarised the British position fairly from a liberal perspective, with the same classical assumptions as those informing political policy makers. His policy conclusions, however, bore little resemblance to those of the Treasury, even though he did not take account of the growth then taking place and assumed that rearmament budget would have to be extracted from a cake of fixed size.

Expenditure would come from three main domestic sources: “existing unemployed productive capacity”; “diversion of the savings of the community”; “a reduction in the consumption expenditure of the public (a reduced standard of living)”, and “borrowing from abroad”. Even from these restricted sources, however, Debenham felt that “[g]iven time and organisation the additional expenditure at present prices, which could be incurred by the full utilisation of all three sources is extremely large”, and could be reckoned at “between £400 and £500 million at present prices”. Further, “the exact limit set to expenditure by our material resources is of no great significance, for it is probably well in excess of any proposal for increased armaments expenditure likely to be made.” Nor was the balance of payments likely to be a constraint on total possible expenditure as long as the E.E.A. was able to cover deficits with its reserves. Debenham felt that: “Provided therefore, that the exchange account is in a position to part with resources, there is much to be said in the interests of rearmament alone, for the policy of acquiescing in an adverse balance of payments during the period when British industry is readapting itself to changes in demand necessitated by the rearmament programme.”

Debenham foresaw pressure on the exchanges to come, but for the wrong reason. He felt that the incipient U.S. depression would draw reserves in that direction according to the classical balance of payments mechanism, whereas in fact Nazi aggression would be the

⁷¹ PRO CAB 58/23. Economic Advisory Council, Committee on Economic Information. Notes on Armament Expenditure, the Foreign Exchanges and Government Finance. Memorandum by Mr. P.K. Debenham, 31st October 1937.

catalyst. However, Debenham's predictions of necessary action are illuminating and prescient. He realised that: "Just as the pace of rearmament in its first stages is limited by the technical organisation of industry, so, as the necessary adjustments are made and the rate of expenditure increases, a second limiting factor is encountered, namely the threat to the stability of the exchanges. The effect of the American depression has been to advance the date when this second limitation comes into play". He was thus anticipating the problem that was about to strike and his remedies were suitable for the eventuality.

Noting that the bulk of the gold reserve had come from "the inflow of refugee funds" he went on to say that:

If it became impossible to finance a moderate increase in the adverse balance of payments by drawing upon the gold accumulated in this country through the inflow of short term funds - and this would be the case as soon as the adverse balance reached a point at which through mistrust of sterling these funds began to be reconverted into gold or other foreign currencies - and if the adverse balance could not be diminished by any of the more orthodox expedients (e.g. the exclusion of competitive foreign imports, or the reduction of British costs through a moderate depreciation of the exchange or other means) then the choice would lie between confining armaments expenditure within the limits set by the necessity of maintaining the balance of payments in equilibrium, and of adopting less orthodox measures to improve our receipts from exports, and to reduce our imports.

In effect Debenham was talking about exchange control, and looking abroad he noted that "comparison of German with French methods surely suggests that even judged by the effects on the standard of living the German methods are to be preferred; and they certainly have the advantage of having produced the armaments". Debenham then went in to a detailed analysis of the Schachtian methods of exchange control practised in Germany and soon to be necessary in Britain. This must have been painful for an economist of Debenham's stamp, and in conclusion he allowed himself the expression of a personal view, stating that:

the great harm done by an accentuation of rearmament is not so much in the field of physical resources as in the field of economic organisation. It involves a progressive increase in Government control over economic activity. In particular it involves profound modifications in the organisation of international economic relationships, which, since they are likely to spread not only among the nations directly interested in rearmament, but also, in self-defence, throughout the rest of the world, are likely to remain long after the hysteria which brings them into being has died down. With

all its faults the comparatively liberal system of international trade, whose final interment we shall soon witness, did allow the choice of consumers to influence the course of trade. The system which seems likely to emerge will pay little regard to that.

Debenham saw the inevitable use of “weapons from the authoritarian armoury” in the near future. Then,

the first steps which will have to be considered are exchange control, and the limitation of dividends on ordinary shares. The second step would be measures to improve the balance of payments, ‘aski pounds’, differential exchange rates, export monopolies, and import boards for raw materials. Finally would come measures of price control and the control of the new issue market.

Even as Debenham wrote, however, the policy battle that was to culminate in the fourth arm policy was reaching a climax. The Treasury’s victory implied that expenditure would be kept within such limits that no exceptional measures would, theoretically, need to be utilised. Debenham thought, as has been noted, that this would necessitate ‘confining armaments expenditure within the limits set by the necessity of maintaining the balance of payments in equilibrium’. However, as the current account of the balance of payments had not been in equilibrium for several prosperous years, and was a slow moving indicator to work to, the measure used would be the value of sterling in relation to the dollar. This had a residual mystique from classical theory as being linked to the balance of payments, although it no longer was, and therefore constituting an indicator of national solvency. As Debenham’s gloomy analysis had concluded, however, the maintenance of ‘balance’, whether of payments or budget, was not really a practical option, even for a liberal economist. The British Government, therefore, was determined to play Canute. When the consequences of this course became apparent, Debenham’s paper was dusted off and discussed uneasily within the Treasury, before being finally rejected and interred.

4:6 *The Starting Gun*

The newly formulated fourth arm doctrine was put to the test immediately after its acceptance by Cabinet when, in the Spring of 1938, British policy makers were faced squarely with the contradictions implicit in the policy. As has been seen this was based on experience gained in World War One, but importantly no special machinery had then been developed in the external financial sphere, and the existing system had been maintained at the expense of extravagant borrowing in the American market, not only to purchase war

material but also to maintain the level of sterling on world markets. Also, in 1914 sterling had not come under pressure until some time after war broke out.⁷² From the moment of Hitler's move against Austria, however, the British Government would be faced with what amounted to a year and a half of undeclared war.

This fact would quickly be reflected in Britain's external financial position, and it was by no means unrecognised at the time, although warning voices, however important, were in a minority. On 14th March 1938, immediately following a Cabinet meeting called to discuss the Anschluss, the Minister for War, Leslie Hore-Belisha, made the point to Basil Liddell-Hart, the Military Correspondent of *The Times*, who noted in his diary that "H.B. said that he had read [passages from] *Mein Kampf* to the Cabinet at this morning's meeting. He remarked that people, even in the Cabinet, did not realise that 'we *are* at war' already - such is the new technique. I agreed."⁷³ The meeting in question was an immediate sign that the international situation had changed. Chamberlain faced demands "[a]s surely as the night follows the day"⁷⁴ for the reconsideration of Service schemes, "which the Treasury had hoped had been heard of for the last time", most notably from the Secretary of State for Air, Lord Swinton, who requested approval of a new scheme, 'K', for the Royal Air Force.

Swinton presented this scheme as an irreducible minimum for British security and the problem for the Government was that it would demolish the newly agreed fourth arm policy by crashing through the agreed financial ceiling of the rearmament programme. Simon raised this issue immediately and "pointed out that this was a very grave matter from many points of view".⁷⁵ The Chancellor's "own view was that if the Cabinet were to adopt substantially scheme 'K', it meant an end to the plan of fixing a total sum for Defence Expenditure. By no conceivable means would it then be possible to adhere to the Cabinet's decision of 16th February". He then went on to elucidate his own interpretation of the fourth arm policy in a manner which revealed all its vagueness and contradiction. He stated that:

There was a fundamental difference in our position from that of

⁷² Quite the reverse. In 1914, The central role of London in world finance and U.S. borrowing in Britain created an effect whereby the exchange rate "had risen as high as \$7 to the pound compared to the normal \$4.86". It took some months for the new realities of wartime to become apparent, but by "December 1914, for the first time since the war had begun, the rate of exchange in New York went against Britain". K. Burk, *Britain, America and the Sinews of War, 1914-1918* (London, 1985), p.56; p.59.

⁷³ B.H. Liddell Hart, *The Memoirs of Captain Liddell Hart* Vol. 2 (London, 1965), p.106.

⁷⁴ Shay, *British Rearmament*, p.198.

⁷⁵ PRO CAB 23/92, p.370. Cab. 13(38) Cabinet Minutes, 14th March 1938, p.11.

other nations. If we became involved in war, we could adopt unorthodox measures such as excessive borrowing, inflation of currency and so forth. At the present moment, however, we were in the position of a runner in a race who wanted to reserve his spurt for the right time but did not know where the finishing tape was. The danger was that we might knock our finances to pieces prematurely.⁷⁶

From the point of view represented by Hore-Belisha, much of Simon's problem was that he did not know where the starting blocks were, never mind the finishing tape.

Inskip came to Simon's aid and "confirmed the view of the Chancellor of the Exchequer that the adoption of Scheme 'K' would wreck the armament programme recently adopted by the Cabinet".⁷⁷ The awful consequence of such a breakdown was that "it would be necessary to approach the Trade Unions with a view to dilution. Such approaches were likely to be badly received."⁷⁸ Inskip "was satisfied that what the Secretary of State for Air required to be done quickly would not be practicable without dilution of labour, which meant the exercise of strong persuasion - perhaps with compulsion in the background". Chamberlain, perhaps sensing that such arguments were not sufficient for the new mood called for further investigation of the matter. It would not rest, however, and the Chancellor of the Duchy of Lancaster, Earl Winterton, who was attending his first Cabinet, brought some of the cold outside air in with him. He:

urged that it was important for the Cabinet to consider the view of the 'Right' as well as of the 'Left' in Parliament. He himself had had exceptional opportunities for knowing Mr. Winston Churchill's views. Since joining the Cabinet and having access to Cabinet documents, he was deeply concerned at our inability to fulfil the pledges of the late Prime Minister. He could see the reason for the difficulties, but the Government were going to be faced with a strong demand. Even the News Chronicle urged that we should press on with rearmament. If the Government were to announce that the matter was [sic] 'under consideration', they would be told that that was what they always replied and that the circumstances needed action.⁷⁹

Using Winterton's forthright intervention as a springboard, Hore-Belisha entered the debate and summarised the logic of the situation. Though he "agreed with the Prime

⁷⁶ Ibid., p.12.

⁷⁷ Ibid.

⁷⁸ Ibid., p.13.

⁷⁹ Ibid., p.15.

Minister that it would be inappropriate to adopt any particular scheme without further enquiry”, he felt:

It was necessary, however, to face the fact that the Cabinet’s present decisions contemplated a re-armament programme spread over five years. It would be said that it had been embarked upon in order to meet a situation which was rapidly becoming imminent. He recalled that the Chancellor of the Exchequer had spoken of what we could do financially if engaged in a war. As a matter of fact, we were at this moment entering on war. The new method of war was for one country to fall on the other in the night.⁸⁰

He then quoted the extracts from *Mein Kampf* which he had mentioned to Liddell-Hart and which gave a rather more extensive definition of Germany’s desired frontiers than Hitler would admit to in 1938. He ramméd the point home by concluding that:

At present we were trying to carry through our Programme without any interference with trade against a Power that was concentrating every effort on armaments. We ought, therefore, to consider a great intensification of our effort. It was all very well to have a five years’ programme, but we should not have five years for it. It was clear that Germany meant business.⁸¹

The tone of Cabinet debate had clearly been transformed by the Anschluss. In response to these forthright calls for action, Halifax could only assert rather lamely that “the events of the last few days had not changed his own opinion as to the German attitude towards this country. He did not think it could be claimed that a new situation had arisen.”⁸² Chamberlain had heard enough and concluded the meeting in a terse and irritated manner. He

pointed out that it was now 12.30 p.m. He was due to lunch with His Majesty the King at 1 o’ clock; he had a number of questions on Foreign Affairs to answer in the House of Commons and he had to make a statement which he had not yet had any opportunity to compose. This discussion confirmed him in the opinion he had already expressed that the Cabinet were not in a position to make any specific statement that day, and that nothing could be said beyond announcing a fresh review in the light of recent events. If, however, the Cabinet had been able to take decisions in time, it would have been possible to make an announcement on the

⁸⁰ Ibid., p.16.

⁸¹ Ibid., p.18.

⁸² Ibid.

morrow.⁸³

Chamberlain's discomfiture was not to be a sign of impending retreat, despite the buffeting that the Government's position had received. Voices such as Hore-Belisha's, although increasingly numerous, were isolated from each other and lacked an ideological context in which to speak. His access to Liddell-Hart was no path to the formation of a constituency as the latter's articles were being subjected to increasingly heavy censorship by Chamberlain's supporters at *The Times*, Dawson and Barrington-Ward.⁸⁴

Hore-Belisha's intervention in Cabinet, though, had found the heart of the fourth arm debate. He had in effect identified the origin of fourth arm policy in the earlier experience of the Great War, which had led the British policy machine to retain its belief that a clear dividing line existed between peace and the declaration of war, before which normal financial machinery could be maintained. He had at once revealed the absurdity of this conviction in prevailing international conditions and the extraordinary difficulty of pressing this perception on the machinery of Government.

There was no military expertise on this matter, for, as has been seen, military plans in the economic sphere were devoted to such issues as the conversion of domestic industry to supply war material, and questions of trade policy were posited in terms of blockading the enemy into surrender, with British financial strength assured. The question of how a war effort might be paid for and sustained financially was not considered to be a military problem, and the CID could not and did not express an authoritative opinion on this issue. Indeed, the concern of the Chiefs of Staff that war should be postponed until their programmes were complete led them to support Chamberlain's appeasement policy, which sought to avoid war until rearmament was completed in 1942, although his concern to maintain economic stability deprived the Services of necessary funding.

Much has been made of the lack of support Hore-Belisha received from the Army Council, and the way in which this hampered his effectiveness in Cabinet.⁸⁵ However, even with their full support he would have lacked a doctrinal counter to the fourth arm policy and

⁸³ Ibid.

⁸⁴ Liddell Hart, *Memoirs*: Vol. 2, p.144.

⁸⁵ It is also suggested that he was happy to work within the limits set by the Treasury. As a former Financial Secretary to the Treasury, Hore-Belisha may well have found this a useful budgetary negotiating position to counter charges of profligacy, but his open attacks on the fourth arm policy in Cabinet in 1938 and 1939 clearly place him in opposition to the Government's financial restraints. B.Bond, *British Military Policy Between the Two World Wars* (Oxford, 1980), pp.255-257.

his acute intuition was not an adequate weapon. Swinton's apparent success in pushing Scheme 'K' led merely to a marginal increase in RAF funding, and the Army would ultimately pay for even this gain. Chamberlain's belief in continued peace led him to eschew measures of structural economic organisation that were necessary for war and he was aided in this by the ingrained assumption of liberal finance that all war measures could be taken when war was declared.

The pressure for increased Service funding was not the only financial consequence of the Anschluss. The flight of capital across the Atlantic began almost immediately, and in contrast to the determined resistance to new defence expenditure which the fourth arm policy dictated, this development would be met not by Government financial control, but by the vast expenditure of funds. Here was revealed the absurdity of the fourth arm policy. The Government would attempt to limit defence spending and support sterling, in the name of husbanding resources and maintaining Britain's international credit position with regard to a war that was yet to come. Maintaining this position when, in a financial sense, war had already begun resulted in the stupendous expenditure of British resources across the foreign exchanges, in money terms well in excess of the extra funding required by the Services' 'impossible' demands of 1937-38.

In March 1938, therefore, a turning point had been reached. Peacetime conditions had ended and now was the time for Britain to look to her resources, economic and Imperial, to weather the storm, to hold what she had and develop the financial machinery required for the physical outbreak of hostilities. Fourth Arm policy, however, dictated the opposite course in the maintenance of business as usual. A war winning policy would, however, have been an independent policy, and the effect of Cordell Hull's intervention in changing the course of British political debate in 1936-37 was enduring. Quite apart from any success that might be achieved in negotiations for a trade agreement, the hope of reaching an understanding with the U.S. precluded the independent British attitude necessary to her development as a world power, and reinforced the existing financial policy.

The position of economic strength built up by the British on the basis of the sterling area was solid, sustainable and invulnerable to U.S. interference. The rise of the dictators, however, made it seem desirable for the British Government, of its own free will, to barter economic power for political allies. The impetus for this view was provided by the Foreign Office and then pushed forward by Chamberlain, who by linking this movement with the

financial basis of his defence policy was able to coordinate the F.O. with the Treasury on the issue, and assert his policy with such success that by the beginning of 1938 all opposition had been overcome. The disastrous drain of reserves that began in March 1938 demonstrated the physical consequences of this policy. American bewilderment when British gold began to flood the New York markets simply revealed the fact that behind the closed doors of British Government the State Department's efforts to destabilise the Ottawa system had succeeded beyond its wildest dreams, for the fourth arm policy was in effect a ringing affirmation of liberal internationalism.

CHAPTER 5

BETWEEN HITLER AND WALL STREET: UNDECLARED WAR VERSUS BUSINESS AS USUAL, MARCH - OCTOBER 1938

In 1938, Hitler demonstrated his willingness to resort to force outside Germany's borders in pursuit of his diplomatic aims, and while the British Government remained hopeful that a political settlement with Germany was possible, currency speculators, for whom optimism was a luxury, did not. Before the reopening of Parliament in January 1939 *The Economist* articulated the mood bequeathed by the past year: "Events in Austria, Czecho-slovakia and Spain have brought the angel of death, whose companionship is the price of failure to be strong and wise in diplomacy, out into the open." It observed that: "Once again the resumption of business in a New Year finds British politics overhung by problems of foreign policy, defence and finance; and the skies are darker rather than brighter for last September's contact with the grimmest of realities."¹

In the circumstances it was hardly surprising that sterling came under heavy pressure against the dollar after the German Anschluss with Austria, and that subsequent events accelerated the process. It was clear that Great Britain would bear the financial brunt of any war with Germany, as the United States, invulnerable across the Atlantic, had legislated through the Johnson and Neutrality Acts to remain aloof as well as neutral. The British authorities were not helpless bystanders, however, and they possessed distinct financial advantages in 1938 which, had they chosen to exploit them, would have left Britain better placed for a decision with Germany. It must be explained, therefore, why a nation committed to a predominantly economic strategy for victory in war, which would rely on economic staying power as the 'fourth arm' of its defence while blockade ruined its enemy, and which was fully aware that its survival depended upon the ability to pay for imports, should finally have resorted to war only when its gold reserves were nearly exhausted, its currency greatly devalued and its Imperial resources unexploited.

¹ *The Economist*, 28th January 1939, p.171.

5:1 Ideological Constraints on Policy

The catalogue of reverses which beset fourth arm policy before war broke out was not merely evidence of accident and blundering, but also of the determined application of ideology to dangerously inappropriate circumstances. The Government's unwavering reinforcement of failure in 1938 and 1939, especially in its efforts to support sterling, can be understood in terms of the fundamental importance of external finance, both for Britain's ability to wage war and, because of this, as a focal point in the ideological debate between supporters of the 'business as usual' viewpoint and its critics. This question went beyond the efficient management of the economy in war. The plans of the CID's various supply committees, the Board of Trade's contingency supply organisation and the putative Ministry of Supply, for the conversion of industry to a war footing would determine how efficient any war effort would be. The ability of the nation to ensure that the required quantities of imports could be paid for and delivered would determine whether there could be a war effort at all.

Stability, the watchword of the fourth arm policy, meant in the final analysis, external financial stability. If critics of the fourth arm policy could argue that the measures of economic compulsion appropriate to wartime could increase the level of production and stem the inflation caused by borrowing, supporters could counter that no measure of compulsion could close the gap between imports and exports opened by rearmament, or increase the amount that could be imported without borrowing recklessly for the purpose of resorting to the printing press. The genius of the Treasury's imposition of rationing had been to take the basic concept of the trade deficit and multiply the direct routes to perdition through the collapse of the pound, often expressed as the destruction of Britain's 'credit' or 'credit facilities.'

Such language slyly presented an image of Britain's relationship to the world analogous to that of powerless debtor to bank manager. A truer image would have placed Britain in the role of the bank's major shareholder, but Inskip's "Interim Report", the 'classic statement' of fourth arm policy, had made no mention of Britain's ability to impose exchange controls, or of the availability of deferred payment for imports in the captive sterling bloc market. Such concepts were dangerous: the fourth arm argument worked only if sterling was seen to be at the mercy of international capital flows, to the extent that the slightest extravagance in the domestic economy would tip it into oblivion. As long as this did appear to be the case, the ideological commitment to sound finance could be maintained

even after strict budgetary balance had been relinquished. The spectre of sterling collapse was to be the enforcer of the position newly formulated in 1937-38, that rearmament expenditure must be financed out of revenue and borrowing at peacetime levels of taxation, with future expenditure and loan repayment to be financed entirely out of taxation after the rearmament programme was complete.

This attitude was open to severe criticism, as Germany demonstrated daily that Government action could forestall the currency problems of rearmament, but it possessed remarkable credibility in the British political arena. The controversy provoked by the proposed Ministry of Supply was not repeated over exchange control. The First World War had introduced no precedent for the control of the currency in international markets, nor manifested any public evidence of an exchange crisis. It was possible to maintain that the stability of sterling in war had been based in sound domestic finance, and the critics of the Government's lack of commitment to rearmament could scarcely argue that a disintegrating currency would improve Britain's strategic position.

The choice of currency stability as the battleground of the financially orthodox, and the cornerstone of their credibility, was unavoidable. This position had to be occupied to forestall the threat to fourth arm policy posed by alternative methods of economic preparation for war. Specifically, this necessitated the maintenance of the sterling-dollar exchange rate by conventional means. If liberal financial practice could be applied successfully to the external position, with a stable pound the symbol of this success, then it would prevail in all other economic spheres. As the stakes were so high it is scarcely surprising that when the factual evidence mounted that the fourth arm policy itself was undermining Britain's financial position and that an alternative was urgently required, such evidence was disguised, withheld or actually suppressed. The fourth arm policy was not about defence, but the maintenance of the economic status quo. It relied upon its advertised association with the most fundamental level of national and Imperial survival for its political potency. In practice it would function as a parasite, acting not as an extra Service for defence but sapping defensive potential in order to maintain the existing financial system.

It has been argued that the structures of defence and foreign policy in the rearmament period were shaped and limited by the need of the National Government to form a domestic

political consensus.² In fact, the imposition of the fourth arm policy had required the destruction of the political consensus formed in 1931, and the staging of what was effectively an economic coup d'état. It is certain that the scale and scope of defence policy were constrained within a level of economy necessary to preserve the existing financial system, and this policy was formed without regard to the views of the opposition. It is difficult to see how it would have changed had opposition parties voiced enthusiastic support for the National Government's rearmament programme. The main challenge to the Fourth Arm policy was to come from abroad.

Throughout 1938 and 1939, evidence that it would not be possible to sustain the 'business as usual' stance mounted, and the list of setbacks it sustained during these years revealed two sides of the same coin. Devaluation and the loss of reserves were evidence of failed policy, while the lack of an Imperial system of war finance, which might have prevented such disasters, stemmed from the concomitant rejection of the alternative. The opportunity cost of the fourth arm policy based on the premise of 'business as usual' was the rejection, consciously or not, of an autarkic system for war finance based on the development of Imperial potential and the operation of the sterling area. As has been seen, the whole course of economic thinking in British policy-making circles after the protectionist triumph of 1931, had moved in an internationalist direction. The development of an autarkic system capable of saving the Empire would have involved sufficient movement towards the consolidation of the Ottawa system to impel the evolution of planning along such lines within the machinery of Government. Attempts to backpedal and pursue an Imperial economic policy after war had been declared, and following the conversion of erstwhile economic liberals, came far too late.

In terms of policy and argument, the damage to Imperial economic potential had been done in 1936 and 1937. In 1938 and 1939, strategic and economic reality was to overwhelm the fourth arm policy and dismantle British financial beliefs. This in itself might well have constituted a positive development, had not the process been too long drawn out and the struggle to resist change prolonged by the squandering of priceless assets. These unhappy

² See particularly Schmidt, who compares "the mobilisation of financial, economic and social resources, and the existing constitution of domestic political forces which allotted to armaments policy its 'hinge function' - its function as mediator between foreign policy and the domestic political and social system". G. Schmidt, *The Politics and Economics of Appeasement: British Foreign Policy in the 1930s* (Leamington Spa, 1986), p.390.

developments were in large part the result of intellectual rigidity in the British establishment, for the trends of previous years had ensured that when the chosen policy was shown to be based on fallacious assumptions, no systematically refined alternative existed to put in its place. As war approached officials and Ministers were reminded of the experience of 1931, in that again cherished beliefs were shown to be worthless and events mocked policy. As in 1931, a new system would have to be improvised after the crisis broke, again with experience as tutor, but this time there was no calm after the storm and too much was wrong that simply could not be put right in the time available.

Meanwhile, Ministers and officials would look on the German system with a strange mixture of awe, incomprehension and hostility, shrinking instinctively from its implications for necessary British action. Instead, when the fourth arm policy began to crumble, the British Government's immediate reaction was not to seek the best alternative but to look for ways in which the United States might be induced to shore up the existing system. It was assumed, incredibly, that the United States not only had the capacity to do this, but could be induced to share Britain's defence burden without exacting a political price. The British attitude was doubly unfortunate, as the United States was to discover during the sterling crisis that it had no physical means to influence British policy, though it was profoundly concerned with the consequences of British actions. Ultimately, Britain would find herself unable to finance war independently of the United States, not because she lacked resources, or because her reserves of gold and foreign currency could not have been held, but because an outmoded view of external war finance had been formed and then applied to disastrous effect before a shot had been fired.

5:2 *A Sea Change*

The beginning of sterling's slide in the spring of 1938 was more than the onset of a specifically British problem. As the year progressed and crisis followed crisis, the scale and dimensions of the issue would also ask fundamental questions of the United States. The point of contact between the economic impact of Hitler on the British world and the political economy of America was the U.S. Treasury Department under Morgenthau. Unlike the State Department, however, the Treasury had no 'program' or premeditated economic attitude toward the British Empire outside the framework of the Tripartite Agreement, and was inclined to manage economic problems and formulate policy on a day to day basis, dealing first with the most pressing problems. Also unlike the State Department, the

Treasury had a domestic economic agenda, to which currency management was extremely sensitive.

By March 1938, the United States was firmly in the grip of the 'Roosevelt recession' and Morgenthau was under considerable pressure to formulate urgent fiscal remedies for this new and terrifying crisis. The implications of the fall of sterling and the franc would pull the Treasury in different directions. On the one hand, the attempts of the European monetary authorities to support their currencies resulted in the U.S. being engulfed by a deluge of gold which, despite initial misgivings, was pumped into the economy as an overtly reflationary measure. On the other hand, declining European currencies meant tougher conditions for U.S. exporters and, more importantly, depressed commodity prices at a time when most American attempts to climb out of depression depended on raising them.

There was no precedent to guide the Treasury Department in dealing with this situation, and, to begin with, no obvious indication whether on balance the situation worked in America's favour or not. The result was a form of policy paralysis, wherein possible measures were continually discussed, but action was forestalled by a mixture of bewilderment and fear of the likely consequences. Inaction was justified by the hope that things might improve, and a dawning realisation that while sterling's decline was moderated by the sheer volume of gold the British were willing to expend, that America was gaining on balance. Though this favourable interaction of forces was produced by British policy, this was neither created by American pressure nor applied in the manner recommended by the American authorities. In fact, the interaction between Morgenthau's Treasury and the British between the Anschluss and the outbreak of war demonstrates the essential autonomy of British policy.

Indeed, before the Czechoslovakian crisis the attention of a harassed Morgenthau and his advisors became focused on the plight of the French franc, which overshadowed the initially more gradual fall of sterling. This phase of U.S. attempts to manage the Tripartite Agreement casts a new light on the Treasury's later dealings with the British, and on the supposed success of American attempts to 'bully' the British into supporting sterling with everything they had. The French, supposedly the weakest of the three parties to the Agreement, failed repeatedly to conform to its terms or inform Morgenthau of their actions, and treated his repeated communications in the most sardonic and contemptuous manner.

The American prescription for French action was based on the imposition of exchange control as a preferable alternative to the devaluation of the franc. Analysis of this episode,

and of the subsequent explosion of the British exchange crisis, shows quite clearly that the British acted entirely of their own free will, and that the U.S. Treasury was baffled into inaction by the complexity of the problem, never formulating a clear policy on the subject and resting on Morgenthau's instinctive but brilliant insight that 'business as usual' in international finance was America's best policy. Had the British given up the fight to maintain peacetime financial practice sooner than they did, Morgenthau and his advisors would have acquiesced in the imposition of British exchange controls as the least of many possible evils. This would have been the most suitable development for British interests as war approached, but was the one outcome that the British themselves were determined to avoid.

5:3 *The Sterling Crisis Begins*

The economic effects of the Anschluss were felt immediately, and their importance for the faltering economy of the United States was indicated by the speed with which the movement in the exchanges was picked up by American opinion. On Sunday 13th March, the *New York Times* front page gave equal prominence to a story detailing Hitler's "triumphal parade" into Austria and another with the headline "FOREIGN EXCHANGE TUMBLES IN CRISIS"³ which correctly linked the two events with the subheading "Chief World Currencies Break Sharply in the Flight of Capital to Safer Centers". It noted that: "Conditions bordering on near panic swept the money markets of the world yesterday as Europeans rushed to purchase American dollars and gold after Germany's conquest of Austria." In these circumstances, "heavy demand for dollars in London found ready reflection in the fall of the dollar value of London gold at price-fixing time, and presaged an early return of heavy engagements of gold in Europe for shipment to New York".⁴

In other words, it would soon be profitable to buy gold in London, and ship it for sale in the New York market. Already, the price of gold in London was "within about 4 cents of the level at which it will be profitable to resume the movement from London to New York".⁵ Such eager expectation of gold inflows, was, however, tempered in official minds by the likely fall in U.S. trade competitiveness, the other main consequence of a rising dollar.

³ *New York Times*, 13th March 1938, p.1.

⁴ *Ibid.*

⁵ *Ibid.*, p.35.

Morgenthau was warned in March that a decline in sterling would have the effect of “reducing the purchasing power of the countries of the sterling area for products from this country, while making it easier for them to undersell us in the export market.”⁶ True though this might have been, the problem was not pressing in March and the Secretary was more immediately concerned by the likely devaluation of the French franc, which had less significance in simple trade terms than an equivalent movement of sterling.

Morgenthau, as the architect of the Tripartite Agreement, was alarmed by the possibility of its breakdown, both for reasons of personal prestige and, as a committed anti-Nazi, because of the strength he believed it gave to the democracies relative to the totalitarian dictatorships. The prospect of unilateral French devaluation thus produced emotion and consternation but, because of the Secretary’s desire to preserve the Agreement, no threats. Morgenthau and his officials were in effect powerless to prevent the French taking whatever action they chose, and the main thrust of their response was, both before and after the fact, to persuade the French to implement exchange controls rather than devalue the franc.

Morgenthau said as early as 14th March in a meeting with his officials that in France’s position “I would slap on complete exchange control and grant commercial permits”.⁷ At the same meeting he raised the matter by phone with Roosevelt and Hull, the latter because exchange control would have implications for the recently concluded Franco-American Trade Agreement. Later that day he told White that:

If I am willing to stretch this Tripartite Agreement twice as far as she was ever supposed to and have it include exchange control, the State Department can stretch their thing and say ‘We will close our eye on this thing’ and give these fellows a chance because when they first put on exchange control it has to be on everything because how are they going to distinguish, the first week, what is merchandise shipment and what is capital flight?⁸

The offer of U.S. acquiescence to French exchange controls was made secretly and in person to Blum through H. Merle Cochran, the Financial Secretary at the Paris Embassy,

⁶ F.D.R. Library P.S.F. Box 97, Treasury Dept. 26th March 1938. Quoted in R.A.C. Parker, “The Pound Sterling, the American Treasury, and British Preparations for War, 1938-9”, *English Historical Review* 98, (1983), p.264.

⁷ FDR MD Book 114, p.277. Treasury Meeting, 14th March 1938, 9:45 a.m.

⁸ *Ibid.*, p.363. Treasury Meeting, 14th March 1938, 2:30 p.m.

but was politely declined.⁹ The French were unwilling to take such action which was not feasible, to say the least, in the context of domestic politics, and indeed Harry Dexter White¹⁰ had pointed out to Morgenthau that the issue divided Left and Right in France.¹¹ Thus, the United States would be left with little alternative but to accommodate the impending devaluation in agreement with the third partner, Britain.

The British, despite their own developing plight, took a more intemperate line over the Tripartite Agreement than Morgenthau, for whom there was no issue of principle at stake in the imposition of exchange control. The secrecy of the approach to Blum was at least in part the result of unease at the likely British reaction had they been told of the move. White had told Morgenthau that “I would be extremely surprised if Chamberlain would acquiesce”.¹² Archie Lochhead, the U.S. Treasury official who administered the Tripartite Agreement noted that: “We are operating under exchange control here in the United States. We are operating under licenses right now.” However, he then asked, “if you are wanting to take a great amount of capital out of Great Britain, do you think you can do that?”¹³ The answer to this rhetorical question was soon to prove an emphatic ‘yes’, but nevertheless Morgenthau knew enough to anticipate trouble if the British were consulted over the offer: “The answer would be no. And I have discussed that with the President. He said inform the British, but he did not say ask them.”¹⁴

The Treasury remained in the dark about French intentions through April, and indeed Morgenthau found it difficult even to contact French Treasury officials. As he remarked in a meeting, “when it gets so that neither the British nor the United States Government can talk to anybody for two days in the French Treasury, it isn’t very good, is it? Huh?”¹⁵ The

⁹ Ibid., p.379. Paraphrase of Telegram received for the Secretary of the Treasury from Cochran. American Embassy, Paris. 14th March 1938, 10 p.m.

¹⁰ In 1938, White held the U.S. Treasury posts of Assistant Director, Division of Research and Statistics, and, subsequently, Director of Monetary Research.

¹¹ MD Book 114, p.279. Treasury Meeting, 14th March, 9.45 a.m.

¹² Ibid., p.277. Treasury Meeting, 14th March, 9.45 a.m.

¹³ Ibid., p.363. Treasury Meeting, 14th March, 2.30 p.m.

¹⁴ Ibid., p.315. Treasury Meeting, 14th March 1938, 11.40 a.m.

¹⁵ Ibid., Book 120, p.316. Treasury Meeting. Re French Monetary Situation, 25th April 1938.

Secretary described himself at this stage as “very calm”.¹⁶ However, when in May the French announced their intention to devalue to 175 francs to the pound and raised the possibility that the devaluation might eventually go as low as 200, his calm evaporated. He said in a telephone conversation with Cochran: “Well, as far as I’m concerned, as I say, I can’t be too emphatic in my disgust and - ah - as far as I’m concerned its the last time I take their word on anything financial.”¹⁷ He went on: “Now I should think that the friendship of the United States would be worth something to them and they keep coming in here and making pretty statements and all that but they don’t keep their word.”¹⁸

The franc having declined beyond the 175 figure mentioned by the French, Morgenthau told Cochran to warn them that “they’d better tonight bring that down to one seventy-five if they know what’s good for them”, failing which “I consider they’ve absolutely broken their word”.¹⁹ When Cochran passed on Morgenthau’s sentiments however, the French seemed anything but repentant. Cochran reported back that there was some confusion over translation of the original French message: “And Rueff said, ‘Well, we must get some British academician to translate - to interpret’”, prompting Morgenthau’s reaction that “Rueff’s getting a little bit too sarcastic and too funny.” Cochran concurred: “I said that absolutely, I said, ‘We don’t want any Britisher to translate that or anything else!’”²⁰ Continuing French insolence was hard for Morgenthau to bear. He told William W. Butterworth, the Second Secretary and Financial Secretary at the U.S. Embassy in London, that “I can’t tell you how much I am upset over - to think that a whole French Government would act the way they act. I mean to me its just unbelievable in international history.”²¹

Finally, the French Ambassador was called in to hear the worst, but he retreated deftly behind the language barrier. Morgenthau told him in the presence of Herbert Feis, the State Department’s Adviser on International Economic Affairs, that: “the French Treasury had ‘chiseled’ on their agreement ever since the recent negotiations had started and that he was

¹⁶ Ibid., p.316.

¹⁷ Ibid., Book 123, p.144. Treasury Meeting, 5th May 1938, 9:06 a.m.

¹⁸ Ibid., p.145.

¹⁹ Ibid.

²⁰ Ibid., p.262. Telephone conversation between Morgenthau and Cochran, 5th May 1938, 10:59 a.m.

²¹ Ibid., p.321. Telephone Conversation between Morgenthau and Butterworth. Treasury Meeting, 5th May 1938.

disgusted with their conduct and practically at the end of his patience. (When the ambassador interpreted the word 'chiseled' as 'cheated' and asked the meaning of the word 'chieseled', [sic] Dr Feis explained it meant sharp bargaining.)"²² The direct approach misfired, however: "The French Ambassador showed great distress", despite Morgenthau's assurance "that this was not a personal matter between the Secretary of the Treasury and the French Ambassador, but in the relations between the two Treasuries".²³ The Secretary, nevertheless, "in order to appease the Ambassador voluntarily offered to destroy the stenographic record of his conversation and carried out this offer by burning the notebook in the fireplace in his office."²⁴

Morgenthau was not supported in his attitude by the British who in fact took the reverse view that, when faced with a choice between devaluation and exchange control in the management of the franc, devaluation was the lesser of two evils. Like Morgenthau they felt the end of the Tripartite Agreement to be the worst possible outcome, but in addition to Morgenthau's position that the dictators would gain thereby, their ideological position, as reported to Butterworth, was that: "A breakup of the Tripartite arrangement would be hailed everywhere by advocates of autocracy as a disaster for liberal ideas in international finance and business."²⁵ Kennedy told Morgenthau that Chamberlain "said that exchange control was a great - was a very serious thing because it was the beginning of the end and it was against all the policies that we've been trying to advocate".²⁶

5:4 The 'Roosevelt Recession' and the 'Billion-Four'

At the same time as Morgenthau was wrestling with the French, the Treasury Department was coming under pressure to take positive action with regard to the domestic economy. In stark contrast to the prevailing mood at the State Department, where Cordell Hull's messianic zeal externalised economic difficulties to the world arena in the manner so congenial to British liberals, the U.S. Treasury had to concern itself with specifically American problems and the effect that world events had on them. By March 1938, the

²² Ibid., p.396. Summary of Meeting with the French Ambassador, 6th May 1938.

²³ Ibid., pp.396-397.

²⁴ Ibid., p.397.

²⁵ Ibid., Book 123, p.209. Butterworth to Morgenthau. British Summary of Events, 4th May 1938.

²⁶ Ibid., Book 122, p.135. Telephone Conversation between Kennedy and Morgenthau, 3rd May 1938.

United States was in the grip of a new recession which, while not in itself as catastrophic as the first had nevertheless wiped out the gains made since the beginning of the New Deal and resulted in a situation in which “in the year of the Munich crisis, the U.S. share of world manufacturing output was lower than at any time since around 1910”.²⁷

American national income had contracted to \$65 billion, though \$80 billion was thought to be required for full employment. In these circumstances it is hardly surprising that the Treasury saw its main problem as the stimulation of recovery, and that this task was overwhelmingly concentrated on the raising of national income by all means available. Fortunately, there existed under the Treasury’s control a huge reservoir of sterilised gold, now being added to daily as the European currency crisis took hold. This reserve, which was becoming increasingly embarrassing, had obvious potential as a tool for recovery and was burdened with a controversial history that made its liquidation seem all the more attractive.

In the relatively buoyant economic circumstances of 1936, the U.S. economic authorities had become worried about the possibility of inflation and had taken steps to restrict credit. A major aspect of this policy was the creation of the ‘Inactive Fund’, in which the existing gold reserve and additional gold imports were ‘sterilised’ to prevent their use as a basis for an expansion of loans. By early 1938, however, the Roosevelt recession was well established and such restrictions on credit were blamed. On 13th March, amidst fresh reports of depressed U.S. production, a leading article in the *New York Times*, under the heading “‘Financial Anemia’”, drew attention to a speech by Leonard Ayres, the Vice-President of the Cleveland Trust Company which

diagnoses the economic malady from which the country is now suffering. The capitalistic system, he points out, requires a continuous flow of new capital; and because that flow has been checked, business stagnation has resulted. He points out, as others have, how we have finally managed to check the flow of capital from all the principal sources.²⁸

Ayres was not alone in this view. On the same day, in a meeting at the Treasury, William O. Douglas, Chairman of the Securities and Exchange Commission,

said that he had told the President that as we have been going along for the last four years with consuming power falling off and without

²⁷ P. Kennedy, *The Rise and Fall of the Great Powers: Economic Change and Military Conflict from 1500 to 2000* (London, 1988), p.426.

²⁸ *New York Times*, 16th March 1938, p.22.

any sufficient backlog of capital expenditures, we have reached the place where there is no longer any capital market. While he thinks it is necessary to spend to increase the consumers' purchasing power, he feels very definitely we can never pull out of the depression by that method. The key is the opening up of the capital markets and getting a regular flow of funds back into industry. We are very foolish if we sit back and hope that business will 'catch' as it has in the past.²⁹

Morgenthau was keenly aware of the scale of the problem, and extremely sensitive to press criticism such as that contained in the *New York Times*. He believed in balanced budgets, though, and was by no means as influenced by Keynes as were his advisers. At the same meeting he hit upon an idea that reflected his personal concerns. He suggested that "we could take \$100 million gold from the Federal Reserve and use it as capital for the regional banks and 'go places'".³⁰ This idea presented possibilities for pump priming without deficit financing, and further investigation took place. As the idea took root, it soon became apparent that the amount of sterilised gold available with which to 'go places' was massively in excess of \$100 million. In an internal memorandum it was revealed that: "As of March 31, 1938 the Treasury held gold in the inactive account in the amount of \$1,183,000,000 and free gold in the working balance of \$210,000,000, or total gold available for creating credits with the Federal reserve banks thereby increasing our cash balance, if the Secretary deems it wise, in the amount of \$1,393,000,000."³¹

On the same day, in a paper prepared by his advisers, Morgenthau was strongly advised to desterilise gold as the best means of increasing bank reserves, a move which, quite apart from its technical benefits,

will be a spectacular pronouncement of a Government policy which the public would interpret as expansionist, and therefore contribute toward the development of a psychology favorable to expansion. It would strengthen the expectation of rising prices because it would be evidence that the Administration proposes to take aggressive steps to reverse the present deflationary trend.³²

This recommendation was accepted, and on 14th April 1938 the U.S. Treasurer was

²⁹ MD Book 115, pp.40-41. Treasury Meeting, 16th March 1938.

³⁰ Ibid., p.46.

³¹ Ibid., Book 118, p.215. Memorandum on the Estimated Financial Requirements for the Next Six Months, 7th April 1938.

³² Ibid., p.218. Treasury Department Inter-Office Communication, To Mr Taylor from Mr White: Shall Excess Reserves be Increased and if so, How? 7th April 1938.

instructed to liquidate the Inactive Fund and distribute what was to become known as the 'billion-four' to the 12 Federal Reserve banks, thereby ensuring that the reflationary effect of the move would be felt throughout the United States.

The excitement displayed by the American press as additions to the American gold stock poured in from abroad was, therefore, understandable. As far as public opinion was concerned, new gold meant an expanded economy and movement out of depression. The British, however, disapproved of Morgenthau's action, as was revealed in a telephone conversation between the Secretary and George Harrison, the Governor of the Federal Reserve Bank of New York, who enquired about foreign reaction. The former replied that he "thought the British were a little bit childish about it. They said they had seen this and that and the other paper, didn't understand it. In the first place, they've got an Embassy with forty or fifty people in it; if they can't read our newspapers and send the cables over, I don't know..."³³

It was pointed out that Britain's own Exchange Equalisation Account acted in the same way constantly, and White noted that "I venture to predict that when next week's 'Economist' comes to us, there will be a very excellent analysis of what desterilization meant and accomplishes, which was probably written 24 or 48 hours after the event. No difficulty in understanding it."³⁴ He was right about *The Economist's* grasp of the matter. It was to observe that: "The increase in the deposits of the member banks in recent months is one of the outstanding economic phenomena of the period."³⁵ Harrison perceptively observed that, "I think the amount is probably what made them think it was not routine."³⁶

British disapproval was tempered by the fact that they had little justification to be openly hostile. After all, classical gold standard theory called for the monetisation of inflowing gold, so Morgenthau's desterilisation operation was technically unimpeachable on grounds of liberal economics. Also, as had been noted, the E.E.A. clearly circumvented classical theory and was designed to do so. However, the British knew that Morgenthau's intent was reflation, not resurrection of the gold standard, and that sterilisation would again

³³ Ibid., Book 120, p.336-337. Treasury Meeting. Re French Monetary Situation, 25th April 1938.

³⁴ Ibid., pp.337-338.

³⁵ *The Economist*, 15th October 1938, p.113.

³⁶ MD Book 120, p.338. Treasury Meeting. Re French Monetary Situation, 25th April 1938.

occur if American prices rose too quickly.

The analogy with the E.E.A. was flawed, as the U.S. Stabilisation Fund had not been touched. The British parallel would have been for the Issue Department of the Bank of England to release all its gold to the clearing banks as backing for a major expansion of credit. Here was the nub of the diverging British and American economic ideals. Although it was difficult for the British to defend the E.E.A. on classical grounds, as it was in fact designed to cushion the British economy from international capital movements, this was nevertheless seen as a specific and regrettable deviation from liberal ideals made necessary by the state of the world.

Morgenthau's action implied a level of state intervention in the workings of the domestic economy that was quite alien to official British thinking, predicated as this was on the pursuit of 'business as usual'. Chamberlain, told Daladier in August that

I have seen various plans and suggestions urging us to expand credit further, but these have always seemed to me to miss the point. Our trouble has been not at all to expand credit on the basis of our gold stocks but to persuade people to use the credit which has been created in some abundance. If I ask what is the reason on the one hand for the renewed demand for gold and on the other for the failure of international business and commerce to expand, I come back immediately to the conclusion that it is due to fear of the international political situation.³⁷

As the developing sterling crisis replaced the plight of the franc as the major issue in the management of the Tripartite agreement, the full width of the chasm between British and American thinking on matters of international finance was to be revealed.

5:5 Morgenthau's Gold Dilemma.

The simultaneous struggles with depression and the French established the character of the U.S. Treasury's responses to the forthcoming British crisis. The French episode had clearly shown that the Americans would be unable to respond effectively to a sterling devaluation. Before the onset of the Munich crisis, however, this was not a severe problem. The British were evidently determined on their own behalf to support the pound with the expenditure of reserves, and the decline of sterling was gradual. This meant that the enormous scale of the speculative assault on sterling manifested itself for the United States in massive inflows of gold.

³⁷ PRO PREM 1/267, p.8. Letter, Chamberlain to Daladier, 17th August 1938.

The Americans had to this time shown eagerness to accept all the gold that was available, but the sheer volume of the metal now entering the U.S. economic system presented severe technical problems for the U.S. Treasury, which could only process so much at a time and was fully engaged in getting the original 'billion four' into the system. The result, ironically, was that Morgenthau was in danger of building up a new gold reserve so large as to make it appear that he had in some underhand way reverted to sterilisation. However, sterilisation of gold was so unpopular and so obviously inappropriate to a time of depression that its resumption was no longer a policy option. No preconceived plan existed to deal with such a situation and it was thought at this stage within Government that the continued gold inflow might be too much of a good thing.

Roosevelt, in a conversation with Morgenthau, had wondered aloud as early as 16th March: "What would be the effect of our declining to receive all gold? I wish you would make a study of it for me."³⁸ Morgenthau was immediately sceptical, fearing that "it would upset everything terribly in this country" and that furthermore: "The gold would go to England. All my reactions are against it."³⁹ He agreed on the study anyway, and produced a discouraging memorandum on 23rd March. Such a move would cause "wild and chaotic fluctuations in foreign exchange rates throughout the world"⁴⁰ and that as the U.S. held one half of the world's gold it would be obviously unwise to create a situation whereby: "The world would be encouraged to attempt to do without gold, leaving us (and England) holding the bag."⁴¹

Thwarting Roosevelt's inane idea, however, simply made the point that the Treasury's hands were tied. To safeguard its own economic position and secure the full value of its immense gold stocks, the United States would have to play the international financial game to the extent of receiving all the gold that was coming. Morgenthau's problem in the short term was what to do with it. On 29th August 1938, George Harrison wrote to Morgenthau that: "Over the past several months comment has appeared in the newspapers that the Treasury has been sterilizing gold since the desterilization of April 14, 1938. In the last few days and, in fact, several weeks ago, we received a number of telephone calls from people

³⁸ MD Book 115, p.27. A Record of Conversation between the President and HM, Jr, 16th March 1938.

³⁹ Ibid.

⁴⁰ Ibid., Book 116, p.261. Treasury Memorandum, 23rd March 1938.

⁴¹ Ibid.

in New York, asking whether it is true that the Treasury is sterilizing gold.”⁴² This was because of the “constantly rising amount of gold held in the Treasury General Fund, which has been increasing ever since April as the result of gold imports and other gold acquisitions by the Treasury which have not been utilized by making transfers to the Gold Certificate Fund of the Federal Reserve System.”⁴³

Harrison went on that “I think that you would want to be informed of the interpretation placed by some persons upon the current treatment of gold”.⁴⁴ Over the summer, the intensifying Czechoslovakian crisis increased pressure on sterling and accelerated the flow of gold to the United States. After the crisis, *The Economist* noted that: “In July gold imports were relatively small; in August they rose rapidly; and in September the net influx was about \$600 millions.”⁴⁵ Even as Harrison wrote, matters were coming to a head.

By early September, American public opinion was becoming ever more excited by the arriving gold and thereby kept its sword in Morgenthau’s back. The *New York Times*, as if in a war report, trumpeted “POUND OFF AGAIN: MORE GOLD TAKEN”,⁴⁶ and told its readers that the \$6,100,000 of gold “engaged” on 2nd September “Makes Total Taken in England for Import Here \$83,400,000 Since July 26”.⁴⁷ The actual movement of the metal was deemed to be of interest and it was reported that the “Holland America liner Nieuw Amsterdam arrived here last night from the Channel ports with \$12,225,000 gold, shipped at Southampton and consigned to the First National Bank and the Bank of Manhattan Company here. The metal will be landed this morning at Fifth Street, Hoboken”.⁴⁸

The sheer scale of this movement and the urgent need for a response pushed the matter to the top of the Treasury’s list of problems. On 21st September, the issue was

⁴² Ibid., Book 137, p.33. Letter from Harrison to Morgenthau, 29th August 1938.

⁴³ Ibid.

⁴⁴ Ibid., p.34.

⁴⁵ *The Economist*, 15th October 1938, p.113.

⁴⁶ *New York Times*, 1st September 1938, p.33.

⁴⁷ Ibid., 3rd September 1938, p.17.

⁴⁸ Ibid.

discussed at a long meeting at the Treasury.⁴⁹ Because of gold inflows the Treasury's general fund had grown to a figure of \$800 million, and in line with Harrison's earlier warning it was feared that if the figure went over \$1,000 million it would be assumed that the Treasury had recommenced sterilising. At this meeting it was decided that all new gold acquisitions would be fed into the Federal Reserve system with additions to make round numbers from the General Fund, which would then gradually decline. In this way the European gold drain and the reflation of the American economy became linked on a day to day basis. However, the size of the General Fund was such that even lengthy interruptions to the gold flow could be made up from its contents, and it was to function as a very sizeable reservoir of gold, slowly emptying.

5:6 Morgenthau's Sterling Dilemma

The nature of the September crisis, however, meant that creating a mechanism to integrate the gold influx would not of itself be an effective American response to the speculative assault on sterling. When war seemed imminent, this attack was so severe that no amount of support from the British reserves could prevent a sharp deterioration in the value of the pound. This situation caused general confusion in the United States. On 4th September 1938, the *New York Times* tended toward the view that sterling's fall was being engineered deliberately on the grounds that "the advantages of a lower pound to help stimulate domestic recovery outweigh any remaining advantages of a higher pound to help the rearmament program and the attitude of the British authorities is changed".⁵⁰ A day later, however, under the headline "LONDON JUSTIFIES FALL OF STERLING", the paper while maintaining that: "Recently, official support for sterling has been almost entirely withdrawn" went on to contradict itself with the observation that "support is by no means entirely lacking", as the "British exchange fund continues, for instance, to supply gold as freely as possible for shipment to the United States and is purposely maintaining that London price of gold at a level that encourages such shipments".⁵¹

This uncertainty was fully reflected in the deliberations of the U.S. Treasury, and was accompanied by consternation, as some policy response to sterling's fall would have to be

⁴⁹ MD Book 142, p.16. Treasury Meeting. Re Gold policy, 21st September 1938, 10.15 A.M.

⁵⁰ *New York Times*, 4th September 1938, Financial Section, F1.

⁵¹ *Ibid.*, 5th September 1938, p.22.

formulated if it continued. There seemed, however, to be no possibility for action where the benefits obviously outweighed the costs or where the likely consequences were clear. It was not as if the Treasury was unwilling to act in American interests, if it could only be discovered where they lay. In a Treasury meeting at Morgenthau's home called to discuss possible American policy in the event of war, Russell Leffingwell⁵² remarked that "it might be wise to find out what it is the British want us to do with respect to sterling and then we could cooperate with them"⁵³ to which Morgenthau "responded that the important question was not what the British wanted us to do but rather what was good for the United States to do". Leffingwell stood his ground and said: "Of course, but you can't fix the price of sterling. England will have to do that. The important question is are you willing to continue to take gold freely at the present price."⁵⁴

Any doubts that the British had about the likely absence of U.S. altruism should have been dispelled by the despatch of American warships to Portsmouth, on Morgenthau's initiative, to remove U.S. owned gold before the fighting started. However, on a strictly practical level, if the U.S. Treasury accepted that the British were doing all that could be expected of them to hold sterling and yet failing, then the implications were worrying. It has been suggested that the U.S. bullied Britain into a full-blooded support of sterling, a position based on the attitude and prolific memoranda output of Harry Dexter White, Morgenthau's most hawkish adviser on Anglo-American affairs. This assertion is beside the point, as the British monetary authorities were already fully committed to the defence of sterling. However, even if the opposite had been true, as White believed, American powers of coercion were not great.

This was illustrated by his preparation of a memorandum for Morgenthau in which he outlined what have been described as "methods of bullying the British into holding sterling at \$4.80".⁵⁵ White returned frequently to the ideas contained in this paper,⁵⁶ bringing them

⁵² Leffingwell was a former Assistant Secretary of the Treasury, and was at this time a member of J.P. Morgan & Co. which may account for the sharpness of his exchange with New Dealer Morgenthau

⁵³ MD Book 138, p.60. Notes on Meeting at Secretary's Home, Thursday 1st September 1938.

⁵⁴ Ibid.

⁵⁵ Parker, "The Pound Sterling", p.270.

⁵⁶ MD Book 138, p.142. Inter Office Communication, To Secretary Morgenthau from Mr White, 6th September 1938.

up again and again at meetings as sterling's plight worsened, but their impracticality was obvious at the time and would become more so, repetition and elaboration doing nothing to alter the facts of the case which asserted themselves ever more forcefully.

The first of White's suggested responses to a continuing decline of sterling was to announce a violation of the Tripartite Agreement of 1936, a move without physical or legal effect, which could only shame the British, and of course destroy Morgenthau's proudest creation. As the considerably more trying French experience demonstrated, the end of the Tripartite Agreement was one thing that the Secretary would not contemplate. The second possibility was to reopen negotiations on the Anglo-American Trade Agreement, then approaching fruition. As this was likely to favour the Americans, the detrimental effects of such a move would be felt more at home than in London. Roosevelt, moreover, was keen to see the Agreement enacted, and quite apart from the President's concerns, such a move would have meant interference with Cordell Hull's pet project, a perilous venture in Washington's political jungle. Both of these measures would also have sent to the world a message of disarray in the democracies that neither Washington nor London were keen to transmit.

White's third option was to devalue the dollar against gold and restore the pre-existing sterling-dollar parity. This would certainly have been effective, and was the one possibility that the British consistently took seriously, although their concern was based on its likely effect on the world economy rather than on themselves specifically. As the 1933 precedent showed, this was an area in which Roosevelt might act by executive fiat to override his Treasury's wishes. However, potential effectiveness did not equal practicality. Morgenthau would never suggest such a move, and both he and the British were united in their belief that such an action would finish the Tripartite Agreement.

This was unfortunate for the British, because in terms of their war potential in 1938 dollar devaluation against gold would have constituted the ideal solution. Sterling and the dollar would then, in effect, have been falling together against gold, thus maintaining British ability to buy from dollar economies if war came. Also, the dollar value of British gold stocks would be increased, enhancing Britain's ability to wage war. As will be seen, though, Morgenthau's attitude was moving in a direction that took him further and further away from such a solution. The fourth possible action listed by White, the conversion of U.S. sterling balances into gold was an oddity never mentioned again.

An indication of the low salience of White's views at this time was that his

memorandum was not produced at the meeting for which it was prepared, as this was preoccupied with the plight of China. When White mentioned his paper Morgenthau told him that: "If this Chinese thing doesn't take too long, maybe we can do a little sterling afterwards."⁵⁷ The occasion did not arise, and indeed White himself seemed to acknowledge the weakness of his specific prescriptions in concluding his memorandum with the observation that: "The chief and decisive weapon in our arsenal is that England needs our good will much more than we need hers at the present time."⁵⁸ This statement, which remains a commonplace of diplomatic histories, is debatable to say the least in the context of the economic and financial arena. In terms of national interest it can be seen that sterling's slide was also America's problem.

Of White's proposed 'threats', three were likely to be as damaging to the U.S. as to Britain and the other, devaluation of the dollar against gold, was so beneficial to British interests as to amount to an abandonment of American isolationism, a point unappreciated for different reasons on both sides of the Atlantic. Unfortunately for Britain, the latter option faded from consideration because it was becoming clear to Morgenthau that the British were indeed sacrificing their financial strength to hold sterling, and that a negative policy of inactivity might reap dividends for the United States.

At the 21st September group meeting at the Treasury Department, after the scheme to deal with incoming gold had been formulated, the economist Jacob Viner, a visiting consultant and former Department employee, asked Morgenthau about the Treasury view on the "drop in sterling...speaking as an outsider".⁵⁹ Morgenthau replied that "I can answer that fairly simply, as an insider. I don't think that until this war situation clears up there is anything that we can do about it, and if anybody in this room knows anything that we can do about it, I wish they'd tell me".⁶⁰ The meeting was uncomfortably aware of American vulnerability on the issue and their dependence on the good faith of the British authorities. It was feared that this might be undermined by the agitation of the British press in favour of devaluation. A declining pound was thought at this stage to be inimical to U.S. interests

⁵⁷ Ibid., p.155. Treasury Meeting, 6th September 1938.

⁵⁸ Ibid., p.145. Inter Office Communication. To Secretary Morgenthau from Mr. White, 6th September.

⁵⁹ Ibid., Book 142, p.54. Treasury Meeting. Re Gold Policy, 21st September 1938.

⁶⁰ Ibid., p.54.

but in crisis circumstances the defence of the pound with reserves simply led to a larger immediate influx of gold into America.

An obvious possibility was for the Treasury to use its Stabilisation Fund, a broad copy of the E.E.A, to buy sterling. The use of the Stabilisation Fund for this purpose was never seriously contemplated, however. This would have meant a politically unacceptable gold drain, and was certainly absent from White's personal prescription. The Treasury view was that the stabilisation fund formed a contingency reserve to deal with unforeseen crisis rather than as a tool of day to day currency management like the British E.E.A. The logic of this position also dictated, however, that if the United States was unwilling to use its reserves to support sterling and simply wanted its own gold inflow slowed rather than reversed, then it could not act to manage the pound-dollar relationship itself and was thus utterly dependent upon British action to change the situation.

This curious and important effect of the gold inflow, and the U.S. Treasury's attitude towards it, was also acknowledged when John H. Williams⁶¹ pointed out that "we seem to be moving back toward - to the orthodox position in international currency matters, giving up gold sterilization and so on; and the question is whether that's the best position to be in. I don't know whether it is or not. It does open up the possibility of England's operating on us." This could be "the best solution" but only "if we could trust them to be wholly unselfish and to take into account not only their interests but ours".⁶²

These less than blustering comments were an accurate reflection of the situation facing the United States. Although Hitler's actions were in the main a British problem, the peculiar circumstances of the earlier 1930s still constrained American action. As the gold policy demonstrated, the geographically remote, disarmed and politically isolated U.S.A. still needed a functioning international, or perhaps more accurately trans-imperial, financial system to drag its economy out of the mire and exert influence, and within such a system Britain was at least an equal partner. In fact as liberal internationalism became less and less appropriate to Britain's circumstances, its importance increased for the United States.

It became increasingly important for the Americans not to take any action which might drive the British any further towards autarky than the maintenance of sterling demanded. Throughout the various crises Morgenthau was helped in keeping his nerve and maintaining

⁶¹ Vice President of the Federal Reserve bank of New York, and Professor of Economics at Harvard University.

⁶² MD Book 142, p.59. Treasury Meeting, 21st September.

a passive policy by the high quality of information that he was receiving from England. The Treasury's information on the sterling market was excellent. It received daily reports from L.W. Knoke, a Vice President of the Federal Reserve Bank of New York, who spoke daily on the telephone with George Bolton, Principal of the Foreign Exchange Section of the Chief Cashiers Office at the Bank of England, and from Butterworth who was similarly informed by the British Treasury. The irony of this situation was that Morgenthau was better informed of the operations of British markets than the British Cabinet, which had to make do with infrequent and partial statements from the Chancellor of the Exchequer. Even more importantly, Bolton's habitual frankness meant that Morgenthau knew at least as much of the Bank of England's thinking and dealings as did the British Treasury. An added bonus was that the British Treasury did not know this, so Morgenthau was often able to judge the candour of Treasury comments against the information he received through Knoke.

5:7 Morgenthau Sees His Way Clear

The passing of the Munich crisis lifted the sterling problem temporarily from Morgenthau's shoulders, and the reports reaching him from London about the attitude of the British authorities were heartening. The pound, which had touched a low of \$4.61, rose more than 10 cents before the Munich euphoria wore off and the pervasive sense of crisis returned to drag the exchanges down, gradually but remorselessly, once more. The unruffled British reaction to the loss of gold during the crisis contrasted sharply with American excitement at receiving it. While the American press was sufficiently excited by U.S. gold receipts to keep score by the day, British fears were calmed by the belief that when the crisis ended the gold would come back.

Even as sterling pressure began to build again in October, Henry Clay at the Bank of England (who was later released to work on Lord Stamp's survey of British economic preparedness for war) exhibited a complacent front to the Americans. He was fully aware of the political cause of sterling's difficulties, and "in the course of a short conversation" with Butterworth he "remarked on the diminution in the pressure on sterling but added that 'these spasms temporarily spend themselves but the movement will be resumed' because the Munich settlement is being increasingly regarded as a truce not a peace".⁶³ The last part of this sentence might have provided a warning to the Americans, but the surprising calmness

⁶³ MD Book 146, p.152. Telegram, For Treasury from Butterworth, 17th October 1938.

Clay displayed in the face of this grim prospect gave a false impression of Britain's ability to meet a renewed sterling crisis, and was in no way based on an understanding of the prevailing conditions of undeclared war.

The roots of Clay's equanimity were ideological rather than empirical, as he revealed when he "went on to say that the United Kingdom could lose a lot of foreign funds without serious domestic repercussions; that after all the gold reserve had been built up against the contingency of foreign withdrawals and therefor [sic] there was no reason why it should not be so employed". The essence of this view was described in the Economic Advisory Council's advice to the Cabinet of October 1937 that "large scale gold movements should be looked upon as a normal element in the preservation of financial equilibrium, and that the stocks of gold in monetary use should be widely distributed."⁶⁴

British gold was certainly being distributed, but not widely, and Morgenthau, faced with continuing inflows of the metal and Britain's willingness to lose it, was gaining a shrewd perception of how to proceed. He realised that the U.S. could do nothing to coerce the British in a crisis, but he knew also that the British monetary authorities could be relied on to do their utmost to maintain the pound for their own reasons, and that a mechanism now existed to manage the consequent gold inflow which was thoroughly advantageous to American interests. In the relative calm between specific crises, therefore, he was relaxed and almost cocky, knowing that a gradual fall in the sterling exchange would not rock the boat at home and being secretly comfortable with any level above \$4.50 as long as this figure was not approached too swiftly. Indeed, resistible pressure on sterling was desirable because British expenditure of reserves maintained the gold flow whilst mitigating the pound's decline and the consequent loss of U.S. trade competitiveness and depression of commodity prices.

Morgenthau thus remained confident, telling a meeting early in October that: "I may be all wrong, but I am going to do what I do very rarely - make a little forecast: I've decided that if I was in Europe and I had any money, at best I'd want to invest it in American property, using the all inclusive word, and I am just thinking that money is going to keep right on coming over here, because its the only place for it."⁶⁵ He continued: "I mean, if I had any money and I was a European, after what's happened, this is the place I'd want to

⁶⁴ PRO CAB 24/273, p.88. CP 287(37) Economic Advisory Council. Committee on Economic Information, Twenty-Third Report, Survey of the Economic Situation, October 1937, p.31.

⁶⁵ MD Book 144, p.250. Treasury Group Meeting, 7th October 1938.

invest it, and, therefore, I think gold will continue to move this way.” The obverse of this attitude, though, was justifiable anxiety when speculators got on top of the British currency defence.

Morgenthau’s spirits thus moved up and down with the exchanges and consequently with Britain’s diplomatic distress, and unfortunately for his peace of mind politically inspired currency crises now came in quick succession. This coincidence of Morgenthau’s attacks of anxiety with sterling crises has tempted British historians investigating the subject to assume that sterling dominated the thinking of Treasury officials. In fact, sterling occupied no more of Morgenthau’s crowded time than, for instance, the Japanese invasion of China. It is not surprising, therefore, that burdened by other business, happy with the immediate situation and lulled by British complacency, he did not immediately perceive the signs of renewed crisis after the brief financial honeymoon of the Munich Agreement. They were there, nevertheless.

5:8 ‘Business as Usual’ Tested to the Limit

Butterworth told the Treasury on 4th October that “for the moment the belief appears to be growing that the pound is not yet a buy”.⁶⁶ Bolton, at the Bank of England told Knoke on 6th October that “The market was a peculiar one at the moment. Nobody quite knew which way the cat was going to jump”.⁶⁷ However: “As regards sterling, the feeling in London was that it would go weaker and there was talk of \$4.50 or even \$4.35 to the pound.”⁶⁸ In contrast to Clay’s calm assurance, *The Economist* observed uneasily that “normal conditions are yet to be re-established. This is an unexpected phenomenon which will take some explaining.”⁶⁹

Hitler’s Saarbrücken speech of 10th October, in which he asserted that Germany no longer required the tutelage of British governesses, then opened a new phase in financial events. The speech, which in Knoke’s description of Bolton’s opinion, “seemed to put an end to the so-called peace that they believed they had secured at Munich”,⁷⁰ began an assault

⁶⁶ Ibid., p.86. Telegram, For Treasury from Butterworth, 4th October 1938.

⁶⁷ Ibid., p.125. Telephone Conversation with Bank of England, 6th October 1938.

⁶⁸ Ibid.

⁶⁹ *The Economist*, 8th October 1938, p.74.

⁷⁰ MD Book 145, p.195. Telephone Conversation with Bank of England, 11th October 1938.

on sterling sufficient to dispel any complacency. Bolton told Knoke that, “the rate had opened today at \$4.75½ and in less than 5 minutes he had sold about \$6,000,000. In addition he had put £750,000 gold into the market at a price to enable its being shipped to New York and thus furnishing more dollars.”⁷¹ When Knoke contacted him at 11.10a.m. “[h]is total sales so far had been \$11,000,000. How long this present movement against sterling would last he didn’t know but it very obviously had its origins in the bitter disappointment over Hitler’s speech”. As in the Munich episode, and in no small part because of it, the new speculative attacks were so severe as to drive sterling down however much gold the British spent.

The Economist became anxious at the implications of sterling’s failure to rebound after Munich. Stark facts were explored such as that: “At a rough approximation, three-quarters of America’s enormous gold acquisitions reached her from or through London”, and that: “The United States took from us the prodigious sum of £126.7 millions”, while: “Arrivals of new gold from South Africa gradually dwindled away.”⁷² The journal went on to make the uncomfortable calculation that the Exchange Equalisation Account’s “reserves of £297.8 millions on March 31st last, must by now have become sadly depleted”.⁷³ And as if these losses were not bad enough: “The dominating factor in the money market is that so far none of the funds which left London during the crisis have shown the slightest signs of returning. On the contrary, the departure of the hot money is now being followed by the transfer to New York of what hitherto had been regarded as permanent balances in London.”⁷⁴ This was bad news for those like Clay, who clearly had faith in the appropriateness of peacetime mechanisms for the situation prevailing at the end of 1938. It was worse news for those who, unlike Clay but like the French, realised that British gold reserves were likely to be required as the basis of a war chest in the very near future.

At a meeting of the U.S.Treasury held on 21st October⁷⁵ to discuss the deteriorating

⁷¹ Ibid., p.195.

⁷² *The Economist*, 15th October 1938, p.123.

⁷³ Ibid., p.124.

⁷⁴ Ibid., p.125.

⁷⁵ MD Book 147, p.74. Treasury Group Meeting. Re: Sterling Exchange Rate, 21st October 1938, 10.00 a.m.

sterling situation, the lack of American policy options and the Department's consequent dependence on the questionable effectiveness of British action was again made painfully clear. Harry Dexter White encapsulated the position by stating that: "It is clear that at present any alteration in the rate is practically British-determined. They can determine the rate and we can't, except indirectly".⁷⁶ This indirect method was, as Jacob Viner⁷⁷ guessed, "[b]y changing the price of gold" to which he added that "we're the passive agents".⁷⁸ U.S. Treasury officials felt a sense of powerlessness and frustration appropriate to an earlier time, a feeling that had been encapsulated by Haas in his weekly business report of 12th September, which wondered whether the "present decline in sterling might not have the same effect upon our economy as England's abandonment of gold had in 1931".⁷⁹

Later, as sterling seemed likely to be overwhelmed, Morgenthau would echo these sentiments, telling a Treasury meeting that "I don't want to be in this chair and see us go through another '31 and '32...I wonder how many people realise what was happening to us in '31 and '32."⁸⁰ However, as things stood he was convinced of British good faith, having told the 21st September meeting that:

I want to say this for the English operation of their funds: that they've gone the absolute limit to cooperate with us to keep the thing - nobody could go further than they have. I mean they've gone the absolute limit. I mean I wouldn't have dreamt of suggesting to them that they go as far as they have. I mean they've just thrown everything into it. So as far as day-to-day operations are concerned, nobody could have gone further than they have.⁸¹

Morgenthau appeared to be suggesting that no action should be taken, and at a later meeting⁸² he confirmed that this was the case and explained why, when White reintroduced the idea of increasing the dollar selling price of gold to check speculation. Rejecting the notion, the Secretary said that "I have announced and the papers have carried and I get great satisfaction out of it 'Morgenthau says business as usual'. I sounded that keynote. Told it

⁷⁶ Ibid., p.87.

⁷⁷ Professor of Economics, University of Chicago, and U.S. Treasury Consultant.

⁷⁸ MD Book 147, p.87. Treasury Meeting, 21st October, 10.00 a.m.

⁷⁹ MD Book 139, p.130. Business Report by Mr Haas. Quoted in Parker, "The Pound Sterling", p.265.

⁸⁰ MD Book 153, p.184. Quoted in Parker, "The Pound Sterling", p.266.

⁸¹ Ibid., Book 142, p.61. Treasury Meeting. Re Gold Policy, 21st September 1938, 10.15 A.M.

⁸² Ibid., p.338. Treasury Meeting, 26th September 1938.

to the President and it's gone through everywhere. Everybody has picked it up. I think it's most important".⁸³ White's suggestion "would not be 'business as usual.'" Morgenthau noted that "the President read this article in the [New York] Times yesterday, somebody, about raising the whole question of gold and the President said, 'Remember, I raised the question of what's going to happen when we get 80% or 90% of all the gold,' and I said 'Mr President so what! Who has a better suggestion?'"

Morgenthau then further explained his reasoning: "I don't want to do anything, as of today, to cast any doubt in anybody's mind as to the fact that we have grown up; we are the monetary center; we are conducting business as usual, and there is nothing in the world which makes me believe I have to worry."⁸⁴ The phrase around which the British attitude to approaching war was based had crossed the Atlantic, but Morgenthau's 'business as usual' policy was dependent upon the continued primacy of the British 'business as usual' policy. If this could be maintained and both the British and American financial authorities treated undeclared war with peacetime measures, then the economic balance of power could only tilt the American way. In February 1937, T.K. Bewley, the Financial Adviser to the British Embassy, had described Morgenthau as "a rather ignorant but an absolutely sincere and direct man."⁸⁵ Alone, however, amongst American and British policy makers, the 'ignorant' Morgenthau had perceived the logic of the situation, to the lasting benefit of his country.

The prize was so great that only a complete collapse of sterling, or one sufficient to force the Secretary's hand domestically, would be sufficient to alter U.S. policy. It followed that the British must be encouraged and supported in their current policy, as it would be disastrous for U.S. finances if the British were driven in the direction of an Imperial war economy. Morgenthau also knew that nothing would anger the British more than a devaluation of the dollar against gold. It was also clear that the British Treasury and the Bank of England were perfectly content to continue expending reserves in the conventional fashion although they were both aware that sterling was under pressure for political reasons. In December 1938, Sir Frederick Phillips wrote to Hawtrey that "of the movement against

⁸³ Ibid., p.339.

⁸⁴ Ibid., pp.339-340.

⁸⁵ *DBFP*, Second Series, Vol.18 (London, 1980). Record by Mr. T.K. Bewley (Washington) of a Conversation with Mr. H. Morgenthau, 23rd February 1937, p.279.

sterling in the last few months 9/10ths is due to distrust of sterling as a currency *in the event of war.*⁸⁶ . This meant that sterling pressure could not be rectified by economic means and barring a swift and unexpected diplomatic success, there was no prospect of the drain ceasing before all reserves were exhausted.

Liberal bafflement concerning the economic forces of the pre-war world of blocs was by no means universal in British public opinion. Whilst generally accepting that the British authorities were behaving in a perfectly proper manner, officials in the U.S. Treasury were made uneasy by the tone of much of the British press, *The Economist* constituting an honourable exception. Many British writers made no bones about the fact that they felt sterling to be considerably overvalued, and Harry Dexter White kept a close eye on British opinion. The U.S. Treasury was kept informed of latest developments in this area by American representatives in England.

On 20th October, The Paris Embassy reported on a “special article reviewing Britain’s foreign trade policy in the FINANCIAL TIMES” which asserted that:

‘Needless to say the entire policy of reciprocity, subsidies and tariff bargaining is in general repugnant to the liberal economic traditions upon which British trade has been built. Nevertheless circumstances are now exceptional and international trade will not revive of its own accord. The greater necessity, then, is to secure for British exports a more reasonable share of the world’s markets by expedients which shall be short termed without being short sighted’⁸⁷

This was compared with an editorial in *The Times* entitled “Dr. Funk’s Progress” which stated that “perhaps the chief lesson for this country is that it might be well for us to review very carefully our own traditional methods and to seeing whether, without sacrificing anything of value, we can modify them in a way which will enable us to compete more effectively with the new methods of the totalitarians”.⁸⁸

This attitude would sit uneasily with the conclusion of the Anglo-American Trade Agreement, which despite the dark practices and wrangling which had attended it, was

⁸⁶ Churchill College Cambridge HTRY 1/62. Phillips to Hawtrey, 15th December 1938. Quoted in Parker, “The Pound Sterling”, p.269.

⁸⁷ MD Book 146, p.239. Copy of Telegram from Wilson in Paris to the Secretary of State, 20th October 1938.

⁸⁸ Ibid., pp.239-240.

intended to be, and would be announced as, an open affirmation of the purest liberal principles as proclaimed by Cordell Hull. Harry Dexter White took these two examples, along with Keynes' earlier letter to *The Times* together as the possible "harbinger of an altered commercial policy in recognition of the weakened British economic status as a consequence of the Munich episode. The item of October 13 introduces for the first time a note of hopelessness in Britain's monetary position in the near future."

5:9 *Paralysis in Washington*

The continuing speculative assault on sterling resulted in two long meetings at the Treasury on 21st October to which outside experts were invited. Everyone at these meetings was free to express an opinion, and though many of these were initially strongly held, the position attained at the end of the day was one of bafflement and deadlock. Although the broad thrust of the meeting was to find ways of halting the fall of sterling, none of the measures discussed were considered likely to be effective, and the opinion was even expressed that a lower sterling rate might be a good thing if it increased British economic activity and thus British imports from the U.S. The only positive recommendation to emerge was that the British should be contacted with a view to informing them of American concerns and raising the possibility of a common policy within the Tripartite Agreement.

The first meeting was based around a paper prepared by Harry Dexter White, which reprised his unconsidered arguments of September and which, owing to a shortage of copies, Morgenthau made him read out loud.⁸⁹ Of White's five points the first three analysed aspects of sterling's decline. The fourth asked "what can we do about it" and the fifth "Should we do anything about it?" As White was the most hawkish of Morgenthau's officials, this hardly suggested an imminent attempt to coerce the British.

Under the heading of what the U.S. could do about sterling, White took his earlier points "in order of severity". The mildest of these was that "we can request the British to consult with us on any further proposed variation - downward variation in the sterling rate, in accordance with the terms and spirit of the Tripartite Accord." The next cog on the ratchet was that: "If the British fail to agree to the consultations, or if the outcome is unsatisfactory we can announce the 'termination of the Tripartite Accord'", on the grounds that the British were "taking a competitive advantage which is in violation both of the spirit

⁸⁹ Ibid., Book 147, p.130. Summary of Memorandum to Secretary Morgenthau from Mr White. Subject: The Dollar-Sterling Situation, 21st October 1938.

and the letter of the Tripartite Accord”. Failing both these measures:

We could use the proposed United States - United Kingdom trade agreement as a lever to prevent substantial depreciation of sterling by insisting that a general provision be included which would terminate the agreement if the sterling rate declined by more than a stated percentage (possibly 5 percent) from the rate pertaining on April 22nd 1938, the date on which the active negotiations began.

In addition to these major options White raised, as in September, the idea “to raise the dollar buying and selling price of gold or “raise just the selling price and leave the buying price where it is. The effects of that we’d have to discuss as a possibility.” Finally, White considered the “[u]se of the stabilisation fund to prevent sterling depreciation and, if necessary to carry out this program, ask Congress for an increase in the size of the stabilisation fund.” White added in the next breath that this option “is practically out for various reasons.”

On this occasion the use of the Trade Agreement provision attracted the most comment, but was found to be impractical for a number of reasons. The setting of a floor at \$4.50 would give the British “a free ride”⁹⁰ down to that level and indeed the Americans had rebuffed earlier British requests for them to reveal such a rate for this reason. Also, if sterling were to go through the floor at whatever rate the trade agreement would be lost and Morgenthau would have made an enemy of Cordell Hull, which would be no small matter. Similarly, such a move would blur the distinction between the Treasury and State Departments in such a way as to give the former more responsibility than it desired. In any case, Morgenthau reiterated that he was not unhappy with the efforts made to date by the British authorities: “if Sir John Simon should walk in here tomorrow and say, ‘are you dissatisfied?’ I couldn’t put my finger on anything to say where they had not done everything within reason to maintain the present rates, and when they spend 60 million dollars in one day I think that they’ve gone as far as they could within reason.”⁹¹

John H. Williams introduced another perspective when he said that depreciation might be in U.S. interests:

Another way to look at it would be to ask ourselves whether we wouldn’t gain more on balance if the English policy were such as to alleviate the depression over there. I can imagine our losing out

⁹⁰ MD Book 147, p.146. Treasury Meeting. Re Sterling Exchange Rate and Government Loans to South America, 21st October 1938, 3.00 p.m.

⁹¹ Ibid., p.92. Treasury Meeting. Re Sterling Exchange Rate, 21st October 1938, 10.00 a.m.

a little bit on the terms of trade and yet getting actually much more trade if England were in a healthy condition. Now I don't know the answer to that; I don't believe anybody does.⁹²

He added that with war approaching,

I can see that the English in some ways would dislike a depreciation of the pound in so far as their thinking about the cost of armament, for example, the necessity of imports. They may be very desirous of preventing a drop in the pound. It is somewhat the same problem that arises for them in war. When they have purchases abroad to make, they're interested in supporting the pound. So it's a very mixed question.⁹³

In view of these considerations, Williams said that "it would seem to me unwise to attempt to state a definite bottom such as would abrogate these whole arrangements. I would prefer to see some other provision which would make possible the modification of the terms of the treaty, or something of that sort".⁹⁴

Williams' views in fact carried the meeting. After lengthy discussion of the possible use of the Trade Agreement to bring the British to heel it was decided that the existing Tripartite Agreement would be preferable, but this after all just brought the meeting back to square one. White argued the case that the British were seeking competitive advantage, while Robert Warren⁹⁵ guessed that sterling was being blown about by great forces beyond British control. Others dithered between the two positions, but all were united in their lack of a policy recommendation.

A synthesis emerged, as Williams reiterated his view:

The real point I'm trying to make is that we may be making a mistake in thinking about this thing as much as we have been accustomed to do in the past in terms of competitive trade advantage, because it is very difficult to say where our advantage lies there. Suppose there is an alteration of rates in our favour and we temporarily gain certain trade advantages. But suppose that has a harmful effect on the country to which we sell; then at the end we may be selling less than before and have lost our advantage. That's the nature of our difficulty. And it might well be that we should

⁹² Ibid., p.96.

⁹³ Ibid.

⁹⁴ Ibid.

⁹⁵ Warren was Vice President of Case, Pomeroy & Co., and had formerly worked as an economist at the Federal Reserve Board

allow England a certain amount of advantage in our own interests.⁹⁶

This was the rub. Even White agreed: “That’s quite possible. In other words, the larger situation has to be examined, and that’s what I take it we’re going to do here.”⁹⁷ As in September it was difficult to act ruthlessly in American interests if these were not known. White noted that it was possible “to get all sorts of hypothetical cases”.⁹⁸ Long and fruitless discussion as to the effects of these hypothetical cases ensued, which pointed to the conclusion suggested by Williams “that what we’re trying - really trying to do is find a basis for consultation that will come into play more or less promptly and effectively”.⁹⁹

Ultimately, Morgenthau asked Feis what the State Department attitude would be if “I should invite a representative of the British Treasury to come over at once to discuss with them the trend of the sterling-dollar rate”.¹⁰⁰ He would “discuss the tripartite agreement with them, not discuss the Trade Treaty at all. ‘This trend has been going on; I’m bothered about it. I want somebody to talk to about it.’” On behalf of his department Feis remarked with regard to such a move that: “We’d regard it as a most natural action.”¹⁰¹ This was hardly the stuff of strong-armed coercion. In the meantime it is interesting to note that the meeting worked on the assumption of an acceptable lower limit for sterling of \$4.50, some 20c below the rate then prevailing, which perhaps indicates that the particular sterling-dollar rate was less critical to the Treasury Department than has been supposed, compared to the speed of its movement in any one direction.

The meeting adjourned for the Department’s officials and invited experts to come up with reasoned recommendations. It reconvened in the afternoon and Morgenthau opened proceedings: “Well, gentlemen, I suppose you’ve got everything solved, sterling is up ten cents, the world looks rosy? Who’s going to report?”¹⁰² White, as spokesman, confirmed the earlier meeting’s general conclusion and rejected any “floor or ceiling” for sterling in the

⁹⁶ Ibid., Book 147, p.114. Treasury Meeting. Re Sterling Exchange Rate, 21st October 1938, 10.00 a.m.

⁹⁷ Ibid.

⁹⁸ Ibid., p.115.

⁹⁹ Ibid., p.116.

¹⁰⁰ Ibid., p.124.

¹⁰¹ Ibid.

¹⁰² Ibid., p.146. Treasury Meeting. Re Sterling Exchange Rate and Government Loans to South America, 21st October 1938, 3.00 p.m.

impending trade agreement, and Randolph Burgess¹⁰³ added that the group agreed instead that: “Our feeling was that the same result might be better achieved by trying to implement the tripartite a little further by seeking to get better consultative arrangements”.¹⁰⁴ According to Herman Oliphant,¹⁰⁵ talking to the British about the exchange rate in connection to the Trade Agreement “pretty near brings trade agreements over into the Treasury” and Morgenthau replied: “I don’t want to do that. That’s what I don’t want to do.”¹⁰⁶

The Secretary was uncomfortably aware that the Trade Agreement was “the apple of the eye of Mr Hull”,¹⁰⁷ an excellent reason for not rocking the boat. He would be happy “if I can find some way of keeping out of their bailiwick so that I don’t have to take a clause in there and tell them that ‘your trade treaty is through’ - now that’s what I don’t want to do.” On the other hand “I have no hesitancy in sending for Bewley on Monday and simply saying ‘I’m bothered about the trend and I’d like the best Treasury man to come over here and talk things over.’” This would have no implications for the Tripartite Agreement, suiting Morgenthau: “Why should I interpret a State Department treaty for them? We can give them the facts.”¹⁰⁸ He believed that “I don’t need anything more than I’ve got. All I’ve got to do is send for Bewley and say ‘Mr. Bewley I want to consult.’ That’s all that’s necessary.”¹⁰⁹

This was a suitably flexible and anodyne formula, for after all it had not been practical to set currency floors and ceilings for France with which the U.S. also had a trade agreement. Morgenthau pointed out that “if we had had signals like that I would have had to kick France out”.¹¹⁰ Also Kennedy had told him that “the tripartite agreement means a great deal more to the British Government than the trade treaty does”, in which case, “using the trade treaty as an excuse wouldn’t bring them here any quicker. Frankly it might keep

¹⁰³ Burgess had been a Vice President of the New York Federal Reserve Bank in the early 1930s and attended Treasury meetings as an expert in the management of public debt.

¹⁰⁴ *Ibid.*, Book 147, p.147. Treasury Meeting. Re Sterling Exchange Rate, 21st October 1938, 3.00 p.m.

¹⁰⁵ Oliphant was a lawyer and had moved with Morgenthau from the Farm Credit Administration to the Treasury Department in 1934. He held the position of General Counsel from that time until his death from a heart attack in January 1939.

¹⁰⁶ *Ibid.*, Book 147, p.152. Treasury Meeting. Re Sterling Exchange Rate, 21st October 1938, 3.00 p.m.

¹⁰⁷ *Ibid.*, p.153.

¹⁰⁸ *Ibid.*

¹⁰⁹ *Ibid.*, p.154.

¹¹⁰ *Ibid.*, p.154.

them away.”¹¹¹ Indeed Oliphant raised “the likelihood of the British postponing the signing of the trade agreement if this question were raised at this time”.¹¹² Finally Morgenthau concluded the group discussion with the summary that “I think I’ve got what you people have in mind: in other words that we do this thing through the tripartite and not try to do it through the trade treaty. Isn’t that right”, to which Walter Stewart¹¹³ replied on behalf of the group: “That’s right.”

The all-day meeting on 21st October was covered in the press. Bewley reported to Waley at the Treasury in London that:

As a special Treasury conference reported to have dealt specifically with the sterling situation has been front page news in many of the papers here I asked Taylor [Assistant Secretary of the Treasury] whether he felt inclined to tell me what it was all about. He said that it was largely a routine meeting and that the report in the ‘New York Times’ (which I enclose) was pretty good. He subsequently added, however, that he expected he might shortly have something to communicate to me.¹¹⁴

Bewley was not unduly concerned. He noted that:

I cannot imagine that any of the authorities here are much concerned with a fall in the pound to its present level of \$4.76, and while Washington is profoundly disabused about the benefits to be obtained from monetary manipulation, I suspect that what the authorities here are afraid of is that if the pound fell much further - say to \$4.50 or even \$4.60 there would be strong pressure from the farm bloc in Congress for a corresponding cut in the dollar.

Bewley even thought that: “Another possibility is that the Administration may calculate that to allow some slight fear of the stability of the dollar to get about may be helpful to sterling, as discouraging capital movements into the dollar”. He noted correctly that the U.S. Treasury “are, I think, definitely opposed to any ideas of dollar manipulation, so long as they are satisfied that the pound is not being deliberately driven, or held, down for competitive reasons”. In this respect: “The danger is that if political pressure were strong

¹¹¹ Ibid., p.155-156.

¹¹² Ibid., p.158.

¹¹³ Stewart was a former Director of the Division of Research and Statistics at the Federal Reserve Board and had been Economic Adviser to the Bank of England between 1928 and 1930. In 1938 he was President of Case, Pomeroy & Co.

¹¹⁴ PRO T160/871/15777. Letter, Bewley to Waley, 22nd October 1938.

enough the President might again take matters in to his own hands”.

Bewley’s letter though, was “a very advance warning. I don’t think there can at the moment be any danger whatever of action of this sort, and it remains to be seen what sort of backing there may be in Congress for this sort of idea.” Later, Bewley met Walter Stewart, who described the meeting.¹¹⁵ He was more expansive than Taylor, and mentioned Morgenthau’s comment that “a little birdie” had told him that the British might let sterling go after the Trade Agreement was signed. Bewley noted parenthetically that “I shouldn’t pay too much attention to that last remark: it is just the sort of thing that Morgenthau would say without meaning anything by it”.

Bewley was more appreciative of Stewart’s view that the U.S. needed more information such as that concerning the holdings of the E.E.A. Bewley at first “said that we refused to give this information to our M.P’s and that in the circumstances I didn’t see how we could be expected to give it to America”. Stewart, however, made the pertinent point that “before the funds were set up Central Banks exchanged information that was not given to Parliaments and that now central banks had to some extent been superseded by Treasuries he thought the same thing should be possible”. Bewley was surprised to learn that there was a faction in the U.S. Treasury which felt Britain’s defence of sterling to be half-hearted, “as the gold exports seemed to make any such attitude really incomprehensible”.

Bewley attributed this dissent to Herman Oliphant rather than Harry Dexter White but, weighing up all that Stewart had said, he concluded that “if there are two parties in the Treasury, as I expect is the case, and if Stewart is right that the Treasury are likely shortly to approach us, we should do what we can to provide ammunition for the more sympathetic party”. Initial British receptiveness to the idea of providing information to Morgenthau was, therefore, born from a desire to cultivate support in Washington, and buttress what was seen to be Morgenthau’s sympathetic position rather than as a response to U.S. pressure, which scarcely existed.

Since the Anschluss, the Treasury Department under Morgenthau had been privileged spectators behind the stage on which the fourth arm policy was played out. With access to information that was denied to the British audience, they had seen the argument pulled apart by the harsh reality of the developing international crisis. As far as the British authorities

¹¹⁵ Ibid., Letter, Bewley to Waley, 2nd November 1938.

were concerned, however, the show had to go on, and Morgenthau, as the major beneficiary of the situation, could only applaud the spirit displayed, despite his puzzlement at the rejection of more rational alternatives. There was method in London's madness, though. It would not have been possible to cut losses and anchor sterling with exchange controls, without admitting the bankruptcy of the fourth arm policy at home and unravelling the political coalition that had worked so hard to construct it. It was possible to maintain the facade of policy at the cost of pouring gold across the exchanges to prop up sterling. Also, the longer the farce was maintained, the more damaging would be the political consequences of revealing its failure. The tendency, therefore, was not to draw back but to go on, whatever the cost, in the hope that diplomatic salvation would arrive before the crunch. To this end the liberal trend in policy was reinforced after the Munich Agreement, when negotiations with the State Department were finally concluded and a Trade Agreement signed with the United States. In this outcome there were two winners: the United States and Hitler.

CHAPTER 6

“IT SEEMS LIKE INSANITY”: THE ANGLO-AMERICAN TRADE AGREEMENT OF 1938 AND THE POINT OF NO RETURN

It was becoming apparent, outside the British Government, that the prevailing international situation would not permit the normal conduct of financial affairs by a state in Britain's position. Nevertheless, there would be no talk in Cabinet of a 'war chest', of gold and foreign currency reserves until 1939, for in late 1938, before Kristallnacht, the Government could point to the Munich agreement and contend that the policy of appeasement was a political success, and that normal business of all types would shortly be resumed. In holding this view it was necessary to believe that the unwelcome economic effects of the September crisis were specific to it and would pass, and that efforts to gain American goodwill had in some way been effective. The signing of the Anglo-American Trade Agreement in November 1938 was, therefore, presented as a great success, a "landmark in the commercial intercourse between the two countries",¹ from which Britain could take comfort, despite the huge gains it afforded to the United States at the direct expense of Britain and the Empire.

The significance of the Agreement is still debated, and some historians, from examination of its many complexities of detail, claim that Britain either gained from the exchange or was not seriously damaged in either a political or an economic sense. The general view is that "the Anglo-American Agreement was a 'balanced' one in the rather negative sense that neither side won significant concessions of real substance",² and that because of this: "By no one's standards could the trade agreement be classified as a success."³ This retrospective view regrets that the treaty was neither a large step in the direction of the liberalisation of trade, nor of much significance in the political deterrence

¹ *The Economist*, 26th November 1938. Trade Supplement, "The British-American Trade Agreement", p.4.

² I. M. Drummond & N. Hillmer, *Negotiating Freer Trade: The United Kingdom, the United States, Canada, and the Trade Agreements of 1938* (Waterloo, 1989), p.148.

³ E. Gilman, "Economic Aspects of Anglo-American Relations in the Era of Roosevelt and Chamberlain" (Unpublished Ph.D. Thesis, University of London, 1976), p.120.

of the dictators by a substantial show of democratic solidarity. If, however, the Agreement is considered in the context of the economic viability of the sterling bloc and the implications of this for Britain's ability to sustain total war, the effects of its provisions take on a weightier aspect, and this point was not ignored at the time.

6:1 *The Trade Agreement: An Invisible Assassin*

The *Journal of the National Union of Manufacturers* of February 1938, was quoted in the fiercely imperialist *National Review* as saying that the aim of the prospective agreement, “to bind the two great democracies together in view of the growing menace of dictatorship”, was unlikely to succeed as “the dictators will view with equanimity an arrangement which, if it is concluded, will weaken England and the Empire, ‘just at a time when economic strength is most needed’”.⁴ This view, buried by history, reflected the very real situation that in time of war it would be essential for the British economy to receive the greatest possible percentage of its imports from the sterling area, payment for which would be deposited in blocked accounts in London, to be released after the end of hostilities. Such a course of action would be counter-inflationary, would not threaten Britain's wartime solvency and would create a captive reservoir of purchasing power for British exports after victory, as long as convertibility with the dollar was suspended.

The Anglo-American Trade Agreement threatened this reassuring prospect in many ways. In the remaining time of peace it would disrupt the trading structure of the sterling bloc, and as the bloc's gold and foreign currency transactions were handled in London, any increase in American penetration of Empire markets would fuel the gold drain resulting from German action in Europe. These facts were belatedly recognised by the British authorities when the Agreement was suspended upon the outbreak of war, and attempts made to fashion an autarkic policy. This, however, was yet another manifestation of the British belief that the financial and economic war effort could be switched on like a light bulb at the outbreak of war.

The Agreement, as its abandonment in September 1939 reveals, specifically prevented any illiberal moves that might have been undertaken by the British Government in peacetime to increase Imperial preparedness for war. For to dispute the many technical details of the Agreement is to lose sight of the fact that it represented a tripwire, any attempt to cross

⁴ *The National Review*, March 1938, p.288.

which would result in outraged complaint from Washington. The Agreement added weight to the fourth arm policy, for its critics could now be confronted with the claim that any movement towards exchange control and the autarkic organisation of Imperial resources would violate the sanctity of an international agreement freely concluded by His Majesty's Government, as well as jeopardising the possibility of assistance from the United States in time of war.

Considering the Agreement in crude terms of national advantage can be frowned upon, however. In one of the few studies devoted to the subject, it is noted that: "Economists certainly do not discuss trade negotiations in these terms and historians ought not to".⁵ However, this would involve suppression of the historical record, such as the opinion expressed in the *National Review* of March 1938 that: "This anti-Imperial trade policy which was designed, by its real authors, to weaken the British people and to disintegrate their Empire, is part of the great push brought against us since the war, and which has, owing to the moral weakness of successive governments, and the fatigue of those who fought, been partly successful in obtaining its object."⁶

Even when historians overcome their scruples and look at the matter in terms of national advantage, though, the issues are not always clear. It has been claimed that: "While neither side made any great sacrifices in the trade talks, the United Kingdom, nevertheless, did get the better of the deal".⁷ This statement is based on Oliver Stanley's postdated attempt to put a gloss on the Agreement as a former "consistent critic of the discussions", who "once the treaty was signed ... became its staunchest supporter". Stanley claimed that the British "would gain between £5,000,000 and £10,000,000 during the first year of the agreement" and "expected these figures to increase substantially because of the devaluation of sterling".⁸ These figures are questionable to say the least, and even if accurate, a gain of £10 million would have made a miserable consolation for the reserve losses measured in hundreds of millions of pounds caused by the devaluation of sterling. It was understandable that the President of the Board of Trade should talk up an Agreement that his Department

⁵ Drummond and Hillmer, *Negotiating Freer Trade*, p.152.

⁶ *National Review*, March 1938, p.290.

⁷ Gilman, "Economic Aspects", p.123.

⁸ BT 11/1085. Draft Memorandum, Stanley for Cabinet, no date. Quoted in *ibid.*, p123.

had negotiated,⁹ and there are indications that the Board of Trade took a narrow technical view of the treaty as it related to Great Britain, but refrained from taking the broader Imperial outlook, which it thought to be of lesser importance.

In the weeks before the conclusion of the Agreement, Stanley and his officials had taken a less optimistic view of cooperation with the United States. Indeed, during preparations for a climactic meeting of the Cabinet's Trade and Agriculture Committee, which would recommend to the Cabinet a view to be taken on the continuance of the negotiations, the Foreign Office had found its position to be diametrically opposed to that of the Board of Trade. In an internal memorandum, Mr. Balfour at the Foreign Office summarised the "attitude" of the Board of Trade.¹⁰ They were inclined to "regard the agreement in the terms now proposed as highly unsatisfactory from the point of view of British foreign trade and of our inter-imperial commercial relations." Furthermore,

As they see it there is an element of bluff in the United States attitude, and they are inclined to think that if we stand firm on some at any rate of the major points now at issue we can induce the United States to withdraw from their extreme position. Even if this assumption is wrong, they are disposed to discount the adverse criticism of Great Britain which a breakdown would arouse in the United States of America and to believe that world opinion will rightly recognise that we have rightly resisted an attempt to exploit our political difficulties for the purpose of inducing us to accede to excessive demands.

The Board of Trade had other concerns too. It was "also apprehensive at the prospect of violent opposition from vested interests in this country as a result of an agreement from which they will suffer". However, Balfour noted that: "In general the Board of Trade view the negotiations mainly as a commercial proposition and maintain the view that the attitude

⁹ When the treaty was concluded Stanley was less upbeat. He wrote to Chamberlain that "I am of course arranging to see the press about it, and I propose some time next week to see Amery, Page-Croft, Herbert Williams and Dorman-Smith who, I think, represent the people in the House most likely to criticise. It is, however, especially vital that industry as a whole should regard the agreement in the best light possible". To this end Stanley asked Chamberlain if he would think of seeing representatives of "the Federation of British Industries, the Association of British Chambers of Commerce and the National Union of Manufacturers, and asking them for obvious reasons to do what they can to see that industrial criticism is expressed reasonably. I do not think it would be necessary for you to see them for more than a very few minutes." This few minutes makes an interesting contrast with the exhaustive consultation required under the American system. PRO PREM 1/291 pp.9-10. Letter, Stanley to Chamberlain, 11th November 1938.

¹⁰ PRO FO 371/A7789/1/45. Note 20 to Chapter 8 in C.A. Macdonald, *The United States, Britain and Appeasement, 1936-1939*, (London, 1981), gives the unfortunate impression that the views expressed in this memorandum were Balfour's own.

of His Majesty's Government towards its conclusion should be determined on this basis." The Board's anger with the Americans had resulted largely from the peremptory technique they employed in negotiation. It was certainly determined to resist fatal damage to British protection, and a Conservative-led Government could only support this stance. Imperial preference was another matter. The Board took a distinctively British view and was less inclined to defend the Ottawa system than the rights of domestic producers.

Sir Arnold Overton, the head of the British Delegation in Washington recalled in 1939 that:

In the trade discussions last year we really had much more difficulty with Mr Hull over empire preferences than over our protective duties, and the root reason for this is his sincere conviction that measures aimed at diverting the channels of trade are harmful to all concerned. I know that this attitude is a trifle pedantic and illogical, but it must be reckoned with as a fact of prime importance.¹¹

If the Board of Trade was not prepared to defend the Imperial system then Imperialists in Cabinet would have little chance against the combined forces of liberal internationalism that would be ranged against them.

Liberal contemporaries, unlike Overton, saw the logic of Hull's arguments all too clearly and were able to form a more accurate impression of the likely consequences of the Agreement. In particular, the important distinction between the tariff protection of the British economy and the wider system of Imperial preference within the sterling bloc was understood. Although the structure of strictly British protection was dented rather than dismantled, the most important fact was the blow that was dealt to Imperial preference as a practical concept. This was realised at the time when the issue between protectionists and liberal internationalists was still live, though the point has since become obscured. A writer sympathetic to the agreement wrote approvingly that it "represents not only a material but also an ideological inroad on the Ottawa system"¹². The *National Review* concurred (and was quoted at length in the *New York Times*), noting that:

It is true that the Anglo-American Trade Treaty does not altogether destroy the policy of Imperial preference, but it greatly compromises it by removing certain preferences thus giving our whole policy a tilt away from the Empire and towards Free Trade

¹¹ PRO BT 11/1142. Overton to Waley, 25th September 1939, Quoted in Gilman, "Economic Aspects", p.123.

¹² H.V. Hodson, "The Empire and the Anglo-American Trade Agreement", *Lloyds Bank Limited Monthly Review* New Series Vol.10, March 1939, p.84.

and internationalism, which the lessons of history show to be destructive to us.¹³

It added for good measure that it was “the fatuous idea of the British authors of this plan that it will ‘please the Americans’”.¹⁴

The material inroad into the Ottawa system was bad enough. In a letter to Lord Lothian, the “influential industrialist” and Director of the Federation of British Industries, Mr Locock,

stressed that the Agreement had really minimized [i.e. disguised] the adverse position of Britain’s exports to the United States, because those from the Empire had been included in the calculations. As most of these exports were raw materials, British industrialists gained nothing from their sale. In fact they actually suffered, because the primary goods were then used in the manufacture of rival American products.¹⁵

The *Economist* calculated that concessions to the United States detailed in Schedule I of the agreement when applied to actual figures for 1936 covered £60,800,000 out of U.S. exports to the United Kingdom of £93,200,000: 65 per cent.¹⁶ Reductions of duty on U.S. goods ranged across the board from the abolition of the 2s. duty on wheat “with the consent of Canada, Australia and India” to cuts “as a rule from the level of 20 per cent. to 15 per cent.” on manufactures.

The dependent Empire fared little better, “one of the most notable concessions made by the Colonial Empire” being the abolition of the duty on unmanufactured U.S. tobacco “throughout the West Indies”.¹⁷ As Locock had told Lothian, it had always been in America’s interest to import raw materials from the Empire without duty and the *Economist* noted that “because the majority of colonial products have always been admitted into the United States duty free...domestic exports from the Colonies to the United States covered by duty reduction amounted to about £290,000 in 1936”:¹⁸ a trifling sum. Ominously for the

¹³ *National Review*, December 1938, pp.713-714.

¹⁴ *Ibid.*, p.714.

¹⁵ Lothian Papers, GD 40/17/390. Locock to Lothian, 12th August 1939, quoted in Gilman, “Economic Aspects”, p.122.

¹⁶ *The Economist*, “The British-American Trade Agreement”, p.8.

¹⁷ *Ibid.*, pp.8-9.

¹⁸ *Ibid.*, p.9.

U.K., and in addition to the impact on British manufacturers mentioned in Locock's letter to Lothian, duty reductions on U.S. manufactures into Britain also applied to the Empire, so that American manufactures could now compete directly with those of Britain in the Imperial market. This struck at the heart of the triangular trading mechanism between the U.S., Britain and the Empire beloved of those supporters of the Agreement who claimed that, with the Empire included, trade between the two powers broadly balanced.

This latter view was attractive to American opinion. The *New York Times* stressed to its readers that "we buy more from the British Empire, exclusive of our trade with the United Kingdom, than we sell to it" and that: "This definitely means that we Americans have not been the 'time-honoured beneficiaries' of British-American trade by buying little from England while selling her a great deal. The bargain we are to strike with the British people themselves, therefore, does not require any major adjustment in either country's favour."¹⁹ This was all to the good as a debating point, but the language of an earlier passage was more indicative of the American attitude. This bemoaned the fact that: "We had a larger export trade in 1929 than England's by more than 30%, but our losses were so disproportionate during the depression that by 1933 England's exports practically equaled our own. In 1937, for the first year since the depression, [and after the Tripartite Agreement and the commencement of British rearmament] the strong advance of our export trade placed us definitely in a superior position." This, like the Imperial provisions of the Agreement sits uneasily with the language of triangular trade and Anglo-American 'balance'.

The *National Review* interpreted American thinking correctly. It noted that the Agreement "appears to involve the grant to the U.S.A. of the inestimable advantage of functioning as an economic entity, while preventing, for the duration of the Agreement, any attempt to organise the British Empire on a similar basis".²⁰ The consequence was that "this means that the U.S.A. will become the practical economic centre of the British Empire. It is interesting to note, in this connection, that in political circles in the U.S.A. plans for the widespread economic penetration of the Empire are openly discussed."²¹

¹⁹ *New York Times*, March 13th 1938, Section 4, p.6.

²⁰ *National Review*, January 1938, p.40.

²¹ *Ibid.*, p.40.

6:2 *The Cabinet Falls Hesitantly into Line*

In the Cabinet, abandonment of negotiations had been seriously considered, and the President of the Board of Trade, Oliver Stanley, showed himself to be sympathetic to such a course, although his willingness to make a stand in Cabinet fell some degrees short of the strength of his language. Supporters of the Agreement at this stage adopted an apologetic tone, and far from claiming that it was desirable stressed the political consequences of a breakdown in negotiations at such a late stage. On 19th October 1938, the Cabinet was presented with the Committee on Trade and Agriculture's Report on the negotiations, compiled after receipt of a new and more extensive list of American demands, which Hull claimed would have to be met before he would conclude an agreement. The Committee's Report stated plainly that unless the Cabinet wished to make the Americans a final offer on existing terms, and be prepared to break off negotiations for a trade agreement if that offer was not accepted, then it would be necessary to make further concessions and grant the Americans free entry on maize and lard.²²

As it was, the difficulties of presenting to the country an agreement based on existing British concessions was fully appreciated. The Chancellor reflected the political agonies of those who sought an agreement when he reflected that, though "it would be a misfortune if we were unable to conclude a treaty, there was a limit to the demands which we could concede. It was impossible to say that the treaty, as it now stood, was one which on balance would be approved by the commercial community."²³ Lord Halifax "said that his general feeling was that it was desirable to go a very long way in order to reach an agreement. Nevertheless he was convinced that it was impossible to make concessions in regard to some of the requests put forward by the Americans."²⁴ Stanley expressed no longing for an agreement but was unwilling to press for the halting of negotiations. He stated that "we should make up our minds now as to how far we should go and should refuse to make any further concessions" but he nevertheless "also thought that, before the negotiations were finally concluded a personal appeal would be made to the Prime Minister, and he thought that there was much to be said for reserving some final concession which we could offer

²² PRO CAB 24/279, pp.177-178. CP 225(38) Cabinet Committee on Trade and Agriculture. The United Kingdom-United States Trade Agreement. Report, pp.1-2.

²³ PRO CAB 23/96, p.18. Cab. 49(38) Cabinet Minutes, 19th October 1938, p.15.

²⁴ *Ibid.*, p.17.

when this appeal was made to the Prime Minister”.²⁵ The Committee on Trade and Agriculture’s report reflected the ambivalence of the political dimension of the Trade Agreement by including two appendices, one from Sir Ronald Lindsay stressing its benefits, and one from Stanley detailing its drawbacks.

The note by Stanley brimmed over with resentment. He commented on the extensive concessions already made by Britain and reported the subsequent receipt of the American *list of final demands*. These were

far reaching and with the exception of those on maize and possibly lard, are to my mind quite unacceptable. Experience over the last three months has shown that the grant of a concession by us has been followed not by the display of a reasonable spirit and a withdrawal of other demands, but by a flood of further demands.²⁶

Stanley did not, however, recommend outright rejection but had “no doubt therefore that we should treat this consolidated list of demands as a final list and should answer by the offer of what we can concede and a definite intimation that that is the full extent of our concessions”. Stanley concluded more boldly by stating: “If the United States Government are not willing to conclude an agreement on the basis thus reached, we must, with great regret, recall our Delegation and announce the breakdown of the negotiations”.²⁷

Lindsay expressed what would become the Foreign Office line in Cabinet, though this was mild in comparison with the position of the Department’s American and economic experts. He complained of the current situation that:

The protracted negotiations which have led to this have brought me personally to that state of bitterness and exasperation which usually results from dealings with the United States Government. Their delays and tergiversations have been intolerable, they can see no point of view but their own and their demands cause His Majesty’s Government loss of revenue and administrative difficulties out of all proportion to the benefits likely to accrue from American trade.²⁸

As with Stanley, however, this spleen was misleading, Lindsay attributing American

²⁵ Ibid., p.15.

²⁶ CAB 24/279, p.181. CP 225(38) Appendix One. Committee on Trade and Agriculture. United Kingdom-United States Trade Negotiations. Note by the President of the Board of Trade, p.2.

²⁷ Ibid., p.2.

²⁸ CAB 24/279, p.196. CP 225(38) Appendix Two. Committee on Trade and Agriculture. United Kingdom-United States Trade Negotiations. F.O. Telegram No.217. Immediate. Important.Trade Agreement, p.1.

behaviour to Britain's being "put through the mangle of American politics"²⁹ rather than to any overtly hostile intent. Initially, he made no attempt to defend the Agreement on economic grounds, stating that:

I myself have always advocated Trade Agreement less on economic than on political grounds. Political grounds today are as overwhelmingly strong as ever before. Not wishing to overstate my case, I have never said that even complete surrender by us would secure the whole-hearted friendship of the United States Government and people but it is certain, in case of failure, that blame will be laid on us in American eyes and we shall alienate the sympathy we can ill afford to lose. We should commit a first class political crime and our justification, even though it might be a real one, would consist of a multitude of minor economic factors which could hardly be understood by any but experts and which would not be perceived at all by the public.³⁰

However, after a plea on behalf of Hull, failure of whose "effort will bring about a tremendous recession" made "disastrous if it were possible to say, as would be said both here and in England, that death blow to his policy was our failure to come to terms now with the United States",³¹ Lindsay proceeded to provide economic justification for the Agreement. With regard to "the actual merits of agreement",³² Lindsay conceded that

I put forward my own opinion with diffidence owing to its technical nature and because factors of other than commercial nature come into consideration some of which are beyond my powers of appreciation. But I am advised by my commercial staff that American concessions to us will be of very great value and even essential to our export trade and I believe from a purely commercial point of view that it would in the last resort be worth our while to agree to it as it stands.³³

Lindsay thus exhibited an attitude typical for a British official. None had suffered more than he during negotiations. The penalties of the agreement were clear in his eyes, and yet, an instinctive and unlearned faith in free trade as an ideal had led him to reject his doubts and rely on the 'expert' opinions of his colleagues, thus leaving himself free to embrace the imagined political benefits of the agreement.

²⁹ Ibid.

³⁰ Ibid., pp.1-2.

³¹ Ibid., p.2.

³² Ibid., p.3.

³³ Ibid.

The view of Foreign Office experts, however, was anything but disinterested. When Lindsay had telegraphed the Department fearing a breakdown of negotiations in October, his colleagues in London had minuted bitterly against the economic connections within the Empire. Assuming that capitulation to U.S. demands would in some way benefit British consumers, Mr Thompson commented that “it is not too much to say that the point has been reached at which the interests of some forty million people in the U.K. are to some extent jeopardised by our endeavours at every point to meet the Dominions, India and the Colonies”.³⁴ He went on: “I think myself that the day is rapidly approaching when a more independent attitude will be necessary”. This was ironic in view of the policy he advocated regarding the United States. However, he continued with the statement that “as I see the situation, the first obligation of H.M.G. in the U.K. is to seek the well-being of the inhabitants of these islands. Any increase in our prosperity and purchasing power can only react favourably on conditions in our Empire overseas.”

These views attracted no dissent from his colleagues. Balfour, by way of corroboration, cited the denunciation of the Anglo-Colombian Trade Agreement over the issue of banana exports, and its possible effects on textiles. He said that “the livelihood of many thousands of Lancashire cotton operatives was thus placed in jeopardy for the sake of the welfare of the Jamaican negroes. Such occurrences demonstrate the penalty of Empire to which Mr Thompson draws attention.”³⁵ Interestingly, the terms of the American Trade Agreement would bring little joy to Lancashire and a prop of the moral case against Ottawa was that it had denied cheap foreign goods to the inhabitants of the colonies, Jamaican negroes presumably included. However, home interests notwithstanding, Balfour stressed that “it is open to the Cabinet to consent as a last resort to the free entry of lard which has apparently been requested in the consolidated list. I submit that we should vigorously support such a concession when the moment arrives.” Moves toward the U.S. position on lumber “should have convinced them of our readiness to comply with their wishes to the fullest possible extent compatible with our commitments in other directions”.

This hostility to the Empire and eagerness to comply with U.S. demands was unlikely to appeal to Cabinet and the full force of such thinking did not reach Ministerial ears.

³⁴ PRO FO 371/21506/A7561/1/45. Note by Mr Thompson.

³⁵ Ibid., Note by Balfour.

Lindsay's memorandum concluded with an appeal to the broad view:

Value of agreement however is not to be measured in terms of goodwill nor are its disadvantages to be valued in terms of departmental difficulties or disturbance of trade or even loss of revenue or protection. Infinitely wider issues are at stake and I myself (though I should hope to obtain some minor adjustments) am so impressed with their importance that I should prefer to accept the draft as it stands rather than break.³⁶

The sheer extremism of liberal opinion in the Foreign Office, though veiled from public expression, even to the Cabinet, can be seen to have exerted an influence on policy. This was obvious to the advocates of protection, who were very conscious of the fact that they were on the outside of policy formation, looking in. The *Journal of the National Union of Manufacturers* contrasted the openness of the American end of the negotiations, where the U.S. Government was required to hear the opinions of affected business interests, and British secrecy. The N.U.M. pointed out that:

These negotiations may perhaps bring home to us that there is something wrong with a system under which business arrangements of such great magnitude and importance can be launched without any kind of prior consultation with the business community, and can be carried through by the officials without the business community having any real say in the matter.³⁷

It was then noted, perceptively, that:

The incident may show us, in a way that perhaps nothing else could, the essential weakness of the bureaucracy in the matter of the formulation of policy, and the tremendous power it has in forcing a policy through once it has been adopted; also the almost complete want of anything like real cooperation in questions of policy or of execution between the Government and the business world.

The author of these words could only have been dismayed if he had been fully aware of their complete accuracy. Criticism of the Agreement had indeed been written off in advance, and the policy machine was by no means confident in the technical basis of its opinions. Cadogan and Halifax formulated a position consistent with that of Lindsay which, while milder in tone than that of Foreign Office experts, yet bowed to the American

³⁶ CP 225(38) Appendix Two, p.3.

³⁷ *Journal of the National Union of Manufacturers*, February 1938. Quoted in the *National Review*, March 1938, p.289.

position. Cadogan minuted that criticism of concessions made to the U.S. was likely but noted that:

We have already made large concessions (which will come in for criticism anyhow, and which may involve loss to the Exchequer) and the further concessions now demanded seem to me hardly to balance against the great disadvantages of a break. Though I confess it is difficult to judge of these matters without detailed and skilled knowledge.³⁸

Halifax, in a marginal note, abandoned any pretence of an economic justification of the Agreement and noted that: "I am afraid that the political reasons for getting a treaty through must outweigh trade and economic considerations and I suppose the Americans have a shrewd realisation of this too."

Chamberlain appeared to balance himself artfully between the extremes, but in truth *Stanley's refusal openly to advocate the breaking off of negotiations and his willingness to countenance some final concessions left this position open to the Prime Minister.* He said that he had "taken great interest in these negotiations", but had "never hoped that we should obtain any great economic or political support from the United States as a result of making this Agreement. The advantages to be derived were of a somewhat negative kind."³⁹ Chamberlain "was in favour of sending a reply to the American Government on the lines of the report of the Cabinet Committee. He thought that they should wait and see whether an appeal would be made to the Prime Minister before considering whether any further concessions could be made."⁴⁰

Perhaps fortuitously, the new U.S. Ambassador, Joseph Kennedy, was fully exposed to Stanley's ill temper and reported his attitude to be representative of the Cabinet. Hull, sensing that the American Government had pushed its luck as far as it could, decided to settle on existing terms. Although the U.S. had been able to conduct the negotiations as if from a position of strength, Hull settled at the first sign of impatience in London. This rather supports the Board of Trade view that the American position was based on bluff. The compliant attitude of the British Government had made possible the arrogant style of American negotiation, but the swift endgame showed that the U.S. needed the Agreement more than the British. This was reflected in the signing ceremony at the White House, where

³⁸ FO 371/A7789/1/45 Memorandum by Cadogan, 11th October 1938.

³⁹ CAB 23/96, p.21. Cab. 49(38) Cabinet Minutes, 19th October, p.18.

⁴⁰ Ibid.

the full American ceremonial was deflated by the absence of any British Cabinet Minister.⁴¹ Sir Ronald Lindsay, whose enthusiasm for American appeasement had been sorely tested but not extinguished, represented his Government.

6:3 *Irrational Hopes and Fears*

The British fear of facing a three front war alone, along with a certain sentimental belief that the Americans would help if the worst came to the worst, became the overriding factors in Cabinet thinking, and the practical consequences of this state of mind were embodied in the Trade Agreement. Prior to its conclusion, work had been done in translating such perceptions into policy, and adapting policy to circumstance. After Munich, the fourth arm policy was ostensibly unshaken, and Chamberlain reasserted in Cabinet his opinion that: "It must be remembered that our financial resources would be one of our greatest assets in any long war".⁴² This view met no dissent in the official machine. The Permanent Under-Secretary at the Foreign Office, Sir Alexander Cadogan, produced at this time a number of policy papers in which he attempted a synthesis of the economic and diplomatic realities then facing Britain.

These documents have been seen as fatalistic assertions of the various reasons why Britain "could not rearm as quickly as Germany", largely revolving around the "greater integration of the British economy with world trade and finance rather than differences in political systems".⁴³ In fact, Cadogan's thinking embodied all the contradictions inherent in fourth arm ideology. Initially, he asserted the physical impossibility of more determined preparations for war. He opined: "It is not a question of this country being unwilling to make the sacrifices required", but that

Germany is far more nearly self-sufficient than these islands can ever hope to be and, with her closed economy, can concentrate the greater part of her industry on the production of engines of war. We have to import the greater part of our food, and consequently to maintain the value of the £ on the foreign exchanges. It is vital

⁴¹ T.Rooth, *British Protectionism and the International Economy; Overseas Commercial Policy in the 1930s* (Cambridge, 1992), p.284.

⁴² PRO CAB 23/96, p.58. Cab. 23/96 Cabinet Minutes, 26th October 1938, p.15.

⁴³ G.C. Peden, "A Matter of Timing: The Economic Background to British Foreign Policy 1937-1939", *History* 69, (1984), p.23.

to us, therefore, to maintain our ordinary export trade.⁴⁴

This was the orthodox fourth arm view, but Cadogan then qualified it. He perceived that although Nazi Germany could intimidate its neighbours into joining its autarkic system, “the Argentine and other parts of the world” were less likely to “be caught in the toils of German ‘autarky’”.⁴⁵ Cadogan believed that “Germany as an ‘autarkic’ Power looks pretty formidable - almost as formidable as the British Empire might be”,⁴⁶ but having come tantalisingly close to stating that Germany could not compete with Britain in a struggle of economic blocs, the idea left him for an assumption of the superiority of the liberal system and the hope that Germany might perceive some “limit to ‘autarky’” and be induced to change “from her closed-economy, autarkic system to a system of free exchange and trade”.

Cadogan argued, therefore, that Germany’s system was a source of weakness but that it somehow gave her an advantage over Great Britain, enmeshed in the supposedly superior internationalist system. Also, according to the logic of Cadogan’s argument, Britain could not be self-sufficient but the Empire had superior autarkic potential to Nazi Germany. It has since been argued by way of addressing this point that in extremis Nazi Germany “could deal with a shortage of foreign currency by conquest; this option was not available for the United Kingdom”.⁴⁷ The obvious answer to this point, and to Cadogan’s confusion, is that the United Kingdom had done its conquering many years previously and that its Empire and the sterling bloc were obliged to accept sterling in payment for their commodities. Cadogan half grasped this point but fell back instinctively on the liberal view.

As has been stated, no suitable and easily digestible alternative had been produced by protectionist thinkers which was suitable to Britain’s particular circumstance as a global power. Thus, in Cadogan’s view, German autarky was limited not in comparison to the economic weight of the Empire but to the liberal economic system. The danger for the British in this line of thinking, as demonstrated by the Anglo-American Trade Agreement, was that ‘their’ system included the United States, and although Cadogan argued that “we must cut our losses in central and Eastern Europe” and “do everything possible to foster our

⁴⁴ David Dilks (ed.), *The Diaries of Sir Alexander Cadogan O.M., 1938-1945* (London, 1971), p.116.

⁴⁵ *Ibid.*, p.118.

⁴⁶ *Ibid.*, p.119.

⁴⁷ R.A.C. Parker, “Economics, Rearmament and Foreign Policy: The United Kingdom before 1939 - A Preliminary Study”, *Journal of Contemporary History* 10, (1975), p.646.

trade with other parts of the world and with the Empire”, he added in the next sentence as part of the same idea that Britain “must do what we can to foster commercial exchange with the United States”. Thinking “not only in the economic field but also politically in the Far East” he concluded that the “Trade Agreement with America would be worth considerable material concessions.”⁴⁸

The economic position adopted by Cadogan in these papers has been described as “identical to the one held by the Treasury (and by Inskip)”,⁴⁹ and thus although Cadogan confessed that “I am not an expert in economics and am ready to admit that I may misunderstand the problem”,⁵⁰ his views embodied what had become the official economic doctrine of the British Government. Cadogan’s political master, Halifax, echoed them in a letter to Phipps in Paris,⁵¹ and in addition to his regular and reassuring despatches to Roosevelt went so far as to reassure the U.S. Ambassador Joseph Kennedy, who was summoned to spend “an hour and a half with Halifax this afternoon, drinking tea in front of his fireplace” that Britain would be “staying very friendly with the United States”.⁵² Thus, whatever the harmful effects of the Anglo-American Trade Agreement on the British-Imperial economy, Chamberlain could claim that this was offset by his belief that “the psychological effect on the world was of great importance”.⁵³

The opposite view was put by the *National Review* which, discussing the appeasing attitude of the British Government, noted that: “The Americans are in no way to blame for this. They have told us in season and out of season that they will have nothing to do with us. That they are isolationists, that they regret their participation in the war and that their motto is ‘never again’.” In these circumstances: “The U.S.A. has now been entreated to come and help us to break up our Empire preferences! It seems like insanity.”⁵⁴

⁴⁸ Dilks (ed), *Cadogan*, p.119.

⁴⁹ Peden, “A Matter of Timing”, p.23.

⁵⁰ Dilks (ed), *Cadogan*, p.118.

⁵¹ *DBFP*, Third Series, Vol.3 (London, 1950). Letter from Viscount Halifax to Sir E. Phipps, 1st November 1938, pp. 251-253.

⁵² *FRUS*, 1938, Vol.1 (Washington, 1955). The Ambassador in the United Kingdom (Kennedy) to the Secretary of State, 12th October 1938, p.85.

⁵³ CAB 23/94. CP 36(38)3. Quoted in Parker, “The Pound Sterling”, p.270, fn.7.

⁵⁴ *National Review*, March 1938, p.291.

CHAPTER 7

A “MAGINOT LINE FOR THE POUND”: PROFLIGACY IN DEFENCE OF A BANKRUPT POLICY, NOVEMBER 1938 - JANUARY 1939

In the torrid months after March 1938, the British authorities had demonstrated their commitment to ‘business as usual’ in their international financial conduct. Their adherence to this policy after the Munich hiatus and the conclusion of the Anglo-American Trade Agreement, was to prove that their commitment to the fourth arm policy remained unshaken. Renewed attacks on sterling at the end of the year hardened London’s position and provided evidence of a widening gulf between British and American practice in the economic and financial spheres. Far from forcing the British to adhere to their policy, the Americans became uneasy at the determination with which the British retained their orthodoxy, fearing that any financial collapse might take hope of U.S. economic recovery with it. However, the massive commitment of Britain’s remaining gold stocks in January 1939 was to calm American fears, as indeed it should have. The move ensured that British wealth would continue to fuel America’s reflationary economic policy, and that the drain of British economic and financial strength, lingering rather than sudden and catastrophic, would not imperil America’s growing domination of a functioning international economy.

7:1 Holding the Line

The policy position of the British Treasury before the outbreak of war has been defined by the official wartime history of financial policy in terms of “the dislike of German methods and the fear of bureaucracy”.¹ An example is provided to encapsulate the Departmental view: “‘Is not freedom’, wrote one official, ‘our greatest asset?’” In Britain, therefore: “A Schachtian army of foreign exchange controllers must be avoided except in the very last resort.”² The Bank of England was less fervent, and despite being “greatly attracted by the policy of freedom to which Treasury arguments pointed, thought the risks

¹ R.S. Sayers, *Financial Policy 1939-45* (London, 1956), p.229.

² *Ibid.*, p.230.

too great”.³ Unlike the Treasury, however, the Bank had no stake in the fourth arm policy, against which its views counted for little. Even in the 1938 crisis, Simon was only prepared to incorporate its views in favour of exchange control in the sense that “some preparatory steps should be taken in case ‘a full exchange control’ should after all prove necessary upon the outbreak of war”.⁴ However, it was the unspoken axiom of fourth arm branch of appeasement policy that the Prime Minister would ensure that war did not occur. The Bank’s reservations were thus removed from the political picture.

If any more proof were needed that the British Government was prepared to live or die according to liberal principles, it was provided by its response to intensifying political pressure on sterling at the end of the year. By the end of November, details of British moves against speculators were emerging. Bolton told Knoke that the British “had \$150,000,000 of forwards maturing (this was the bulk of their total short position in dollars). They were going to let them all run off and they were going to ship gold here for that amount less any spot dollars which they might be able to buy”.⁵ At the same time they were asking the clearing banks to deny their funds for use in forward exchange contracts. These actions would hopefully “raise the sterling spot rate or else put a big premium on forward dollars, thereby, and to that extent, reducing the profit of the speculators. The arrangement with the clearing banks was a confidential one; the market knew nothing about it and there would be no publicity of any kind.”⁶

This was the first measure of any sort used by the British to restrict exchange movements since the Anschluss. “Bolton thought that this program was the only one of a technical nature which they could at this time embark upon short of a general embargo. The latter, very obviously, would advertise the weakness of sterling and have most unsatisfactory repercussions.”⁷ This rather complex position was translated for Morgenthau by Knoke in a telephone conversation, and the Secretary initially remarked: “Well, they’re getting a little sense aren’t they?”;⁸ but on being told that Knoke had discovered “the figure that the

³ Ibid., p.230.

⁴ Ibid., p.232.

⁵ FDR MD Book 153, p.81. Telephone Conversation with Bank of England, 28th November 1938.

⁶ Ibid., pp.81-82.

⁷ Ibid., p.82.

⁸ Ibid., p.143. Telephone Conversation between Knoke and Morgenthau, 28th November 1938.

forward contracts outstanding are between thirty-five and forty million pounds”, he responded incredulously: “And you mean to say those damn fools have been financing forward contracts on gold?”

As if to rub home the enormity of this information, Knoke reminded the Secretary of the “gentleman’s embargo” which had existed “preventing operation of forward gold... earlier in the year”, though “when things began to look a whole lot more normal they thought it would be the right gesture for them to - to remove whatever restrictions had been on the forwards”.⁹ This revelation that the British were only restoring a pre-crisis level of financial control spoke loudly to the U.S. authorities of a possible lack of British competence, an impression reinforced when Butterworth, temporarily back from England, told a meeting that “my sense is that the British have no real long-range policy; that their policy consists of a series of daily improvisations, and that in many instances they haven’t been as skillful as we have always been led to believe that they are; that there is a general jittery political atmosphere”.¹⁰

7:2 Thinking the Unthinkable: Exchange Control

Butterworth believed that the British were not yet ready to compromise their liberal principles, expecting them “to move along the lines that they have just undertaken yesterday, with various rather minor devices”.¹¹ However, if the British were “to change the character of London as a money market, with all that that means in their services - I should think that it would be a long and difficult period that they’d have to go through with before they would move in that direction”. White expressed the view that if the British believed the sterling crisis to be politically motivated, then the realisation that this pressure would be indefinite would leave them with

a definite responsibility to the world, because a decline in sterling has other repercussions than merely British considerations. So if they can envisage only a continuation for some time to come of a downward course in sterling, responding to the political pressure, may they not have to give more serious consideration, much as they dislike it, to taking the steps necessary to remove the spearhead of

⁹ Ibid.

¹⁰ Ibid., p.189. Treasury Meeting. Re Sterling Exchange Rate, 29th November 1938.

¹¹ Ibid., p.198.

that downward pressure?¹²

This was the first mention in the U.S. Treasury of the possibility of British exchange control. As has been seen, it was generally in the American interest for the British to pursue a 'business as usual' policy, but in circumstances where sterling seemed likely to collapse and isolate the dollar world again, the purity of Britain's liberal economics was worrying to the United States. In these circumstances the need was not to do something more, but to do something different. The imposition of exchange controls, as had been shown by the French crisis, and would be again when sterling did collapse in August 1939, was the response preferred by the American Treasury when the crunch came. After all, the reservoir of gold available in the General Fund would have enabled the U.S. to cope with a temporary stoppage of the gold inflow, without the feed into the U.S. economy being interrupted. The U.S. would thus be able to bear exchange controls in the short term, as these would have no effect on the American economy.

A collapse of sterling, on the other hand, would have damaged U.S. competitiveness immediately, and in keeping with the American Treasury's short-termism, the possibility that any British exchange control might be retained in perpetuity was not considered. British moves to halt the gold flow and the slide of sterling by exchange control would as White indicated, have been welcomed, as meeting all current U.S. requirements in the short term, and the Treasury never thought beyond the short term. Exchange controls extended over time would have been a different proposition but the question never arose, as the British Treasury had already ruled out this option.

The British economist P.K. Debenham, Secretary of the Committee on Economic Information, had raised the possibility of a more autarkic system in his paper for that body of October 1937, and in the aftermath of Munich this was once again considered by the British Treasury and a response to the ideas it contained discussed. Sir Frederick Phillips asked the opinion of the former Secretary of the Economic Advisory Council, Hubert Henderson, who wrote that: "I agree with almost everything in it." Further,

I also suspect that we should make preparations for evolving some system of exchange restrictions appropriate to our conditions, in case something of this sort should become imperative later, in a more serious situation. I'm sure we shall have exchange control in France before very long, and I doubt whether we can long maintain

¹² Ibid., p.199.

essentially laissez-faire methods in a world predominantly ruled by autarkic systems.¹³

Uneasy at this growing tide of professional economic revisionism, the Treasury turned to its own economist, Ralph Hawtrey, whose name runs like a red thread through the sorry tale of British economic unpreparedness, and he bolstered his superiors with a series of memoranda hostile to any alteration of liberal practice. Interpreting Henderson's letter without heed to the danger of war he wrote: "I am not sure whether he would regard exchange restrictions as an appropriate retort to the German measures. In my opinion the adoption of them would be a deplorable blunder."¹⁴ Restrictive measures "need not be interpreted narrowly to mean exchange control", though "whatever the method adopted the outcome would inevitably be a serious further diminution of the whole of the international trade of the world in general and of our own external trade in particular".¹⁵ Later, in another paper, Hawtrey displayed an extraordinary detachment from current circumstances in stating that: "For the moment the danger of the pound being over-valued is obviated by capital movements. No doubt these are in their nature temporary and will be reversed later on, and all we have to do is see that when they are reversed we do not let the pound rise higher than is appropriate to our circumstances, including our armament expenditure".¹⁶

7:3 American Fears.

It was clear that the imposition of stern measures of exchange control by the British was not an immediate prospect however bad the situation became, and the U.S. Treasury returned to a consideration of the possibilities of American action, turning again to the help of outside experts. A gathering took place at the Treasury on 29th November. The experts were presented with a hawkish memorandum prepared beforehand by White which he called, inaccurately as it transpired, the "Agenda for Conference on the Sterling Situation, November 29 1938".¹⁷ This described events to date, criticised British policy and suggested

¹³ PRO T 160/878/F16506. Mr Debenham's Memorandum on Armament Expenditure and its Effect on U.K. Finance, Trade and Exchange Position. Treasury Views On. Letter, Henderson to Phillips, 12th October 1938.

¹⁴ Ibid. Memorandum by Hawtrey, 25th October 1938.

¹⁵ Ibid.

¹⁶ Ibid. Memorandum by Hawtrey, 16th November 1938.

¹⁷ MD Book 153, p.221. Memorandum, White to Morgenthau, 28th November 1938.

various responses, to be carried out either solely by the British, jointly between the U.S. Treasury and the British, or solely by the U.S. Treasury.

This hostile paper was not received well by the experts, who criticised its narrow-mindedness and were unwilling to consider it as a basis for the meeting. The discussion which did take place was wide ranging, but this served only to reveal and exacerbate the utter confusion that already existed in the Treasury over an appropriate response to the sterling crisis. Walter Stewart pointed out that Morgenthau was hampered because being “in an executive position”, he had “to deal with these problems as they come to you, day by day as they come to you; that as outsiders, not being confronted with that, the contribution we ought to make to you, it seems to me, is the attempt to get a sufficiently broad basis of approach so we understand the problem”.¹⁸ He could only recommend what used to be called moral suasion, constantly asking the British for information and thereby subjecting them to a “series of additional pressures, without any manifestation of an outward move on your part”.¹⁹ This approach was necessary because: “There aren’t many things, as I see it, on the dollar - actions on the dollar-sterling rate that we have in our hands to do.”²⁰

The discussion then explored the undesirable short-termism of U.S. Treasury operations, and while Morgenthau defended the professionalism of his advisors he confessed that “I personally am dissatisfied with what I personally am trying to do on the - not day-to-day but the trends over a period of years, see? And that kind of thinking neither my staff nor myself have time to do”.²¹ Expert advice was required because “we have unlimited money but we have very limited brains”.²² The remedy for the situation in which Treasury employees were too harassed to think clearly was

that somebody has to sit back that doesn’t have the telephone ringing every minute, that doesn’t have to be worrying about complaints, that doesn’t have to be worrying about a Senate and Congress, and that thing, and this little thing, and political appointments and what not, and the hurly-burly of the thing. You just don’t get time. Now, I - on a day like this I devote the day to it. I think I’m pretty good to be able to devote a day to it.

¹⁸ Ibid., p.232. Treasury Meeting. Re Sterling Exchange Rate, 29th November 1938.

¹⁹ Ibid., p.233.

²⁰ Ibid., p.234.

²¹ Ibid., p.235.

²² Ibid., p.236.

Wednesday, Thursday and Friday I got my financing, and if Harry White comes in and talks about the pound I'm going to be very cross, because I've got to do my financing.²³

Morgenthau wanted to consider "forming a group to take the long distance view on this thing and not just come down when we're in trouble; because I don't know what position the United States is slipping into, and I can certainly say - in the world's market - and as far as I know there's nobody in Washington that knows".²⁴ It was suggested that a committee formed with the British could determine "the best way to restrain the movement of the exchanges".²⁵ This could be "a very fruitful field for discussion; it could be entirely sympathetic and we might all learn something by it, we as well as they".²⁶ This current of moderation was added to by Warren, who remarked on

the unwillingness of the group to discuss these [White's] very drastic proposals at this time. I think that was because they were drastic and because everyone felt they would like to have a little more time to think about them, that there was not an immediate emergency and that I don't think very many of us felt prepared to offer an opinion on a drastic proposal immediately.²⁷

Morgenthau replied: "You and I both." He was, though, "fearful that we're going - that the thing is going to get worse. I'm very discouraged, very discouraged. I mean I think the whole trend is against us." Warren reassured him with the comment that the trend "may not be as precipitous as it has been, lets say, for the last two weeks, which means that we do have a certain amount of time to think them over". Morgenthau, partly reassured said: "I think that's right, but I - in these times..." Warren concluded, "I hope its right".²⁸ Washington remained on edge.

7:4 British Reassurances

On 30th November, eagerly awaited information from London was delivered to Morgenthau by Bewley. The latter "asked that no verbatim record be made of his remarks",

²³ Ibid., p.237.

²⁴ Ibid., p.238.

²⁵ Ibid., p.241.

²⁶ Ibid., pp.241-242.

²⁷ Ibid., p.251.

²⁸ Ibid.

and proceeded to “read out what was obviously a telegram he had received from the British Treasury”,²⁹ which reprised the measures which Bolton had already discussed with Knoke. The financial attaché “took occasion to point out, on behalf of the British monetary authorities, that if the international political situation had not arisen, the fundamental economic trend in recent months would, nevertheless, have made impossible the maintenance of a \$5 pound”. This was as much explanation as London thought recent events called for, and Bewley struck an upbeat note for the future when: “At the same time he expressed the hope that the technical measures undertaken would gradually operate to strengthen the pound, but that that, in turn, presented a problem of policy as to the degree to which the pound would be permitted to rise in relation to the amount of resources to be recouped”.³⁰

This was certainly not the response Morgenthau had been expecting. It seemed the British were confident that the very limited measures they had announced would be sufficient to arrest sterling’s decline: so confident, in fact, that they seemed willing to echo the optimism shown by Hawtrey when discussing Debenham’s paper, and engage in preliminary horse trading about the pound’s ultimate ceiling. To this bravado, an apparently bemused Morgenthau “replied by saying that, at first blush, he hoped that in their desire to replenish the Fund that the British authorities would not weigh too heavily against letting the pound rise”.³¹

Bewley mentioned “the question of the use of the devaluation powers” whereby the President, or Morgenthau acting with his consent, could lower the value of the dollar by increasing its gold price. This, Bewley said, “was a matter which his Treasury, from time to time, pressed him about. He wished to know whether their use was being considered.” Morgenthau told him that “the question of further devaluation I consider a device only to use in a great emergency, and at this time I don’t envisage any such emergency”. This was hardly fighting talk and “Mr Bewley expressed entire satisfaction with this answer”.³² Morgenthau, assuming the British to be acting rationally on information known only to them, could not have known that their optimism was based on self-delusion. Indeed, Bewley

²⁹ Ibid., p.385. Record of Bewley’s visit to the Treasury, 30th November 1938.

³⁰ Ibid., pp.385-386.

³¹ Ibid., p.386.

³² Ibid.

later wrote to Waley that “Morgenthau remarked that he was not so pessimistic about sterling as we were”.

The extent of Bewley’s satisfaction was expressed the following day in his report to Waley in London. With regard to the British Treasury’s earlier grumbling about American ‘weakening’, he pointed out that: “In the first place there is, I believe, no difference of opinion between the two Treasuries or at any rate between the responsible officers in the two Treasuries - as regards dollar devaluation.”³³ He went on: “Morgenthau is at heart a firm believer in permanent stabilisation on gold, and moreover regards the stabilisation of 1934 and the Tripartite Declarations as his personal successes.” In putting the British view to Morgenthau, therefore, Bewley was “pushing at a door already wide open”. He guessed with absolute accuracy that in requesting information Morgenthau wanted “to keep us up to the mark as much as possible: not that he really thinks the pound has been indifferently supported, but that he thinks the knowledge of his serious concern can do no harm and may possibly stimulate us to even greater exertions”.³⁴

Thus the approach that the Americans thought to be based on subtle psychological pressure was utterly transparent to the British, whose chief concern was to support a sympathetic Morgenthau against imagined domestic pressures. Bewley thought the Secretary to be “afraid of what political agitation there may be, especially after Congress meets, and he is looking for anything that will help him combat it successfully”.³⁵ Bewley felt that it was “hard to believe that at present levels there is any real danger”, but that in the event of much more serious sterling pressure, Roosevelt “might well overrule the Treasury”. To guard against such remote contingencies, Bewley thought that: “As regards any possible help from us, the more Mr Morgenthau can say that we are keeping him fully informed, loyally cooperating, and so on, the better.” Bewley enclosed a leading article from the *New York Times* supportive of the liberal view and noted that: “Of course New York is far ahead of the rest of the country on this sort of topic but you may like to see that the true doctrine gets some vigorous publicity.” Later, Hopkins in London wrote on a note attached to Bewley’s letter, that: “I assume the Chancellor has seen this from Washington. For the

³³ PRO T 160/871/15777. Letter from Bewley to Waley, 1st December 1938.

³⁴ Ibid.

³⁵ Ibid.

moment all seems to be fairly well.”³⁶

7:5 Hard Facts and Righteous Satisfaction in London

In early December the figures requested by Morgenthau, recommended to be sent by Bewley and promised on 30th November, were finally furnished to the Americans in a meeting between Bewley, prominent U.S. Treasury officials and Cochran from the State Department. These had been brought over in leisurely fashion on the *Queen Mary* and Bewley noted that they were “not as complete as the Secretary requested, most importantly because such detailed information as the Secretary desired was not available to the British Treasury, due in part to the British regard for the professional attitude of the banks toward the confidential character of their clients’ transactions with them”.³⁷ This encounter with the official British style must have been frustrating to the technocratic U.S. Treasury men, but Bewley “did give specific figures in regard to the gold holdings of the exchange equalisation account.”

These revealed to the Americans that gold holdings of £297 million “at the end of March 1938” had, including the loss of £40 million “required to cover future operations maturing in December”, dwindled to “approximately” £60 million. These figures, said Bewley, “proved conclusively that the British officials had been taking every appropriate and possible measure to stop the decline of sterling. There was considerable discussion of the possible effect on American prices of the depreciation of sterling, and it was agreed that any further talks on this subject be between Messrs. Bewley and White”.³⁸ The figures certainly had the effect of quashing the sort of speculation indulged in by White, that British support of sterling had been half hearted, and indeed no further memoranda of this nature appeared from him.

There followed an interesting exchange during which

Bewley remarked to Mr Taylor that in the conversation which Bewley had had with Secretary Morgenthau some days ago the latter had remarked that the French had not seen fit to follow American advices. Bewley asked Taylor if he could give him a little more light on the significance of this remark, particularly since it was desirable under the tripartite arrangement that the three parties

³⁶ Ibid. Note By Hopkins, 5th December 1938.

³⁷ MD Book 154, p.232. Memorandum by H. Merle Cochran, 3rd December 1938.

³⁸ Ibid.

there to [sic] be conversant with policies discussed between the various members”.

Responding formally to this probing, “Mr Taylor thought it would be necessary for him to speak further with Secretary Morgenthau before he could elaborate upon the point with Mr. Bewley”.³⁹ Bewley had reason to be pleased with this exchange and the meeting, given the British preoccupation with financial probity, and his comments about the French further emphasized impeccable British credentials on matters associated with the Tripartite Agreement. This could not disguise, however that the figures he had given to the Americans revealed a desperate situation, from which there seemed little escape if the rules of the game continued to be applied.

In the 3rd December meeting, Bewley revealed a British plan to increase E.E.A. holdings by moving £60 million from the Issue Department of the Bank of England, the sole remaining untapped reserve of gold,⁴⁰ and this was indeed the only meaningful action open to the British under the prevailing system. Morgenthau, though, no longer sharing earlier British optimism, gave through Taylor a request to Bewley saying he “would like to have from Sir John Simons [sic] his opinion of the developments of the past week and his general feel of the situation”,⁴¹ along with statistics of the dealings of the E.E.A. in that week. Bewley appeared cooperative, and would try to obtain “this information by Monday, but that it might be a little difficult as the week-end was probably in the process of occurring”.

Bewley then went on to the offensive, producing an article from the *Journal of Commerce* by one Clarence Linz which “mentioned that people here felt dissatisfied with the manner in which the British authorities had handled the pound, et cetera, et cetera. The article also mentioned the fact that the so-called ‘Committee without a name’ had given considerable consideration to the gold holdings and the position of the pound.” Taylor assured Bewley, falsely, “that the committee had not devoted its attention to either of the subjects which he mentioned”. Nevertheless, Bewley embarked on a lecture, in which he “went on to say that he felt that if we did have any feeling such as those [sic] expressed in

³⁹ Ibid., pp.232-233.

⁴⁰ Ibid., p232.

⁴¹ Ibid., Book 155, p.218. Inter Office Communication. To Secretary Morgenthau from Mr Taylor, 9th December 1938.

the Linz article, that he felt that we should discuss them frankly with his Government”.⁴² Taylor assured Bewley that Morgenthau had been completely frank with him about his views on the pound and that “he need have no fears along those lines”.⁴³ Bewley, however, continued his tirade and “emphasized the desirability of complete frankness on our part if we should ever feel that matters were not being handled to our mutual satisfaction, because otherwise the close cooperation and consultation contemplated by the Tri-partite Agreement and subsequent cooperative efforts could not be effective”. Taylor “assured him that we felt exactly the same way and would not hesitate to tell the British anything we had on our minds and that they should feel the same way”. Bewley’s indignation was somewhat less than real. He sent the Linz article to Waley and giving no hint of his dramatics simply noted that: “As I thought the enclosed was a rather mischievous article I asked Taylor about it.”⁴⁴

7:6 The Bear Squeeze Fails

By 21st December 1938, the British confidence in sterling’s imminent recovery which had radiated in Morgenthau’s direction had clearly evaporated. On that day Frederick Phillips informed his colleagues at the Treasury that: “The Bank of England are once more in a state of deep depression as to the future of the sterling exchange.”⁴⁵ Norman had “expressed doubts whether it would not be wiser to transfer a larger sum from the Bank of England, say £100 million of gold or even more”. In view of the fact that the situation was likely to be very much worse in the new year, Norman was “very anxious in these circumstances that we should inform Mr Morgenthau immediately of the view which we hold of the future and in that connection he thinks it would be desirable if we were to discuss the position orally with an American representative”. Phillips concurred, as:

The last cable we sent to Mr Morgenthau was of course the very reverse of cheerful. In the light of the view which the bank take as to the future course of exchange I am inclined to agree with them that an immediate message of warning to Mr Morgenthau would be a wise precaution. It does not seem to me that there is really the least hope that the Americans will be able to give us any assistance since they could only do that by buying sterling and holding it

⁴² Ibid., pp.218-219.

⁴³ Ibid., p.219.

⁴⁴ T 160/871/15777. Bewley to Waley, 9th December 1938.

⁴⁵ Ibid., memorandum by Sir Frederick Phillips, 21st December 1938.

without converting it immediately into gold. But if in fact the rate is bound to fall in the near future obviously such an idea would not be attractive to them.⁴⁶

Hopkins wrote “I agree” in the margin.

Such elaboration proved to be unnecessary. That day Bolton telephoned Knoke “and unburdened himself”.⁴⁷ He told Knoke that

‘We have been sending you warning cables that the undertone of sterling is worrisome. At the moment the sterling rate is simply being maintained by means of the squeeze which we have engineered and money rates are rising. Over the turn of the year, that is from December 30 to about January 3, the exchange market is ready to borrow sterling against dollars at between 7 and 10 per cent per annum. That is just a measure of their conviction that sterling is bound to go down and of their determination to maintain their long dollar position. The best we have been able to do during the last three weeks by the squeeze was to keep some sort of stability in the rate. Now, with the news of some dissension in the Cabinet, the situation will become much more difficult for us and there is very little likelihood that this matter of Cabinet dissension will be cleared up before the middle or the end of January. Over the turn of the year there will be a large scale raid on sterling and unless there is some improvement in the political situation from January 3 on, I think we are going to find ourselves in an untenable position.’⁴⁸

This would mean that: “On January 3 we shall have to give up the sterling squeeze”, because

‘In the long run it is impossible politically and economically. I am still discussing all these things with Governor Norman and, of course, he is discussing them with the Treasury. What will come of it I don’t know but there will be a very heavy pressure against sterling from the end of the year onward; so heavy I am afraid that we will have to let the rate go down a bit more. Personally I don’t want to see the rate drop below the present level which I think is low enough already. We shall resist to the extent of our resources but we shall probably be up against an impossible movement which may well carry us below 4.61. I shouldn’t doubt if in the first week in January we shall lose £50,000,000 of gold.’⁴⁹

Bolton thought that, although: “We have a fortnight before anything is likely to

⁴⁶ Ibid.

⁴⁷ MD Book 157, p.217. Telephone Conversation with the Bank of England, 21st December 1938.

⁴⁸ Ibid.

⁴⁹ Ibid., p.218.

happen”, nevertheless: ““Unless there is some political improvement our position is going to be very very difficult.”” Bolton then detailed the measures likely to be taken (and which were taken) before concluding that:

‘I may be exaggerating the dangerousness of the situation and if I am I shall be only too glad to be wrong. Everybody is convinced that Hitler is going to make a move early in 1939. Hope is low that Chamberlain’s meeting with Mussolini will bear fruit. Domestically there is very strong objection against Chamberlain’s foreign policy. There is also the belief that certain of our defense ministers have not done their job very thoroughly. In addition there is a growing movement in the Conservative Party to make major changes in the Government. I repeat I am giving you my personal opinion but what I am telling you is necessarily for free discussion. I am putting you under no obligation to keep it to yourself.’⁵⁰

Bewley called on Morgenthau on 23rd December with the message decided upon on the 21st. It covered much the same ground as Bolton’s outpouring to Knoke, though somewhat more calmly expressed. Far from being shocked, Morgenthau admitted, according to Taylor’s record of the meeting addressed to the Secretary,

that as a result of Bolton’s message, the news of the situation...did not come to you as a complete surprise, and that whereas you had no specific suggestion to make, you wished to emphasize the fact that you would cooperate in any way possible with his Government in order to help meet the situation; that naturally his Government was in better position to determine what the specific measures might be. Bewley then stated that it might be necessary for the British Treasury to discuss the question with some one on the ground prior to communicating again with you after the holidays. You told him of Butterworth’s arrival and suggested that they get in touch with Butterworth immediately as Butterworth could undoubtedly throw considerable light on the Treasury’s attitude, as he had just spent several weeks reviewing various aspects of the situation here.⁵¹

In other words, no special cooperative arrangements would be made to deal with the sterling crisis. As Morgenthau mentioned, Butterworth was back in London and on the 28th December he attended a meeting with Sir Frederick Phillips, Waley, and Catterns, the Deputy Governor of the Bank of England. Phillips was considerably more sanguine than Bolton had been with Knoke, and pronounced “recent measures taken by the British

⁵⁰ Ibid., pp.219-220.

⁵¹ Ibid., p.282. Inter Office Communication. To Secretary Morgenthau from Mr. Taylor, 23rd December 1938.

monetary authorities...as being on the whole a success”.⁵² However, “he added that only the normal tightness of money towards the end of the year had made them practical expedients and consequently with the beginning of the New Year their efficacy would be largely impaired”. Butterworth was being consulted because

the British authorities had been canvassing the situation and had made it a point not only to consult each other but to feel out the temper of foreign centers as regards the general attitude of those who might hold sterling balances in London. Practically without exception they had found that the view held was that sterling would depreciate further and that there was every expectation that after the year-end the movement out of the pound would be renewed.⁵³

Butterworth continued:

Phillips said that he realized that this would coincide with the convening of Congress and consequently he had been desirous of communicating to you the position as they saw it. He said he was sorry to have to convey such doleful tidings for the New Year but it was a painful fact which they themselves were in the process of facing and he wished to play straight and fair with you. He said that the expectation was that sterling would touch the ‘Munich’ level of 4.61 and even go lower. He went on to say that 80% of the trouble lay in the international political field and those who held foreign balances in London would find little or no comfort in the course of international events.⁵⁴

Interestingly, Phillips said that “he was well aware that such a depreciation of sterling would have repercussions on the Continent as well as in America”, and refusing to show special consideration to the U.S., talked of the difficulties faced by the French, Belgians and Dutch. Butterworth “did not conceal the fact that I considered this very disturbing news and I pointed out that the average American, including the average members of Congress, looked upon the dollar rate as a sort of monetary barometer and I also emphasized the relation of the commodity price level to our recovery”.⁵⁵ This well-tryed gambit of threatening the British with the xenophobia of Congress drew a surprisingly terse response: “Catterns then said that they realised that this might produce ‘fireworks’ in the United

⁵² Ibid. Book 158, p.66. Telegram. Strictly Confidential for the Secretary of the Treasury from Butterworth, 28th December 1938.

⁵³ Ibid., pp.66-67.

⁵⁴ Ibid., p.67.

⁵⁵ Ibid., p.68.

States; that in fact it would produce them everywhere and that no one regretted it more than they did or wished to avoid such a contingency more than they did. But unfortunately political fireworks were going on all over the world which they were not able to control.”

When Butterworth asked uneasily

whether they had in their mind even a tentative figure below 4.61 at which they were prepared to resist, both Catterns and Phillips said that while they hoped that the rate would not in the near future go much below that level, they did not see how they could do more than what they had been doing, which was to use their best efforts and their gold in resisting the trend.⁵⁶

Catterns went on to say that he saw

only three possible courses of action: (one) to adopt a Schacht system, which as far as he knew was not even up for consideration; (two) to peg the rate at [a] definite point, which he was convinced was ‘sure death’ (incidentally this was the phrase used by Montagu Norman when I talked to him the day before I sailed); or (three) to do what they had been doing, namely to use their skill and their gold with a view to maintaining the rate as best they could. When pressed on the matter of how liberally they were prepared to use their gold, Catterns stated that they were prepared to resist ‘until the last shot is left in the locker’.⁵⁷

This would prove no idle boast but Butterworth was not to know that, and received further discouraging news when he

pointed out how desirable it was for the American Treasury in such difficult circumstances as the present to have a well rounded picture of the situation, upon which Phillips commented that he had never found the Bank of England’s figures worth anything to him and Catterns went on to express very much the same view about this matter as I gave you in Washington, namely that the figures were admittedly so inadequate as to be practically useless.⁵⁸

This conversation was not cheering to American ears, but Butterworth perceived a silver lining and reported to his chief that:

I think I should point out that ‘it is not done’ for any official of the Bank of England to participate together with Treasury officials in such a conversation as today’s, and the fact that the Deputy Governor was present can only be interpreted as indicative of the concern of the British monetary authorities and of their desire to

⁵⁶ Ibid., pp.68-69.

⁵⁷ Ibid., p.69.

⁵⁸ Ibid., p.71.

obtain your sympathetic consideration.⁵⁹

In December, public opinion had a chance to catch up with recent events when the six-monthly publication of the holdings of the E.E.A. revealed the losses that had taken place between the Anschluss and the Munich Crisis. Butterworth reported a stoical reaction, noting that “the London financial press in general plays down the gold losses as much as the facts permit; no doubt at the suggestion of the British authorities”.⁶⁰ The U.S. Treasury, with its more recent and worrying knowledge, did not really have time to express an opinion on the warnings of December. As had been made clear, the British knew that the squeeze on forward sales of sterling would soon cease and that these chickens would come home to roost in early January. If they were hoping that a generally easier situation would cushion the blow and enable them to keep the ‘last shot’ stored in the locker they were sadly mistaken.

On 3rd January 1939, Bolton told Knoke that: “Since they had started dealing for January, that is since December 27, their daily losses had been from £3,000,000 to £4,000,000. He knew, Bolton continued, that there was a big speculative account open against sterling and he also knew that that account was growing.”⁶¹ Bolton was clear enough about the causes of this constant pressure: “The predominant factor was the belief that there was going to be another war scare in the near future”.⁶² At this stage, even the prospect of a war scare, never mind the actual occurrence of one, was enough to begin a stampede out of sterling. Bolton had little confidence in countervailing forces, noting that: “One weak step taken to counteract that in the near future was Chamberlain’s visit to Mussolini and nobody believed that this visit would bear any fruit.”⁶³

7:7 Desperate Remedies: “absolutely shooting the works”

In the face of the alarming trend in the currency market, the Bank felt constrained to take further steps toward the restriction of exchange dealing. Knoke reported Bolton’s description of this “program” which was to consist of “a letter” to the “Bankers Association,

⁵⁹ Ibid., p.72.

⁶⁰ Ibid., p.237. Telegram. For Treasury from Butterworth, 31st December 1938.

⁶¹ Ibid. Book 159, p.71. Telephone Conversation with the Bank of England, 3rd January 1939.

⁶² Ibid.

⁶³ Ibid.

asking their members to prohibit completely all advances against gold and all forward gold transactions. Similarly, they would be asked to scrutinize and reject any transactions in exchange which they believe to be speculative in origin.”⁶⁴ In addition it was hoped that: “To some extent the banks might also be able to limit speculative transactions in foreign exchange but as to the success of that he was not very hopeful”.⁶⁵ If this programme seemed limited, even with the support of “the central banks of the tripartite countries”, a further step would be taken when “towards the end of the week a substantial transfer of gold would be made from the issue department to the exchange account. As to the exact amount to be transferred, no decision had as yet been made”.⁶⁶

Bolton said that: “Everybody had agreed to this program and Mr Morgenthau would be duly advised by cable”. It was clear that American pressure played no part in this decision. The British authorities had become quite scared enough themselves by the situation, and they clearly regarded these measures as the only conceivable response. Bolton told Knoke that: “The only alternative to this program was complete restriction (I suppose he meant of the German kind) and that, they thought, was politically impossible under the present conditions and would be complete frustration of all they had done”.⁶⁷

It would be a mistake to judge the term ‘politically impossible’ in terms of public opinion. The political difficulty of full exchange control would be the certainty of its exploding completely the political and economic basis of the fourth arm policy, the fantasy of ‘business as usual’. This was the cornerstone of policy, preventing Britain from becoming that different kind of nation the National Government so feared. However, the rejection of sterner measures of exchange control implied complete loss of control over the situation, and a policy simply of hoping for the best. Bolton said of the British authorities that:

For the time being they were inclined to encourage the growth of the bear account now open and to wait for some new factors with which to fight it back. This would at least technically weaken the bear position and give them a better chance to combat it with success later on if and when the political outlook had improved, for one thing was clear to everybody, namely that the basis of the

⁶⁴ Ibid.

⁶⁵ Ibid., p.72.

⁶⁶ Ibid.

⁶⁷ Ibid.

present problem was primarily political.⁶⁸

This attitude was simply storing up trouble. The authorities knew that the possibility of a war scare was causing barely surmountable difficulty. An actual war scare would clearly obliterate the Exchange Equalisation Account, even with the new measures announced. The British had painted themselves into a corner, and as they insisted on staying there, only one move of any magnitude was possible. Accordingly, on 6th January 1939, the U.S. Treasury received a strictly confidential triple priority telegram from Butterworth at the British Treasury. He stated that:

The British monetary authorities informed me last evening of the following steps which they are taking:

(a) It will be announced at 4 o' clock this afternoon London time the transfer from the issue department of the Bank of England to the Exchange Equalization account of some pounds 200,000,000 of gold valued at the old statutory price of 85 shillings per ounce. There will remain in the Bank of England some pounds 126,000,000 valued at 85 shillings an amount which is roughly equivalent to the amount of gold in the possession of the Bank of England when it abandoned the gold standard in 1931.

The object of the transfer of so large an amount instead of the contemplated pounds 60,000,000 is to attempt to impress the market that henceforth the account possesses ample resources to meet the call upon it and that all the gold resources acquired since 1931 are available for that purpose.⁶⁹

This move was indeed the proverbial death ride. Rather than adjust to a saner policy which reflected reality, the British were in terms of their ideological convictions putting their money where their mouths were, and were clearly willing to risk ruin in the upholding of liberal financial principles. The ground had been prepared in terms of public opinion and Butterworth noted that: "The nature of the announcements and editorial comment indicates that the press is complying with the British authorities' desire that the measures be launched in a favorable atmosphere, the steps being generally characterized as desirable and not unexpected, the only editorial criticism being that the action might well have been taken earlier."⁷⁰

For the U.S., Wayne Taylor remarked in the daily Treasury meeting on 6th January

⁶⁸ Ibid., pp.72-73.

⁶⁹ Ibid. Book 159, pp.152-153. Telegram. For Treasury from Butterworth. Triple Priority, Strictly Confidential, 6th January 1939.

⁷⁰ Ibid., pp.163-165. Telegram. For Treasury from Butterworth, 6th January 1939.

that the British announcement was “the big news of the day. It means they are absolutely shooting the works.” Duffield asked: “Have they got anything left after they do that?” After Lochhead replied that the British were down to the 1931 position, of “about a hundred twenty-one million pounds”, Taylor again emphasized that “it is certainly laying it all on the line”.⁷¹

An intriguing feature of the British move was an initial tendency on both sides of the Atlantic to regard it as an aggressive act. Lochhead reflecting on a slight initial jump in the sterling rate stated: “I think a lot of people like the idea that England is taking a little more aggression than they have done. A lot of people figure England has been drifting the last two or three months with a hopeless spirit. This shows more of a fighting spirit, which they like.”⁷² Butterworth, following up his earlier remarks about the preparation of the British press for a favourable response, noted that “the strengthening of the Exchange Equalisation Account’s gold reserves is universally approved” as “a bold and judicious means of making clear to the world the full amount available to defend sterling. Such phrases as the MANCHESTER GUARDIAN’S ‘reserves are being moved up to the front for a firm defence of sterling’ and the FINANCIAL TIMES’ characterization of the ‘Maginot Line for the pound’ are typical.”⁷³

None could know it but the latter comparison was wickedly apt. After the replenishment of the E.E.A. in January, the pound would remain in the vicinity of \$4.67 until August, and as was their way, the U.S. Treasury ceased to worry about the matter. This did not mean that the problem was any less acute for Britain: quite the reverse. The multiplying war scares would now simply be reflected in a pronounced increase in the amounts of gold leaving Britain for the United States. By 1939, however, the U.S. administration had convinced itself that all measures likely to result in reflation of their economy were welcome, and in pursuit of a national income of \$80 billion from the 1938 figure of \$65 billion, very large sums indeed were likely to be required.

7:8 A Parting of the Ways

The measures adopted by Morgenthau in 1938 to absorb the gold flow, and his

⁷¹ Ibid., pp.179-180. Treasury Group Meeting, 6th January 1939.

⁷² Ibid., p.220. Treasury Group Meeting, 7th January 1939.

⁷³ Ibid., p.233. Telegram. For Treasury from Butterworth, 7th January 1939.

support for the British defence of sterling through a passive 'business as usual' policy had answered U.S. needs quite brilliantly. This was by no means appreciated in Britain, and indeed the initial and continuing success of Morgenthau's policy relied on the failure of the British authorities to realise what they were doing to themselves and change course before Britain's finances were fatally weakened. Such a transformation was unlikely as there was a clear and ingrained lack of understanding of, and a certain condescension towards, American economic thinking.

In January 1939, *The Economist* wrote on what it referred to as "The Dogma of Purchasing Power".⁷⁴ This referred to the importance the U.S. attached to the maintenance and increase of what Keynesians would come to refer to as aggregate demand. It was lamented that "these views are now held in a dogmatic or doctrinaire fashion. That is to say, they are accepted as, say, the gold standard was formerly accepted - as something so generally accredited that to doubt it would be economic heresy if not social perverseness." The "purchasing power doctrine" held that "purchasing power is regarded as antecedent to production; that is, purchasing power is not so much the reward of production as the initiating force of the demand that calls production into being".

Such thinking led directly in the opposite direction from the British attitudes that restricted the rearmament budget in the name of financial stability, to "the view that the cash deficit of the Treasury represents a contribution by the State to the national income - regardless of whether the deficit is financed by increasing the supply of money or by savings." This led to the logical conclusion that:

Since the cash deficit is a contribution or addition to the national income (the aggregate of individual incomes, not the value of national output), and since the largest possible national income is admittedly desirable, any argument in favour of a balanced Budget is economically subversive, so long as the national income is below some acknowledged 'normal' level.⁷⁵

It was noted that "emphasis on the expression of the purchasing power theory in terms of the national income is of relatively recent growth", replacing earlier, and unsuccessful, U.S. attempts to end the depression by raising commodity prices. "Confidence that the price level can be controlled, or the rate of industrial activity determined, by solely monetary devices has been considerably weakened in recent years; but to a considerable and growing

⁷⁴ *The Economist*, 21st January 1939, p.120.

⁷⁵ *Ibid.*

extent the public demand is shifting to the belief that the national income can be raised to, and maintained at, a desired level.”⁷⁶ This belief was in no small measure supported by the influx of foreign gold.

The Economist's summary of American opinion was accurate to the extent that many of its points were reiterated in the President's annual State of the Nation Message to Congress which stated that “The first duty of our statesmanship to-day is to bring capital and man-power together. We want to get enough capital and labour at work to give us a total turnover of business, a total national income, of at least eighty billion dollars a year.”⁷⁷ The developing gulf between the practice of the British and American Governments can perhaps best be stated by the difficulty of imagining Sir John Simon rising to express similar sentiments to the House of Commons. By 1939 British and American economic thinking had bifurcated completely, and London had been left far behind.

The British were left with their financial probity intact and their war-fighting economic potential disintegrating about their ears. There was no-one else to blame. The United States Treasury had been puzzled, had not subjected the British to any material pressure and indeed had not been sure what British action it would have liked. American enjoyment of the fruits of British folly, whilst not especially laudable in the context of democratic solidarity against the dictators, was nevertheless far removed from the coercion of the British into compromising their defensive strength. Morgenthau was inclined during the year to claim credit retrospectively for the British action in January; but as we have seen the British acted for their own reasons and there is no evidence that pressure from Morgenthau caused them to act any differently than they would have without it.

7:9 Defence Pays the Price

By the end of 1938, the attitude of the British Government was taking a naive and dangerous turn in the field of defence economics, but in truth it was not being helped by the quality of expert economic advice it was receiving. In December 1938, the Committee on Economic Information presented a report to Cabinet entitled “Problems of Rearmament”.⁷⁸

⁷⁶ Ibid., p.120.

⁷⁷ Quoted in *The Economist*, 28th January 1939, p.175.

⁷⁸ PRO CAB 24/281, p.296. CP 296(38) Economic Advisory Council. Committee on Economic Information, Twenty Sixth Report. Problems of Rearmament, December 1938.

This acknowledged the problem caused by loss of gold and foreign currency reserves. The Committee “felt that we could be most useful in setting forth a list of the various available remedies without advocating any one in particular to the exclusion of others”.⁷⁹ If this seemed like sitting on the fence, the Committee added that “we desire to emphasize in conclusion our strongly held opinion that action along one or other of these lines is urgently required and that the present position has potentialities of real danger”.

The report was a curious mixture of complacency and fear, as if the Committee were struggling to reconcile events in two different worlds. The Cabinet was reassured that: “Our gold reserves are large; fully sufficient, if we had to take account only of the adverse balance of payments in the next three or four years on current account.”⁸⁰ However, the role of fugitive capital was such that the reserves “have been entirely accumulated through short-term capital movements which may be reversed. It is the combination of a continuing drain on current account with a sudden drain on capital account which would be dangerous.” The report pointed out that: “The greater part of our gold reserve has been acquired since the beginning of 1932. Between that date and the end of 1937 we had an aggregate adverse balance of payments estimated by the Board of Trade at about £80 millions”.⁸¹ Net repayments of foreign loans of £50 million did not offset this figure and the situation “would, in the absence of short term capital movement, have resulted in a loss of gold in the period”.⁸² The position was, therefore, that “the inflow of short term money in the six years was at least large enough to finance our actual gold acquisitions”.⁸³

Far from regarding this as a happy eventuality, the report recalled an earlier crisis and stated that: “The position has potential dangers, not less than those discovered by the Macmillan Committee shortly before our departure from the gold standard”. It was revealing that the Committee should have been thinking of a time when orthodox financial practice was threatened, for the figures just quoted, although actually an encouraging record of success, demonstrated beyond doubt that the concept of ‘business as usual’ was completely fallacious, and they were disturbing to those who wished this were not the case. The report

⁷⁹ Ibid., p.11.

⁸⁰ Ibid., p.6.

⁸¹ Ibid.

⁸² Ibid., pp.6-7.

⁸³ Ibid., p.7.

chose to ignore, although the fact was not secret, that large scale withdrawals of this short money had been occurring since March 1938, under the threat of war, and stated that: “In spite, therefore, of the apparent strength of our reserves, we cannot regard the position of sterling as unassailable”. This curious unreality continued with the statement that, despite the previous assertion that the balance of payments was immaterial to the state of the reserves: “A series of adverse balances of payments which led to a substantial loss of gold might set in motion a withdrawal of short-term funds from London which would quickly exhaust the resources available to meet it”.⁸⁴

The detachment of the Committee from the full urgency of the situation might be explained by the fact that not all its members were being absolutely frank with their colleagues. Sir Frederick Phillips, writing to Catterns at the Bank of England during the preparation of the Report informed him of “some suggestions which Keynes has put in to the Economic Advisory Committee: you will appreciate on reading them how careful I am not to impart indiscreet information to that body”.⁸⁵ However, the reality of impending war could not easily be ignored. In a Treasury summary of the report, Phillips noted that “the Committee of course have not got access to the position of the Exchange Equalisation Account but they conclude that the situation is unsatisfactory and that anything possible to improve our adverse balance of payments should be effected as rapidly as possible”.⁸⁶

Phillips’ comment about indiscreet information might be read in the light of the Committee’s recommendation for action to be taken in the event of a drain of reserves: the Government could well “have to consider protecting the sterling exchange by the most stringent and unsatisfactory form of exchange control, that is to say, exchange control which applied to foreign, as well as to British capital”.⁸⁷ This was the rub. The report concluded that with regard to the outflow of “the liquid resources of nervous foreign holders...it is doubtful whether there are appropriate financial measures for checking it, short of exchange control”.⁸⁸ The stark position was that, because such movements “depend primarily on

⁸⁴ Ibid.

⁸⁵ PRO T 160/771/F19429. Economic Advisory Council. Committee on Economic Information. 26th Report. Problems of Rearmament. Letter from Sir Frederick Phillips to B.G. Catterns, 29th November 1938.

⁸⁶ Ibid. Treasury Summary of the Committee on Economic Information’s 26th Report, 21st December 1938.

⁸⁷ CAB 24/281, p.300. CP 296(38) Problems of Rearmament, p.7.

⁸⁸ Ibid., p.10.

political confidence and secondarily on the expectations held abroad as to the future of the sterling exchange”, the British authorities faced a very clear choice: “Unless and until we are prepared to impose a general exchange control, we have to let these resources go to the extent they want to”.

Having concluded that “any available action under the other heads”, however desirable, would be “liable, by indicating nervousness on our part, to accentuate this drain”, the Committee then expressed the incredible opinion that the loss of all short term balances was preferable to the unpleasantness of exchange control. It stated that “the amount of such withdrawals is not unlimited” and that: “They are a perpetual source of danger which we are perhaps better without.”⁸⁹ In short, the British Government’s expert economic advisors, with full possession of the facts of the physical situation concealed by its Treasury members, had concluded that the loss of the bulk of Britain’s reserves was preferable to exchange control, and that the problem of falling reserves would cease when all these reserves had gone.

The Committee on Economic Information’s report was supplemented in January 1939 by a statement to the Cabinet from the Chancellor of the Exchequer on currency legislation.⁹⁰ In this, Simon sought to explain the transfer of the Bank of England’s monetary gold stocks into the Exchange Equalisation Account for the support of sterling, and at the same time obtain the Cabinet’s permission to legislate for a compensating increase in the issue of paper money. This statement, taken with the Committee on Economic Information’s effort, demonstrated the manner in which defence, finance and the international political situation had become utterly interwoven. However, it also indicated the Government’s continuing determination to keep a tight hold on Britain’s response to the situation. The statement was merely for the information of the Cabinet, which was invited to give retroactive approval to official action and authorise the consequent increase in the fiduciary issue. Simon did not raise the possibility of any remedial action save that which he had already taken, nor were opinions sought on the matter.

The statement was prepared by Treasury civil servants and a draft was sent to the Cabinet Secretary, Sir Edward Bridges, by Hopkins. This draft was “a copy of the stuff which we have suggested to the Chancellor that he should say at the Cabinet tomorrow. The

⁸⁹ Ibid.

⁹⁰ PRO CAB 23/97, p.39. Cab 1(39) Conclusion 9. Most Secret. Not Circulated. Currency Legislation. Statement by the Chancellor of the Exchequer, 18th January 1939.

Chancellor has not said whether he likes it or not. I assume that he will talk more or less on these lines.”⁹¹ In fact the draft statement formed the Cabinet record, which was regarded before the event as a matter of some sensitivity. Hopkins explained to Bridges that “we have suggested that the Cabinet Minute about the statement should go on the Secret Cabinet file, but should not be circulated”. In a marginal note expanding this statement, he added: “comparisons with 1931 not good for too wide circulation”.⁹² This is puzzling because, as we have seen, the Committee on Economic Information, of which Hopkins was a member had openly made such a comparison in its previous report.

The contents of the Chancellor’s statement were nevertheless embarrassing for the Treasury, and consisted of a weak attempt to reconcile appalling facts incompatible with the fourth arm mentality. Simon revealed to his colleagues the full extent of Sterling losses since April 1938, and while he did not comment on the proximity of this date to the Anschluss, he did concede that the prospect of war was affecting the exchanges. In a neat attempt at self-justification he drew attention to the flow of capital to London in recent years and stated that: “The £800 millions worth of gold which we held last April represented in considerable measure the accumulation here of refugee money of this kind”,⁹³ and in a note added to the draft by Hopkins stated that this “gave to our financial position an appearance of strength which was in part misleading”.⁹⁴ Simon went on to say that: “Since last April anxieties on the part of foreigners as to the fate of this country in the war which they regarded as impending had led to a great efflux of these funds, chiefly to America, which was regarded as a safe repository”.⁹⁵ The point can be made that the ‘appearance of strength’ which this fugitive money was giving to the United States was anything but ‘misleading’.

Simon confessed to a bitter blow for fourth arm advocates when he lamented that: “One would have hoped that with the Munich settlement the drain on the pound would have subsided, but that was not what had occurred. It appeared only too evident that the view continued to be persistently held abroad that war was coming and that this country might

⁹¹ CAB 23/97, p.35. Cab.1(39) Appendix. Letter from Hopkins to Bridges, 17th January 1939.

⁹² Ibid.

⁹³ CAB 23/97, p.39. Cab.1(39) Conclusion 9, p.1.

⁹⁴ Draft enclosed, *ibid.*, p.37.

⁹⁵ *Ibid.*, p.1.

not be ready for it”.⁹⁶ Simon then turned his reasoning to add that “lying behind that anxiety there was, of course, the further anxiety created by the obvious worsening of our financial position, by the heavy increase in the adverse balance of our trade, and by the growth of armament expenditure”.⁹⁷ This muddied the waters and concealed the significance of the next statement that: “In the three months from the 1st October the drain had continued, the value of the pound falling from a top figure earlier in the year of 5 dollars to a figure little above 4.60.” Simon was suggesting that the fall in the pound was equally attributable to conventional economic causes beyond the control of the Government, while linking the reserve drain firmly with fear of war. He thus separated cause and effect, and more than implied that Government was an entirely passive spectator, with no hand in events. The Chancellor then made the comparison with earlier times in stating that he “was afraid that it must be said that the recent conditions had been painfully reminiscent of those which obtained in this country immediately prior to the financial crisis of September, 1931”.

Apart from the fact that sterling was under pressure, conditions in 1939 bore absolutely no relation to those of 1931. In comparing a purely economic crisis with one based on impending war, Simon served the Treasury case in a number of ways. The Government could claim the crisis to be beyond its control, and the Cabinet could be prepared to accept the squandering of the gold reserve as an economic response to an economic crisis. It was a reckless gamble given that Simon had acknowledged that nothing had changed in the circumstances that were responsible for the situation, but he stated that he “hoped that this measure would have a good effect, though another shock would await when the figures of our finances for the next Budget came to be portrayed”. Simon felt able to state that: “The big transfer from the Bank of England to the Exchange Equalisation Account appeared to have had a considerable effect on ‘bear’ speculators, as showing that we had every intention of maintaining the pound.”⁹⁸ The impact on bear speculators was no doubt considerable, because as long as Hitler continued to act as he had to date the Government’s action ensured that they stood to make spectacular fortunes. At no point in the Chancellor’s statement did he mention the possibility of exchange controls.

⁹⁶ Ibid., pp.1-2.

⁹⁷ Ibid., p.2.

⁹⁸ Ibid.

It has been argued that the Treasury adapted its view to face changed circumstances in 1939, but the evidence suggests that the Treasury made determined efforts to uphold the fourth arm policy even as it became impossible for the Government to resist demands for increased armaments expenditure. In January 1939, the war scare over an imagined Nazi threat to Holland provided the occasion for a major Government retreat. Initially this seemed unlikely, even when measures for the acceleration of defensive preparations were put on the agenda of the Foreign Policy Committee, for immediate authorisation without further reference to Cabinet. It was felt, however, after “general discussion” in Cabinet “in regard to the state of our defensive preparations as compared with the position last September, and to the steps which could be taken to accelerate production” that:

The view generally expressed was that virtually all the action which could be taken to accelerate production over the next two or three months had already been taken, and that any extension of the range of our defensive preparations which it might now be necessary to consider could not affect the position in the immediate future.⁹⁹

The Cabinet thus concluded that:

while there was little scope for acceleration of the Defence Programme over the next two or three months, it was important to take all practicable steps to put the Defence Services into a state of readiness to meet the contingency of a possible emergency in the near future.¹⁰⁰

In the Foreign Policy Committee, chaired by Chamberlain, these practicable steps amounted in their entirety to certain measures to improve the A.A. position and a request to the King not to travel to Canada on the battlecruiser *Repulse*, as preparations for the Royal quarters involved the removal of anti-aircraft equipment. The King would be asked to charter a liner instead.¹⁰¹

This level of complacency was not sustainable, however, and at the Cabinet meeting on 2nd February, Hore-Belisha presented proposals for the equipment of the Army on a continental scale. On political grounds, with the French demanding such a move and British public opinion hardening, this demand would prove to be irresistible, and the occasion is regarded as a decisive change in policy. However, when the proposals were put forward

⁹⁹ CAB 23/97, p.62. Cab 2(39) Cabinet Minutes, 25th January 1939, p.10.

¹⁰⁰ Ibid., p.11.

¹⁰¹ PRO CAB 27/624, p.133. Thirty Sixth Meeting of the Cabinet Foreign Policy Committee, 26th January 1939.

both Chamberlain and Simon resisted them and the Cabinet meeting was the occasion for a reiteration of the fourth arm policy. Chamberlain “said he thought that this was a rather new conception so far as our plans were concerned”.¹⁰² He pointed out that although Hore-Belisha “had described his proposals as modest”, nevertheless “the total cost of the items in the Secretary of State’s paper amounted to £81 millions”.¹⁰³

Noting that Simon “would deal with the financial side of the proposals”, Chamberlain carefully prepared the ground for him by stating that:

Speaking generally, he thought it was clear that an unanswerable case could be made out for increased armaments in every arm, if the financial aspect of the proposals was ignored. But finance could not be ignored since our financial strength was one of our strongest weapons in any war which was not over in a short time. The Chancellor of the Exchequer would, no doubt, say whether he thought that we could continue adding to defence expenditure at the rate of the last few months. As a former Chancellor of the Exchequer, the financial position looked to him extremely dangerous.¹⁰⁴

Bearing the scale of Britain’s financial commitment in mind he thought that the French should be told not to expect the creation of a large British Army.

Simon took his cue and reminded the Cabinet of the agreed basis of finance for defence. He “said that it was necessary to include financial resources among our total available resources”,¹⁰⁵ in other words as a fourth arm of defence. He noted that Hore-Belisha’s proposals at £81 million “were...broadly equivalent to the whole cost of the Army in 1937-38”, at £82 million. They also amounted to less than a quarter of the sum transferred from the Bank of England’s gold reserve for the defence of sterling, but this was not mentioned. Simon added that in the next financial year, the estimates in “total for the three Defence Services would be over £500 millions”¹⁰⁶ and that he, therefore, “entirely accepted the view that, in the present circumstances, there was no alternative but to use borrowing powers.”¹⁰⁷

¹⁰² Cab 23/97, p.175. Cab 5(39) Cabinet Minutes, 2nd February 1939, p.6.

¹⁰³ Ibid., pp.6-7.

¹⁰⁴ Ibid., p.7.

¹⁰⁵ Ibid., p.8.

¹⁰⁶ Ibid.

¹⁰⁷ Ibid., p.9.

Despite this unhappy departure from strict fiscal probity, incremental borrowing left the fourth arm philosophy intact at the cost of weakening its boundaries. Simon's greater concern was "that there were limitations to what we could borrow. It was already clear that the existing borrowing powers were inadequate and shortly he would be putting before his colleagues proposals for doubling the existing borrowing powers. Further, it was clear that even this increase would not meet the aggregate defence needs over the 5 years to March, 1942." Simon then sought to alarm his colleagues with the budgetary implications of defence expenditure. He said that "for the financial year 1938-39...he had provided for the largest sum ever provided out of taxation by this country for defence."¹⁰⁸ Interestingly, 'out of taxation' was added by hand to the record in place of the original 'for', indicating that the authors of Simon's statement had overlooked the First World War in their eagerness to make a point.

At any rate Simon anticipated "a substantial Budget deficit" in the current financial year. He further stated that:

In the ensuing year there would be a vast gap to bridge between the sum available for defence from the Budget and a defence expenditure of over £500 millions. Further, he was extremely anxious as to the position in later years. The peak year of defence expenditure was always receding, and under present plans the rate of defence expenditure in 1940-41 would exceed defence expenditure in 1939-40. Further, it was now becoming clear that the maintenance of the defence forces now being equipped would cost an annual figure far in excess of any figure which we had ever raised out of revenue to meet defence services. It would be substantially in excess of £300 millions a year. It was out of the question to conemplate [sic] borrowing for a continuing annual charge. It was impossible to escape the conclusion that we were advancing to a position in which the financial situation would get altogether out of hand.¹⁰⁹

It was clear to Simon that something had to give. Ignoring the possibility that measures appropriate to wartime might be considered, he made an impassioned plea for business as usual and the restriction of defence expenditure. He reminded his colleagues that: "A year ago, the Cabinet had very deliberately decided to work on the ration principle and had reached a conclusion that a total of £1650 millions should be made available for defence purposes". Since Inskip "had been given the task of allocating this sum", Simon

¹⁰⁸ Ibid.

¹⁰⁹ Ibid., pp.9-10.

noted that

matters had developed rapidly and it was clear that the total defence expenditure which we were now faced with over five years, April 1937 to March 1942, enormously exceeded the total of a year ago. Every addition, such as was involved in the proposals now made by the Secretary of State for War added to our already gigantic financial burden for defence.¹¹⁰

The rapidly increasing scale of expenditure, like Simon's other great problem of disappearing reserves, was a symptom of impending war. This did not matter, however. Simon "did not dispute" the case that Hore-Belisha's proposals "could properly be represented as both urgent and necessary. But had they any better claims to be so described than, for example, proposals in regard to further financial assistance to agriculture and shipping", and other proposals. Simon

was satisfied that, not only he himself but all his colleagues would find themselves greatly embarrassed by the problem of how all these proposals could possibly be financed. He agreed with the Prime Minister's view that our financial strength was an element of the greatest importance, but he was gravely disturbed lest that strength might be slipping away.¹¹¹

Simon then mentioned exchange difficulty in support of his argument:

During the previous autumn he had been faced with serious difficulties in maintaining the level of the pound. Once a loss of confidence showed itself on a wide scale, there would be no means of arresting it. We might be faced with a financial crisis as grave as that of 1931, but with the added difficulty that the foreign situation was now far more serious.¹¹²

He "felt bound to ask whether it was really necessary to adopt all the proposals made by the Secretary of State for War, at any rate, in their present form, and whether a substantial reduction could not be effected".¹¹³

7:10 *Policy Consumes Itself*

Simon's argument revealed many things. His front in Cabinet with Chamberlain was intact and both were as convinced of the fourth arm argument as in 1937. Simon's inability

¹¹⁰ Ibid., p.10.

¹¹¹ Ibid., pp.10-11.

¹¹² Ibid.

¹¹³ Ibid.

to comprehend the seriousness of the international situation had the consequence that, as his performance in the 2nd February Cabinet Meeting showed, he had no idea that the currency crisis and a growing budget deficit were related aspects of the same problem. He seemed to feel that financial difficulty was coincident to the threat of war rather than a feature of it. This latter fact was obvious enough to be mentioned by Stanley and Halifax, who both felt that war was imminent. Their interventions, however, demonstrated that their opposition to fourth arm thinking was far from homogeneous, and that two distinct schools of thought were emerging within Cabinet. Dangerously for Chamberlain, they were both predicated on fourth arm logic.

Halifax articulated a point of view that was to become a fall back position for economic liberals, the ultimate logical outcome of which was total economic dependence on the United States. He “was satisfied that the present state of tension could not last indefinitely and must result either in war or in the destruction of the Nazi regime. We could argue, therefore, that we were borrowing in respect of a period which could not last indefinitely”.¹¹⁴ He was to develop this position in favour of immediate expenditure to answer criticism of the dangers it might present in the event of a long war, stating during the climactic July Cabinet, at which the Treasury expounded its position, that he thought the Treasury gave “too gloomy a view”. If a war “should last longer than we anticipated, it would be reasonably safe to assume that when the war had continued for some time the attitude of the United States would be sufficiently favourable to us to enable us to win the war”.¹¹⁵ This was a precarious hope on which to base policy, but the course of appeasement policy to this point left Chamberlain’s Government with no effective answer.

The position adopted by Halifax effectively enquired as to the point of the financial sacrifices made to conciliate the Americans, if it was not intended to rely on them in war. It harmonised with the comforting illusion that Britain could not lose in its dealings with the United States. The currency and trade agreements had seemed to point to the ultimate restoration of a global trading system, itself a liberal dream. If war were avoided and a settlement with Germany were reached, this momentum could only be increased, while the pressure on sterling caused by fear of war would of course be removed. If war came, on the other hand, the United States would provide the means of victory and yet leave the existing

¹¹⁴ Ibid., p.13.

¹¹⁵ PRO CAB 23/100, p128. Cab.36(39) Cabinet Minutes, 3rd July 1939, p.18.

structure of British power intact. War would involve not a change of economic outlook, but the involvement of the United States to save the current system. Halifax, though, “was the first to admit his relative ignorance of financial matters”¹¹⁶ and noted in his diary, when the consequences of such ignorance had been revealed, that the area formed “one of the subjects that I made up my mind long ago I should never understand, and so I do not make any attempt”.¹¹⁷ This though, was what made his intervention dangerous to existing policy, which was designed to beguile the ignorant, rather than be usurped by them.

The basis of Halifax’s reasoning, that the crisis was at hand rather than simply a possibility, had broad support. Stanley made this clear: “The Foreign Secretary had expressed what many of them were feeling. From one point of view we were already at war and had been for some time”.¹¹⁸ The illiberal implications of this realisation had been stressed by Hore-Belisha in March 1938, and in a more emphatic statement by Hermann Goering, expressed fully two years earlier during a speech to a group of German industrialists in which he asserted that “we live in a time when battle is in sight. We are already on the threshold of mobilisation and we are already at war. All that is lacking is the actual shooting.”¹¹⁹ Goering went on to tell his audience that as “far as securing foreign exchange was concerned, it was quite immaterial whether the provisions of the law were complied with or not, provided only that foreign exchange was brought in somehow”.¹²⁰

Stanley’s line of reasoning was developed along different lines to that of Halifax, though the final version of his argument was also expressed in the July cabinet. Stanley thought: “The point would ultimately come when we should be unable to carry on a long war. There would, therefore, come a moment which, on a balance of our financial strength and our arms strength, was the best time for war to break out.”¹²¹ Stanley’s logic was potentially more devastating to policy than that of Halifax, which essentially claimed that Britain could fight or spend to deter, because it contained a grim imperative. According to

¹¹⁶ A. Roberts, *The Holy Fox, A Biography of Lord Halifax* (London 1991), p.297.

¹¹⁷ Halifax Diary, 19th October 1945, quoted in Roberts, *The Holy Fox*, p.297

¹¹⁸ CAB 23/97, p.182. CP 5(39) Cabinet Minutes, 2nd February 1939, p.13.

¹¹⁹ Goering to a meeting of the Reichs Gruppe Industrie, 17th December 1936. Quoted in A. Bullock, *Hitler, A Study in Tyranny* (London, 1954), p.358.

¹²⁰ Ibid.

¹²¹ CAB 23/100, pp.130-131. Cab.36(39) Cabinet Minutes, 3rd July 1939, pp.20-21.

this view, British finances did matter, as the Government said, but Britain must fight while she still could. War would bring with it exchange controls and an end to the pointless and debilitating drain of foreign exchange and gold. In the absence of conscious political action the same was not true of undeclared war, and as long as the British attempted to maintain normality, the loss of gold and currency to the United States would continue, with each day bringing complete dependence on the United States measurably closer.

Neither Stanley nor Halifax doubted Simon's financial premise. It did not seem to occur to Stanley that policy might change in peacetime, and Halifax hoped for American charity in the worst case. Because of this, however, they both struck at the heart of fourth arm policy. A danger thus arose that fourth arm logic might actually drive Britain precipitately into war rather than preserve 'business as usual' for the peace saved by Chamberlain's appeasement policy. Ultimately, the 'now or never' point of view represented by Stanley did help to bring war about, and ironically in doing so under fourth arm policy made the Halifax position prophetic.

Witnessing the seeds of this dissent in Cabinet as Hore-Belisha stated his case, Chamberlain, perhaps perceiving that his own and Simon's arguments were turning in upon themselves, urged that the new Minister for Coordination of Defence, Chatfield, "should have an opportunity of considering these proposals before any final decision was reached". This breathing space had of course been provided by the Prime Minister's forcing of Inskip's resignation days previously.

The confusion evident in official circles as to the potentialities and dangers of Britain's financial position is often evident in the writings of historians, and much of the Treasury's alarmism, especially concerning the external position, continues to be taken at face value or misinterpreted, even in works critical of the National Government's progress in rearmament. Critics have tended to adopt either the Halifax or the Stanley position, sometimes both, and thus remain within the confines of fourth arm logic. It has been written, from the Stanley perspective, that, despite the defeats it suffered over increased defence expenditure in 1939, the Treasury, "like the Government...chose to carry on as though nothing had changed, ignoring the first signs of economic disintegration that were embodied in the country's increasing loss of gold."¹²² As has been seen, however, the gold loss had little to do with the

¹²² R.P. Shay Jr., *British Rearmament in the Thirties: Politics and Profits* (Princeton, 1977), p.246.

state of the economy, and was largely a function of the Government's determination to continue 'as though nothing had changed'.

The accelerated gold drain was in no way the result of the rearmament process,¹²³ as the Treasury itself acknowledged that the drain caused by the deficit on the balance of payments' current account was supportable for years. Like accelerated rearmament itself, the gold loss was the result of a worsening diplomatic situation, but unlike increased expenditure which created its own impetus against the fourth arm policy, the gold loss could only have been halted by a conscious decision to abandon this policy, and while the Treasury fought the former it would hardly take action with regard to the latter.

A directly causal link has been assumed along the lines that "appeasement failed and war became imminent, rationing was abandoned and gold fled Britain's shores",¹²⁴ by both critics and defenders of the Treasury. In accordance with this logic, critics adopt the Halifax perspective and thus the fourth arm system has been praised as enabling Britain to survive until U.S. aid became available. Indeed, much of the autonomous flight of capital instigated by foreigners has been ascribed to the fear that when war came Britain would 'freeze their assets'. This, though, would have been so far from fourth arm policy that even in 1956 the official history of financial policy reported uncritically the view that on the outbreak of war no power on earth could be expected to prevent these funds leaving Britain, "at some fairly early stage in the proceedings, and to do so with such certainty that no step taken by the British authorities could influence their withdrawal".¹²⁵ This view relies on uncritical acceptance of Treasury interpretations of facts that are by no means compatible with such analysis.

It is not necessary to accept the view that in Britain's position of gold haemorrhage, the only possibilities were to ration expenditure or fight quickly. As we have seen, the British Government was unwilling, not unable, to enforce effective exchange control and thus give Imperial war potential a chance. As growing Cabinet dissension showed, Chamberlain could no longer rely on argument to sustain his policy, which was now under

¹²³ Even today this misconception persists, a recent study maintaining, with incorrect figures, that: "This sort of expenditure did put great strain on the economy. In June 1939, Britain's gold reserves fell to £300 million, which represented a drop of £800 million from April 1938". F. McDonough, *Neville Chamberlain, Appeasement and the British Road to War*, (Manchester, 1998), p.42.

¹²⁴ Shay, *British Rearmament*, p.280.

¹²⁵ Sayers, *Financial Policy*, p.229.

attack even according to its own logic. As 1939 progressed, therefore, it would be necessary to rely on naked political force to maintain the fourth arm policy at home, and perhaps more importantly, on secrecy. To abandon the fourth arm policy would have been to reveal shocking information, as was soon to be realised when some attempt at economic preparedness had to be seen to be made.

CHAPTER 8

“NOT A DAMNED BIT GOOD”: THE CONCEALED CATASTROPHE, 1939

By the spring of 1939, the Government's continuing belief in the fourth arm policy was tested by ever more adverse circumstances. Hitler's move into Prague in March imposed a more bellicose public stance on Chamberlain but, as has been seen, even natural supporters of 'business as usual' were beginning to spoil for a fight. This imposed a ticklish problem on the Government machine, which had neglected warlike economic and financial preparations in good faith that Chamberlain would secure peace. An early war would have the advantage of forcing a change in policy while disguising the full picture of unpreparedness that existed. This was possible because much remained unknown outside a small circle of officials and the inner-Cabinet, for instance the full story of the gold drain and the paucity of even contingency planning for war. Similarly, if normality were by some miracle restored, these facts need never come to light. However, in what appeared to be a period of impending war, the Government was faced by increasing pressure from influential groups outside the solely political world for far reaching economic measures, and the situation demanded at least the appearance of action. The expert job of stonewalling that occurred ensured that when the roof did fall in August, the near-immediate outbreak of war concealed the traces of what had gone before with such thoroughness that even 60 years later the story has not been fully uncovered.¹

8:1 *The “large blank spaces on the map”*

In April 1939, Sir John Anderson, the Lord Privy Seal and the Minister most closely identified with Civil Defence, wrote to inform the Chancellor that he had received a memorandum prepared by a prominent group of industrialists headed by Sir Arthur Salter, a fellow of All Souls and M.P. for Oxford University, entitled “Economic Defence”.

¹ It is still maintained that so far as the economic and financial activities of the British Government concerned wider policy, they were driven by narrow national self interest. It is argued here that although self interest was certainly evident it was hardly patriotic, and that this enduring perspective is the reverse of the truth. F. McDonough, *Chamberlain, Appeasement and Britain's Road to War* (Manchester, 1998).

Anderson noted that it was a document “which I am assured has influential backing”.² It called for an “Economic General Organisation Staff to which industry, trade and finance could have access on questions of economic defence in time of war” and asked if “the Government would welcome the formation of an Association for economic defence, representative of industry, trade and finance, to work in conjunction with and assist the official organisation suggested”.³

It was difficult to ignore this appeal in the political circumstances prevailing, especially as, Anderson noted, the memo “practically synchronises with a very important memorandum put forward by the Prime Minister’s Panel of Industrialists on ‘Industry in War’”.⁴ The two memoranda were connected, as the Salter paper had been forwarded by Colonel Greenly, the chairman of the Prime Minister’s Panel, and Anderson saw that action would be necessary. He suggested “that the two should be considered together, preferably by an ad-hoc Committee of the Committee of Imperial Defence”. Anderson noted that the Salter memorandum

suggests certain measures for the fuller development of economic planning for war and for bringing outside opinion into closer touch with Government policy. While I do not feel particularly drawn to the specific course of action suggested, I certainly feel, and have felt for some time, that it would be of great advantage to clew up more firmly the various measures that have been under examination as separate problems, to fill in certain obvious blanks and to place commerce and industry in a position to relate their own plans more closely and more intelligently to the policy of the Government.⁵

Though Anderson had set the ball rolling, control of the matter soon passed into the hands of Sir Horace Wilson, the Government’s Chief Industrial Adviser, who canvassed the views of leading Treasury civil servants. Between them they sought to absorb these new demands within the existing machinery of Government. Hopkins agreed that “there is everything to be said for some type of organisation wh. Wd. [sic] coordinate the action of the different Depts in this very important field and survey the results as a whole.”⁶ This

² PRO T 160/885/F17545. Arrangements Leading up to Lord Stamp’s Survey of War Plans in the Economic and Financial Spheres. Letter, Anderson to Simon, 8th May 1939.

³ Ibid. Memorandum by Salter and Schuster. “Economic Defence”.

⁴ Ibid. Anderson to Simon, 8th May.

⁵ Ibid.

⁶ Ibid. Memorandum by Hopkins, 17th May 1939.

would however be kept within Government and would “not of course be the kind of thing Mr. Falk and his colleagues would like - a lot of economists operating in vacuo - but perhaps an organisation similar to that wh. [sic] has been run by Sir A. Robinson in connection with supply”. In a marginal note Warren Fisher agreed: “What is wanted is a civil CID (the original C.C.R. was intended to be this). What is not wanted is a panel of economists and doctrinaires.”

After the matter had been thoroughly considered by civil servants, Anderson’s idea for a full Committee had been completely abandoned and he was persuaded to accept instead an interdepartmental survey of financial and economic matters. A draft for Simon was discussed after Anderson’s acquiescence had been obtained and “it was arranged that the next step should be a talk on the draft between Sir Horace, Sir William [Brown], Sir Richard Hopkins and Sir Frederick Phillips”.⁷ Wilson then wrote to Simon that

Sir John does not wish to press his suggestion for a C.I.D. Committee. He would be content - and indeed would, I think, prefer - that there should be selected someone with the necessary knowledge and experience to undertake a review of the plans and proposals that have hitherto been prepared by the various Departments (including the Treasury) for the purpose of keeping the country going during war, in order to advise whether the various plans and proposals are consistent in themselves with one another and at the same time adequately cover the ground.⁸

After this was done: “The report made as a result of the review, in addition to indicating defects or gaps that might have been perceived should include recommendations as to how these defects and gaps may be dealt with.”⁹

It had been hoped, naturally, that “it would be possible to select a senior civil servant, but there does not seem to be anybody available who has both the necessary knowledge and experience and is at the same time sufficiently free”.¹⁰ In the absence of such a figure, Wilson and his colleagues had decided upon Lord Stamp, who as a director of the L.M.S.

⁷ Ibid. Draft proposal for Simon, 10th June 1939.

⁸ Ibid. Wilson to Simon, 14th June 1939.

⁹ Ibid.

¹⁰ Ibid.

railway could only do the job on a part-time basis.¹¹ He requested the assistance of the economists Professor Clay, then working at the Bank of England, and Hubert Henderson. Wilson arranged the release of the former and the acceptance of the latter. There were indeed compelling reasons, as far as the Civil Service was concerned, why a more determined and urgent attitude to the problem could not be entertained. The Salter memorandum had noted that:

One major field in which industry is entirely uninformed concerns finance. How is the next war to be paid for? Is it to follow the previous method of 1914-18 viz. of business as usual, with resort to borrowing on a grand scale, accompanied by additional taxation to cover the annual service of the new loan? Or is there, in the alternative, to be a war economy in which all productive and other services are to be placed at the disposal of the country for war purposes?¹²

In truth, the Government had no idea. Wilson had written to Hopkins that “Stamp’s main functions would be I think to deal with the large blank spaces on the map which represent at present our policy for controlling imports, for encouraging exports and for controlling the general course of production in the event of war”.¹³ The creation of Stamp’s Survey was a most discreet confession that a body for the direction of the fourth arm in war could not be formed, as the information it would need to function had not been collected or simply did not exist. The subsequent transmutation of the Survey into a war directing body, and the lack of comment on the Government’s total unpreparedness in so important a field indicate that Wilson’s objectives were achieved.

On 22nd June, A. Nevil Rucker, Chamberlain’s Parliamentary Private Secretary, wrote to the Cabinet Secretary, Bridges, that:

I have discussed the whole matter with H.J. [Wilson] and he thinks that it would be best not to take action at your end, at all events at present. He has had discussions with the departments concerned on

¹¹ There were other attractive reasons for choosing Stamp, who chaired the Committee on Economic Information and was a former civil servant and a director of the Bank of England. As such he was “a principal link between the the academic world and business and Whitehall”, and could not, therefore, be described as a hostile outsider. Wilson wrote to him appreciatively, noting that “ the Prime Minister, the Chancellor, the Lord Privy Seal, and the President of the Board of Trade are in agreement with the plan and have blessed you for coming to look after it for us”. This genial tone continued when Wilson explained that Stamp’s work would begin with “a little meeting in this room of yourself, Henderson, Clay, Hoppy, Phillips and myself”. L.G. Wickham-Legg & E.T. Williams (eds), *Dictionary of National Biography, 1941-1950* (London, 1959), p.818; T 160/885/F 17545. Letter, Wilson to Stamp, June 1939.

¹² T 160/885/F17545 Memorandum by Salter et al, “Economic Defence”.

¹³ Ibid. Wilson to Hopkins, 12th June 1939.

the wider questions of industrial planning and he thinks that this matter should continue to be examined inter-departmentally rather than that an ad-hoc Committee should be set up. He does not think we need take up at the moment the question of a special Department under the Board of Trade or the Lord Privy Seal.¹⁴

In July Wilson stated the position to Bridges more bluntly, when the latter sent him papers that had been collected for “circulation to the sub-committee on the Central Control of Business”. Bridges told Wilson that: “These papers do not cover the whole ground. For example, they do not cover the measures for the control of exchanges, or for the control of new capital issues. These are Treasury matters, and while they are listed in the War-Book, we have no details of them. You will, no doubt, obtain information of this from the Treasury.”¹⁵ Wilson replied of the papers that “in my view they only exhibit the bareness of the ground in our particular sphere of war planning”.¹⁶

When the Stamp Survey convened, it wasted no time in seeking the views of the Treasury’s leading civil servants and Hopkins, Phillips and Waley attended its second meeting. It “emerged” at this meeting that: “No central planning body had been established by the Government for the consideration of war plans in the economic and financial spheres, each Government Department being charged with the responsibility for preparing its own plans”.¹⁷ This dissipation of effort meant that there were “in many cases plans affecting two or more departments, and in these cases the work was done mainly through the medium either of inter-departmental committees and subordinate organisations of the Committee of Imperial Defence” This was in fact a description of the labyrinthine system of war planning bequeathed by Hankey, but the interesting point, as described earlier, was that the financial dimension was entirely distinct from the rest of this tortuous machinery.

The Survey noted that:

As regards the Treasury itself, their plans were in the main self-contained. The Treasury proposed to use the Board of Inland Revenue as agents in regard to questions arising from the

¹⁴ Ibid. Rucker to Bridges, 22nd June 1939.

¹⁵ Ibid. Bridges to Wilson, 1st July 1939.

¹⁶ Ibid. Wilson to Bridges, 4th July 1939.

¹⁷ PRO CAB 89/1. War Cabinet. Survey of Economic and Financial Plans. Proceedings P(E&F). 1st to 70th MTGS 1939. Vol.1: Survey of War Plans in the Economic and Financial Spheres. Second Informal Meeting.

destruction of property, and the Bank of England as agents for exchange control. The Treasury were, therefore, not faced with the necessity of building up a special staff and organisation of their own.¹⁸

The Treasury thus stood aloof and unaccountable, and given that it was the Government's only point of contact with wartime financial machinery, and its sole conduit to the Bank of England, it might be said that far from the Bank being the Treasury's agent, the Treasury was in fact the Bank's representative on earth. The Bank's misgivings about the Treasury's exchange policy were thus unlikely to reach a wide audience.

The Treasury was able to give the Survey the impression that all was under control. It stated that:

General exchange control would be essential from the outset; and this would be operated in conjunction with the Board of Trade measures for the control of imports. In the operation of exchange control bankers and bullion brokers would be appointed as authorised agents; the necessary forms, etc., had already been printed; and the Dominion Governments informed privately.¹⁹

These confident assertions disguised the patchy nature of existing plans and the Treasury's abiding reluctance to enforce comprehensive exchange control, even on the outbreak of war. Because of the Treasury's lack of accountability, these defects would only then become apparent.

In the meantime the Stamp Survey was provided with draft copies of various forms and a Bill to be put before Parliament on the outbreak of war. Interestingly, a summary entitled "Treasury Financial Arrangements for War" to be employed "to deal with the first shock" was also provided²⁰, and this document is highly revealing, both of the inadequacy of existing arrangements and the great potential for positive action that might have resulted from a different attitude. It began with the less than ringing assertion that: "According to present intentions, foreign exchange control will be imposed in the United Kingdom immediately on the outbreak of war, for the purpose of economising and using to the best advantage the gold and foreign exchange resources of the country".

If 'present intentions' did not change and controls were introduced, the document

¹⁸ Ibid.

¹⁹ Ibid.

²⁰ PRO CAB 89/3. War Cabinet. Survey of Economic and Financial Plans. Memoranda P(E&F), 1-14. 1939. Vol.1: Survey of War Plans in the Economic and Financial Spheres. Memoranda furnished by the Treasury, Reference W.P.(E&F) 2nd Meeting, Conclusion 2, 11th July 1939.

soon showed that they would not be comprehensive. The capital of non-residents could be removed from the country, subject to applications “to be considered individually by the Bank of England with a view to permitting such withdrawal of capital to be made in an orderly and controlled way”. To ease this process: “If dollars are not available, non-residents may be allowed to ship gold if it is possible for them to secure transport.” This constituted an astonishing gap in the wall of exchange control to which the word ‘loophole’ does scant justice. The document explained that “accounts of non-residents will not be blocked, as they are under German and other exchange control systems: this may lead to a ‘Black Bourse’ rate for sterling, but the Treasury have felt extreme reluctance to block ‘non-resident’ accounts”.²¹

Having revealed its inclination to shrink from firm action, the Treasury then gave tantalising hints of the extent of the possibilities which it was unwilling to exploit. The document went on to state that the “Dominion; Colonial; etc., Governments have been informed on the above lines and asked to consider to what extent [sic] and with what modifications a similar scheme should be introduced in other parts of the British Empire”.²² In contrast to the deferential tone that the British government has been accused of adopting towards the Dominions in diplomatic matters, this request was peremptory:

It has been suggested to the Authorities concerned that within the [sic] British Empire, an area dominated by British sterling, local exchange controls must be imposed in order to protect the local currency from the risk of a capital flight which if not checked by a control would involve either a [sic] depreciation of the exchange or a drain on sterling funds to support it.²³

Here the Treasury was baldly stating the totality of sterling area dependence on Britain, and it included an extract from the communication in question. The recipients were told that

‘arrangements will be required to ensure that the entire credit facilities of each area will become available for the financing of exports necessary for the conduct of the war and other essential purposes. It is obvious that the more complete the local control in any area is, the greater will be the latitude permissible for United Kingdom transactions with that area and the less hampering will be the financial formalities between that area and this country. Pending

²¹ Ibid., p.12.

²² Ibid., pp.16-17.

²³ Ibid., p.17.

the conclusion of satisfactory arrangements by the area concerned its currency, even if linked to sterling, will, from the point of view of the British regulations, be treated as a foreign currency.²⁴

8:2 *The “time which we dare not regard as peace”*

In July 1939, the Committee on Economic Information once again gave the Cabinet the benefit of its opinion on the economics of defence. In contrast to its position of December 1938, the Committee’s Twenty-Seventh Report made no pretence that peace time conditions prevailed although it still could not bring itself to advocate complete defensive preparations. It acknowledged that “our defence programme has nothing to lose and everything to gain by the adoption of remedies less drastic than those required in war, but appropriate to a time which we dare not regard as peace”.²⁵ The Committee now confessed that:

It would be surprising indeed if adequate defence preparations could be achieved on top of the undisturbed normal economic activity of the country without special measures. We believe that the attempt to do so would produce dangerous repercussions on the price level and the balance of trade.²⁶

This was obviously a complete reversal of normal fourth arm logic which had claimed since 1936 that any ‘dangerous repercussions’ would come from attempts to interfere with ‘normal economic activity’. The Committee’s change of heart was attributable not only to the worsening international situation but also to the realisation that the trade recession of 1937-38 was offset in Britain by defence expenditure. It was noted that with regard to civilian investment “a decline of no less than £120 millions attributable in part to a reduction of stocks of raw materials and semi-finished goods” had taken place:²⁷

Normally this decline might have produced a serious slump, but its effects were mitigated in 1938 by the expansion of defence demand. This decline in ordinary domestic demand, however, made possible a simultaneous expansion of defence expenditure and an improvement of the export surplus of the investment industries,

²⁴ Ibid.

²⁵ PRO CAB 24/288, p.122. CP 167(39) Economic Advisory Council. Committee on Economic Information, Twenty Seventh Report. Defence Expenditure and the Economic and Financial Problems Connected Therewith, 20th July 1939, p.5.

²⁶ Ibid.

²⁷ Ibid., p.6.

after paying for their raw material imports, of £42 millions compared with 1937.²⁸

This concern with the wider economy indicates why the Committee on Economic Information had become interested in defence. It has been argued that Keynes had converted leading Treasury figures to his views on the management of the domestic economy and the contribution that State expenditure on defence had made to the mitigation of recession was powerfully supportive of his case.²⁹ The actual economic requirements of defence, however, appeared to remain in the background, especially with regard to the necessary measures to be taken in respect of Britain's international economic position. The Committee thought that import controls seemed a logical answer to balance of payments difficulties:

But it must be remembered that we are debarred from increasing duties on a wide range of engineering products, e.g., by our recent trade agreement with the United States, and from imposing quantitative limitations on imports that do not apply to home production by that and other trade treaties. Even so it is possible that the present pressure on our balance of payments may be so accentuated by the increase in our defence expenditure that more fundamental remedies, in the direction of import and exchange control, may have to be considered.³⁰

In this respect the Committee's thinking was unchanged. Action might be needed only to correct poor balance of payment figures, not the continuing drain of reserves caused by the proximity of war. Even at this late stage, exchange control was a regrettable possibility, not an urgent necessity.

As at the turn of the year, the Cabinet received Treasury advice in close proximity to the Committee on Economic Information's contribution. On this occasion, however, the Treasury's ability to rationalise bad news was stretched to the limit, and the presence of Hopkins was required at Cabinet to field terse and searching questions that would otherwise have been directed at Simon. The Cabinet was invited to consider the Treasury's "Note on the Financial Situation",³¹ which sought to convince the Cabinet of the Treasury's

²⁸ Ibid., pp.6-7.

²⁹ S. Howson & D. Winch, *The Economic Advisory Council, 1930-1939: A Study in Economic Advice During Depression and Recovery* (Cambridge, 1977), p.149.

³⁰ CAB 24/288, p.124. CP 167(39) Committee on Economic Information, Twenty Seventh Report, p.9.

³¹ PRO CAB 24/287. CP 149(39) Cabinet. Note on the Financial Situation. Also appended to Cab 36(39).

interpretation of recent events. This document was thought so sensitive that Ministers were asked to hand it in at the end of the meeting. The first striking feature was the title of its first section: "The War Chest". For the first time Britain's reserves of gold and foreign currency were explicitly referred to as assets for use in war. This, however proved to be the full extent of the Treasury's mental adjustment.

The report downplayed the effect on the exchanges of Hitler's actions and said that 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.³²

This choice of culprits for the loss of gold made the phenomenon seem to be an unavoidable and unpreventable natural event, which exonerated officials from blame for the losses which had already occurred. However, the Committee on Economic Information, containing both Phillips and Hopkins, had already told the Cabinet that reserves were adequate for four years if purely financial criteria were applied. The Treasury's report repeated the assertion that although the £800 million gold stock of the previous year "looked imposing" it, "in fact, gave a rather misleading appearance of strength".

The report then embraced a strange contradiction. Appearing to deplore the volatility of short money it stated that: "In less than 15 months of international tension nearly 40 per cent of our gold stock has disappeared". However, in giving "reasons for our gold loss of over £300 million in 15 months", international tension was not mentioned. A curious collection of reasons was put forward: the "economic setback of 1937" was cited which "profoundly disturbed world conditions, the effect being especially marked among the best customers of our export trade". British gold reserves, though, grew throughout 1937. The return of "[a] great deal of fugitive French money"³³ was also mentioned.

Another reason given was revealing: "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 the countries of the sterling *bloc* were falling at the rate of some

³² Ibid.

³³ Ibid., p.1.

£80 million a year.”³⁴ The reasons for this phenomenon were many and complex, and were, incidentally, aggravated by the Anglo-American Trade Agreement, but the point is disingenuous. By deliberately excluding Britain herself as a member of the sterling bloc it excluded the effect of debt repayment to her by the bloc, that is the sizeable portion of the £80 million quoted which simply moved to British accounts and thus remained in London. The demands of war were to lead to a dramatic reversal of this position as Britain incurred massive obligations to the newly named sterling area, while abrogating the American Agreement. This money also remained in London.

After the listing of these unconvincing causes of gold loss the report came to the international situation as an aggravating rather than fundamental cause of gold loss, though of course it had been repeatedly stated amongst insiders that the political situation was the real culprit:

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.

The report then detailed the adverse effects of war preparation on the visible balance of payments and the cost of loans to the same untrustworthy foreigners, before turning to the measures of defence which had been undertaken. It stated that:

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 speculators have been taken.³⁵

A subtle shift in reasoning had been used here to disguise the true situation. The report had previously discussed the defence of the reserves. Now it was talking about the defence of the exchange, for which the reserves were being used.

This subterfuge was spotted in Cabinet by Hore-Belisha, who subjected Simon and Hopkins to persistent questioning on the case for devaluation. As it was, the case for the Treasury looked flimsy and the report contended that “very little more could be done even

³⁴ Ibid., p.2.

³⁵ Ibid.

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.” Exchange control was not mentioned. This statement was made a month before sterling was forced down to \$4.03 and the defence of sterling with the reserves abandoned. Even as they spoke in Cabinet, Simon and Hopkins were aware of the enormous and increasing pressure being exerted on the currency. The report stated, however, that: “Up to the present the disadvantage of our gold loss has been largely political. It must discourage our friends and encourage the Axis powers”.

In addition to an understandable desire to minimise the scale of the disaster, the report betrayed a genuine confusion as to the boundaries of political and economic reality, and an unspoken desire that the two should remain separate in peacetime. If the gold loss “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.”³⁶ The blurring of the distinction between peace and war was thus explicitly linked for the first time with the damage that could be done to wartime finances in time of peace, according to fourth arm logic. A comparison with 1914 revealed the difficulties for Treasury officials grappling with these concepts, chiefly with the realisation that the economic environment of 1939 bore little resemblance to that of the earlier time.

The report acknowledged that World War One financial conditions had been sustained by borrowing in the U.S., and made the obvious point that “under the Johnson Act we cannot borrow in the United States, either privately or from the Government”, and that “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”.³⁷ In these circumstances, which had been apparent for some time, it was probably a poor idea to continue donating gold to the United States. However, this strangely paradoxical position was dictated by fourth arm logic, which had to conform to Great War practice to remain consistent. This led to the sobering conclusion that: “At the rate of £20 million a month, at which we have been using gold, our reserves would barely last three years and considering

³⁶ Ibid.

³⁷ Ibid., p.4.

the increased demands likely in war, this estimate of the period is very likely too optimistic.”³⁸

Despite the Treasury’s pessimistic reasoning it was necessary to present the Cabinet with a plan of action. The report concluded that: “Apart from increased taxation, the following means of arresting the general deterioration suggest themselves”.³⁹ The first of these was to state the obvious that: “The primary need is to conserve our resources in gold and foreign exchange, which represent our staying power in war”. Inflation and tax increases were mentioned, without context, and the opinion expressed that “in the course of time general controls are likely to become necessary and the standard of living must be directly or indirectly affected”. The avoidance of foreign arms purchases was recommended on the grounds that: “Further expenditure on Armaments in this country cannot be undertaken without counting the cost in gold.” In terms of defence expenditure generally, “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”.⁴⁰

This statement was an unrealistic attempt to reimpose rationing and in recognition of this the report stated that: “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.” Next, in an extraordinarily convoluted passage, the fact was addressed that little had been done to lay in stores

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 desirable and capable of safe storage, should not be carried further in spite of the immediate gold losses which this course involves.⁴¹

Such a confused and contradictory document, containing veiled confession of monumental failure might have been expected to produce an explosion in Cabinet, and Hopkins’ presence

³⁸ Ibid.

³⁹ Ibid., p.5.

⁴⁰ Ibid., p.5.

⁴¹ Ibid., p.5.

was surely connected with this.

8:3 A Minor Revolt

The response in Cabinet to the Treasury's paper ranged from bewilderment to anger, as if from a sense of betrayal. The sharpest questioning came from Hore-Belisha, the Secretary of State for War, who appeared to sense the document's fundamental dishonesty. He was the only Minister to ask a specifically technical question when he "asked Sir Richard Hopkins what were his views on the general level of sterling, and whether it was fair to say that we were weakening our position by not allowing the natural level to operate".⁴² Hopkins' reply was revealing of the difficulty of the question. He said that "in the opinion of some the level of sterling was rather too high. Any difference of opinion on this matter, however, related to a relatively small margin, say \$4.55 to \$4.68, and this would have but little effect on gold losses."

Hopkins did not indicate who the different sides of this controversy were, but said that:

It must be remembered, however, that any large modification in the exchange level would have a disturbing effect and would not be effective if other countries took retaliatory measures. Further, a number of countries in the sterling bloc banked in London and would, it could be assumed, automatically follow sterling. There was also the question whether the United States of America would automatically follow suit.⁴³

This was far from being an answer to Hore-Belisha's question, which was about stemming the gold loss, not the competitiveness of sterling, the benefits to which of devaluation were, in Hopkins' opinion, "likely to be transient".⁴⁴

Ministers were now unsettled, and the Secretary of State for Air, Kingsley Wood "asked Sir Richard Hopkins whether his view was that we were not in a position to fight a long war". Hopkins' reply was studied. He

said that the situation undoubtedly grew more difficult with every month that passed. If war should break out in the near future, we should have in our war chest the existing gold stock less those foreign balances which would be removed. If, however, war

⁴² PRO CAB 23/100, p.117. Cab. 36(39) Cabinet Minutes, 3rd July 1939, p.7.

⁴³ Ibid., p.8.

⁴⁴ Ibid., p.9.

occurred say a year hence, those stocks would have been diminished by the drain in the intervening year. So long as we continued on the present course our financial position was being weakened.⁴⁵

Wood pursued his question and “said that he had understood that it was a fundamental feature of our policy that we should conserve our strength for a long war, and he asked Sir Richard Hopkins whether that strength had gone”.⁴⁶ Hopkins “said that this was not his view, but the memorandum drew attention to very serious matters which must be borne in mind”. Wood refused to let go and “asked whether we were in a worse position to fight a long war than in 1914”. Hopkins replied “that this must be the case subject to the question whether the United States was prepared to help us with finance.”

This led Stanley to ask whether the Americans “were in a better position” to do this than in 1916. Hopkins’ reply is revealing; first in that it followed the question in ignoring neutrality legislation, and secondly in its assumptions. He said of the Americans that “he did not think that their vast gold stocks would be of much help to them in financing us in war”. All the more reason, it might be thought, for stopping British gold stocks heading in that direction. It was at any rate a surprising assumption that the Americans might even have entertained the possibility of using their gold stocks for such a purpose.

Hopkins foreshadowed lend-lease by stating that: “The primary need would be that they should give us a share of their production without our paying for it.” This, bearing neutrality legislation in mind, was an incredible statement. Britain’s realisable wealth was of course to be exhausted before U.S. aid was forthcoming, and even though the money value of lend-lease was to be written off, it was certainly paid for by other consideration. Hopkins then agreed “that the production of gold from South Africa could be increased, but South African gold belonged to South Africa, and we should have in effect to pay for it, either by exports to South Africa or by a loan from that country.”⁴⁷ This statement was also untrue. South Africa was a member of the sterling bloc and as such would have to accept sterling payment for its gold. Like Treasury mandarins before and since, Hopkins’ spirit of economy extended to the truth.

⁴⁵ Ibid., p.9.

⁴⁶ Ibid., p.10.

⁴⁷ Ibid., pp.10-11.

The Cabinet paper on Britain's financial position was accompanied by another entitled "The German Financial Effort for Rearmament." This "Note by the Chancellor of the Exchequer" formed "an analysis of the present financial effort of Germany as compared with that of this country".⁴⁸ It was also noted that because "the question is often asked why this country cannot at all times do what Germany does it may be well to make one or two general observations on that subject." If this was intended to reassure the Cabinet it failed. After listing supposed German advantages, such as a "docile population" willing to tolerate high levels of tax, paragraph 6 of the Report turned to Germany's external position. It stated that:

As Germany cannot expect in war to import from overseas, the policy has been to acquire great stocks of imported necessities, to produce at home substitutes for particular types of essential imports, though involving great economic waste, and to acquire power over adjacent territories which can supply German needs. The question of the means of payment for overseas imports in war - an ever present anxiety in our case - scarcely arises in Germany. We cannot be self-supporting even if we wish to.⁴⁹

In the subsequent discussion, nobody sought to contrast this statement with the official position that in war Germany would be blockaded into surrender. The report expressed astonishment at the yield of taxation likely to be achieved by the Germans, as this method of finance replaced earlier borrowing. The report stated that "the implications are staggering".⁵⁰ This was because "from roughly the same kind of total national income",⁵¹ the Germans "will have over £880 millions a year for defence *without* borrowing against our £247 millions and unless their Budget breaks down they can keep it up indefinitely".⁵²

The contradictions in Government policy were by this stage painfully apparent and Hore-Belisha, obviously well briefed, pointed out some of the inconsistencies in British thinking revealed by the report. He

drew attention to a statement in paragraph 6 of the Introductory Section of C.P. 148(39) which referred to the self-sufficiency of

⁴⁸ PRO CAB 24/287. CP 148(39) The Financial Situation. The German Financial Effort for Rearmament. Note by the Chancellor of the Exchequer. Also appended to Cab 36(39).

⁴⁹ Ibid.

⁵⁰ Ibid., p.6.

⁵¹ Ibid., p.2.

⁵² Ibid., p.6.

Germany. He contrasted this with a paper prepared by the Industrial Intelligence Centre which reached the conclusion that Germany would not last out for more than a year of war. He also referred to a paper which the Director of the Industrial Intelligence Centre had read to the Imperial Defence College which indicated that Germany would have to produce at seven times her existing rate if she was to maintain 100 divisions in the field.⁵³

Hopkins replied that “he was not qualified to speak on the capacity of Germany to wage a world war” (any more than on that of Great Britain it seems):

no doubt the views in the paper expressed by the Director of the Industrial Intelligence Centre did not purport to be more than estimates. He did not think that our war plans were prepared on the assumption that war could not in any case last for more than a year. The important point was, he thought, that for whatever period the war lasted, whether a year or longer, we should have to continue to import food and raw materials. Germany, on the other hand, had not got command of the seas and could not expect to import goods except from adjacent countries. Her plan, therefore, had been drawn on the basis of self-sufficiency.⁵⁴

This was a weak answer and the Minister of Labour “asked whether the logic of this argument was not that we should make every acre of this country as productive as possible?”⁵⁵

Hopkins, whose performance was rapidly deteriorating under unaccustomed questioning, made an obvious reply which showed how trapped was his thinking within peace-time conditions. He

said that no doubt this process could be carried out to a certain further stage with reasonable economy. He thought, however, that to apply our resources to the uneconomic development of the agricultural capacity of this country would probably involve an even greater strain on our resources than dependence on imports. It seemed to him that the right course was that we should seek to reserve a reasonable part of our foreign exchange resources in case we were in a tight corner. He also thought that we should consider every possible method of forcing the export trade in time of war.⁵⁶

In response to a helpful prompt from the Prime Minister “that the point of paragraph 6... was that Germany relied on the policy of stocks or self-sufficiency”, Hopkins “agreed. If at

⁵³ CAB 23/100, p.121. Cab.36(39) Cabinet Minutes, 3rd July, p.11.

⁵⁴ Ibid., p.11.

⁵⁵ Ibid., p.12.

⁵⁶ Ibid.

any time Germany was short of a particular commodity and had to buy from countries overseas, her lack of gold would be the determining factor.” This was nonsense, as was soon to be pointed out.

Next, Hore-Belisha summed up his tidy inquisition into the Treasury’s papers by stating that

these papers held out a dismal prospect for this country but not for Germany. Thus paragraph 19 of C.P. 148(39) appeared to indicate that Germany could keep up her expenditure on armaments indefinitely. In this connection the Secretary of State for War drew attention to paragraph 5, on page 2 of C.P.148(39). He asked whether it was in fact the case that Germany was in no way relaxing her efforts and that she would keep up expenditure on armaments indefinitely.⁵⁷

At this point, Hopkins drew a distinction between internal and external finance in stating

that so far as concerned internal finance, he thought that this seemed to be the case. So far as concerned obtaining necessities from abroad, there was a great difference between the position of this country and that of Germany. Germany was largely self-supporting in food. A commodity such as rubber was now produced in Germany by synthetic processes, though at great cost, thereby limiting the need for imports from abroad. So far as concerned overseas finance, Germany was bankrupt and the position was kept going only by severe controls which limited the imports of what we should regard as necessary commodities.⁵⁸

Unsubstantiated assertions that Germans worked harder for less than their British counterparts followed, before Kingsley Wood returned to pertinent questioning and “asked whether a financial breakdown in Germany could be regarded as either inevitable or indeed likely”.⁵⁹ Despite his distaste for German methods, Hopkins admitted that he “saw no reason to anticipate a breakdown, at any rate within an early period of time”. Wood then, like Hore-Belisha before him, summed up his impressions in a damning manner, and

said that Sir Richard had said that Germany was spending more than we were spending on armaments, that there was a prospect that Germany could fight a war as long as we could, and that none of the remedies proposed seemed likely to see us through a life-and-death struggle [sic]. Was it not necessary that we should consider whether we should do more to model ourselves on

⁵⁷ Ibid.

⁵⁸ Ibid., p.13.

⁵⁹ Ibid., p.14.

German methods?⁶⁰

Hopkins referred him to paragraphs 36 and 40 of CP149(39) which considered the possibility of action when full employment had been reached. Hore-Belisha then moved in again, backing up Wood, and

said that C.P.149(39) seemed to indicate two alternative courses; that we should copy Germany's taxation or that we should adopt the measures of control therein indicated. Possibly both these courses should be adopted. He noted that the various measures of control were being studied, and he assumed that before the Cabinet was invited to reach any conclusions they would be informed of the results of that study.⁶¹

Hopkins once again referred to paragraphs 36 to 40 of CP 149(39). Silent to this moment, Chatfield then delivered a withering comment on the Treasury's competence when he referred to "paragraph 6 of the Introductory Section of C.P.148(39), where it was stated that Germany could not expect to import goods from overseas in war. He said that in the last war Germany had imported large quantities of goods from Scandinavia, and would be able to do so again."⁶² Hopkins could only reply "that it had not been within his knowledge that Germany had been able to secure a large volume of imports in the last war. Any large volume of German imports in War would pro tanto modify the arguments in the paragraph referred to".⁶³ If Hopkins could be so ignorant of such a fundamental point, what did this say of the need to modify his arguments in other paragraphs?

8:4 *The Crunch: "a real bad day"*

The irrelevance of U.S. opinion to British action was demonstrated in August, when the gold hurled into action in January was virtually gone. A change in policy was now forced on the British authorities and, as they were unable to peg the currency and yet recoiled from Schachtian devilry, a floating pound became the preferred policy. On 10th August, Bolton's deputy, Hawker, called Knoke and told him that:

War fears on the Continent and in the Far East were developing as the recently much talked of August 15 (the day on which German mobilization supposedly reaches its climax) was approaching and

⁶⁰ Ibid., p.15.

⁶¹ Ibid., pp.15-16.

⁶² Ibid., p.16.

⁶³ Ibid., p.17.

the Japanese situation was steadily growing worse. As a result of all this, the demand for spot and forward (for end August and for three months delivery) dollars today, both from the Far East and from the Continent, had been heavy and the British fund had sold about \$30,000,000 in support of sterling. In other words today had been a real bad day; the first one, as a matter of fact, in many weeks. Talk in the street and in the press about a possible further devaluation of sterling in the next three months was increasing and Morgenthau's visit to Europe was causing further rumors.⁶⁴

Knoke thought that: "All one could say as to the future of sterling was that it really should be weak in view of all these fears and talk of war the world over and of the strain on Britain's finances which the rearmament programme was bound to cause. One must expect to see sterling under attack so long as this war fear and tension in Europe continues".⁶⁵

The plight of sterling once more appeared in meetings of the U.S. Treasury, initially in renewed concern at the amount of gold that the U.S. was being called upon to absorb. On 24th August, however, Butterworth was sent for by Phillips and told of the British position "that the mounting European crisis was producing an increasing drain on their gold resources and the rate of increase was very alarming".⁶⁶ In the first three days of that week £35 million of gold had been lost and the British

had been hanging on 'from day to day' and after raising the bank rate this morning they had reluctantly come to the conclusion that they must adopt one of two courses to conserve their gold resources; either put on exchange control or let sterling depreciate. They had decided not to adopt the former course principally because if the crisis should pass many months would ensue or perhaps as long as a year before they could remove the controls but if they let sterling depreciate, if the political crisis should pass they were convinced sterling would rapidly rebound to near the current level.⁶⁷

Consequently, "when London opened tomorrow the British fund would stay out of the market and let sterling find its own level."⁶⁸ A rather stunned Butterworth

asked him to what level he expected sterling to depreciate and how

⁶⁴ FDR MD Book 206, p.92. Telephone Conversation with the Bank of England, 10th August 1939.

⁶⁵ Ibid., p.92.

⁶⁶ Ibid., Book 206, pp.290F. Telegram. For the Acting Secretary of the Treasury from Butterworth. Strictly Confidential for Immediate Delivery, 24th August 1939.

⁶⁷ Ibid., pp.290F-290G.

⁶⁸ Ibid., p.290G.

long the British fund proposed to stay out of the market. He said that they would stay out until sterling found a new level which would certainly take a day or two and that it was difficult to prejudge what rate it would be since political events were moving so fast, but he implied that he did not expect the depreciation to be drastic.⁶⁹

In conclusion, “Phillips emphasized the confidential character of this message and the fact that he was sorry that such short notice was being given but they had been hanging on from day to day and the decision had only just been made”.⁷⁰ In a supplementary telegram, Butterworth noted that during the discussion he had “pressed strongly for information regarding the actual state of the British equalization fund”, and was told that total British gold reserves now totalled £400¼ million, down from £590 million in March.⁷¹ Butterworth further reported that: “In supplying these figures Phillips took pains to emphasize that at the moment it was the pace that was killing.”⁷² Knoke was given the same news by Hawker, although he already knew through the Treasury Department of Phillips’ conversation with Butterworth.⁷³ Asked for his personal opinion Knoke said that the news “would naturally be a terrific shock although people had more and more generally figured in recent weeks that something was bound to happen”.⁷⁴ Knoke

felt that restrictions as a first step would have been less of a shock to the public here. That was what I would really have expected though fully aware of the fact that restrictions would not be very effective in the long run. Nevertheless, I would have thought that, considering the great tension in the international atmosphere, they would have considered it preferable to carry on with restrictions at least until the crash had come (if there was to be a crash) rather than risk giving Hitler a chance to use this development as a further inducement to stand pat.⁷⁵

The story told to the Americans was by no means the whole truth. The unwillingness

⁶⁹ Ibid.

⁷⁰ Ibid., p.290H.

⁷¹ Ibid., p.290I. Telegram. For Immediate and Personal Delivery to the Acting Secretary of the Treasury, 24th August 1939.

⁷² Ibid., p.290I.

⁷³ Ibid., p.293. Telephone Conversation with the Bank of England, 24th August 1939.

⁷⁴ Ibid.

⁷⁵ Ibid., pp.293-294.

of the British authorities to impose effective exchange controls was hardly the result of the likely difficulty in removing them. A briefing document was prepared for the Chancellor,⁷⁶ which weighed up the various options available to him. This acknowledged that “from the summer of 1938 onwards it became apparent that international politics were the dominant influence on the exchanges and on sterling in particular”. It surveyed, wistfully, the damage already done to the gold reserves by existing policy: “If we were in a period of assured peace, such a reserve, though somewhat narrow, could be regarded with equanimity”, but: “Actually our position is one in which we are threatened with war and gold is exceedingly necessary to us as a reserve for purchasing food and munitions under actual war conditions. For this purpose our present reserve of 469¾ millions must be regarded as altogether too low already”.

This belated clarity of vision makes the recommendations contained in the document seem all the more bizarre, especially in their continuing insistence on a razor-sharp dividing line between conditions on the last day of peace and the first day of war. It was conceded that “we could proceed to apply measures of exchange control similar to those enforced in Germany and to the extent to which we were successful we could no doubt maintain the £ at almost any rate we chose”. Further comment on this seemingly attractive option, however, was not such as to increase the Chancellor’s enthusiasm for such a measure. It was explained that

adopting exchange control may be inevitable in actual war. If a country is prepared largely to sacrifice its export trade (relying on subsidies from the taxpayer to enable its goods to be sold abroad), to enforce rigorously a lower standard of living on the population, and to abandon its position as a great financial and banking centre, there is no reason why it should not adopt exchange control in war, and we should no doubt do so in a great war in which we had not from the start the help of the United States. But the adoption of exchange control in time of peace is another matter. It might well mean the final loss of much of our financial power, which is a lesser sacrifice than losing a war but still not to be contemplated with equanimity. Exchange control was no doubt for this kind of reason rejected even by the French in their worst period last year.⁷⁷

This was hardly disinterested advice, and the option actually taken sounded rather less attractive. If support for the pound was withdrawn:

⁷⁶ PRO T 160/877/16003. Brief for Chancellor, 21st August 1939.

⁷⁷ Ibid.

The heavy fall in sterling might be widely regarded as a sign of fundamental weakness in the British economic system, with adverse repercussions on the diplomatic situation. This danger would be particularly great if the freeing of sterling were unaccompanied by any other measure suggesting that an active policy was being pursued, since it might in these circumstances convey an impression of helpless feebleness.⁷⁸

This was sound prediction. At a meeting later that day, U.S. Treasury officials attempted to come to terms with the situation. Hanes put his finger on the general view when he said “it’s an accomplished fact and they’re simply saying to us this is what we’re going to do”. He wondered “should we make any answer or should we tell Butterworth we have no comment to make. We regret this move of course but we have no further comment to make.”⁷⁹ Lochhead added: “I think that’s the safest thing because of course it’s water over the dam. I’m terribly sorry they didn’t try to use exchange control but that - it’s too late, I mean they’re not going to - they’ve made up their minds.”⁸⁰ The option of announcing a breach of the Tripartite Agreement was hardly discussed. Lochhead commented that “we could take the attitude that this is an exceptional time just now and we’re reviewing the situation. In the meantime the tripartite will continue”. The British had after all “actually made their decision on it, and nothing we’re going to say is going to change it”, and so “we should just simply tell Butterworth that we regret very much the decision and not make any more comment on it”.⁸¹ Hanes remarked that “I think that jibes with everybody’s opinion here too, Archie”.

Lochhead had also discussed the matter with Harrison at the Federal Reserve Board who “said the same thing. He said that’s the safest.”⁸² In terms of positive action Lochhead thought “there’s nothing certain that I can see that we can do. We can’t tell them you can’t do it”, and consequently “it looks to me as if we’re going to have to swallow something, for a short time at least”.⁸³ American official reaction was explained in a telephone conversation between Lochhead and the absent Morgenthau. The former explained that after the British

⁷⁸ Ibid.

⁷⁹ MD Book 206, p.307. Telephone Conversation between Hanes and Lochhead, 24th August 1939.

⁸⁰ Ibid., p.307.

⁸¹ Ibid., p.308.

⁸² Ibid.

⁸³ Ibid., p.309.

announcement “the boys came in right away and wanted to know whether the tripartite had busted up”, and whether Hanes “was considering devaluing the dollar under the power you have and Johnny said - spiked that right away - said we hadn’t thought or talked about it”.⁸⁴

The French were old hands at this game, and it was fortunate for the Americans that the British authorities were not of like mind. The views of the Finance Minister Paul Reynaud, as expressed to the American Embassy, remain instructive. Reynaud “thought the British idea somewhat sketchy, of what constituted consultation under the tripartite agreement”. Nevertheless, “he hoped that the United States Government would also pretend that it had been informed in advance.”⁸⁵ Reynaud went on to say that:

According to his private opinion, the matter had been foolishly handled by the British. They would have had a cheap money and a strong one which would have drawn gold, had they abolished all restrictions on gold exports and simultaneously stopped operations of the stabilization fund, and let the pound drop with a resounding thud to a very low point indeed and then pegged it there.⁸⁶

This was, of course, Morgenthau’s worst nightmare, but the prospect of such action would have been valuable to the British chiefly as a peacetime bargaining weapon, a depreciated sterling being undesirable in wartime.

8:5 Preparations for War: “well into the 1917 stage”

Butterworth remarked perceptively of the British authorities that “these people are awfully determined, - not because they want to do anything but because they don’t see any way out”.⁸⁷ He encapsulated the establishment mentality perfectly with the statement that: “They’re on the horns of the dilemma; either they fight - and its going to be awful - for if they don’t fight and do another Munich, they’ll never be able to hold their Empire and the Allies together again.”⁸⁸

At this stage normal peacetime considerations began to fade into the background. As

⁸⁴ Ibid., p.349. Telephone Conversation Between Lochhead and Morgenthau, 25th August 1939.

⁸⁵ Ibid., pp.314O. Paraphrase of Telegram received From American Embassy Paris. For the Treasury, 26th August 1939.

⁸⁶ Ibid., pp.314O-P.

⁸⁷ Ibid., p.327. Telephone Conversation between Hanes, Lochhead and Butterworth, 25th August 1939.

⁸⁸ Ibid.

Butterworth put it, “the atmosphere is not a damned bit good over here”.⁸⁹ He had observed in a telegram the day before that:

The City is naturally bewildered and despairing at the speed and turn of events. Its mood at the moment is to see no alternative to fighting regardless of the character or condition of the so-called peace front. An incident may serve to paint the emotional picture: a lieutenant in the Guards’ scarlet uniform happened to pass through the City in an automobile. Crowds gathered from nowhere and he was cheered to the echo by top-hatted senior partners and messengers alike. How long this mood will last remains to be seen. But at any rate it is well to doubt that it is shared by those who hold the political power of decision.⁹⁰

On 28th August, Butterworth reported a lunch appointment “with Clay at the Bank of England”.⁹¹ The latter

confirmed...that in the event of war Great Britain would become economically and financially a totalitarian state as rapidly as possible and problems would be regarded in the light of manpower, tons and tonnage rather than pounds, shillings and pence. Clay felt that their plans were sufficiently developed so that they would start off at well into the 1917 stage.⁹²

The City was willing to set an example in facing the coming struggle. Butterworth noted that: “Preparations for war are far advanced in the city. [sic] The clearing banks have already transferred their head offices to the country where the section of the Bank of England with which they deal is also now located.” In fact: “All financial institutions have during the past year duplicated their records and have made arrangements to continue as much of their operations as possible in places of comparative safety.”⁹³

In these last days of peace, ‘a place of comparative safety’ for functionaries had not yet become a ‘funk-hole’, but Simon’s statement that the Treasury “might almost be considered as one of the fighting services” was vindicated and financial honour preserved because: “The hard nucleus of the Bank of England and the Treasury are remaining in London” along with the bulk of the populace. This was only fair, for as Butterworth noted

⁸⁹ Ibid.

⁹⁰ Ibid., p.290D-E. Telegram. For Treasury from Butterworth, 24th August 1939.

⁹¹ Ibid., p.426L. Telegram. For Treasury from Butterworth, 28th August 1939.

⁹² Ibid., p.426M.

⁹³ Ibid.

in his next telegram on 30th August, the Treasury was expecting a lot from the ordinary citizen. The Treasury told Butterworth

that sales of securities by British residents to non-residents will be permitted, provided the foreign exchange is turned over to the British monetary authorities in return for sterling at the going rate. The British Treasury is, of course, aware that there is nothing to prevent the recipient of such sterling from converting it back into say dollars and having those dollars placed in another name, but it is at the present time content to rely on the 'general trustworthiness and patriotism of the man-in-the-street' not to make use of such loopholes. Furthermore, the Treasury points out that to close such loopholes would necessitate a complete exchange control system. The Bank of England has been besieged with requests for rulings covering unanticipated contingencies.⁹⁴

When war came, the British Government was heading in an opposite direction to the other great powers of the day in the prosecution of financial and economic policy. The irony of the situation was that while, as in other nations, the physical impetus of the rearmament effort was dragging the nation towards economic health, the measures of limitation imposed upon the process by the Government were doing much to reverse the process of recovery. Liberal ideology had ridden back to the summit of British thinking on the back of the economic recovery its eclipse had made possible. The result was that the fourth arm policy was exporting British growth across the Atlantic, as a gift to the United States.

The appalling consequences of the fourth arm policy became apparent with the outbreak of war on 3rd September, when exchange controls were introduced automatically at the newly depreciated exchange rate of \$4.03 to the pound. In peacetime this would have been an attractive enough rate, but in war the existing trade gap with the United States was bound to widen massively, and the remnants of Britain's gold and dollar reserves would be stretched very thinly. The utility of devaluation lay in the American desire that it should be avoided. If Anglo-American cooperation in the financial sphere had been a real possibility, the Americans could have been prevailed upon, in the spirit of the Tripartite Agreement, to use their enormous gold reserves to support sterling. Britain could have concentrated American minds by reserving the sanction of letting sterling go, as Reynaud suggested, much earlier than actually happened. The Americans, as we have seen, though unhappy, had no power to resist this outcome when it did come, but the British did not seek their help in

⁹⁴ Ibid., p.521K. Telegram. For Treasury from Butterworth, 30th August, 1939.

preventing it.

The British therefore gained nothing from their late devaluation, and were left only with its adverse effects in wartime. Nor did they reap the available benefits from exchange control. Had it come even a fortnight earlier, and it could have with American blessing, the sterling collapse would not have occurred, and massive wartime savings on dollar imports would have been secured. Indeed, had controls been introduced in March 1938, these gains would have been supplemented by the hundreds of millions of pounds expended in sterling's defence against political pressure. Even in war, however, the British authorities were half hearted about exchange control. They permitted the existence of an unofficial 'black bourse' in sterling for the surprisingly large number of transactions not immediately covered by controls, so that the situation was worsened by the existence of a second value of sterling at a considerable discount to the official rate.

There was also precious little to show in the political sphere for the financial sacrifices made in 1938-39. The curious belief that the United States would somehow underpin the British war effort without exacting a political price would soon prove to be false, and it would become clear over time that the insufficiently developed economic structure of British Imperialism would have to be broken up at America's whim to ensure national survival. The tragedy for the British was that the financial weakness they faced on the outbreak of war was the freak creation of their own mismanaged policy. It bore no relation to the fundamental economic position, which was insurmountable as long as the Imperial economic structure could be preserved. Any alteration of this situation required the dismantling of the structure. The Americans realised this: unfortunately, the British did not. Thus, as war approached, the British continued to play the financial game, heedless of the risks they were running with their basic economic strength; unlike the Americans who had suffered by it, and the Germans who, applying their autarkic concepts in a small way against their neighbours, could only marvel at the grandiose extension of their thinking open to the British and work keenly towards a time when they too might exercise such power.

Britain had, as a result of the economic status regained since 1931, managed to accumulate considerable reserves of gold and foreign currency by the beginning of 1938, and these, being composed largely of foreign balances accumulated against an adverse balance of payments were a tribute to the credibility of the economic system created after the departure of sterling from the gold standard. As gold began to drain, in fact was permitted to drain, across the exchanges, nothing was done by the British Government to retain the

financial credibility which had been so painfully re-established since 1931. And this was the irony of the situation. The fourth arm policy relied on the maintenance of Britain's external credit, but this credit had been built by determined intervention in the workings of markets. The 'business as usual' attitude of fourth arm economics clearly demonstrated an unwillingness to intervene in British interests, and this more than any other single factor destroyed Britain's financial credibility.

The Stamp Survey stumbled upon the true ghastliness of the situation too late and was still attempting to construct its machinery when time ran out. Indeed much of the initial effort expended on it by Wilson and other senior civil servants was aimed at keeping the lid on the appalling picture of unpreparedness that the Survey should have uncovered. In August 1939, the Survey reported optimistically that "we have made a preliminary survey of practically the whole ground and have arranged for the choice of documents to be supplied to us. A consideration of these and of our notes, after the holidays will provide the basis for a more detailed enquiry on particular points."⁹⁵ After the holidays the work of the Survey was of necessity accelerated, and became essential to the war effort, but its endeavours would have paid much greater dividends had they been conducted some years earlier in time of peace, and it is hard to discern any sound reason why they were not.

⁹⁵ CAB 89/1. Survey of War Plans in the Economic and Financial Spheres. Twenty Fourth Meeting. Conclusion, 3rd August 1939.

CONCLUSION

The history of the fourth arm policy, although it reveals shocking failure, does not tell of a lack of operational competence within the British Government. Indeed, it was carried out all too effectively. Neither is it solely a tale of Government, as many respected figures outside the administration, even Keynes, would have been hard pressed to distance themselves from at least some of its aspects;¹ conversely, distinguished figures inside the Government, notably Hore-Belisha, rebelled against its operation. A policy position was formulated, around a common acceptance of liberal economics, which united disparate interest groups. Their objectives overlapped but were not identical, and the concept of an unholy alliance between the City of London, the Treasury and the Bank of England is overstated. There is no indication that the City welcomed the uncontrolled panic conditions of 1938-39, which favoured its great rival, New York. The Treasury and the Bank were not of one mind on a number of issues, notably exchange control, and guarded their prerogatives from each other. On the other hand liberals of all hues, even progressive economists whose radicalism was confined to the domestic economy, rallied to the fourth arm argument at one time or another, whatever their general objections to the performance of the National Government.

The political interaction of these interest groups, forming around Neville Chamberlain and the Government machine, ensured that Britain in the late 1930s witnessed what was effectively an economic coup d'état. The common ground for those who participated was the need to defend liberal values or lose what they held dear, in differing measures of spiritual or material value. This was true of lovers of profitable peace like Chamberlain; pan Anglo-Saxon dreamers like Lothian, and the Treasury-led Civil Service heirs of the 'nightwatchman' State. To these groups, the argument that the Government's hands were tied during rearmament by economic weakness, and that consequently the fourth arm policy was pursued out of national necessity, was the base upon which their argument had to rest. It could not be questioned without doubting the essence of the liberal faith itself. In this context the fourth arm policy was little related to defence needs, but this was hardly the

¹ Keynes' support for aspects of the Government's rearmament policy has been well documented. However, this does not amount to a vindication of fourth arm policy, as Keynes internationalism left him blind to many of its most dangerous failings. It has been observed that "Keynes and the Treasury were broadly at one regarding international monetary policy after 1931". G.C. Peden, *Keynes, the Treasury and British Economic Policy* (Basingstoke, 1988), p.26.

point. In the world of shattered polities and ideological innovation that existed during the interwar years, everything was at issue and the stakes were high. This was especially true for the British Empire after 1931.

In a time of danger, liberals knew that the defence ground they had recaptured in the 1920s had to be held tenaciously, for if it had fallen to protectionists the size and importance of the Imperial economy and the wider sterling bloc were such as to place the liberal economic system in jeopardy, both at home and abroad. As far as the architects of fourth arm policy were concerned, Hitler was a possible opponent but protection and Imperial preference were existing enemies against which a long, arduous and, until 1936, losing battle was already being fought outside the defence arena. This in part, along with a failure in Government to comprehend the effects of diplomacy on finance, helps to account for the rigidity of the policy and its survival until the outbreak of war. Any change would have betrayed and overthrown a partner in the coalition and undermined the basic causes of its stunning success, which were primarily the unity of belief and coordination of action its members could rely upon, in contrast to the diffracted effort of its protectionist opponents.

After the success of resurgent liberalism, the situation created did not simply amount to a static defence of a new status quo: it had a spiralling momentum which was appallingly destructive. The fourth arm policy enforced the application of liberal finance and economics, and thus worsened the economic and military situation. This increased the attractiveness of an appeasement solution and the apparent importance of winning U.S. diplomatic support. Attempts to gain these ends weakened the economic and military situation still further and, thus failing, further strengthened the appeasement imperative. As a result of this process, the various adherents to the fourth arm policy were drawn closer to each other by its failures, to avoid hanging separately, and in 1939 the position was reached that they would hang together unless Chamberlain won an unlikely reprieve through diplomacy to add to the stay he had gained at Munich. Alternatively, the war that the policy assumed would be avoided might arrive before the full scale of shortcomings in peacetime became apparent.

Under the most severe pressure, therefore, Simon continued to resist additions to the budget, the Treasury and the Bank watched as speculative assault on sterling spilled Britain's war chest across the exchanges, and a Trade Agreement was concluded with the United States that prevented any strengthening of the sterling bloc in the year before open war was declared. The ultimate and woeful consequence of this perseverance was that the continued viability of the Empire came to rest on the avoidance of war and thus on the good

wishes of Hitler which, though frequently professed, could hardly be the basis of a prudent policy.

A.J.P. Taylor stated that: "Historians often dislike what happened or wish that it had happened differently. There is nothing they can do about it."² Historians, though, should surely be aware of what did not happen and why not, if they are to complete Taylor's thought and "state the truth as they see it without worrying whether this shocks or confirms existing prejudices". It is important to be aware, like Holmes, of the dog that didn't bark. Thus, to understand the full significance of the fourth arm policy we should be aware of the opportunity cost of the actual course of events. In Britain's case this was colossal, and is measurable in the economic distress of 1945. For all concerned in the policy debates of the interwar years, and for the future of Britain, the cost of defeat in the struggle for control of economic policy could not have been higher. In this conflict, the resurgence of the liberal view was an event of the highest importance, and the achievements of its advocates were very great: fully commensurate with the damage that resulted. The move towards a more liberal economic outlook on the part of the British Government between 1936 and 1939 went against the grain of economic progress since 1931, the increasing military dangers facing Britain, and, it must be stressed, against the initial inclination of the Government itself, explicitly stated to U.S. representatives, to depend on British sources of supply and economic strength to meet the growing crisis. This implied a policy resting on the Empire and the sterling bloc, a political choice that went to the heart of the matter. Everything about the bloc was big: its actual size; its growth potential; its schismatic political power in Britain, and the horror it provoked amongst Atlanticists on both sides of the Ocean. We have seen that the liberal case in Britain was powerfully supported by the U.S. Treasury and State Departments under Morgenthau and Hull, and that their interventions were a considerable factor in its success.³

² A.J.P. Taylor, *The Origins of the Second World War* (Harmondsworth, 1963), p.7.

³ Milward contends that in the War: "British Strategy opened the gates of supply to the whole world and ensured from the very start that the economic effects of the war would be world wide. The maximization of production in Britain would mobilize the resources of a world economy which was wallowing in unemployment and stagnating trade, and sinking rapidly into another severe depression." The second sentence serves as an accurate description of the British economic role after 1931. However, in war, unlike depression, the United States and not Britain would benefit economically, and the events of the late 1930s played a decisive part in this eventuality. A.S. Milward, *War, Economy and Society, 1939-1945* (Harmondsworth, 1977), p.42.

Britain's economy was, nevertheless, thrown back onto the newly formalised Sterling Area as soon as war broke out, despite the liberal sentiments of her policy makers and the anger of the Americans.⁴ However, it was far too late for the potential of the area to be fully developed, and this has coloured perceptions of the area as a limited thing ever since.⁵ Much of the case for fourth arm policy is sustainable only in ignorance of, or denial of, the potential of the sterling bloc before 1939, because the foundation of the fourth arm case, and the basis of its historical respectability, rests on economic threats to Britain alone. The threat posed by extravagance to stability could at any point be the threat to the budget, to the balance of payments or to the pound sterling, according to need. All of these factors added up to an appeal against a threat to Britain's external economic position and, taken together in the context of Britain at the heart of the sterling bloc, they all appear ridiculous.

The fatal-seeming balance of payments figures quoted by the architects of the fourth arm policy and subsequently by historians to justify the rationing of defence expenditure, do not take account of the fact that in the years before the war a growing percentage of Britain's imports came from the sterling bloc. Given this fact, it was really not possible for

⁴ Ambassador Kennedy observed that "Mr Hull's Trade Agreements program is completely out of the window." Quoted in E. Gilman, "Economic Aspects of Anglo-American relations in the Era of Roosevelt and Chamberlain." (Unpublished Ph.D. Thesis, University of London, 1976), p.263. Gilman's excellent account of trade tensions during the 'Phoney War', has been criticised by Reynolds on the grounds that "he takes the State Department's suspicions too much at face value", having "overlooked" a speech by Chamberlain in defence of the Agreement and liberal practice on 31st January 1940, which constitutes "an important piece of contrary evidence". Reynolds notes that: "It seems important, therefore, that Anglo-American economic competition should not be exaggerated or misunderstood." D. Reynolds, *The Creation of the Anglo-American Alliance 1937-41: A Study in Competitive Co-operation* (London, 1981), p.317, fn.87; p.78. This criticism is harsh: Gilman simply relates the full force of the State Department's Anglophobia whilst doing justice to the conflict in official British minds between liberal principles and the now unavoidable imperatives of economic survival. Gilman, "Economic Aspects", pp.263-302.

⁵ Paradoxically, Keynes, a latecomer to the joys of autarky, was optimistic even after the collapse of France. In a memorandum entitled "Foreign Exchange Control and Payments Agreements", which set the agenda for a meeting of the Chancellor's Exchange Control Conference, he explored this new area of interest. He saw the need for Schacht style payments agreements as "one of the most important instruments at our disposal for the long term financing of a long war", although he acknowledged that "I write this in a state of considerable ignorance ... I have never seen the text of a payments agreement". Nevertheless, he was confident that the extension of blockade to "almost the whole of continental Europe" would eliminate "the possibility of scarcity of supply and high prices in the international markets. On the contrary, in commodity after commodity there is a prospect of a hideous unsold surplus and a market collapse. Reasons of internal politics and internal economy will turn most overseas countries, when they have fully tumbled to the new situation., into suppliants for our custom, passionately anxious to find a market on almost any terms for their overwhelmingly burdensome domestic surplus." He concluded that "whilst we must not abuse our strength, it would be foolish to overlook it." Keynes Memorandum, 29th July 1940. D. Moggridge (ed), *The Collected writings of John Maynard Keynes Vol.23, Activities, 1940-1943: External War Finance* (Cambridge, 1979), p.6; pp.8-9.

a deficit on the balance of payments' current account to undermine sterling, as any deficit with a sterling area country in visible trade increased the London balances of these countries and directly strengthened sterling's rate of exchange against the Dollar. Therefore, when we talk of imports weakening the stability of the country we must mean imports from outside the sterling area, a declining proportion of a total volume of imports that was itself declining as a proportion of national income. Moreover, in 1933 the Americans had demonstrated their ability and intent to prevent a competitive depreciation of sterling, so it is hard to see how a trade related collapse of the sterling-dollar rate could have occurred.

These facts were known in the thirties. But confessions of false advocacy, unlike the carefully crafted edifice of the fourth arm policy, were thrown into Cabinet papers individually, over time, and hedged about by countervailing verbiage, as, for example, in the case of the Committee on Economic Information's point that existing gold reserves would last for four years if the balance of payments were the only problem.

The opportunities foregone in the 1930s can be judged from the partial achievements that followed in the far worse circumstance of war in progress. The formal creation of the Sterling Area after the outbreak of war eased Britain's financial position, as witnessed in the switch from U.S. to sterling sources of supply before the collapse of France. After France's fall, the dependence on U.S. sources of supply and the scale of lend-lease are much quoted as justification for pre-war economic appeasement. However, it should be remembered that much of the American weaponry recorded at sale price, item by item, in lend-lease was produced in factories built with the capital provided by British (and French) orders, and yielded little of value before 1942. It would reward study to calculate how much could have been taken off lend-lease had these resources of capital been used to create capacity in the Dominions or at home. At any rate supplies from sterling sources were equally important. These suppliers accepted, as they were bound to, sterling created and held in London in payment for their wares.

A general failure to consider such possibilities stems from lacunae in the interwar documentary record, often deliberately contrived, and the consequences of these for historians. It is no coincidence that the potentialities and technicalities of the Sterling Area are written about with greater confidence by historians considering the immediate post-war period, when it was keeping the nation afloat and was prominent in the documentary record. However, even in these studies, the consequences of failure to adequately consider the

lessons of the 1930s are apparent in strange contradictions. Correlli Barnett provides a classic example. Hostile to free trade and liberal internationalism, yet strangely partial to liberal financial mechanisms, he initially traduces the Sterling Area along the now familiar lines that it was too small (for what is not made clear), and somehow archaic. Strangely, for something brand new and born of Britain's departure from gold "for the first time during a peace"⁶ it was nevertheless "the detritus of successive episodes of history".⁷ Ignoring its role in feeding and fuelling Britain in war to the tune of £3 billion, Barnett describes it simply as a means for Britain to "strut her Victorian role of central banker" on a "diminished stage".⁸

The sterling paid to the members of the wartime Area naturally ensured that their holdings of pounds grew phenomenally during the war, as of course the currency was not freely convertible for dollars, and Britain (partly as a term of lend-lease) did not produce anything like a sufficient quantity of exports for them to buy. Barnett, typically and incorrectly, describes these transactions as the obtaining supplies "on tick", and that by "1945 the United Kingdom's sterling debts (or 'balances') had risen to £2969 million".⁹ However, the Sterling Area was hungry for British exports after the war, having access to dollars only through London, and to the unmitigated benefit of the British economy it had sterling to pay for them. To accept like Barnett that the balances were 'debts' We must accept a peculiar concept of the Area as creditor.

The 'creditor' in the first place accepts cash for his wares, in currency redeemable only with the 'debtor' and his subsidiaries. He therefore obtains no interest, but is constrained to hold the money for an unspecified number of years while war inflation erodes its value. In the fullness of time the debtor reappears and offers his own goods, at current prices, in return for the original cash. This would be bad enough business for the creditor, but the debtor now has his original cash, plus an inflationary margin, to spend again. He offers part of this once more to the creditor in return for more goods, and the creditor again obliges. It can safely be said that a business providing credit on these terms would not long endure.

However, recent scholarship continues to refer to this money as the 'sterling debt'-

⁶ C. Barnett, *The Lost Victory: British Dreams, British Realities 1945-1950* (London, 1995), p.107.

⁷ Ibid., p.106.

⁸ Ibid., p.107.

⁹ Ibid.

a post war liability. Barnett makes much of the fact that London undertook to meet the dollar deficits of the R.S.A. (Rest of the Sterling Area), largely from the proceeds of the 1945 U.S. loan of \$3 billion. However, for exclusive access to a market of £3 billion, and bearing in mind the benefits already received there, this seems a small price to pay. The fundamental economic concept involved was expressed succinctly by Ralph Hawtrey, writing of the newly restored gold standard in 1926, so his comments can be repeated without risking accusations of hindsight. The true status of the sterling balances can be explained in terms of Hawtrey's statement that: "The idea of money is derived from the idea of a debt"¹⁰ and his subsequent explanation:

A debt is one of the fundamental concepts of economics. It must not be thought of as arising only from the borrowing of money or from the postponement of payment. Every sale of goods or service rendered gives rise to a debt. The debt may be immediately discharged, but that does not affect its nature from the point of view of the means of payment.¹¹

The sterling balances were no more 'debt' than any money is debt, and as money the sterling involved was far more effectively employed than that sent across the Atlantic between 1938 and 1941, in that it retained its utility for the British economy, as opposed to that of the United States. The soundness of Hawtrey's comments was unwittingly endorsed by the American Government after the war, for it was no coincidence that in return for the 1945 loan the U.S. insisted, fruitlessly as it transpired, on the convertibility of sterling by 1947, so that it might gain a slice of the sterling 'debt' cake.

To think in terms of sterling as a source of weakness in the post-war world it is necessary to hold contradictory views. Barnett contends that the Sterling Area was "a legacy of history now too burdensome for the United Kingdom to carry except at the expense of damage to her own progress as an industrial society."¹² However, "British industry... continued to seek refuge, as it had done since the late Victorian era, in the easy markets of the sterling area (above all the Commonwealth)."¹³ How it could be that the Sterling Area was at once an intolerable burden and yet a soft option, which made conditions for British exporters so easy that they became complacent and sloppy, is not explained.

¹⁰ R.G. Hawtrey, *The Gold Standard in Theory and Practice* Second Edition (London, 1931), p.2.

¹¹ Ibid., p.3.

¹² Barnett, *The Lost Victory*, p.108.

¹³ Ibid., p.397.

It is also not clear how the markets of the Sterling Area were any 'easier' for the British than were the protected markets of Britain's competitors for their own producers, in which British exporters faced discrimination or exclusion. In this connection it has been observed that, "if German and American businessmen and entrepreneurs were so superlatively great at being entrepreneurs, why did they need high tariff walls to keep out their creampuff, backward, epicene British rivals?"¹⁴ The strange contradiction of viewing the Sterling Area as both burden and crutch is the logical conclusion of an argument that can be traced backwards to the acceptance the pre-war fourth arm argument hook, line and sinker.

Barnett is by no means unique in the completeness with which he does this, arguing in relation to material needs of rearmament that "[b]y 1938 the volume of all these imports was running Britain straight towards a balance of payments crisis", and quoting Sir John Simon's lamentations to Cabinet without qualification or analysis. Barnett states, solely on the basis of such official pessimism that: "With a fall of a quarter in Britain's total gold and convertible currency reserves since the previous year, national bankruptcy, a distant iceberg on the horizon in 1937, now began to loom huge and jagged in the offing."¹⁵ Ignoring the issue of whether this drain could have been avoided or halted outright, he uses the fact of it to maintain, like Simon, the position that: "By the spring of 1939 the contrast between Britain's self-perpetuated role of first class world and imperial power and her backward industrial economy had brought her within the zone of icy chill that spelt inevitable shipwreck."¹⁶

As we have seen, however, it was admitted within Government before 1939 that the deficit on the balance of payments current account posed no immediate threat to British solvency, even under the existing system with no extension of market controls, and it was hardly responsible for the bulk of the gold drain which was known to be motivated primarily by the diplomatic situation. Barnett is alone in suggesting that British industrial 'backwardness' had any connection with the loss of reserves. Indeed, even the Government line was rather that the voracious appetite of the buoyant industrial machine was sucking in

¹⁴ W.D. Rubinstein, "Cultural Explanations for Britain's Economic Decline: How True?", in B.Collins & K. Robbins (eds), *British Culture and Economic Decline*, (London, 1990), pp.67-68.

¹⁵ C.Barnett, *The Audit of War: The Illusion and Reality of Britain as a Great Nation* (London, 1986), p.144.

¹⁶ Ibid.

imports. Even then, the Treasury's complaint in 1939 that 30% of rearmament expenditure went abroad, still indicated that 70% of arms production was generated from domestic resources, and the strength of British industry during the 'Roosevelt recession' has great significance when viewed in a wider context.

It has become widely accepted that the final and spectacular U.S. recovery from the depression was the result of rearmament, which mobilised the 'spare capacity' in the U.S. economy. However, the inadvertent British rôle in U.S. recovery before the war cannot be ignored. The volume of gold fed into the U.S. economy with London's help, was in itself vast but there were two other factors of importance. The gold was distributed through the Federal Reserve system as a *basis* for the creation of much larger amounts of money in the form of bank credit. Then, once this money was in circulation there was of course the multiplier effect, discovered in Britain by Kahn and in the late 1930s becoming understood through the mechanism of Keynes' General theory. A remarkable combination of Morgenthau's intuitive though unlearned grasp of America's economic interest and the corresponding ignorance of his supercilious British counterparts, paved the way for American success. The foundation of U.S. recovery was thus well in place before significant orders for weaponry were placed.

The concept of 'spare' American capacity is, however, too glibly stated. British shipbuilding fell to 7% of its pre-war total before rearmament¹⁷ yet nowhere is it argued that there was spare capacity for the industry to increase its production more than fourteenfold, and with good reason because this was not the case. Nor was it in the United States. Capacity is not the same as potential. Productive capacity lost is capacity lost forever. New Capacity can be created only when new capital mobilises available resources, and realising this America triumphed. The United States flourished because the Federal Government accepted by 1938 that capital scarcity was its single greatest problem and took action accordingly.

The British, in contrast, blinded by a fourth arm perspective believed their capital stock ample to finance their modest military programme, until the outbreak of war showed the need for the money that had been allowed to go to America. The British Government

¹⁷ P.Kennedy, *The Rise and Fall of the Great Powers: Economic Change and Military Conflict from 1500 to 2000* (London, 1988), p.408. Kennedy's argument that the U.S. economy "was merely underutilized because of the Depression", with idle American resources simply waiting for employment on weapons contracts is now a truism. *Ibid.*, p.429.

was oblivious both of the scale of production that would be required and the scale of production that was possible if correct measures were taken. As has been suggested, this gulf of comprehension was the single largest factor working for the United States. To look at the matter another way, indeed from an Atlanticist liberal viewpoint, both Britain and the U.S. were looking to mobilise their vast though undeveloped resources with the available capital of the capitalist world. The sums available were not sufficient for both to succeed. The U.S. used the gold it had captured since 1914 for this purpose, and the British contributed the share under their control for American use, while neglecting their own needs. Added to the direct purchases of weaponry before lend-lease it is small wonder that the U.S. economy recovered, or that British economic independence was lost. It is tempting to speculate what might have been achieved had this money been spent at home.

This is particularly true of the years of U.S. non-belligerency, when the return on the money poured into U.S. contracts was small indeed. "Munitions production in the U.S. was quite small even at the time of the entry of the U.S. into the war. What expansion had been realised was in part the legacy of cash orders placed by the U.K. and other Empire Governments with individual firms and with the encouragement of the U.S. administration."¹⁸ Indeed: "Deliveries on these orders in the eighteen months up to the end of 1941 were 40 per cent. of all aircraft production in the U.S., and even then the contracts were by no means fully delivered."¹⁹ The legacy of the fourth arm policy can be seen in the war years and the explosion of U.S. war production. If "[i]t was British ordering which established U.S. production of such important types as the Mustang fighter (developed from the Spitfire design)" and the progress of U.S. contracts was so painfully slow, it can be argued that it would have been better to build up a Canadian industry sooner than was done and reserve some of this money for the development of types which could have been built at home and in the Empire.²⁰ This would have avoided the wasteful situation where America

¹⁸ R.G.D. Allen, "Mutual Aid between the U.S. and the British Empire", in *Journal of the Royal Statistical Society* 109, (1946), p.267.

¹⁹ Ibid., p.268.

²⁰ Development of a Canadian armaments industry could have served a useful political purpose. Canada's Liberal Government opposed closer military involvement with Britain, but "the Canadian military establishment ... more clearly than most saw that Canadian public opinion would ultimately accept, even demand, the overseas commitment of armed forces". Mackenzie King could scarcely have resisted lavish inward investment at Britain's expense which would have tied Canada more closely to Britain's war effort. Such a move was expected in the United States, and Roosevelt, uneasy at the possibility of a vast Canadian industry falling into the wrong hands illustrated his fears in conversation with Morgenthau. The latter said that "it sounds very silly

“remained a large producer of weapons and ammunition of British design until quite late in the war, but her contribution might have been larger had there been a greater standardization of types and calibres”.²¹ There is an ironic echo here of the 1920s Treasury Argument that a little saving at present made huge debt saving possible later. The same applies to investment in that money spent early makes possible great returns from production later.

The economic events of the war, though, useful as they are in aiding our understanding of British unpreparedness, were but echoes of past mistakes. In fact, the triumph of liberal economics in overturning the protectionist victory of 1931 can be measured in the scale of Britain’s financial embarrassment in 1938 and 1939. Far from constructing the impressive military capacity of which they were capable, the British actually worked hard to weaken their ability to wage war, in ways of which the limitation of expenditure was only a component. The drain of sterling, the Tripartite Agreement, the Anglo-American Trade Agreement were all, along with rationing of defence expenditure, aspects of the same philosophy: that the fight against Nazism was a struggle of ideals, not of nations, and if the price of maintaining these ideals in victory was to pass the torch to the United States then so be it. However, this issue was hardly faced by liberals, who took an absurdly unrealistic view of American altruism and selflessness, just how unrealistic being demonstrated day by day in the last years of peace.

In making these points about the relative importance of capital movements we are in fact drawing attention to the importance of the time factor in the economics of war potential, a consideration which makes nonsense of talk of structural weakness and long term decline. Economic power is a protean force, which can be made or wasted with phenomenal speed. Success lies in getting it right and continuing to get it right with each new day. The war and its aftermath demonstrate this point, whether in the explosion of U.S. wartime production, or the recovery of defeated Germany and Japan to having the second and third largest economies of the capitalist world within a few decades of being reduced

today, but how long do we know that Canada and England are going to be our allies?” Roosevelt amplified this point by reference to the example of the Napoleonic turncoat Bernadotte. J.A. English, “Not an Equilateral Triangle: Canada’s Strategic Relationship with the United States and Britain, 1939-1945” *The North Atlantic Triangle in a Changing World: Anglo-American-Canadian Relations, 1902-1956* (Toronto, 1996), p.152; FDR MD Book 146, p.289. Treasury Meeting, 20th October 1938, 11.a.m.

²¹ Allen, “Mutual Aid”, p.268.

to bare subsistence on the victors' rations. War, as Hitler knew well, could be employed as a policy option to transform the relative wealth of nations at speed. The particular and volatile circumstances of the 1930s meant that relative failure to rearm was likely to result in the unfortunate loser being churned under by subsequent military attack. A successful economy had to be protected from this outcome to prevent its wealth becoming plunder. This truth was expressed succinctly in Chamberlain's observation that: "We are a very rich and a very vulnerable Empire, and there are plenty of poor adventurers not very far away who look on us with hungry eyes."²² The British practice of sharply dividing times of peace and war in economics was, therefore, desperately dangerous. Lord Swinton, pressing for increased estimates after the Anschluss argued that "it was the only insurance. Without it we could not live to use our resources."²³ More cruelly, Simon was criticised as husbanding funds, even into wartime, to "ensure that the country had enough money left to pay indemnities to the victors".²⁴

The decline of Britain from a position of prosperity to the wartime consumption of its remaining capital stock and dependence on the U.S. was not an inevitable, or indeed logical, outcome. The post-1931 recovery was based on a new system that proved conducive to rearmament, and the strong growth of the 1931 recovery was continued into the rearmament period, at which time the *financial* problem was to contain sterling's upward surge. The beginning of rearmament stoked this engine still further. After the Anschluss, the financial indicators went naturally in the other direction. In these circumstances it was necessary to extend the Ottawa system to increase the capacity of the Imperial system, and to bring the financial system into line with economic progress by introducing exchange control to conserve the capital that would maintain economic impetus into wartime and serve as a base for further expansion. Then the economy could have continued to grow, the capital stocks to increase and the reserves to accumulate.

The fourth arm policy froze these levers and prevented their use. Financial disaster ensued, resulting in the ironic paradox that the weakness produced by this policy of fending off war preparation kept bringing forward the optimum date for the commencement of hostilities. This was the practical consequence of the attitude that only the actual outbreak

²² K. Feiling, *The Life of Neville Chamberlain* (London, 1946), p.323.

²³ PRO CAB 23/93, p.123. Cab. (18)38 Cabinet Minutes, 6th April 1938, p.22.

²⁴ B.E.V. Sabine, *British Budgets in Peace and War, 1932-1945* (London, 1970), p.300.

of hostilities would impel the adoption of a financial and economic policy more suitable to Britain's actual situation of undeclared war. By early 1939 it was obvious to members of the Cabinet that under existing policy, and with war seemingly inevitable, the crisis should not long be delayed. Had policy remained on the course pursued until 1936, the question might not have seemed so urgent. On 3rd September 1939, Britain, being rich, had no excuse for being vulnerable.

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