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# Chapter 3

# Government Controls and Lombard Street in World War II

WARTIME economic policy changed the scope and character of Lombard Street's activities in three ways. First, the huge scale of government borrowing resulted in greatly increased investment in government securities by financial institutions; this effect is discussed in Chapter 4. Second, the position of Lombard Street in the British economy was affected by the changed pattern of resource use, brought about by greatly expanded government expenditures, tax policy, direct controls of prices, production, manpower, foreign exchange, etc. Third, the banking system was accorded some new administrative functions in connection with war finance. Government policies related to the second and third of these effects are outlined in the present chapter.

The broad outlines of the changes in the structure of the British economy brought about by wartime policies are indicated in Table 3. Between 1938 and 1945, the proportion of total resources devoted to meeting personal consumption fell from 77.4 percent to 51.8 percent, and the proportion devoted to investment for nonwar purposes fell from 6.5 percent to 1.3 percent. On the other hand, the share utilized in government activities rose from 16.1 percent to 46.9 percent. Net imports of goods and services (which are paid for by borrowing abroad and by the sale of foreign assets) rose over twelvefold, reflecting a contraction of exports in excess of a concurrent decline in imports.

Government expenditures on goods and services in 1944 constituted about half the total value of production ("gross national product"); this was also true in the United States and Canada. Two conditions, however, distinguished the British war effort from the Canadian or American, as far as the magnitude of the financial task was concerned. First, as early as 1940 government expenditures on goods and services exceeded 40 percent of gross national product, whereas this figure was not reached until 1942 in Canada and the United States. Second, because Britain suffered more destruction of plant and more disruption of production throughout the war period, and because she entered the war with less unemployment, less excess capacity, and smaller stock piles than the United States or Canada, the problem of controlling

Table 3—British National Resources and Their Disposal[a]
(in millions)

| | 1938 | 1939-44 Average | 1945 | 1946 |
|---|---|---|---|---|
| National income of United Kingdom | £4,671 | £7,027 | £8,340 | £8.200 |
| Borrowing from abroad and sale of assets to foreigners | 70 | 645 | 875 | 380 |
| Total resources available for use at home | 4,741 | 7,672 | 9,215 | 8,580 |
| National cost of | | | | |
| Personal consumption | 3,668 | 4,033 | 4,777 | 5,500 |
| Government | 765 | 3,838 | 4,320 | 2,330 |
| Net nonwar capital formation at home | 308 | —199 | 118 | 750 |
| Total resources used at home | 4,741 | 7,672 | 9,215 | 8,580 |

[a] From *National Income and Expenditure of the United Kingdom, 1938-1946,* Cmd. 7099 (London, April 1947) p. 5.

inflation was more acute than it was on this continent. In the United States and Canada, fighting a "total war" involved no reduction in the volume of civilian consumption as a whole; but in Britain, civilian consumption declined by about 20 percent.[1] While complete prevention of inflation in the United States and Canada would have involved merely recapturing or sterilizing *increases* in money income, in Britain it would have been necessary to *reduce* disposable income in the hands of civilians. As Chart 2 shows, none of these countries succeeded in preventing wartime inflation altogether; but to achieve even the degree of success she did, Britain was compelled to use heavier taxation and more rigorous direct controls than her North American allies.

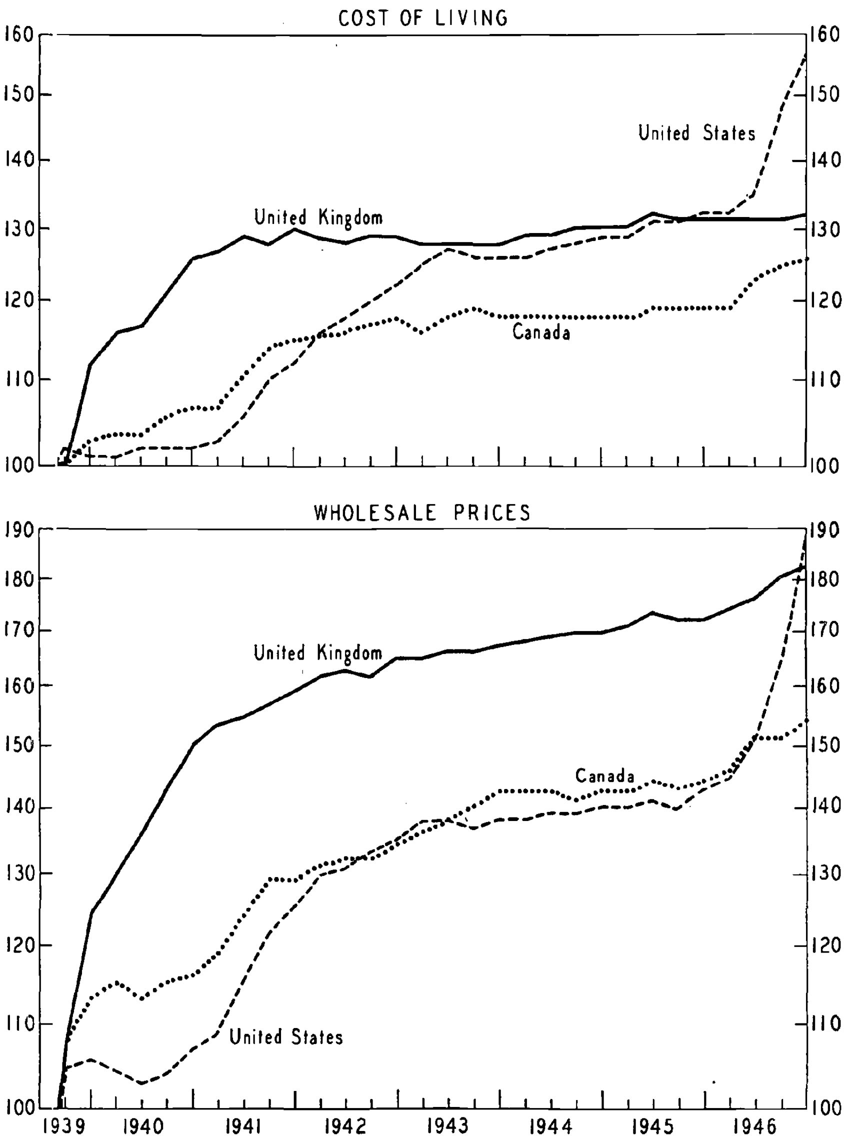
## Taxation

From the standpoint of fiscal policy, taxation is generally considered the most desirable instrument for absorbing increases in income.[2] In the six years ending August 31, 1945, Britain met about 46 percent of total central government expenditures by taxes (Table 4)—less than

[1] Combined Production and Resources Board, *The Impact of the War on Civilian Consumption in the United Kingdom, the United States, and Canada* (Washington, September 1945) Table 13, p. 21.

[2] Cf. William Leonard Crum, John F. Fennelly, and Lawrence Howard Seltzer, *Fiscal Planning for Total War* (National Bureau of Economic Research, 1942) Chapters 5, 6, and 7, and especially pp. 137-44.

Chart 2—INDEXES OF COST OF LIVING AND OF WHOLESALE PRICES FOR UNITED KINGDOM, UNITED STATES, AND CANADA[a]
(*August 1939 = 100; logarithmic vertical scale*)




[a] Sources: United Kingdom: *Ministry of Labor Gazette* and *Board of Trade Journal;* United States: *Monthly Labor Review;* Canada: Dominion Bureau of Statistics Reports and Bank of Canada, *Statistical Summary.* Data plotted are for the last month of each quarter.

Table 4—BRITISH GOVERNMENT RECEIPTS AND EXPENDITURES, BY WAR YEARS[a]
(pound figures in millions)

| | Years Ending August 31 | | | | | | Total |
|---|---|---|---|---|---|---|---|
| | 1940 | 1941 | 1942 | 1943 | 1944 | 1945 | |
| Expenditure | | | | | | | |
| Interest | £222 | £229 | £281 | £325 | £376 | £424 | £1,856 |
| Supply services | 2,368 | 4,139 | 4,801 | 5,409 | 5,439 | 5,438 | 27,594 |
| Other items | 17 | 17 | 17 | 16 | 17 | 18 | 101 |
| TOTAL | 2,607 | 4,384 | 5,099 | 5,750 | 5,831 | 5,880 | 29,551 |
| Receipts | | | | | | | |
| Taxation | 1,105 | 1,575 | 2,166 | 2,664 | 3,001 | 3,130 | 13,641 |
| Canadian government contribution | .... | .... | 141 | 83 | .... | .... | 225 |
| Other items, including War Damage Fund | 43 | 82 | 137 | 104 | 88 | 177 | 631 |
| Net borrowing | 1,459 | 2,727 | 2,655 | 2,899 | 2,742 | 2,572 | 15,054 |
| TOTAL | 2,607 | 4,384 | 5,099 | 5,750 | 5,831 | 5,880 | 29,551 |
| Taxation as percent of total expenditure | 42% | 36% | 42% | 46% | 51% | 53% | 46% |

[a] From *The Economist,* Banking Supplement, October 27, 1945, p. 2. In some cases totals do not agree with the sums of the items because of rounding.

Canada but more than the United States. Since taxes in Britain at the beginning of the war period were somewhat heavier than those in the other two countries, the increase in tax revenues was less striking. Tax collections increased less than 200 percent from the first full year of war to the sixth, while American tax collections rose nearly 700 percent and Canadian over 400 percent. In 1944, British central government tax revenues were some 37 percent of national income, while both Canadian and American federal revenues were about 27 percent.[3] When state or provincial and local taxes are added in, the differences among the three countries in this respect are less marked.[4]

[3] Figures for Britain are based on years ending August 31, 1940-45; for the United States, on fiscal years ending June 30, 1940-45; for Canada, on fiscal years ending March 31, 1940-45.

National income taken at market prices. This figure, which is the income out of which taxes can be paid without capital consumption, is the most relevant one for measuring the burden of taxation.

[4] Cf. R. A. Musgrave and H. L. Seligman, "The Wartime Tax Effort in the United States, the United Kingdom, and Canada," *Federal Reserve Bulletin,* January 1944, p. 18.

## Price Control

In contrast to American and Canadian practices in World War II, Britain did not have a single agency to administer price control, or an over-all price ceiling. With few exceptions, the same agency that controlled the supply of a commodity also regulated its price. The original Prices of Goods Act (or POGA) of 1939 was found to be ineffective, and the continued price increases led to a new Goods and Services (Price Control) Act in July 1941. Clothing, furniture, and about 90 percent of the average housewife's expenditure on foods were subject to specific price ceilings by October 1943.

Rationing was much more extensive and much more stringent in Great Britain than it was in either Canada or the United States. It began with foods, under the Rationing Order of December 1939, and spread to a wide range of essential civilian commodities. Clothes rationing was introduced in June 1941, and was applied to virtually all clothing. To facilitate administration of the system, all dealers, except a few small retailers, were required to conduct their ration coupon transactions through coupon accounts held with their banks.

Subsidies also were a more important part of the price control system in Britain than in Canada, and much more important than in the United States. The greatest proportion of direct subsidies was applied to foods which constituted 60 percent of the Ministry of Labor's cost-of-living index;[5] however, prices of certain raw materials also were subsidized. In October 1942, subsidy payments amounted to nearly 10 percent of expenditures on food,[6] and by June 1945, they had risen to nearly 17 percent.

Consumer credit restrictions were less severe than in the United States or Canada, probably because instalment buying is less important in Great Britain and because many consumer durables were very difficult to get under any circumstances. Consumer instalment credit extended by banks was virtually eliminated by the government's request to limit credit to purposes essential to the war effort.

No wage ceiling was imposed in Great Britain. The government felt that stabilization of the cost of living would limit the need for wage increases, and relied upon trade unions and employers not to raise wages unduly. The dangers of an upward wage-price spiral were fully recognized, but the government hesitated to interfere with the normal mechanism of wage negotiation and determination. Many trade unions made use of their wartime bargaining position; average earnings of wage

[5] See *Food Control in Great Britain* (International Labour Office, 1943).
[6] *Bulletin of the Oxford Institute of Statistics,* October 13, 1945.

earners rose about 70 percent and wage rates around 50 percent in six years of war, considerably more than the cost of living, although less than wholesale prices.

## Production Control

The policy for reducing the use of plant and materials in civilian production went through three stages. In the first stage many industries producing for the domestic civilian market and some producing for export were designated "controlled industries" and were restricted as to the volume of deliveries they could make to retailers. In some cases, output was prohibited altogether, while in others production was permitted only under license from the Board of Trade.

Limitation led logically to concentration. Reduced output of controlled industries meant that many of them were operating part time or with only part of their plant. In order to check inefficient use of resources, the Concentration of Production Plan was introduced in March 1941. Originally applied to only 30 industries, the coverage was later broadened to include some 70 industries. It is estimated that these measures closed 3,294 factories by August 1943, and released 260,000 workers and 70 million square feet of floor space for war production.[7]

The third step, sometimes labeled "concentration of products," involved stripping production specifications of unnecessary details and reducing the number of grades or types of particular commodities produced. The final development in this branch of industrial regulation was the "utility product," which consisted of "goods sufficiently clearly defined for their prices to be fixed, designed to meet essential needs in a sensible manner, and produced in the most economic manner possible."[8]

Like Canada and the United States, Britain experimented with various types of war contracts. By the end of the fourth year of war, cost-plus-a-percentage-of-cost and cost-plus-a-fixed-fee contracts had been largely abandoned, even when subject to a maximum price, and the "target price" contract (fixed price plus shared excess profits or losses) was also considered unsatisfactory by British authorities. "None [of these types of contract] offered any real incentive to efficient, and therefore, cheap production," reports the British Information Services. All methods suffered "from the difficulties inherent in any attempt to

[7] British Information Services, *Concentration of Consumer Industries and Trade in Britain,* I.D. 279 (December 1943) p. 6.

[8] British Information Services, *"Utility" Production in Britain,* I.D. 404 (April 1943) p. 2.

determine actual and proper costs for specific jobs."[9] Therefore, fixed price contracts were made whenever possible. Critical materials were allotted when contracts were let, and thus the producer was spared the necessity of applying for supplies after an order was received.

Special efforts were made to utilize small concerns, usually as subcontractors. In the months immediately following the great loss of British equipment at Dunkirk, it was considered particularly desirable to take advantage of the ready capacity of small plants, rather than to wait for construction of larger ones which might ultimately be more efficient. These efforts seem to have been attended by considerable success, probably because in Britain small concerns normally play a large role in those industries so important for war production.

## Manpower Regulations

Although in Great Britain shortages of manpower caused more concern than shortages of raw materials, it was not until the spring of 1940, when the Emergency Powers (Defense) Act was passed, that manpower regulation was effectively organized. By an amendment to this Act the Minister of Labor and National Service was empowered to "direct any person in the United Kingdom to perform such services in the United Kingdom as may be specified . . . , being services which that person is, in the opinion of the Minister, capable of performing." Under the Essential Work (General Provisions) Order of April 1941, permission of the Ministry was required before a worker could quit or be removed from a job listed in the Minister's Schedule of Reserved Occupations.

## Exchange Control

A major financial problem for Britain was to obtain, with a minimum strain on her productive resources, foreign exchange (especially dollars) to pay for vital imports. Britain entered the war with an Exchange Equalization Fund already established, and with several years of experience in operating it. When war seemed inevitable, diminished exports and increased imports were expected to make it difficult to support the pound at the then current rate of $4.68. Accordingly the official sterling rate was allowed to drop for several weeks, and then was established at $4.03. British holders of gold and foreign exchange were required to offer them to the Treasury; the Treasury was authorized to acquire foreign securities held by residents; and export of capital from Britain was forbidden. The Bank of England's gold reserves were

[9] British Information Services, *Industrial Mobilization of Great Britain*, I.D. 328 (April 1943) p. 8.

transferred to the Fund, so that all gold in the country could be used to meet an adverse balance of payments.

For several months after the war began, transactions in sterling between residents of other countries were subject to no restrictions, and a considerable spread developed between the "official" and the "free" rate. It was gradually realized, however, that the disposition of sterling balances acquired at free market rates by residents of other countries was a matter of some importance. If such balances were held idle, no strain would be placed on British productive resources; if balances were used to buy British exports, resources would be diverted from war production while relatively few dollars would be provided.[10] On March 26, 1940, foreign holders of sterling balances were forbidden to use them in payment for six major Empire exports: whiskey, furs, tin, rubber, jute, and jute products. These commodities had henceforth to be paid for in foreign currencies or in sterling bought at the official rate. The immediate effect of these provisions was to reduce the demand for free sterling, which fell in price from $3.96 in February to $3.27 in May. In June, restrictions on the use of free sterling were extended to all exports to the United States and Switzerland, but at the same time sales of sterling securities by foreigners were limited. The reduced supply of sterling, and the rush of speculators to cover their positions, brought the free pound up sharply. After September 1940 it remained very close to the official rate.

Exchange control was supplemented by the direct regulation of exports and imports. In the early months of the war, exports were encouraged as a means of obtaining foreign exchange, but insufficiently high priority ratings for men and materials, and shortage of shipping space, made severe inroads into the export trade. A British Export Council was organized with advisory powers, and together with the Board of Trade and the Ministries of Supply and Labor, the Council undertook to confine exports to goods demanded by friendly countries whose exchange was in turn needed by Britain for essential imports. The Ministry of Economic Warfare obtained power to prevent exports altogether if their destination or some other cause made them inexpedient or injurious to the war effort. Imports were under the direction of an Executive Committee for Imports, composed of the President of the Board of Trade, the First Lord of the Admiralty, and the Ministers of Food, Supply, and Aircraft Production. This Committee limited imports to essential goods and services, regulated the placing of orders, and arranged for shipping space.

[10] See F. W. Paish, "The Free Sterling Rate," *Memorandum No. 82 of the Royal Economic Society,* May 1940, p. 11.

Britain's most difficult wartime period with regard to foreign exchange was from the beginning of the war until early in 1941. From September 1, 1939 to December 31, 1940, Britain lost £575 million in gold and dollar resources, primarily to the United States, Canada, and Newfoundland.[11] Substantial amounts of Canadian and American securities held by British investors were requisitioned and sold. Net borrowing abroad plus net sales of foreign assets and financial claims in 1939 and 1940 amounted to more than £1 billion.[12]

During 1941, the sterling area deficit of Canadian dollars was financed largely by the accumulation of sterling balances, and in March of that year Lend-Lease began to operate. A year later came the Canadian billion dollar gift; at the same time, Canadian sterling balances were converted into a $700 million interest-free loan; [13] and with the United States in the war, Lend-Lease was in full swing. Obtaining foreign exchange then was not a major problem of British war finance, although the means of obtaining it had serious postwar implications.

### Effects of Wartime Controls on Lombard Street

Fiscal policy, price and exchange controls, and production and manpower regulations inevitably altered the functioning of the money market; their net effect was to reduce the usual demands for credit. Higher taxes in themselves diverted income from other uses—consumer spending, saving, and private investment—and reduced net return on capital; they therefore tended to restrict the demand for both consumer and commercial credit. Production and manpower regulations, by limiting the resources available for nonwar production, had a still more forthright effect on credit requirements of companies concerned with normal peacetime pursuits. The bulk of war construction and of war production was financed directly by the government. Price ceilings and rationing, and consumer credit restrictions, directly diminished the demand for consumer credit, and indirectly contracted the demand for commercial credit by reducing the volume of business transactions. Direct procurement and distribution by the government tended in itself to reduce the credit needs of distributors. The sharp contraction in physical volume of foreign trade and the greatly expanded role of

[11] "Gold and Dollar Resources of the United Kingdom," *Federal Reserve Bulletin,* February 1941, pp. 99-101.

[12] *National Income and Expenditure of the United Kingdom, 1938-1945* (Cmd. 6784, April 1946) p. 8.

[13] Canadian aid to Britain is discussed more fully in Benjamin H. Higgins, *Canada's Financial System in War* (National Bureau of Economic Research, Financial Research Program, Occasional Paper 19, April 1944) pp. 32-33.

governments in financing foreign trade, greatly reduced the demand for private finance from this quarter. Exchange control limited the volume of foreign lending.

True, wartime controls gave Lombard Street some new jobs, notably coupon-banking and administration of exchange control regulations. These new jobs were important in the administration of Britain's wartime economy, but from the banks' point of view they hardly offset the effects of the contraction in normal banking operations. However, war finance had another and more powerful effect on banking activities; it resulted in a huge demand for credit from the government itself.