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Chapter 5

Effects of War on Lombard Street

CHAPTER 4 has indicated clearly that war brought unusual activity to Lombard Street, and that the activity was limited almost entirely to transactions with one customer—the government. So drastic a departure from the normal functioning of British financial institutions necessarily produced changes that may have far-reaching implications.

BANK OF ENGLAND

The most pronounced changes in the Bank of England's return during the six years of war were the virtual disappearance of the Issue Department's gold holdings, the decline in the Banking Department's reserve ratio, the 150 percent rise in note circulation, and the accompanying 370 percent increase in the Issue Department's holdings of government securities (Appendix Table A).

The growth of the Bank's note circulation, and the corresponding increase in holdings of governments by the Issue Department, was fairly steady throughout the entire war period. The expansion of about 165 percent in total active currency circulation, which in World War II consisted almost entirely of Bank of England notes, seems moderate when compared with the 700 percent rise during World War I, or even with the 340 percent rise in the Canadian and 280 percent rise in the United States active currency circulation during World War II.

In so far as the Bank's profits were concerned, developments in the Issue Department were of no importance. As mentioned in Chapter 1, gold and government securities were the Issue Department's chief assets, notes its sole liability, even before the war; and since profits of the Issue Department reverted to the government, the replacement of gold by interest-earning government securities added nothing to dividends.[1]

In the Banking Department, total assets expanded considerably, and earnings probably rose more than costs, although no official information is available on this point. However, throughout the war period dividends were held at 6 percent, as they had been ever since

[1] Profits of the Issue Department for various fiscal years were published in the House of Commons *Debates* (July 21, 1943), as follows (in millions of pounds sterling): 1940, £6.1; 1941, £8.9; 1942, £7.6; 1943, £9.1.

1923. When the dividend for 1943 was declared, this rate, which is the same as the first dividend of the Bank, declared in 1695, provided a yield on current value of shares about equal to the yield on consols. Possibly the Bank accumulated undistributed profits not shown in its return, but, on the whole, its position in respect to earnings (which for many generations has not been a major consideration in the operation of the Bank) was not profoundly altered by the war.

The Bank's position as a world institution, however, was affected significantly by developments in both departments. The substitution of government securities for the Issue Department's gold holdings, and the drop in the Banking Department's reserve ratio (or "proportion") far below the traditional 30 percent, constituted a profound change in British banking. For at least a century before 1931, the Bank of England's reserve ratio was the primary index of the credit situation in the whole money market—not for England alone, but for virtually the whole financial world. No substitute for this easy guide to probable developments in the money market has been provided. Henceforth, monetary policy will be guided less by the state of the Bank's return, and more by a whole complex of criteria, including such factors as the volume of unemployment and the balance and terms of trade. The very ease with which the Bank's gold holdings were removed and the ratio of reserves to deposits reduced without the slightest flurry in the money market shows how far the world has moved away from a monetary system in which major decisions were based on purely banking considerations.

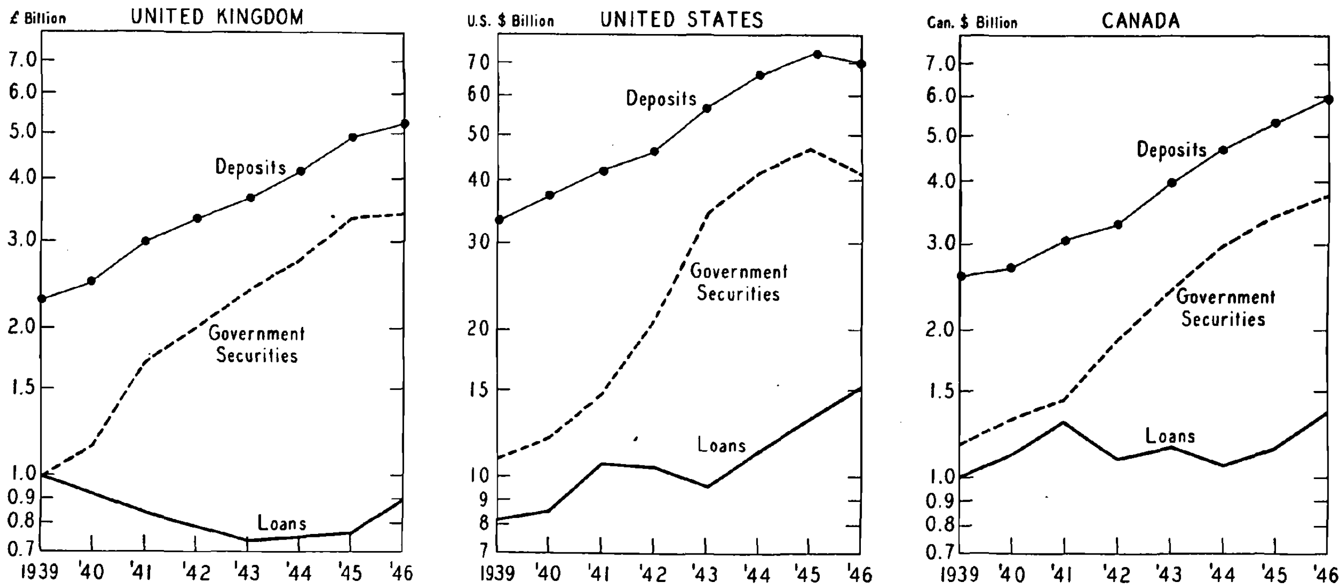
Joint Stock Banks

As in the United States and Canada, the most obvious effect of war finance on the balance sheets of commercial banks was the increased holdings of government securities on the one hand and the growth of deposits on the other (Chart 3).[2] The importance among total assets of government securities of all kinds—both short-term and long-term—grew considerably. At mid-1945 they amounted to 61 percent of total assets compared with 58 percent for the United States and 52 percent for Canada. "Investments"—i.e., medium- and long-term securities—doubled (Table 8); as a percent of total assets, however, they declined from 24 percent to 22 percent, and as a percent of total deposits from 27 percent to 23 percent. More important was the port-

[2] Since detailed balance sheet statements for all joint stock banks combined are not available, the figures in this section are based on data for London clearing banks. A comparison of the data in Appendix Table B and those in Table 8 indicate that the percentage changes for the two groups of banks differ only slightly.

Chart 3—Selected Balance Sheet Items for Banks in the United Kingdom, United States, and Canada[a]

(*logarithmic vertical scale*)



[a] Sources: United Kingdom: Bank of England, *Statistical Summary* and *Monthly Digest of Statistics;* United States: *Banking and Monetary Statistics* and *Federal Reserve Bulletin;* Canada: Bank of Canada, *Statistical Summary.*

Figures as of August each year. Data cover eleven London Clearing Banks, Reporting Member Banks of Federal Reserve System, and Canadian Chartered Banks.

Table 8—COMBINED BALANCE SHEET OF THE LONDON CLEARING BANKS[a] (pound figures in millions)

	August 1939[b]		August 1945[c]	
	Amount	%	Amount	%
Assets				
Coin, notes, and balances with Bank of England	£233	9.3	£511	10.0
Balances with other banks[d]	68	2.7	128	2.5
Money at call and on short notice	147	5.8	233	4.5
Acceptances and endorsements	132	5.2	e	e
Advances to customers and other accounts	985	39.1	756	14.8
Bills discounted	279	11.1	195	3.8
Investments	599	23.8	1,126	22.0
Treasury deposit receipts	....	....	1,993	38.9
Miscellaneous assets	75	3.0	177	3.5
TOTAL[f]	2,518	100.0	5,119	100.0
Liabilities				
Current accounts	1,239	49.2	3,236	63.2
Deposit and other accounts	1,007	40.0	1,638	32.0
Total deposits	2,245	89.2	4,875	95.2
Other liabilities	273	10.8	244	4.8
TOTAL[f]	2,518	100.0	5,119	100.0

[a] From Bank of England, *Statistical Summary,* June 1940, p. 46, and December 1945, p. 96. Data are for 11 banks.

[b] Averages of weekly balances.

[c] Balances on a day, varying from bank to bank, toward the end of the month.

[d] Balances with, and checks in course of collection on, other banks in Great Britain and Ireland.

[e] Data not available.

[f] In some cases totals do not agree with sums of items because of rounding.

folio of Treasury deposit receipts, which grew from nothing to 39 percent of total assets. Finally, "bills" at the close of the war consisted almost entirely of Treasury bills, and amounted to slightly less than 4 percent of total assets. Advances during the war period dwindled from 39 percent to 15 percent of total assets; in fact, they declined even in absolute terms.

The rise in investments and the drop in bank advances reversed the customary relationship among bank earning assets.[3] Investments, consisting mainly of government securities, had increased substantially during the years 1929-33, but were fairly stable during the later thirties; the rapid rise since 1939 can be regarded as essentially a wartime phenomenon. Advances, however, showed a tendency to fall off relative to other assets even in the thirties, and the wartime decline may be merely an acceleration of this prewar trend. *The Economist* has stated, "Before the war 44 percent of the banks' resources (taking the clearing banks as a whole) were employed in advances to industry and private borrowers, while 46 percent represented direct and indirect loans to the Government—excluding cash, which is really a further, interest-free, loan. Now the corresponding proportions are 17 percent for private borrowers and 70 percent for public."[4]

Total monetary expansion in Britain was considerably less than in the United States, about the same as in Canada, but somewhat more than British monetary expansion in World War I, when the money supply approximately doubled. When clearing bank deposits are added to currency in circulation, British money supply increased somewhat more than 115 percent in the six years of World War II, while the Canadian money supply rose by approximately the same amount, and the American supply by more than 165 percent. The bulk of deposit expansion was in current accounts; by August 1945 total deposits had risen 117 percent while current accounts had increased 161 percent. Direct loans to customers played a relatively small role in deposit expansion; for the most part, the increase in deposits (as in Canada and the United States) represented growth of business accounts (Chart 4).

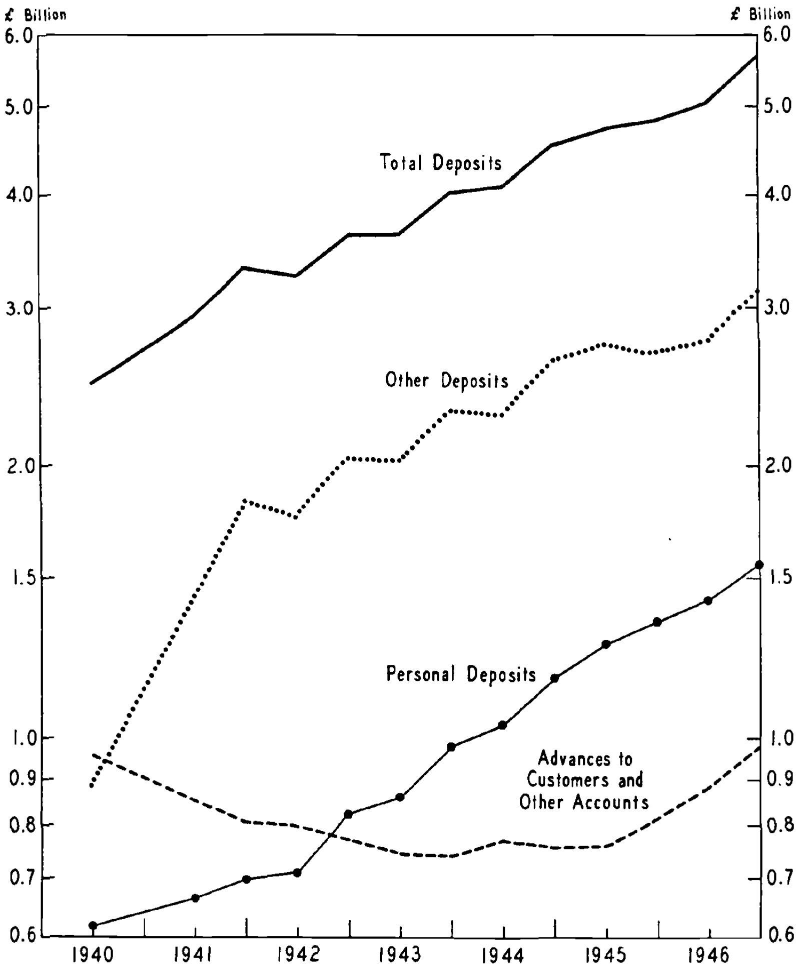
[3] The "ideal" asset structure was presented to the Macmillan Committee on Finance and Industry in 1930 by Frederick Hyde, then managing director of the Midland Bank. A comparison of the current asset structure with this "ideal" shows that, while the broad outlines are unchanged, the banks have departed considerably from the "ideal" structure in so far as the detailed assets are concerned (figures are ratios to assets):

	"Ideal" Asset Structure		London Clearing Banks August 1945	
Cash items				
Cash, etc.	10.0		12.5	
Money at call	6.3	16.3	4.5	17.0
Earning assets				
Advances	49.5		14.8	
Bills discounted	14.5		3.8	
Investments	10.8		22.0	
Treasury deposit receipts	....	74.8	38.9	79.5
Other assets	8.9		3.5	
TOTAL	100.0		100.0	

[4] *The Economist,* January 26, 1946, p. 140.

Chart 4—Growth of Personal and Other Accounts of the London Clearing Banks[a]

(*logarithmic vertical scale*)



[a] Source: British White Papers on *War Finance, National Income and Expenditure* (Cmd. 6520, April 1944, and Cmd. 6438, April 1943); *Monthly Digest of Statistics,* March 1947, Table 126.

Net personal deposits exclude the accounts of businesses, financial institutions, public authorities, and also those of individual traders, shopkeepers, farmers, and professional men where the accounts are known to be used for the purpose of business.

Cash reserves kept pace with deposits, so that the reserve ratio was maintained between 10 and 11 percent.[5]

Published figures of bank profits are not very satisfactory,[6] but it seems clear that war did not injure bank prosperity. While the composition of earning assets changed, the ratio of earning to total assets increased, and total assets doubled. Replacement of advances carrying 4 or 5 percent with government obligations bearing 3 percent on long-term and 1 to 2 percent on short-term, inevitably lowered the rate of earnings on total bank assets. According to various financial writers, National War Bonds bearing 2½ percent comprised a large share of bank investments. Nevertheless, total profits apparently increased as a result of over-all expansion. *The Economist* estimated that gross earnings of the London clearing banks rose from £67 million for the year ended June 1939 to £84 million for the year ended June 1944.[7] Apparently no bank became subject to excess profits taxation, and there was considerable speculation as to why this was the case. Several reasons were suggested: Profits in the base year were high because of advantageous security sales. The banks were allowed to write off their German standstill balances against profits for tax purposes. Low profits in the early war years reduced the taxable average of later years.

[5] It will be noticed that the rate of deposit expansion dropped after the second year of war. This deceleration has been attributed to the introduction of tax reserve certificates in December 1941. Individuals and businesses which had previously held cash balances to meet tax payments preferred to hold tax certificates once these were made available.

[6] *The Banker,* February 1943, p. 93, speaking of bank profit figures, asked: "What are we to make, in the circumstances, of the Banks' published profits? Not a great deal, evidently. 'It is not always easy,' says Lord Wardington, 'to decide whether any item in a particular year is likely to be of a recurring nature, and therefore to be reasonably included in our Profit and Loss, or whether, on the other hand, it would be wiser to consider it as exceptional and more suitable to be placed to reserve for contingencies in a less favorable year. All these, and many other factors, make a scientifically accurate comparison of profits one year with another a matter of considerable difficulty. To show these differences year after year by a closely detailed analysis of our Profit and Loss would be impracticable in any statement short enough to be intelligible. The whole matter seems to resolve itself into a question of sound banking judgment . . .' "

[7] July 22, 1944, p. 117. The basis of the calculation is as follows, with volume and earnings figures given in millions:

	1939			1944		
Assets	Volume	Yield	Earnings	Volume	Yield	Earnings
Call money	£150	1¼%	£1.9	£184	1%	£1.8
Bills	249	1⅝	4.0	202	1	2.0
Treasury deposit receipts				1,246	1⅛	14.0
Investments	600	3⅝	21.7	1,169	3⅛	36.5
Advances	988	4	39.5	770	3⅞	29.8
Gross Earnings			£67.1			£84.1

Costs rose on several counts. The banks paid full salary less soldiers' pay to members of their staffs who entered the Armed Forces. Interest paid on deposits rose a little in absolute terms, but as a percentage of deposits it declined, since most of the increase in deposits was in current accounts on which relatively little interest was paid.

Table 9 suggests that bank profits rose substantially but tells us nothing about profitability of banking as a business enterprise. Mr. McKenna, late Chairman of the Midland Bank, quoted bank earnings on "the shareholders' true capital" at about 4 percent; but *The Economist* believed that, if this figure was correct, the banks must have had substantial reserves in excess of those reported.

Table 9—NET PROFITS OF JOINT STOCK BANKS[a]
(in millions)

	1943	1944	1945	1946	Profits "Grossed-Up"[b] Change, 1939-1946	Change, 1929-1946
Barclays	£1.6	£1.7	£1.7	£1.7	+10.8%	+10.0%
Lloyds	1.5	1.7	1.6	1.6	+17.4	— 4.9
Midland	2.0	2.0	2.1	2.0	+ 7.0	+13.7
National Provincial	1.3	1.3	1.4	1.3	+28.5	+10.0
Westminster	1.3	1.4	1.4	1.4	+24.3	— 3.3
TOTAL	7.7	8.0	8.2	7.9	+13.5	+ 5.2

[a] From *The Banker,* February 1947, p. 104.
[b] "The year 1943 was the first in which comparisons in published profits between the several banks was possible, as in earlier years some banks computed 'net' profits after deducting tax on their dividends while one bank showed the dividends gross. This difference is eliminated, however, if published profits are 'grossed-up' by adding back income tax at the standard rate (and N.D.C. for war years), thus making comparisons possible over a longer period." *Loc. cit.*

MERCHANT BANKS

Because of their unfortunate experiences during and after World War I (as outlined in Chapter 2), the position of the merchant banks was none too strong when World War II broke out. During World War II their normal operations were again restricted by the virtual disappearance of bills of exchange and acceptances, by suspension of new issue business, and by their omission from the list of authorized dealers in foreign exchange. Little of the expansion noted for the joint stock banks was evidenced by merchant banks.[8] (See Appendix Table E.)

[8] Since few of the merchant banks publish complete statements, it is not possible to give a picture of the effects of the war on merchant banks as a whole.

Indeed, S. Japhet suffered a net contraction of total assets between 1939 and 1945; advances were reduced sharply, while investments showed only a slight increase. Baring Brothers and Hambros also added to their portfolios of "other securities." The net effect on earnings of the merchant banks is not easy to ascertain; but it seems possible that those firms which expanded their total assets were able to increase their total earnings as well.

Discount Market

The discount houses, while hardly showing the expansion of the joint stock banks, were not held in check so much as the merchant banks. Bills discounted and investments, in particular, rose substantially.[9] The growth of this latter item, which consisted largely of increased holdings of short-term government bonds, constituted what *The Economist* termed "a silent revolution in Lombard Street." In the late thirties, the discount market "did indeed deal substantially and increasingly in short bonds," but this break with tradition was "tolerated simply as a means of keeping discount market machinery in working order until its bill-dealing functions revived." Because of their key role as go-between for the Bank of England and the joint stock banks, the disappearance of the discount houses would have required considerable reorganization of the British financial system. During the war, bond dealing became "legitimized, and, if not yet the primary function of the discount market, . . . certainly as important as its bill-dealing function."[10] It is questionable, however, whether the over-all growth and the shift to bonds were sufficient to offset entirely the reduction in earnings resulting from the substitution of Treasury bills for commercial bills. The figures of the three major houses indicate that it was not.

It may have been considerations such as these that persuaded the Bank of England to express openly in 1941 its long-felt wish to see the discount market consolidated into fewer and stronger units. In the first four years of World War II, seven discount houses disappeared, leaving a total of eleven concerns. By the spring of 1944, the resources of each remaining concern (except Seccombe, Marshall, and Campion[11]) were at least £500,000, and the eleven combined had resources of £14.4 millions.[12]

The interesting feature of this wartime consolidation, however, is that it took the form of absorptions and mergers rather than with-

[9] See Appendix Table D.
[10] "Short Bond Problems," *The Economist*, November 24, 1945, p. 756.
[11] Brokers for the Bank of England in transactions with the market.
[12] "Consolidation of the Discount Market," *The Banker*, May 1944, pp. 79-84.

drawals from the market. Only two concerns retired altogether, and during the sixth year of war there was actually a net inflow of capital to the discount market. The reason lies in the opportunity for profitable investment in government obligations that developed during the war and which was expected to remain when the war was over. "It can be taken for granted," wrote a correspondent to *The Banker* in 1944, "that [the actual] method of achieving the desired consolidation would not have been permitted had the authorities not been convinced that the market after the war will have an important function to perform in the gilt-edged sphere."[13]

Capital Market

The effectiveness of the embargo on new capital issues is apparent from Table 10. The immense capital expansion necessitated by the war was not financed through the regular channels of the capital market.

Table 10—New Capital Issues in the London Market[a]
(in millions)

	1938	1939	Total 1940-44	1945	1946
Home					
Public bodies	£27.6	£12.1	£3.7	.0	.0
Production	48.3	19.0	17.6	£13.1	£73.5
Trade	11.0	3.4	1.3	2.9	26.5
Transport	.5	7.4	.1	.2	.4
Finance	5.4	1.5	.4	.8	11.3
Total[b]	92.7	43.3	23.1	17.0	111.7
India and Ceylon					
Public bodies	.0	.0	.0	.0	.0
Companies	.5	.9	.2	.1	.1
Total	.5	.9	.2	.1	.1
Other British Countries					
Public bodies	10.1	12.6	.0	.0	.0
Companies	10.7	4.8	1.7	2.4	16.7
Total	20.8	17.4	1.7	2.4	16.7
Foreign Countries					
Public bodies	.0	.0	.0	.0	.0
Companies	4.1	4.6	1.6	1.0	2.3
Total	4.1	4.6	1.6	1.0	2.3
Total Overseas[b]	25.4	23.0	3.4	3.5	19.1
All Issues	118.1	66.3	26.5	20.5	130.8

[a] From Midland Bank special report on new capital issues, released January 1, 1947. Figures for years ended December 31.

[b] In some cases sums of items do not agree with totals because of rounding.

[13] *Ibid.*, p. 84.

This development is not surprising, for, while the Capital Issues Committee would probably have authorized public issues by war industries, such securities would hardly have appealed to the investing public. War plants are specialized investments subject, on the one hand, to profit limitations and, on the other, to special risks because of the nature of the market and the high rate of obsolescence of war equipment. It is for such reasons that a large part of Britain's war machinery was built up by the government on its own account.

The war and the financial difficulties of reconstruction, inherent in war on so vast a scale, finally brought action to meet the problem of providing small and medium-sized British concerns with investment capital, and of providing intermediate-term credit for British industry. This problem is one of long standing in England. During the fifty years prior to 1945, every person and every parliamentary committee concerned with financial problems of British industry and trade emphasized the need for new machinery to meet it. The joint stock banks were frequently criticized for their policy of restricting themselves to short-term advances representing only a small proportion of the funds in use by a specific business, and their "noncommittal" attitude toward their customers. Some critics lauded the American investment bank and the continental industrial bank financing of industry as examples that might be followed. Others, however, pointed to the failure of the German industrial banks, and emphasized the drastic revision in the nature of British banking that would be entailed in expansion of its industrial business to the German scale. It was also argued that, whereas German industry had always been short of capital, there might not exist in Britain a sufficient long-run demand for intermediate-term industrial credit to warrant a transformation of the banking system.[14]

Certain relatively small organizations had been set up to assist with industrial financing: Credit for Industry, Ltd., owned by the United Dominions Trust; the Charterhouse Industrial Development Company, controlled by the Charterhouse Investment Trust; and the Bankers' Industrial Development Company, set up during the early 1930's under the joint auspices of the Bank of England and the joint stock banks to assist large or basic industries with reconstruction. The combined resources and operations of these organizations, however, were not adequate to meet the need for intermediate-term credit, and for capital of small and medium-sized concerns.

In the spring of 1945, with the European war in its final phase, the

[14] Cf. G. Eberstadt, "Industrial Banking Reconsidered," *The Banker,* April 1944, pp. 15-19.

Chancellor of the Exchequer announced in the House of Commons that two new financial institutions would be set up to meet this vexatious problem. One was the Finance Corporation for Industry, owned by the Bank of England, the insurance companies, and the trust companies, which held respectively 30, 40, and 30 percent of the total capital of £25 million. It had power to borrow up to an additional £100 million, bringing its total potential resources to £125 million. The stated purpose of the Corporation was "the provision of temporary or longer period finance for industrial businesses of the country with a view to their quick rehabilitation and development in the national interests, thereby assisting in the maintenance and increase of employment." It was to take no initiative in the reorganization of industry and to confine its activities to the provision of finance. It was intended to supplement, and not to displace, previously extant channels through which industrial concerns obtained finance. The Board of the Company was chosen from the business world, but "the appropriate Departments" of the government were to be "kept informed" of "developments of major importance."[15]

The second institution, the Industrial and Commercial Finance Corporation, had capital of £15 million, one-third subscribed by the Bank of England, the balance by the London Clearing Banks and the Scottish banks. It had authority to borrow another £30 million from its shareholders. Its function was "to provide credit and finance by means of loans or the subscription of loan or share capital or otherwise for industrial and commercial businesses or enterprises in Great Britain particularly in cases where the existing facilities provided by banking institutions and the Stock Exchanges are not readily or easily available." This statement of purpose was interpreted to mean that the corporation would make loans mainly within the range of £5,000 to £200,000—loans too big for the joint stock banks and too small for the capital market.

Like the Finance Corporation, the Industrial and Commercial Finance Corporation was designed to supplement, and not to compete with, other banking facilities and particularly to meet the capital needs of small and medium-sized businesses. The directors were appointed by the share-holding banks, and the first chairman was named by the Bank of England. In keeping with British tradition, no *legal* limitations were placed on the powers of the Corporation in regard to the size of loans it could make.

[15] See "Finance for Industry and Commerce," *Journal of the Institute of Bankers,* April 1945, p. 72.

Other Developments Important to Lombard Street

Other wartime developments of significance to Lombard Street were, for the most part, similar to those during World War I: a decrease in exports, loss of shipping, industrialization of other countries, loss of continental insurance and short-term credit business, liquidation of foreign assets, and accumulation of sterling balances.

Exports

Commercial exports of the United Kingdom shrank from £471 million in 1938 to £258 million in 1944. In terms of physical volume, exports in 1944 were only 30 percent of their 1938 level. Indeed, the demands of the armed forces and war industries imposed a greater relative reduction of employment in the direct export industries than in any other major group of industries. However necessary or advantageous this re-allocation of manpower may have been in terms of allied war strategy, it left Britain with a particularly difficult task in attaining her postwar objectives of maintaining full employment and providing a high standard of living for her people, while meeting her needs for foreign exchange. The achievement of these goals depended upon the export industries.

Shipping

Income from shipping was a large factor in Britain's prewar balance of payments. The insurance of shipping and the financing of trans-oceanic trade was an important prewar source of revenue to Lombard Street. The City therefore has a double interest in the fate of British shipping: one immediate and one indirect. While the correlation between nationality of ships and nationality of the firms insuring them and financing their cargoes is by no means perfect, there is some relation. Other things being equal, it is reasonable to suppose that the share of Lombard Street in insuring and financing world trade will vary directly with Britain's share in world oceanic shipping. In addition, since shipping contributes heavily to British prosperity, especially through helping to balance foreign payments without restrictive or deflationary policies, it contributes indirectly to the general activity of Lombard Street.

During World War II, as in World War I, Britain's relative position as a world shipper deteriorated (Table 11). Before the war, Britain had the world's largest merchant fleet, amounting in June 1939 to more than 18 million gross tons, or more than one-quarter of the world's merchant fleet. During the European war, Britain's loss was

Table 11—MERCHANT TONNAGE (1,000 GROSS TONS AND OVER) OPERATED BY PRINCIPAL MARITIME COUNTRIES[a]

Country	June 30, 1939 (gross)	June 30, 1945 (gross)
United States (nonmilitary)	8,672,090	27,959,000
United States (military)		8,254,000
British Empire (except Canada)	18,179,020	14,934,00[b]
Canada	654,786	892,000
Belgium	374,575	241,000[b]
Brazil	419,962	445,000
Denmark	1,069,937	748,000
France	2,745,884	1,113,000[b]
Germany	3,973,893	1,068,000
Greece	1,727,931	697,000[b]
Netherlands	2,728,381	1,576,000[b]
Italy	3,245,670	350,000
Japan	5,255,627	1,526,000
Norway	4,552,895	2,813,000[b]
Spain	775,828	850,000
Sweden	1,364,683	1,389,000
Other countries	4,865,360	4,462,000
WORLD TOTAL	60,606,522	69,335,000

[a] From Knute E. Carlson and Geraldine Lytzen, "Postwar Shipping," *Foreign Commerce Weekly*, February 23, 1946, p. 4. The 1939 data were taken from Lloyd's Register of Shipping, Vol. II (1939-40) Table 5. Except for the United States, for which data were supplied by the U. S. Maritime Commission, the figures for 1945 were developed by adding construction and other acquisition to 1939 figures and subtracting losses.

[b] United States owned tonnage under lend-lease has been reported as part of the tonnage of the countries operating it. Thus Great Britain had 1,997,448 gross tons under lend-lease; U.S.S.R., 613,950; Norway, 181,923; Greece, 100,771; France, 93,445; Belgium, 50,327; Netherlands, 28,202; Poland, 16,529; and China, 14,386. Great Britain's figure also includes approximately 620,000 gross tons turned over to Great Britain by Canada.

considerable. Moreover, after the entry of the United States into the war, Britain diverted resources from merchant shipbuilding to other fields of war production, leaving merchant shipbuilding mainly to the United States, and to a lesser extent to Canada. During the whole period of the European war, Britain built less than 9 million tons of merchant shipping; captures and non-returnable acquisitions amounted to some 2 million tons. In sum, Britain's merchant fleet in June 1945 was less than 15 million tons, some 80 percent of the prewar fleet. Moreover, in quality and age the merchant fleet in 1945 was "immeasurably inferior" to the prewar fleet.[16]

Meanwhile, world tonnage of merchant shipping had increased

[16] "Shipbuilding Problems Now," *The Economist*, March 6, 1948, p. 386. See also "British Shipping in the New World," *ibid.*, February 7, 1948.

about 14 percent, with the increase concentrated mainly in the United States. Canada also enjoyed a substantial growth, and Spain, Sweden, and Brazil slight increases. All the rest of the world suffered losses; but while the Axis countries lost the highest percentages of their fleets, the net loss of tonnage in absolute terms was much higher for Britain than for any other country except Japan.

Britain therefore entered the postwar period at a considerable disadvantage so far as competing for postwar shipping business was concerned. Not only had her merchant fleet dwindled, both relative to the rest of the world and absolutely, but her shipyards were operating below prewar capacity, while the yards of the United States and Canada were operating well above prewar rates.

Industrialization of Other Countries

Britain's problem of expanding exports has been complicated by the wartime industrialization of countries that formerly provided markets for British manufactured goods.

In Canada, World War II accelerated the trend, already discernible in the interwar period, for that country to become an essentially manufacturing, rather than an essentially agricultural, country. During 1919, agriculture contributed 44 percent of the total net value of Canadian production, and manufacturing 33 percent. When World War II began, agricultural production had already shrunk to 22 percent of the total, while manufacturing had grown to 39 percent. In 1943, well over half the net value of Canadian production consisted of manufactured goods, and agriculture, despite a 60 percent increase in the value of agricultural production, accounted for only 20 percent of the total. The Canadian export situation has been well described by Homer S. Fox, Commercial Attaché of the United States Embassy in Ottawa. "Prior to World War I . . . exports of raw materials were nearly double the total exports of fully and semi-manufactured goods. . . . By 1944, . . . exports of manufactures were nearly three times those of raw materials, although the latter were in turn more than three times the corresponding exports in 1930."[17]

In Australia, wheat acreage was reduced during the war, acreage of some coarse grains expanded, and manufacturing output greatly increased. Factory employment rose from 542,000 in 1938-39 to 724,000 in 1944-45. Output of industrial metals, machinery, implements, and conveyances nearly doubled.

The war also led to acceleration of industrial development in such

[17] H. S. Fox, "Canada's Economy in 1945," *Foreign Commerce Weekly,* January 19, 1946, p. 6.

relatively unindustrialized countries as China and India. There is good reason to suppose that some of these wartime gains will be maintained. India has certain raw materials, such as cotton and leather, in abundance. Its labor is as yet relatively cheap, and with training can be made just as efficient as the British labor force. Moreover, India's new industries are not handicapped by established labor and managerial procedures, and are in many cases equipped with the most up-to-date machinery.

Some of the fields of Indian industrial expansion compete directly with former British exports. Mill production of cotton, for example, rose 90 percent between 1921-25 and 1934-38, and another 10 percent from 1938-39 to 1944-45. The value of production of woolen and worsted cloth rose during the war from £7.3 million per year to £27 million, and output of woolen clothing increased over 300 percent. Output of army footwear rose over sixfold. The iron and steel industry grew substantially, and two new aluminum plants were established. The engineering industry also expanded; whereas before the war only 10 percent of hand tool requirements were met by domestic production, by 1944 domestic production met virtually all Indian needs. The chemical, fertilizer, and drug industries also grew considerably.

There is, of course, no incompatibility between world-wide industrialization and a high level of world trade. A fact frequently cited is that the bulk of international trade takes place among the advanced industrial countries. It is equally clear, however, that *all* countries cannot export *all* types of manufactured goods. World-wide industrialization must be accompanied by increased geographical specialization within the field of manufacturing if world trade is to grow at the same time. In this process, Britain may find it necessary to abandon some of her traditional fields of export and to develop new ones.

Effects of the War on British Insurance

Insurance of foreigners was a significant source of income to the British money market before the war, and payment of insurance premiums by foreign policyholders was an important source of foreign exchange. "The overseas business of British insurance companies and underwriters at Lloyd's," *The Economist* has said, "is a national asset of substantial importance." Aggregate annual premiums were estimated at £100 million, and the net contribution to the balance of payments at £12 million to £15 million.[18]

Much of this business had been derived from countries in Europe and Asia which fell under the Axis domination during the war. Years

[18] "The Export of Insurance," *The Economist*, August 25, 1945, p. 272.

of enemy occupation resulted in dispersal of prewar portfolios. In Japanese-occupied cities such as Shanghai, not only portfolios but records and staffs disappeared, making it necessary, at the war's end, for British insurance firms to start from scratch to rebuild their shattered business in the Far East.[19] In Europe, the Germans had made not altogether successful attempts to transfer the British business to German concerns. A nucleus of perhaps 10 percent of prewar business in France was available at the war's end as a basis for rebuilding, as a result of a German regulation which permitted French policyholders to continue British policies already in force, provided the policies were reinsured in full with German companies.

Loss of Overseas Investments and Increase in Overseas Debt

Assistance provided by the United States, Canada, and other United Nations under the Lend-Lease and Mutual Aid Agreements was "too little and too late" for Britain to avoid liquidation of overseas investments on a scale even larger than in World War I. Total sales and repatriations of British foreign investments up to VE day, most of which took place before the Agreements were negotiated, are itemized in Table 12.

Table 12—PROCEEDS OF SALES OR REPATRIATION OF OVERSEAS INVESTMENTS OF THE UNITED KINGDOM, SEPTEMBER 1939 - JUNE 1945[a]
(in millions)

Sterling Area	
Dominions (Australia, New Zealand, South Africa, and Eire)	£201
India, Burma, and Middle East	348
Colonies and other sterling area countries	15
Total, Sterling Area	£564
North America	
United States	203[b]
Canada	225
Total, North America	428
South America	96
Europe	14
Rest of world	16
TOTAL	1,118

[a] Estimates from *Statistical Material Presented During the Washington Negotiations,* Cmd. 6707 (December 1945) p. 9.
[b] Does not include collateral for Reconstruction Finance Corporation loan.

[19] *The Economist,* September 22, 1945, pp. 424-25.

At the same time that the debts of foreigners to Britain were reduced, the debts of Britain to foreigners were increased. British external liabilities, most of which consist of short-term sterling balances accumulated by foreign banks, increased from £476 million on August 31, 1939 to £3,355 million on June 30, 1945.

The Lend-Lease agreement involved an increase in British net foreign obligations, not definitely stipulated at the time but later settled at $650 million. Finally, the financing of wartime imports involved a substantial depletion of the United Kingdom's gold and dollar reserves. Between August 31, 1939 and June 30, 1945, those reserves were reduced from £605 million to £453 million.

The effect of the war on the estimated international capital account position of the United Kingdom is summarized in Table 13. The figure for prewar long-term foreign assets, is, of course, only an estimate in so far as direct investments are concerned.

Table 13—ESTIMATED POSITION OF UNITED KINGDOM ON INTERNATIONAL CAPITAL ACCOUNT, SELECTED DATES[a]
(in millions)

Foreign Assets 1939		Foreign Indebtedness, September 1939	£476
Gold and foreign exchange	£700	*Plus*: Creation of debt, Sept. 1939—June 1945	2,879
Long-term investments[b]	3,900	*Equals*: Foreign Indebtedness, June 1945	£3,355
	4,600		
Less: Sales of Foreign Assets, Sept. 1939—June 1945			
Gold and foreign exchange	152		
Long-term investments	1,118		
	1,270		
Equals: Foreign Assets, June 1945[b]	£3,330		

[a] Data on foreign assets are from *The Economist,* November 10, 1945, p. 688; other data are from *Statistical Material Presented During the Washington Negotiations,* Cmd. 6707 (December 1945) pp. 11, 12.
[b] Estimated nominal value.

Figures of foreign assets and foreign debts, even if completely accurate, would provide no clear-cut indication of the relationship between interest and dividends received and paid. The net income on capital account obviously depends not only upon the relative magnitudes of assets and debts, but also upon the rate of return paid on each. By and large, since the foreign assets liquidated have not consisted, to any significant extent, of direct investments upon which the highest returns are earned (at least in prosperous years), and since the debts acquired are short-term obligations upon which the rate of interest, even after conversion into long-term debt, is not likely to be high, it would seem that Britain's position at the end of the war had deteriorated considerably less in terms of net income from foreign investment than in terms of net long-term capital position.

The figures presented in Table 14 substantiate this view. In 1945, despite the fact that Britain was probably a slight net debtor on capital account, she enjoyed a net income of £97 million from foreign investment. On the other hand, it should not be forgotten that this figure was less than half that received in 1938, and that this decline in net income from foreign investment involved a serious deterioration in Britain's balance of payments position as a whole.

Table 14—UNITED KINGDOM OVERSEAS RECEIPTS AND PAYMENTS OF DIVIDENDS, INTEREST, ETC., 1945[a]
(in millions)

Area	Gross Receipts[b]	Gross Payments[b]	Net Receipts
Sterling Area			
Dominions (Australia, New Zealand, South Africa, and Eire)	£45	£16	£29
India, Burma, and Middle East	11	22	—11
Colonies and other sterling area countries	17	12	5
Unallocated, sterling area	22	[c]	22
TOTAL	95	50	45
North America			
United States	9[d]	13[e]	—4
Canada	14	3	11
TOTAL	23	16	7
South America	28	1	27
Europe	12[f]	6	6
Rest of world and unallocated	12	[c]	12
TOTAL	170	73	97

[a] Data are partly estimated. From *Statistical Material Presented During the Washington Negotiations,* Cmd. 6707 (December 1945) p. 10.

[b] Gross receipts and payments include certain collections of interest on external securities remitted to holders overseas. This does not, of course, affect the figures of net receipts.

[c] Less than £1 million.

[d] Includes income on investments (other than insurance holdings) pledged to RFC.

[e] Includes interest charges on RFC loan.

[f] Includes nonrecurring payments of arrears arising in the war years.

Importance of Britain's International Financial Position for Lombard Street

Apart from the dependence of Lombard Street for its prosperity on the general economic and financial health of the nation that it serves, the British balance of payments problem is important to Lombard Street because it leads to replacement of private by public lending. The money market of a debtor nation can still be active; the City could make money from commissions on foreign borrowing just as well as on foreign lending. However, concern for the safety of the pound will limit the volume of private lending to Britain; and Lombard Street cannot make money out of inter-governmental loans, or from the operations of the International Monetary Fund and the International Bank for Reconstruction and Development. In addition, some of the foreign assets liquidated to meet Britain's wartime needs for dollars were presumably held by financial houses. Others were held by clients of these houses. It is at least questionable whether domestic lending to replace these lost assets could be expected to yield returns equal to those formerly earned on the liquidated assets. Indeed, there is a strong likelihood that it could not.

On the other hand, in so far as the British international financial position leads to a successful program of expanding exports, the position of Lombard Street will be improved to the extent that the increased exports are financed by British houses. How successful Britain will be in expanding foreign trade, and what the share of the City in its financing will be, are among the major factors that will determine the future of Lombard Street.