1945–51: Fiscal and monetary policy during the post-war Labour governments.[*]

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1 Historical context

Our study of macroeconomic policy in the UK starts in mid-1945. In May, the European front of World War II ended with Nazi Germany's unconditional surrender. In July, the UK held a general election, won by the Labour Party in a landslide, leading to the formation of the Attlee cabinet. In August, with the surrender of Imperial Japan, also the Asian front of the conflict ended, and the Second World War was over.

2 The War economy

Clement Attlee's Labour government inherited a war economy: an economy dominated and shaped by the imperatives of war. The extraordinary features of the 1939-1945 economy, the difficult legacies it left, and the challenges and opportunities of transitioning out of it, were fundamental in shaping the fiscal and monetary policy of the post-war Labor governments.

So, how did the war economy look like? First and foremost, Government exerted unprecedented direct control and command over economic activities, through military and industrial conscription, price controls, quantity controls, import and export controls, and rationing. Through *military and industrial conscription*, the state directly allocated manpower across both military and civilian activities. Throughout the war, the Ministry of Labour and National Service issued an annual "Manpower Budget" laying out the allocation of the working-age population between the army, the mines, the factories producing arms and essential goods. *Price controls* forcibly prevented the prices of essential goods in the economy from spiralling up,

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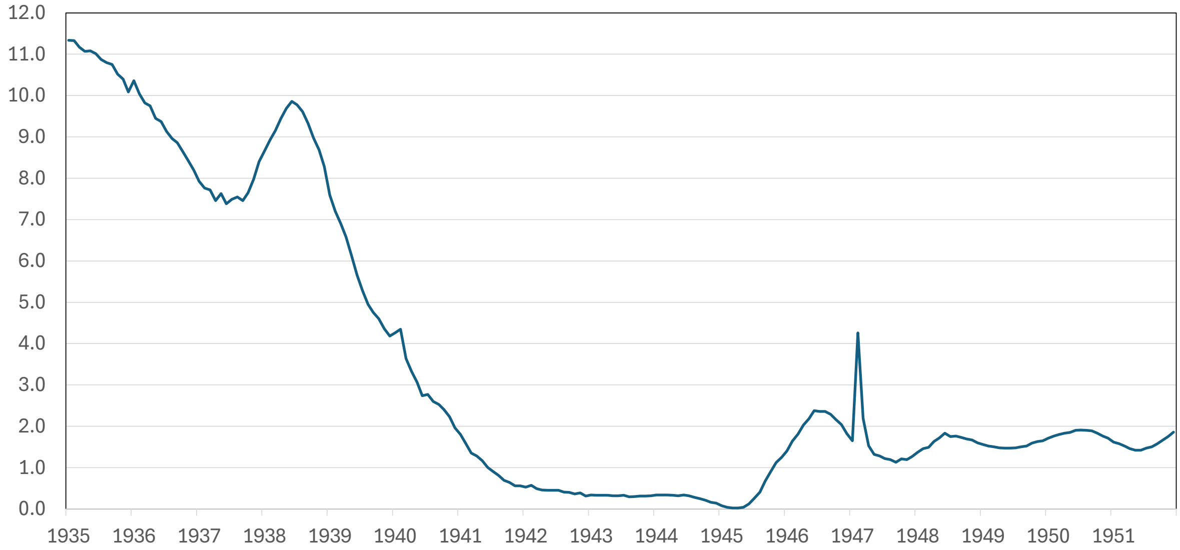
Figure 1: UK monthly unemployment rate, 1935-1951



Source: Bank of England, A Millennium of Macroeconomic Data.

notwithstanding their scarcity and notwithstanding the potential purchasing power injected in the economy by huge government deficits. *Quantity controls* made sure that the production of non-essential goods remained limited and thus could not displace that of essential ones. *Import and export controls* meant you needed a government authorization to export or import goods. Export controls guaranteed that only limited resources would be absorbed by production for export. Given the low level of export, the UK brought in a very limited amount of foreign currency (and especially of valuable US dollars), and import controls made sure that scarce foreign currency was used in service of the war effort too. *Rationing* allocated food and other essential commodities, scarce given the shrinking of civilian non-military production activities, in an egalitarian way instead of based on purchasing power as in normal times. Food subsidies were also in place to help lower income households afford a minimum level of nutrition.

Moreover, the productive capacity of the economy was over-stretched, and overwhelmingly directed to government military and military-related spending. Unemployment was basically non-existent during the war, as shown in Figure 1. Between one half and two-thirds of economic activity was directed to Government current spending for the war effort, with the rest absorbed mostly by private essential consumption. Fixed investment was very limited: building of new houses, schools, hospitals and factories and maintenance of existing ones was essentially postponed until after the war.

The lend-lease program Help from the United States, in the form of the *lend-lease program*, was fundamental for the sustainability of the British war economy. Essentially, since the start of the program in 1941 and until its abrupt discontinuation in 1945, the United States provided the UK (and other Allied countries) with shipments of essential goods like food, energy products and materials, at no cost.

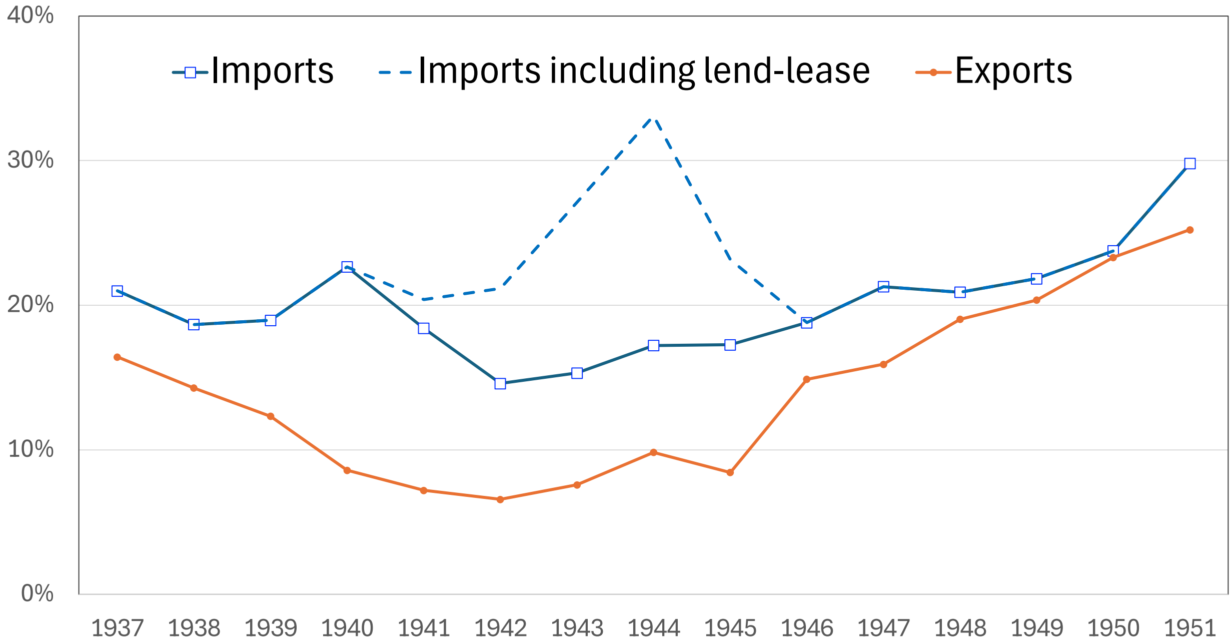
Lend-lease allowed the UK to devote an even larger share of its resources to the army and arms production. It meant that the UK could run a huge trade deficit (meaning that imports, including lend-lease commodities, were much higher than exports), without having to worry about procuring the foreign currency to fully finance it through foreign income, exports or foreign loans. Exports fell to around 30 percent of their pre-war volume in the middle years of the war, allowing manpower and resources to flow from the export industries into the military and arms production. Imports excluding lend-lease also decreased relative to the pre-war volume (in 1945 they equalled around 60% of their 1938 volume), but much less than exports, resulting in a sizable trade deficit. Moreover, if the value of lend-lease commodities is included in the computation of UK's imports, the real extent of the gap between imports and exports is seen to be enormous, amounting to around 20% of UK GDP in 1944. This is shown in Figure 2, that displays imports and exports as a share of GDP, including the value of lend-lease commodities.

Ultimately, the lend-lease program represented a division of labor within the Anglo-American alliance, in which the US provided most of the essential supplies and the UK did most of the fighting. During the war and from the point of view of the war effort, this division of labor made sense and provided mutual benefits for the UK and the US. However, in view of the future and from an economic perspective, it further strengthened and stimulated the already ascendant US economy, while further weakening non-military productive capacity in the United Kingdom.

Public finance during the war Of course, fiscal policy and government budgets were dominated by the war imperatives too, and financial caution was (justifiably) thrown to the winds. Government spending increased enormously, naturally dominated by military expenditure, as shown in Figures 3 and 4. Taxation greatly increased too (mainly through an increase in income tax), but not nearly as much as expenditure (Figure 3). Of course, the result were huge government budget deficits, and a dramatic increase in government debt and in the debt-to-GDP ratio.

Taxation, moreover, became more progressive during the war, due to both an increase in

Figure 2: United Kingdom total imports and exports (% of GDP) 1937-1951



Source: Bank of England, A Millennium of Macroeconomic data.

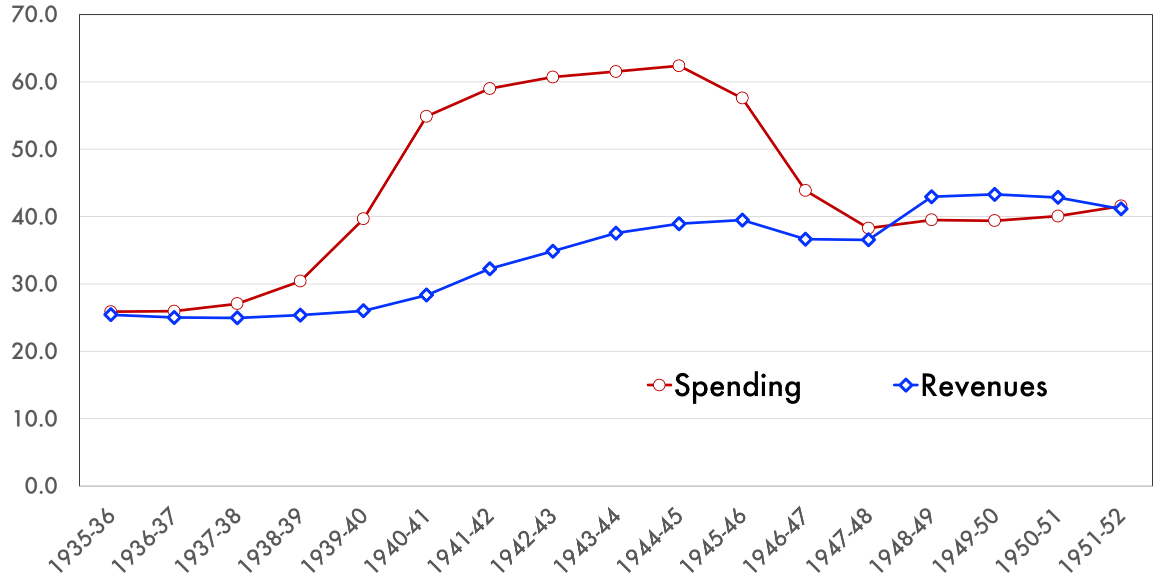
the importance of income tax relative to sales taxes, and an increased progressivity of income tax itself.

Compulsory savings were also part of the fiscal policy toolkit used to pay for the war effort and keep inflation at bay. Since the 1941-42 fiscal year, in addition to income tax, additional amounts were compulsorily deducted from people's salaries and wages, in exchange for 'post-war credits' to be reimbursed after the war.

Monetary policy during the war Monetary policy during the war basically consisted in keeping interest rates as low as possible, so that the Government could borrow cheaply. The Bank rate was kept at 2 percent throughout the war. Bank of England intervention fixed the rate on short-term Treasury bonds even lower, at 1 percent, and long-term (30 years or more) gilts at only 3 percent. As shown in Figure 5, these low rates did indeed prevail in 1939-45. Once accounting for inflation, *real* interest rates were negative.

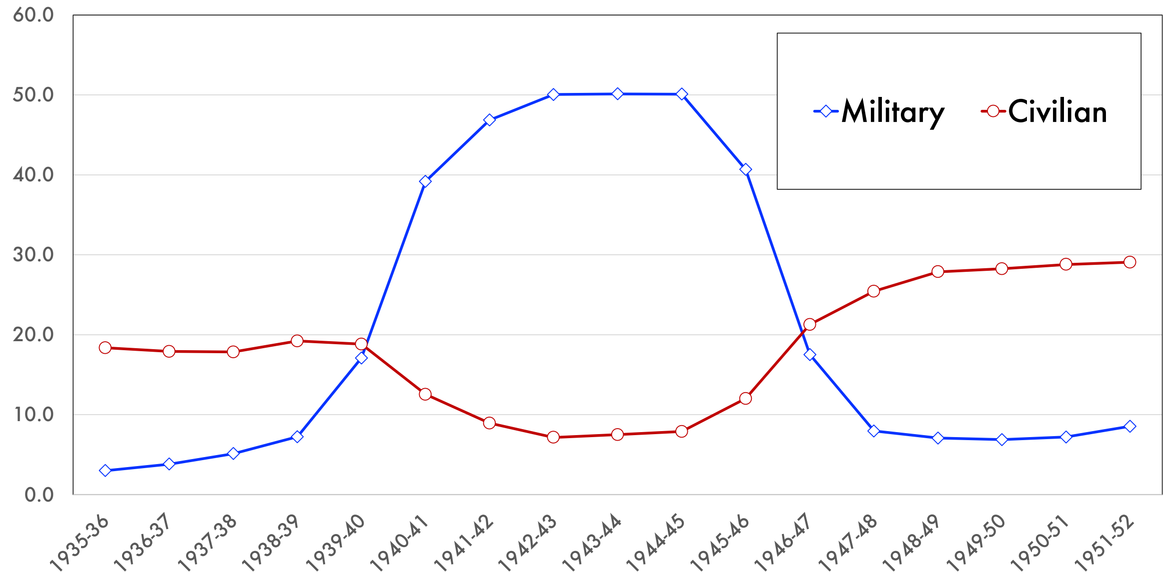
Given the imperative of financing the Government war effort as cheaply as possible, any attempt to use monetary policy to influence macroeconomic conditions was completely abandoned. For example, the risk of a large increase in inflation was substantial, but increasing the interest rate to prevent it was out of question. In the war economy the job of keeping inflation

Figure 3: UK public spending and revenues (% of GDP), 1935-1952



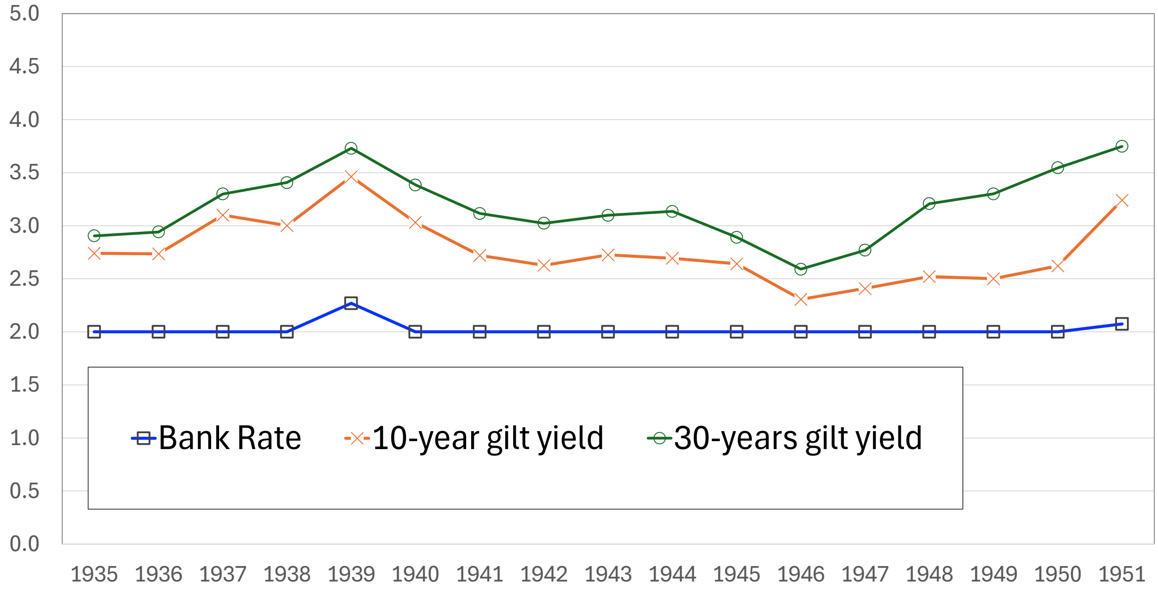
Source: Office for Budget Responsibility, Historical public finances database.

Figure 4: Composition of UK primary public spending (% of GDP), 1935-1952



Source: Office for Budget Responsibility, Historical public finances database.

Figure 5: Interest rates, 1935-1951



Source: Bank of England, a Millennium of Macroeconomic Data.

under control (normally a key prerogative of monetary policy) was left to price controls and rationing.

During 1939-1945 the exchange rate of the pound was fixed at around 4 US dollars. Not only was the exchange rate fixed by the authorities rather than determined by the market, but it did not even have to be (and indeed was not) remotely compatible with demand for and supply of UK pounds in foreign exchange markets. The forces of supply and demand could not exert their usual pressure on the exchange rate because foreign exchange markets were severely restricted. Extensive exchange controls were implemented by the Bank of England on the orders of the Treasury and in practice individuals could not freely convert their pounds in US dollars or other foreign currencies.

During the war the Bank of England, in charge of monetary policy and of managing the sale of government bonds, was still a private financial institution, listed in the stock exchange and owned by private shareholders. However in practice, like many other private economic institutions, it was fully enlisted at the service of the government and its war effort.

3 The post-war settlement in economic policy

The war coincided (not by chance) with the emergence of a new consensus about the role of the state in the economy. These new ideas had been brewing since at least the mid-1930s, in the context of the Great Depression and of Keynes' influential work in economic theory and policy. They represented a stark departure from pre-1930s policy and ideas, and would remain dominant until the 1970s.

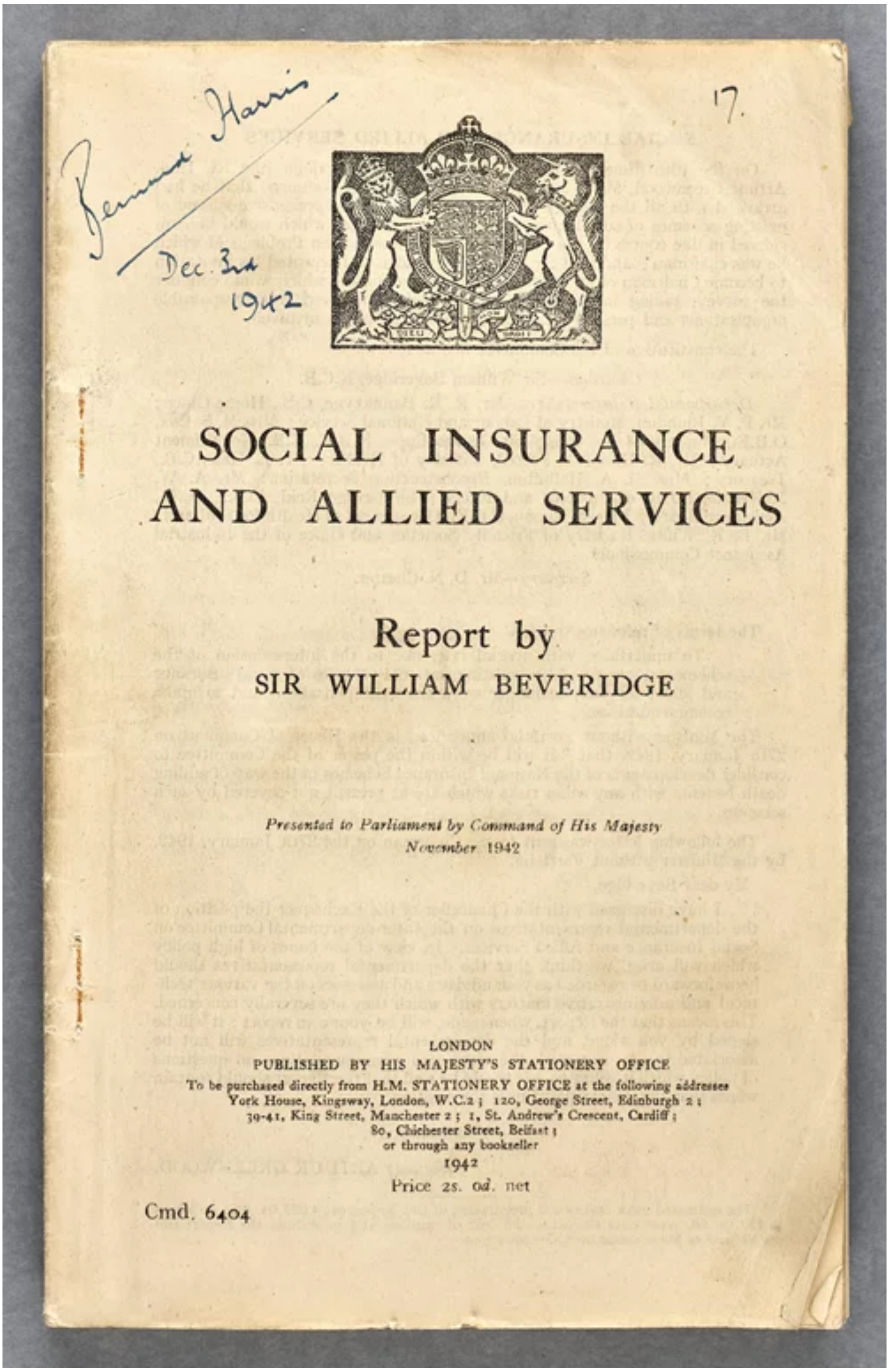
The 1942 Beveridge Report and the 1944 White Paper on Employment Policy of Churchill's Coalition Government influentially expressed and articulated the new consensus. The Beveridge Report provided a blueprint for the building of a comprehensive and universal welfare state by consolidating, unifying and expanding the existing National Insurance scheme, and creating a National Health Service. With the White Paper on Employment Policy, the Government accepted as one of its main aims and responsibilities the maintenance of a high and stable level of employment.

During the war, moreover, the Coalition Government started explicitly using its budget as a macroeconomic policy tool for influencing the economy. The 1941 Budget was the first to explicitly discuss its macroeconomic impact, and to be accompanied not only by estimates of government spending and revenues, but also by tentative national income estimates. This represented a sea change: for centuries, the government budget had been seen merely as a statement of government spending and revenues, with the main objective of balancing the books (or financing the latest war). Now it was also seen as a key tool for managing the economy.

This new consensus about a larger role for the state in the economy included nationalisation of some key industries. On nationalisation there was more political divergence than about fiscal policy: the Labour party was for nationalising a much larger share of the economy than the Conservatives. However, the nationalisation of the Bank of England, the railways, airlines, coal mining, and electricity production was largely uncontroversial and accepted by both parties.

In the post-war settlement, moreover, labor unions were stronger than ever. Throughout the war and in the immediate aftermath, union membership climbed up, reaching 50% of the workforce in 1947. Churchill's appointment of Ernest Bevin, General Secretary of the Transport and General Workers' Union (TGWU) and Labour MP, as the Minister of Labour and National Service of the wartime Coalition Government, responsible for drafting the 'manpower budgets', was an important symbol of the new power and prestige of unions.

Figure 6: Front page of the Beveridge Report



4 Structural measures: Nationalisations and welfare state

The economic policy of the Labour governments in power between 1945 and 1951 was not only or primarily aimed at managing the economy in the short-run. More ambitiously, the Labour government wanted to lay the foundations for a welfare state along the lines of the Beveridge Report, and for a mixed economy of which the state controlled the 'commanding heights' through public ownership of essential utilities and key industrial sectors.

4.1 Nationalisations

The post-war Labour governments nationalised the Bank of England (with a vesting date of March 1946), the coal mines (January 1947), the railways (January 1948), the electricity (April 1948) and gas (May 1949) supply industries, and finally iron and steel production (February 1951). The previous private owners of these industries were compensated, usually with government securities, and overall seem to have received a favourable treatment.

Although the Labour Party at the time saw these nationalisations as the first steps towards building a socialist economy where the means of production would be under common ownership and democratic control, these industries were generally natural monopolies and/or producing essential public services, and their nationalisation could also be justified entirely on grounds of economic efficiency and national interest. Moreover, some of these industries, like gas and electricity, were in significant part already owned by local public authorities, or heavily regulated by government.

Indeed, many of these nationalizations had already been envisaged (or even initiated) by Churchill's Coalition government during the war, and were either approved or not strongly opposed by the Conservative Party. Iron and steel was the notable exception, and indeed was later de-nationalised by a Conservative government.

4.2 The welfare state

Attlee's Labour government was elected with a clear mandate to build a comprehensive and universal welfare state along the lines of the Beveridge report, and proceeded to do so. It created a national insurance system covering all workers, a national assistance system to reach the poor who were out of the workforce, a National Health Service that would provide free medical care to the whole population, and a system of child allowances to families.

The key pieces of legislation were the 1945 Family Allowances Act, the 1946 National Insurance Act, the 1948 National Assistance Act and the 1948 National Health Service Act.

- The *1945 Family Allowances Act*, which had already been initiated by the caretaker Conservative government, provided families with a weekly allowance (initally set at five shillings) for each child other than the first. The money was paid to the mother as guardian of the child.

- The *National Insurance Act* of 1946 provided all workers with financial protection in case of unemployment or sickness, and with a retirement pension. Workers and employers would finance the scheme through weekly contributions. This created a comprehensive and unified national system of social insurance covering all workers, in place of the many partial, scattered and unconnected benefit programs that previously existed.

- The 1948 *National Assistance Act* established a safety net for those who were out of the work force, and therefore excluded from National Insurance contributions and benefits, providing them with a minimal level of income.

- The 1948 *National Health Service Act* created the NHS. Financed through general taxation, it initially provided GP cover, hospital accommodation, medicines, dental care and spectacles at no cost to the user. The creation of the NHS was probably the most difficult of the Labour welfare reforms to achieve, mainly because of opposition by medical professionals, who did not want to become public employees, and by the Conservative Party, which supported the principle of a National Health Service in general but considered the one created by Labour too expensive for the taxpayer.[1]

Moreover, with the 1946 New Towns Act and the the 1949 Housing Act, the government attempted to tackle the problem of poor housing and homelessness, planning 12 brand new towns and expanding and improving the stock of public housing.

The creation of a modern welfare state meant that non-military public spending rose to an hitherto unprecedented level. As shown in Figure 4, in 1951-52 non-military primary government expenditure as a share of GDP was more than 10 percentage points above its pre-war level.

[1] The compromise that the Labour government struck with the professional bodies led to GPs being formally considered independent contractors providing services to the NHS rather than NHS employees– an arrangement that lasts to this day.

4.3 The nationalisation of the Bank of England

The 1946 nationalisation of the Bank of England brought important changes for the conduct of monetary policy. Since October 1946, the Treasury became officially in charge of appointing Bank leadership and acquired the power to give policy directions (including, most importantly, on interest rate decisions) to the Bank. The latter, however, did maintain substantial operational independence. The nationalised Bank of England was more like a powerful and operationally independent public corporation than a government department.

The Bank of England had been founded in 1694 as a privately-owned joint-stock bank, which mission was to act as a banker for the Government. Initially this mainly meant using its own capital, provided by its shareholders, to make loans to the Government to finance war against France. Over time, the Bank started managing all the existing Government debt and organising all new sales of Government bonds, holding the country's gold reserves, and acting as a banker (and lender of last resort) for all other banks. Its bank notes became the main form of money in the economy, and the Bank rate the main regulator of all interest rates in the economy. At the same time, it also remained a profitable privately-owned institution, able to pay substantial dividends to its shareholders.

As the public role and powers of the Bank of England became more and more prominent, the issue of its ownership came to the fore. During the long tenure of Montagu Norman as Governor from 1920 to 1944, in particular, the Bank of England made or participated in economic policy decisions that had enormous (and very likely detrimental) consequences for the British economy. Most important, Norman's 'tight money' policy and insistence on returning to the Gold Standard are very likely to have contributed significantly to economic depression and high unemployment in the UK in the 1930s. In general, the Bank, as representative and leader of the City, had always openly and proudly prioritised the international position of sterling and the needs of the financial sector over the interests of industrial firms and workers. The Bank had also been the object of significant controversy, which had partly shattered its reputation with the public. This included Governor Norman's sympathy for the Nazi regime in Germany (in 1934 he is reported to have defined Hitler and its chancellor Schacht as 'bulwarks of civilisation') and the infamous 1939 'Chzech gold' affair. Amid Germany's invasion of Czechoslovakia, the Bank of England assisted the Nazi regime in grabbing and selling Czechoslovakia's gold reserves, which were in London under the custody of the BoE.

In the 1945 election campaign, the Labour Party explicitly committed to nationalising the

Bank of England, and did so immediately after taking power. The Conservative Party had a more ambivalent attitude on the issue, but eventually decided not to oppose nationalisation, with Churchill declaring in the House of Commons that ‘the national ownership of the Bank of England does not in my opinion raise any matter of principle’.[2] Given the political and public opinion climate, the Bank was not in a position to resist nationalisation, and instead focused (pretty successfully) on trying to maintain as much independence as possible in managing its affairs.[3]

The nationalisation act had three main clauses: First, the Treasury had the power to give the Bank policy directions, but only ‘from time to time’ and ‘in consultation with the Governor of the Bank’. In practice, this was interpreted in the post-war period as both the Governor and the Chancellor having veto power over monetary policy decisions, although the issue was not completely clear and there were occasional Treasury-Bank rows over it. Second, the Bank retained the power to give directives to the clearing Banks. In practice, this meant that the Treasury was permitted to give directions to the private banks only through the Bank of England and not directly. This was also not completely settled, and a source of occasional conflict, especially when Labour Chancellors like Gaitskell or Healey were in power and wanted to talk directly to the banks. Third, the Bank essentially maintained operational independence: ‘the affairs of the Bank shall be managed by the Court of Directors’, and not directly by the government. Upon nationalisation, the former shareholders of the Bank received compensation at market values in the form of government bonds.

5 Macroeconomic policy in 1945-51

5.1 The main goals and problems of post-war macroeconomic policy

Walking a tightrope between inflation and deflation In macroeconomic policy, the main goal of the Labour government was to manage the conversion of the war economy into a sustainable peacetime economy in such a way as to maintain full employment and at the same time avoid high inflation. Given the high-pressure economy inherited from wartime, there was a risk that the removal of controls would unleash an inflationary spiral in the immediate

[2] Hansard – UK parliament, Bank of England Bill, Volume 415: debated on Monday 29 October 1945, retrieved at https://hansard.parliament.uk/commons/1945-10-29/debates/ca1b1160-4553-4bf8-ad80-bf8be938d974/BankOfEnglandBill

[3] A good summary account of these negotiations is provided, for example, in Kynaston (2017)’s detailed history of the Bank of England.

post-war period. At the same time, the government was also concerned that, once the end of the war and demobilization would have eased the pressure of aggregate demand, the economy would fall into a prolonged slump. This is exactly what had happened after the First World War: after a brief inflationary burst in 1919-20, the economy fell into a long depression. With millions of men to be released from the armed forces (three million only in 1945-46), the danger that the civilian economy would not be able to absorb them all, and mass unemployment would eventually return, was considered serious. Indeed, upon taking office in 1945, Chancellor Hugh Dalton declared that *"the risk of inflation now is less than the risk of deflation later"*.[4]

Therefore, the Government was thinking of fiscal policy in the immediate post-war period as walking a tightrope between the risk of high inflation and that of a return to the deflationary high-unemployment environment of the 1930s.

The general policy adopted by the Labour government to walk the tightrope between inflation and deflation can be summarized as follows: retain most wartime price controls and restrictions on consumption in order to suppress inflation; with controls taking care of inflation, interest rates can be kept very low, thus avoiding a deflationary environment. This strategy had to be modified since 1947, when it became clear that more needed to be done to control inflation, and at the same time there was no sign of the feared deflationary forces. So, starting with the 1947 budget, a significant amount of fiscal austerity (mainly consisting of increases in taxation) was added to the mix, while monetary policy remained passive and interest rates low.

The balance of payments problem The most urgent problem, however, was the large payments deficit with the rest of the world (and especially with the dollar area). During the war, the UK had reduced its exports to a minimum, while its imports were much higher and essential to civilian production and subsistence. The gap between exports and imports was not bridged by net financial inflows of foreign currencies in the form of investment, but by the US lend-lease assistance program. The UK just had not had to pay for all its imports during the war.

Somewhat paradoxically, the earlier than expected end of World War II made the balance of payments problem much harder to manage. In May 1945, when war ended in Europe, the Allied expected the war against Japan in Asia to drag on for an additional year and a half. This would have afforded the government a period of transition, during which it could have started

[4]Dalton, 1962, p.165, quoted in Dow, 1964

to partially demobilize the economy, gradually transfer workforce from the war effort to civilian sectors, and gradually expand exports to eventually match the level of imports, to arrive at the end of the war (and of the lend-lease program) with a more viable peacetime economy and a balance of payments closer to equilibrium.

Instead, by August 1945 the war was over, and the lend-lease program immediately terminated by the United States, triggering a real crisis for the UK. All lend-lease shipments were halted two days after the Japanese surrender, suddenly creating a huge hole in the UK balance of payments. Filling the hole by decreasing imports would have required a dramatic decrease in incomes and living standards in the United Kingdom. This was considered unacceptable, especially when consumption was already low, people were already experiencing hardships, and essential goods still scarce and rationed. It should also be considered that while imports were much higher than exports, they were still much lower than their pre-war level due to restrictions, controls and war-related disruptions to trade, and if anything they could be expected to recover with the gradual dismantling of wartime controls. Expanding exports to match the volume of imports was thus the only viable solution in the medium-run, and became an utmost priority for the government, but could not happen immediately. Restoring and rebuilding the export industries would take time. The government own estimates suggested that it would take between three and five years to increase exports sufficiently (although these estimates then proved slightly too pessimistic).

Prime Minister Clement Attlee put it as follows in a speech to the House of Commons in August 1945:

> *"The system of Lend-Lease from the United States (...) ha[s] been an integral part of the war organisation of the Allies. In this way it has been made possible for us in this island to mobilise our domestic man-power for war with an intensity unsurpassed elsewhere, and at the same time to undertake expenditure abroad on the support of military operations over a widely extended area, without having to produce exports to pay for our imports of food and raw materials or to provide the cash we were spending abroad. The very fact that this was the right division of effort between ourselves and our Allies leaves us, however, far worse off, when the sources of assistance dry up, than it leaves those who have been affording us the assistance. (...)*
>
> *We can, of course, only demobilise and reconvert gradually, and the sudden cessation*

of a support on which our war organisation has so largely depended, puts us in a very serious financial position. [O]ur overseas outgoings on the eve of the defeat of Japan were equivalent to expenditure at the rate of about £2,000 million a year, including the essential food and other non-munitions supplies which we have received hitherto under Lend-Lease but must now pay for. Towards this total in the present year, 1945, our exports are contributing £350 million and certain sources of income, mainly temporary, such as receipts from the U.S. Forces in this country and reimbursements from the Dominions for war expenditure which we have incurred on their behalf, £450 million. Thus the initial deficit with which we start the task of re-establishing our own economy and of contracting our overseas commitments is immense."[5]

The solution to the lend-lease crisis was a large loan from the United States. This would allow to bridge the gap between inflows and outflows of US dollars until UK exports could expand sufficiently to bring the balance of payments to equilibrium. The loan was negotiated for the UK Treasury by John Maynard Keynes and its size was 3,750 million US Dollars, plus an additional $1,250 obtained from Canada, for a total of 5 billion US dollars. The materials presented by UK representatives at the negotiations indicate that this was seen at the time as the bare minimum required to cover the expected balance of payments deficits for the next three years (until 1948).

The American loan, established and regulated by the Anglo-American Financial Agreement of December 1945, was long-term (50 years) and at a low interest rate (2 percent), and repayment would only start at the end of 1951, but came with a challenging condition attached: the UK would have to make sterling freely and fully convertible with the US dollar by summer 1947. Given the imbalances that wartime left in the currency markets, and in particular the scarcity of and high demand for US Dollars, such an accelerated timeline for full convertibility was not what the government would have wanted. British government officials thus tried hard to resist the commitment to full convertibility, but were not in a strong bargaining position vis a vis US officials. Ultimately, there was no alternative to accepting the loan and its condition.

[5] House of Commons debate, 24 August 1945, retrieved from House of Commons Hansard at `https://hansard.parliament.uk/Commons/1945-08-24/debates/2725a848-9465-4436-a989-4597c8211a97/Lend-LeaseContracts(Cancellation)`. This speech is also quoted in Cairncross (1985, pp.5-6)

5.2 Macroeconomic policy in 1945-47

The 1945-46 budgets The Labour Chancellor Hugh Dalton presented his first budget in October 1945. It was a special budget due to the end of the war and the change in government, as the norm at the time was to present the budget once a year in April, at the start of the fiscal year.

The October 1945 budget started reducing taxes from their wartime high. This was considered desirable to allow a recovery in private consumption and investment and in civilian production, and sustainable given the concomitant huge reduction in military spending due to the end of the war. According to estimates by Dow (1964), the tax reductions amounted to around \$385 million or around 4.4% of GDP. Their composition is displayed in Figure 8. Most of the reduction was in the personal income tax, but also taxes on firms' profits and sales taxes were decreased. These tax cuts would only come into effect in April 1946, giving the government some time to confirm or reassess based on observed economic conditions.

When April 1946 came and the government presented the regular April budget for 1945-46, the tax reductions were confirmed and in fact enhanced with a modest further decrease in personal income and profit taxes, in addition to the ones announced in October. This was only in very small part offset by a small increase in inheritance tax (Figure 8).

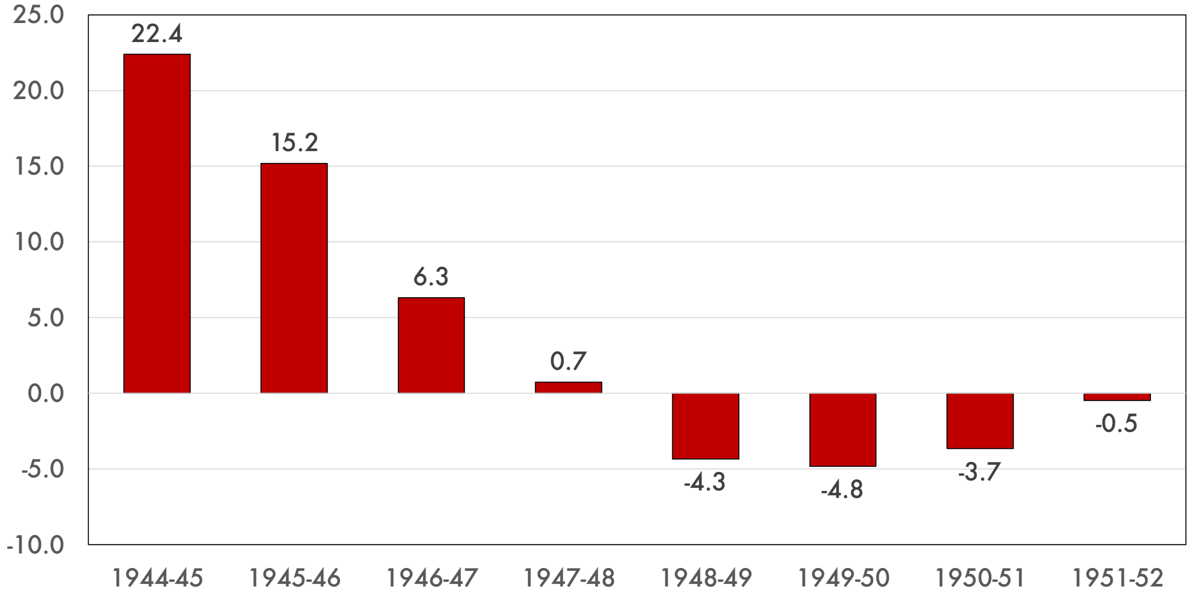
Overall, the additional tax reductions announced in the April budget brought the total reduction in taxes to take effect in 1945-46 to around £531 million, or around 6 percent of GDP, again according to the Dow (ibid.) estimates.

While a tax reduction of around 6 percent of GDP is substantial, it was actually a cautious one in that context, given that wartime tax rates were exceptionally high, and given the concomitant huge reduction in government military spending.

Indeed, notwithstanding the reduction in tax rates, the government deficit shrank very substantially in the 1946-47 fiscal year, from 15% to 6.3% of GDP, mainly due to the fall in military spending due to demobilization (Figures 3 and 7). Military spending fell by over £2,000 millions in the 1946-47 fiscal year, while non-military spending increased by £980 millions and total public revenues decreased by around £186 million.

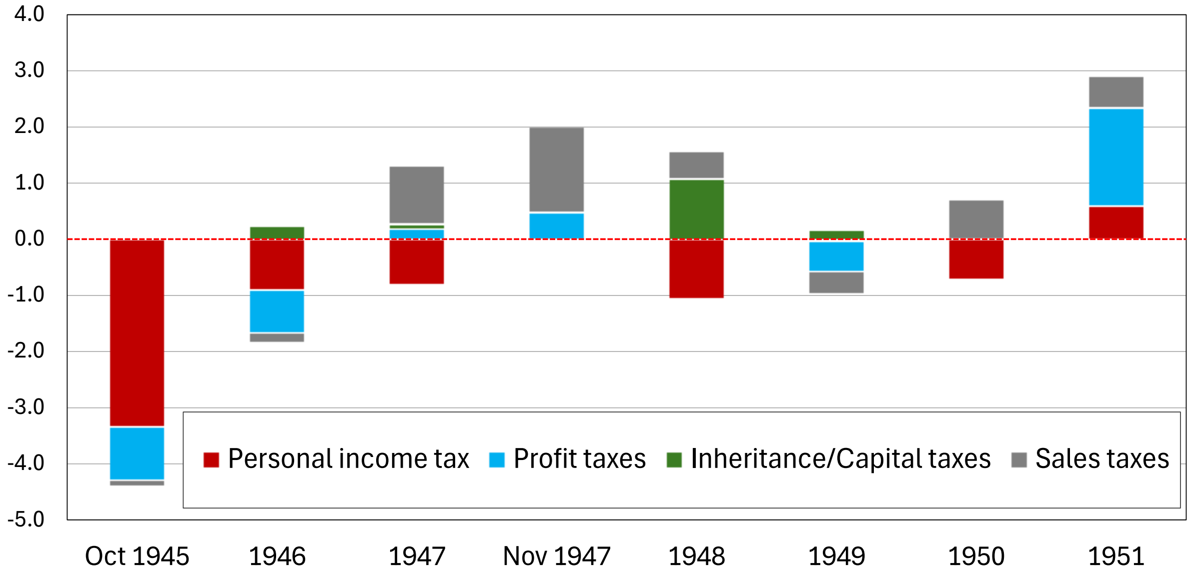
Cheap (but not cheaper) money In monetary policy, the wartime 'cheap credit' policy was maintained, with Bank rate remaining at 2 percent, although an attempt by Dalton to reduce long-term interest rates even below the (already extremely low) wartime levels failed

Figure 7: UK public sector deficit (% of GDP), 1945-1951



The measure of the deficit used is public sector net borrowing (PSNB), measured as a share of GDP. A positive value implies a budget deficit; a negative value implies a budget surplus. Source: Office for Budget Responsibility, Historical public finances database.

Figure 8: Budget tax changes (% of GDP), 1945-1951



Source: Dow (1964) based on *Financial Statements*. The changes in the October 1945 budget took effect only in April 1946.

spectacularly. Dalton tried to push down nominal interest rates on long-term (20 or 30 years) gilts, which during the war had been kept at an already extremely low 3 percent, to 2.5 percent. This was pushing it too far (or too low): not even Bank of England moral persuasion and market intervention could get banks to buy long-term government bonds at a 2.5 percent rate. Early in 1947 the government had to recognize that an 'even cheaper money' policy was not possible, and had to be content with continuing the 'cheap money' one (Howson, 2004, p.143). The crises that started in early 1947 might have contributed to the failure of 'cheaper money', including through their effect on expected inflation.

These dynamics can be seen in the pattern of interest rates displayed in Figure 5. In 1946 Dalton's attempt to implement 'cheaper money' brought the long-term interest rate down to 2.5%, but only temporarily: since 1947 it started (modestly) increasing.

The 1947 crises In 1947 the UK economy was hit by multiple (interconnected) crises: a fuel crisis, a balance of payments crisis, and a convertibility crisis.

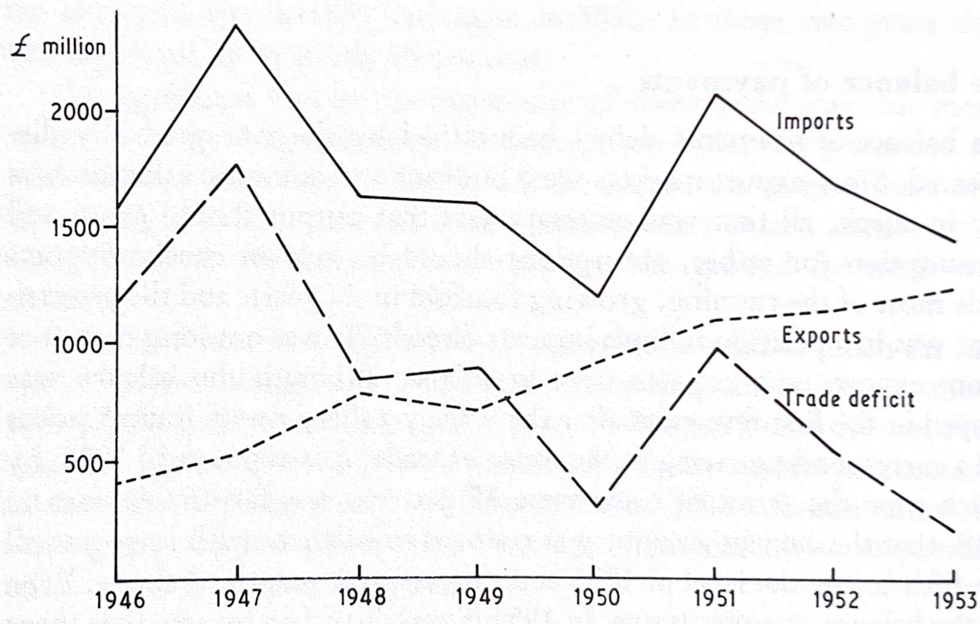
The fuel crisis hit at the very beginning of 1947, when a bad winter caused a severe shortage of coal. A substantial share of industrial firms had to halt operations for lack of fuel and electricity, leaving around two million workers temporarily unemployed (a spike that can be seen in Figure 1), and causing a slump in much-needed exports. The government probably managed the crisis less than optimally: it acknowledged it too late, and therefore started too late to ration energy use to slow down the running down of coal stocks and preserve the most essential uses and the country's exports.

At the same time, a balance of payments crisis progressively mounted in the first months of the year, reaching concerning levels around March and a serious crisis by August. In particular, the dollar position of the country worsened considerably: the difference between outlays and earnings of US dollars rose dramatically in the year up to August 1947. By then, well over two thirds of the 5 billion dollar loan secured in December 1945 had been exhausted. At that pace, the country would have run out of US dollars to pay for its imports very soon.

In part, the dollar drain was due to the trade deficit with the dollar area (shown in Figure 9), which was structural but made worse by the fuel crisis and the resulting slump in exports. An even more important contribution, however, came from *financial* outflows caused by the convertibility crisis.

Indeed, the balance of payments crisis coincided with, and was in substantial part caused by,

Figure 9: United Kingdom trade with the dollar area, 1956-53



Source: Cairncross (1985, p.44) with data from *United Kingdom Balance of Payments*, 1946 to 1954.

the obligation to make the sterling fully convertible with the US dollar, as part of the December 1945 loan agreement. The latter set a deadline of 15 July 1947 for full convertibility. The government gradually lifted restrictions on sterling foreign exchange transactions in the nine months leading to the deadline, and on 15 July sterling was fully convertible as required by the agreement.

Convertibility triggered a massive run on the sterling, which in turn led to a massive loss of US dollars for the Bank of England. The US dollar was by far the most scarce and desired currency in international markets, and sterling was the first and only European currency to return fully convertible after the war. It is thus unsurprising that foreign holders of UK pounds would rush to convert them into US dollars en masse. Foreign holdings of UK sterling were very large, given the trade deficits that the UK had been running during the war and the status of international currency that sterling still retained. Therefore, the scale of foreign demands to convert pounds into dollars was large relative to UK dollar holdings. Only in the month between 15 July and 15 August 1947, the UK had to draw 600$ million from the American loan, which were consumed to fulfil exchange market transactions.

Figure 10, compiled by Naef (2022) based on archival data, shows gold and US dollars held by the United Kingdom in its Exchange Equalisation Account (EEA, the account where UK reserves of gold and foreign currencies are held) at the daily frequency.[6] The bottom line shows how the amount of dollars held by the UK fluctuated during the crisis: each upward jump is an injection of dollars drawn from the American loan and is followed by rapid market losses.

After five weeks, on 20 August 1947, convertibility was necessarily suspended. In announcing the suspension, Dalton argued that *"Sterling, alone of all the other currencies of the European belligerents, was freely convertible. (...) The burden of the desperate dollar shortage of so many other countries was simply shifted to our shoulders"*.

This was undoubtedly true and it also appears clear, in hindsight, that there was just no possible way to make convertibility work in 1947. Indeed, after the 20 August 1947 suspension, convertibility was not resumed until 1958.

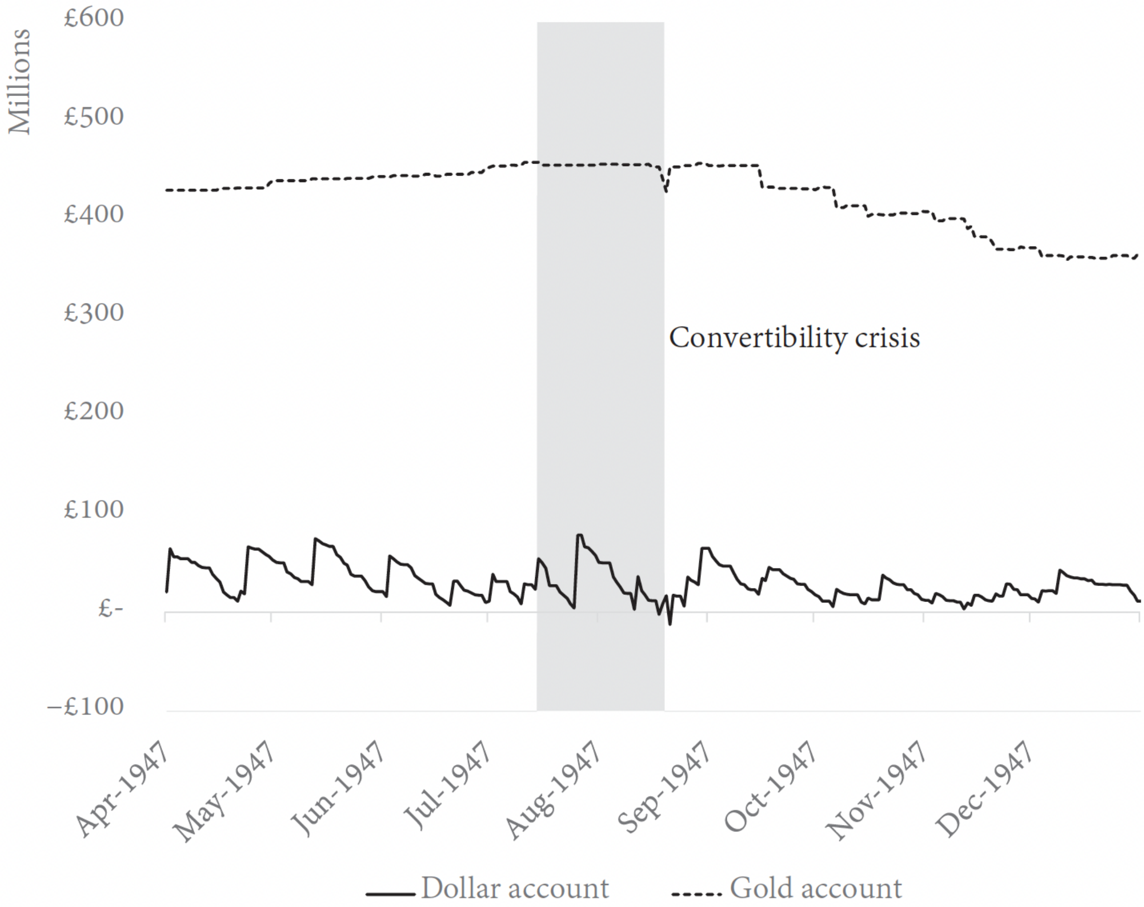
At the same time, the government seems to have completely failed to anticipate the massive run on the sterling triggered by convertibility, even in the first half of 1947, when there were already signs of it. It is possible that the government, had it been better able to appreciate the danger that convertibility posed, could have acted earlier to prevent or stop the dollar drain. It seems fair to say that also the Bank of England could have done a better job in that instance: while they had warned against early convertibility in 1945 when the loan was negotiated, when the deadline approached they advised the government to go ahead with it. In general it appears that the Bank of England thought of the success or failure of early convertibility as if it depended entirely on 'market confidence' in the sterling, rather than objective international economic conditions which made convertibility impossible at the time.

In the short-run the suspension of convertibility, together with the imposition of significant import cuts, reduced the dollar deficit to a more manageable dimension. The end of convertibility eventually reduced the outflows of dollars due to financial transactions. Imports of many commodities from America were banned altogether in the weeks following the crisis, reducing also the outflow due to trade.

However, in the medium-run it was only the 1948-1951 Marshall plan that solved the balance of payments crisis. By 1947 the shortage of US dollars in international markets was recognized as a significant obstacle to the post-war recovery of all European economies. In a speech in June 1947, the American Secretary of State George C. Marshall expressed openness to providing financial assistance to European countries if they drafted a coordinated plan for using the

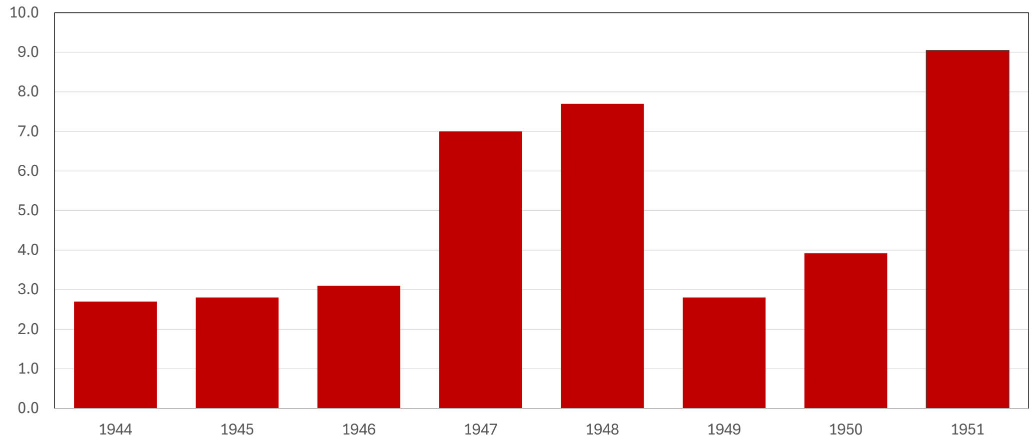
[6]EEA is still the account where UK reserves are held – see `https://www.gov.uk/government/collections/hmt-exchange-equalisation-accounts`.

Figure 10: UK gold and dollar holdings (measured in equivalent £), April–December 1947



Source: Naef (2022, p.44) with data from 'Ledgers of the Exchange Equalisation Account', 1947–70, London, Archive of the Bank of England, 2A141/1–17. The dollar holdings have been converted to sterling at the $4.03 per sterling parity.

Figure 11: Yearly inflation rate (growth rate of CPI index)



assistance for economic development. The UK Foreign Secretary Ernest Bevin took the initiative and called for a prompt conference of the European nations to create the cooperation structure (Committee of European Economic Co-operation - CEEC) that Marshall had laid out as the condition for US assistance. The Marshall Plan became effective in April 1948 and effectively provided European countries, the UK being the biggest recipient, with the resources to finance their US dollar imports in the next three years.

The 1947 budgets: Labour turns to austerity The budgets presented in April and November 1947 marked a shift towards fiscal contraction. The April budget implemented, on net, a small increase in taxation, inverting the previous trend towards lower taxation. A later supplemental autumn budget issued in November implemented a further and larger increase in taxation, and a significant cut in public investment spending. Overall, with the 1947 budgets the Labour government reversed around one third of its previous tax cuts. The composition, however, was not symmetric, as shown in Figure 8: personal income taxes, which had been cut most in 1946, were cut further, and the increase was in profit and sales taxes.

In presenting the April 1947 Budget, the government expressed the view that the most important danger was no longer a possible future deflation, but the risk of an inflationary spiral. This was the rationale for the tax increases. Indeed, as can be seen in Figure 11, the inflation rate was increasing substantially, and in 1947 consumer prices would increase by around 7 percent.

In his Budget Speech, Dalton explained the government pivot towards fiscal consolidation as follows:

> *"Today there is plenty of purchasing power. That has been our aim. We have sought to lubricate the economic system with a sufficiency of purchasing power, much more evenly spread than before the war. That has been our aim, and we have achieved it. Therefore, deflation is no longer the immediate danger today. The immediate danger is of an inflation going beyond bounds, and breaking through the various controls that we have set up. So far, our price controls, our financial and physical controls, our production and our savings have held the inflation reasonably well in check. There has been inflationary pressure, as some of the writers in the Press say; but there has been no inflationary break-through the dams. "*

Dalton also justified the turn to fiscal consolidation based on the need to create fiscal space for possible future expansions:

> *"That is the position now. But another year, particularly if a trade depression started somewhere else in the world outside this island, deflation rather than inflation might be our pressing danger. In that case, if I were still Chancellor of the Exchequer, I should not hesitate to ask Parliament and the country to approve a Budget deficit, if need be, a large one, in order to redress that deflationary lack of balance. That is not the position now. If we are to balance the Budget over a series of years, we must earn the right to a Budget deficit in another year by recording a Budget surplus this year."* [7]

The balance of payments and convertibility crises, together with the persistence of inflationary pressures, induced the government to issue further fiscal measures in a supplementary autumn budget in November 1947, which deepened the fiscal consolidation with further (and larger) tax cuts and with a significant cut in public investment.

Overall, the tax increases of the two 1947 budgets amounted to 2.5 percent of GDP according to the estimates in Dow (1964), and therefore represented a partial but significant reversal of the 1946 tax decreases (which overall had amounted to around 6 percent of GDP). The 1947 tax increases were on sales taxes (which increase yielded an estimated additional £262), profit taxes (£67 million) and inheritance taxes (£9 million), while personal income taxes were further reduced (by an estimated £87 million). The public investment cuts in the supplementary

[7] House of Commons debate, 15 April 1947, retrieved from House of Commons Hansard at `https://hansard.parliament.uk/Commons/1947-04-15/debates/23e7a18f-cba6-45ab-81ce-8feae5dbee99/FinancialStatement`. This speech is also quoted in Dow (1964, p.27)

autumn budget amounted to around £200 million. The increases in sales taxes were mostly concentrated on goods like tobacco and heating appliances, in order to reduce exports from the US (in light of the dollar drain) and fuel consumption (in light of the coal crisis).

As a result of these fiscal consolidation measures, as well as the continued decrease in military spending due to demobilization, which was more or less completed that year, the public deficit fell further in 1946-47, from 6.3 to 0.7 of GDP (Figure 7). Given that interest payments amounted to around 5 percent of GDP, the government was now running a significant primary surplus.

Notably, the April 1947 budget introduced for the first time different tax rates on distributed and retained profits, to provide an incentive for firms to reinvest their profits rather than distributing them as dividends. In the April budget, the tax rate on retained profits remained at the previous 5 percent, while the tax rate on distributed profits were raised to 12.5 percent. The Autumn budget doubled both rates: the new profit tax was 10 percent on retained profits and 25 percent on distributed profits.

Chancellor Hugh Dalton had to resign the day after presenting his Autumn budget, because he had inadvertently disclosed to the press (*The Star*, in particular) information about the budget proposal just before presenting it to parliament.

The new Chancellor was Sir Stafford Cripps, previously President of the Board of Trade and Minister for Economic Affairs in the Attlee government. Upon becoming Chancellor, he maintained the functions of Minister of Economic Affairs, bringing them into the Treasury, thus increasing the centralization of economic policy making.

5.3 Macroeconomic policy in 1948-51

Notwithstanding the 1947 fuel and currency crises, by the end of 1948 the rebuilding of the UK economy after the war was well under way. Industrial production was 20% above its pre-war volume. Exports grew spectacularly: they doubled in real terms (and also as a share of GDP) between 1945 and 1948. As a result, by 1948 the overall trade deficit was essentially eliminated (Figure 2), although, importantly, a deficit persisted with the US dollar area (Figure 9).

The April 1948 budget The April 1948 budget presented by Chancellor Cripps maintained the policy of fiscal consolidation initiated by Dalton the previous year to reduce inflationary pressures. Overall, the net effect of the budget measures was to increase taxation by a further

0.5% of GDP, according to the Dow (1964) estimates.

The main announcement of the April 1948 budget was the 'Special Contribution': a one-off levy on wealth. The Special Contribution sidestepped the difficulties in detecting and measuring wealth (and getting people to fully report it) by basing itself on previous year's investment income, as assessed to income tax. In practice, it levied up to 50% of previous year's investment income, and brought in as much as 105 millions (around 1 percent of GDP).

At the same time, the personal income tax was further reduced, especially on lower incomes, leading to a reduction in revenues of around £100 million, while sales taxes were increased by around £55 million (Figure 8).

The delayed impact of the cuts in public investment mandated by Dalton's last budget, the further modest tax increases implemented by Cripps, and (perhaps most importantly) strong economic growth combined to produce a further large improvement in the public finances in 1948-49. The overall budget registered a surplus by 4.3 points of GDP. Considering that interest payments amounted to 4.6 % of GDP, the primary surplus amounted to almost 9 percent of GDP.

The April 1949 budget The budget presented in April 1949 brought little change to the fiscal stance. Some changes in indirect taxes were made, but they cancelled each other out, with little net impact on expected revenues. Inheritance taxes were increased. Depreciation allowances for firms were made more generous to encourage investment. Overall, taxation decreased by little more than the amount of the Special Contribution, which was a once-for-all and was not repeated.[8]

Given the essentially no-change budget and the continuation of strong economic growth, a budget surplus was maintained, and even slightly increased, in 1949-50 (Figure 7).

The summer 1949 currency crisis Since at least December 1948, a possible devaluation of sterling was debated within the government. Given the persistence of a large trade deficit with the dollar area (Figure 9), it was natural that devaluation of the sterling vis a vis the US dollar would be under discussion. Devaluation was an obvious candidate solution to increase the competitiveness of UK exports and reduce incentives to import from the US. Moreover, there was by then a large gap between the official exchange rate of 4.03 dollars per pound, and

[8] The decrease in taxation due to the end of the Special Contribution is not displayed in Figure 8 because it was not associated with any change in tax laws – the Special Contribution was always meant to be a one-off measure.

the much lower rates at which the sterling was traded in unofficial black markets, which was seen as another sign that sterling was grossly overvalued.

The government initially decided to resist devaluation, but a currency crisis forced its hand, and sterling was devalued by as much as 30.5 percent on 18 September 1949, to a new parity of \$2.80. The currency crisis of summer 1949 was caused both by a recession in the USA, which widened the UK trade deficit with the dollar area, and by the widespread expectation that a devaluation would eventually happen. Investors came to see devaluation as inevitable, because of trade patterns and because at that point it was favoured by the US government and the City of London. This caused a new run on the sterling, that could be stopped only by the announcement of a substantial devaluation.

Many other countries, which were also suffering from the dollar scarcity, followed suit and devalued their currencies too. The sterling area countries, Finland, Denmark, Sweden, Greece and the Netherlands devalued by a full 30.5% like the UK pound. Canada, France, Germany, Portugal and Belgium devalued by less than the UK.

February 1950 election Labour had completed a full term in office, and general elections were held in February 1950. The Labour government was returned, but with a greatly reduced majority. Attlee remained prime minister and Sir Stafford Cripps was confirmed as Chancellor

April 1950 budget The April 1950 budget maintained the disinflationary fiscal stance followed since 1947. No change was made to the overall tax burden. Income taxes on lower incomes were reduced further, but the impact on revenues was completely offset by an increase in indirect taxes on petrol, as shown in Figure 8. Modest reductions in some components of government spending, announced after devaluation in October 1949, were also implemented.

The April 1950 budget was the third and last one crafted by Sir Stafford Cripps, who resigned the Chancellorship for health reasons in October 1950 and was replaced by Hugh Gaitskell. Prior to becoming Chancellor, Gaitskell had been Minister of State for Economic Affairs and in that capacity had been working closely with Chancellor Cripps.

The Korean war, commodity prices and rearmament The outbreak of the Korean war in Summer 1950 marked a new phase for the British economy and for macroeconomic policy. First, global rearmament (together with the recovery of the US economy from its 1949 recession) caused large increases in international commodity prices, which led to a large increase in inflation (Figure 11) and a new worsening of the trade balance (Figures 2 and 9) in the subsequent two years. Second, the UK involvement in the war led to a substantial domestic rearmament program. This halted and reversed the declining trend in military spending, with important fiscal implications.

The April 1951 budget and the end of the Labour government The 1951-52 budget presented by Gaitskell in April 1951 was dominated by the rearmament program. The increase in military spending was around £700 million, or around 5 percent of GDP. This constituted a nominal 86 percent increase in military spending over 1950-51.

The increase in military spending was partly financed by increases in tax rates, which impact was to raise an additional £387 million (or 2.9% of GDP) according to the Dow (1964) estimates, and by measures aimed at limiting the growth in health spending.

Given that the restrictive measures only partly offset the expansionary effect of the rearmament program, the result was an expansionary swing of the fiscal balance, which moved from a large surplus of 3.7 percent of GDP in 1950-51 to a much smaller (0.5 percent of GDP) one in 1951-52.

The increases in taxation were across the board, as can be seen from Figure 8: income taxes (with a positive impact of around £79 million on revenues), profit taxes (£233 million) and sales taxes (£75 million) were all increased, and depreciation allowances for firms made less generous. Old age pensions, on the other hand, were increased by around one sixth to compensate for rising inflation.

The measures to contain the growth in health spending were modest but very controversial within the Labour party. From now on, adult patients would be charged half the cost of dentures and spectacles. The estimated savings were between £13 and £25 million a year, and were deemed necessary to avoid health spending surpassing £400 million in the fiscal year. This was not a big cut, but it breached the principle of the NHS being free at the point of use.

The 'Korean' inflation motivated the Bank of England to reopen the debate on monetary policy. The Bank wanted to resume active monetary policy, and proposed an interest rate increase to contrast inflation. The government, however, was still committed to the 'cheap money' policy and refused.

On its part, the government wanted the Bank of England to impose quantitative limits on bank lending, as a way to control money creation and inflation. This was, however, successfully resisted by the Bank of England, which thought that its authority on the banking sector rested on its use of moral suasion rather than formal restrictions.

So, with the Chancellor vetoing an interest rate increase and the BoE Governor vetoing formal quantitative restrictions on lending, monetary policy remained essentially passive, except for the Bank of England using moral suasion to get banks to not expand lending too much.

At the end of April 1951, the Minister of Health (and 'father' of the NHS) Aneurin 'Nye' Bevan resigned, immediately followed by the President of the Board of Trade Harold Wilson. The main source of disagreement was the scale of the rearmament program, which Bevan and Wilson considered too large and unsustainable for the economy. Bevan also cited the health service charges imposed in the April Budget as a reason for his resignation.

The future prime minister Harold Wilson explained his and Bevan's resignations to the House of Commons as follows:

> *"As my right hon. Friend the Member for Ebbw Vale (Mr. Bevan) made clear yesterday, the issue on which both he and I have felt it necessary to tender our resignations is not a narrow issue. It is not a matter of teeth and spectacles. It is more fundamental than that. The Budget of my right hon. Friend the Chancellor of the Exchequer was based on a series of Estimates which included a re-armament programme which I do not believe to be physically practicable with the raw materials available to us. I am myself, and I am sure this is true of the vast majority in the House, strongly in support of an effective defence programme. With whatever degree of reluctance we may have come to that view, it is a fact which has been forced on us by the state of the world today.*
>
> *But if the financial programme for rearmament runs beyond the physical resources which can be made available, then re-armament itself becomes the first casualty, the basis of our economy is disrupted and the standard of living, including the social services of our people, is endangered. That, I believe, to be the position today. Recent statements in the House by the Minister of Supply and myself make it clear that we are not getting enough raw materials to maintain our economy, our essential export trade and the size of the re-armament programme that we have announced."* [9]

The resignation of Bevan and Wilson meant the collapse of the Labour government, which

[9] HC Deb 24 April 1951 vol 487 cc228-31, retrieved at https://api.parliament.uk/historic-hansard/commons/1951/apr/24/mr-harold-wilson-statement, also cited in Dow (1964, pp.60-61)

no longer had its (very thin) majority. Elections were called for October 1951.

The period between the April budget and the October 1951 election was characterised by a new external crisis. The boom in international commodity prices plus the rearmament program temporarily undid all the progress made in the trade balance, which returned to a large trade deficit in the course of 1951 because of a spike in both the volume and the price of imports (Figures 2 and 9). Between July and October, the Bank of England started losing reserves at an accelerating rate– eventually, the equivalent of £420 million in foreign exchange reserves were burned in 1951.

Bevan and Wilson, moreover, turned out to be completely right. Within a year or so of the 1951 Budget, Gaitskell's rearmament program had revealed itself to be not merely inflationary and damaging to the trade balance, but fundamentally unworkable—the necessary raw materials and physical resources simply didn't exist. The Conservative government, elected in October 1951, was forced to acknowledge this reality in its 1952 Economic Survey and scale back the program accordingly.

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