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# Economic Statecraft and Power Redistribution during Wartime: Lessons from the Sterling Era and the Future of America's Military Might

The redistribution of power in the international system occurs in many ways. The outcome of war redistributes power between the victor(s) and the defeated in absolute terms. What is less understood, however, is the relative redistribution of power during wartime between belligerents, but also among allies, and indeed even neutrals. This article seeks to understand relative redistribution of power in the international system by exploring the conditions under which belligerent and allied states are able to exert their power during wartime, specifically, the use of economic statecraft. When are states, at minimum, able to insulate themselves from outside influence (i.e. autonomy) and, at maximum, extract concessions from other states? I explore this power dynamic via the relationship between creditor and debtor states during war and the ability of creditor states to engage in economic statecraft.[1]

The relationship between wartime creditor and debtor states has been studied through (1) post war state decline (Rasler and Thompson 1983), (2) post war debt repayment (Poast and Shea 2013), (3) war outcome (Schultz and Weingast 2003), and (4) the ability to finance war (Cappella 2012). One aspect these studies do not touch upon is the political and economic interests of lending states and the power dynamics that exist within this creditor-debtor dyad during war. I argue that lender states are able to successfully wage economic statecraft against debtor states due to distinctive financial dependencies created during wartime (versus peacetime).

The relationship among allies during World War II provides an example. In desperate need of a dollar loan to continue supplying the war effort, the British government was at the whim of the United States' demands. These demands included the liquidation of British-owned

[1] A creditor state is a state to which money is owed while a debtor state is one who owes a debt to another.

American investments, the shipment of South African gold to the United States, and the turn over of gold held in Canada to the United States.[2] The British, against their national interest and will, were forced to consent in order to continue fighting the war. In an attempt to shift American policy, Prime Minister Churchill messaged President Roosevelt,

> While we will do our utmost and shrink from no proper sacrifice to make payments across the exchange, I believe that you will agree that it would be wrong in principle and mutually disadvantageous in effect if, at the height of this struggle, Great Britain were to be divested of all saleable assets so that after victory was won with our blood, civilization saved and time gained for the United States to be fully armed against all eventualities, we should stand stripped to the bone.[3]

The result of the U.S. policy was extreme. Not only did the U.S. policy directly undermine British autonomy and increase American gold holdings, it solidified the decline of the sterling, a cornerstone of British power. There is no doubt that the war effort hampered British power vis-à-vis other states in the international system. However, it was U.S. creditor policy, the demanding of all gold reserves and transfer of value assets that ensured decline. In 1945, the British government published a report to Parliament, which estimated that the country lost roughly 25% (£7,300 million) of its estimated pre-war wealth (£30,000 million). Within this overall figure, internal disinvestment in non-essential industries amounted to £885 million. Internal disinvestment was dwarfed by external disinvestment in the form of selling British overseas investments in order to pay for essential imports during the war (£4,200 million) and the destruction of buildings, capital goods, and shipping due to war damage (£2,200 million).[4]

The British example invites a host of questions: Why was the United States in a position to extract such concessions from its ally? Related, how did Britain arrive at a place of diminished autonomy? Furthermore, why was such a close wartime alliance subject to economic

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[2] Hall, *North American Supply*, p. 273.
[3] The British Prime Minister (Churchill) to President Roosevelt, 20 December 1940, *FRUS, 1940*, III: 25.
[4] Till Geiger, *Britain and the Economic Problem of the Cold War—The Political Economy and the Economic Impact of the British Defence Effort, 1945-1955* (Burlington: Ashgate, 2004), p. 219.

statecraft? The answers to these questions contribute to the understanding of shifts in the distribution of power in the international system as well as the ability to sustain warfare.

I argue that the Roosevelt administration was able to successfully wage economic statecraft vis-à-vis the British due to distinctive financial dependencies created during wartime. While economic statecraft can be waged on various fronts, I emphasize the role of balance of payments and currency reserves. I argue the ability to run balance of payments deficits plays a unique role in war. Under certain conditions, in order to effectively fight a war, a belligerent will need to use its currency reserves to finance non-state-produced (i.e. imports) inputs for the war effort. Unfortunately for these belligerent states, due to the effects of war mobilization on their economy, they are unable to self-correct for the problem. That is to say, traditional mechanisms for increasing your currency reserves (i.e. increase exports and decrease imports or encourage capital inflows) are not available. While, these traditional mechanisms are not accessible in wartime, this dependency is not static. It varies with the structure of the nation's trade and preexisting currency reserve levels, domestic arms production, and the intensity of the war effort.

Leadership's desire to win the war, remain in power, and avoid economic instability during the war and to ensure economic prosperity once the war is over compounds this dependency.

The ability to engage in a balance of payments deficit during wartime not only allows the state to sustain long wars and aid in the execution of the war effort, it also ensures autonomy during wartime.

I test my argument via case study analysis and process tracing. The universe of cases is creditor-debtor dyads during wartime. I engage in a structured, focused comparison of the various experiences Britain has had as both creditor and debtor of its various interstate wars between the heights of the sterling's prominence in the 1850s to its demise in the 1950s, beginning with the Crimean War of 1853 and ending with the Korea War.[5] I also provide a brief discussion of the 1956 Suez Crisis. Given the difficulty of teasing out power dynamics during war and the over determined relationship between war and economic decline, I employ process tracing to ensure that the outcome I am capturing can be attributed to the main variable of interest, the ability to run a balance of payments deficit during wartime. Process tracing also allows me to focus on the unfolding of events or situations over time, i.e. how the dynamics of the war and its progression affect this relationship. Thus, I find not only across-case variation but also within-case variation.

This article has two primary motivations, one scholarly and the other to provide a better understanding of the sources and sustainability of America's power. In regards to scholarly, the majority of works that discuss economic statecraft emphasize peacetime conditions.[6] When wartime conditions are discussed, scholars emphasize how states attempt to deny enemy access of badly needed goods, not economic statecraft within alliances. Given that the last hegemonic transition (UK to US), took place amongst a wartime alliance, this article seeks to fill that gap.

In addition to understanding the role of economic statecraft during wartime, this study has implications for understanding the ability of states to wage and sustain war as well as the transfer of power in the international system. Scholars understanding the ability of states to sustain war have emphasized decision making by political elites (i.e. Goemans 2000, Weisiger

[5] I focus on interstate wars for two reasons. First, the Indian Army, of which the British Treasury only financed a fraction of the cost, fought most of British colonial wars. Second, the policy for financing colonial wars not fought by the Indian Army was to supply and pay forces locally. The Sudan, for example, was conquered in 1888 at the cost of £2,354,000 at the expense mainly of the Egyptian Exchequer. The extra finance required from the British Treasury was only £500,000, not enough to put up income tax from 8*d*. in the pound. Susan Strange, *Sterling and British Policy: A Political Study of an International Currency in Decline* (London: Oxford University Press, 1971), p. 182.

[6] [Jonathan Kirshner's Currency and Coercion is a notable exception that will be discussed later in the article]

2013) while the ability to procure inputs for the war effort has often been limited to an aggregate index of capabilities (Bennett and Stam 1996). This work is an attempt to disaggregate the inputs of war so as to understand sources of military power and vulnerabilities during wartime. In regards to power shifts, it has long been understood wars can play a major role in changing the distribution of power in the international system (i.e. Gilpin / Rasler & Thompson). However, the emphasis has been on hegemonic war and war outcome, not how power changes due to war mobilization and the role of third parties. Lastly, this study sheds light on the unexplored question of why states extend credit to other states during wartime, especially given that economic incentives suggest investors would prefer to avoid risky investments.

This article is also motivated by conversations regarding America's ability to project its power abroad. An economic pillar of America's military power is its ability to run an unlimited balance of payments deficit. The role of the dollar as a global reserve currency, combined with America's credit and market depth for its debt, underpins this ability. The past several years, especially the recent events in 2013, have put this economic pillar at risk. While the dollar has been the dominant reserve currency since the end of World War II, recent events have caused the dollar's dominance to come into question. Since 2009, China and Russia have repeatedly called for a replacement to the dollar as the dominant reserve currency.[7] In addition to foreign states

[7] In March 2009, the governor of China's Central Bank, Zhou Xiaochuan, released a statement calling for the replacement of the dollar as the dominant currency and creating "an international reserve currency that is disconnected from individual nations." At the G20 summit meeting a month later, Russian President Medvedev echoed China's statement, suggesting "the creation of strong regional currencies and to use them as the basis for a new reserve currency." In November 2011, Chinese President Hu Jintao again proposed a new regime based on an International Monetary Fund currency basket, "reform the SDR (Special Drawing Rights) currency basket, and build an international reserve currency system with stable value, rule-based issuance and manageable supply." These claims by Asian leaders are consistent with Benjamin Cohen's prediction that there will be no single challenger currency to the dollar. Rather what will emerge is a fragmented monetary system with several currencies in contention and none clearly in the lead. Benjamin Cohen, "Towards a Leaderless Currency System," in Eric Helleiner and Jonathan Kirshner (eds.), The Future of the Dollar (Ithaca: Cornell University Press, 2009), p. 143. Zhou Ziauchuan, *Statement on Reforming the International Monetary System*, 2009 (Washington D.C.: Council on Foreign Affairs). Helene. Cooper, "Medvedev Resurrects Idea of Replacing Dollar as Reserve Currency," *The New*

calling for an end to dollar supremacy, there has been a fear within the United States that the recent trend of dollar depreciation will result in decreased demand for the dollar as foreign states restructure their reserve holdings.[8] In the fall of 2013, this dollar decline conversation was followed by an unprecedented near-default on U.S. government debt, resulting in credit rating warnings.

While the economic effects of potential dollar decline have been fiercely debated, the current relationship between the dollar and the ability of America to project its military power has been ignored. Today we are in a new environment of arms production where autarkic defense production is no longer the norm creating pressing need for reserve currency and new potential economic vulnerabilities.[9] This phenomenon began in the United States in the 1970s and has been steadily increasing. According to Brooks (2005) the total number of licensed production and coproduction/co-development programs in 1986–1990 was almost 200% greater than in 1961–1965 and more than 50% greater than in 1971–1975. In 1990, an Office of Technology Assessment report noted that, "Much weapons technology…is developed by large multinational companies with manufacturing facilities around the world…Many U.S. weapons

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*York Times*, April 2, 2009. Rebecca Christie & Zijing Wu, "China to Commit on Currency Flexibility at G-20, Treasury's Brainard Says," *Bloomberg*, November 2, 2011.

[8] In addition, In a 2007 Congressional hearing, Brad Setser testified, "most foreign central banks have already concluded that they are saturated with their U.S. Treasury holdings and they are looking to find investments that offer higher yields. Brad Sester, *Foreign Holdings of U.S. Debt: Is Our Economy Vulnerable,* 110th Cong., 1st sess., 2007. Craig K. Elwell, *The Depreciating Dollar: Economic Effects and Policy Response*, 2012 (Washington, D.C.: Congressional Research Service). It should also be noted that not all scholars fear that dollar depreciation will result in a decline in dollar supremacy. Drezner Gilpin, R. (1981). War and Change in World Politics. Cambridge, Cambridge University Press. in particular argues that it is unlikely that China and other actors in the Pacific Rim will challenge the dollar's status in order to gain a strategic geopolitical advantage. Daniel W. Drezner "Will Currency Follow the Flag?" *International Relations of the Asia-Pacific*, Vol. 10**, No.** 3 (2010). See also Eichengreen, "The Rise and Fall of the Dollar." Helleiner and Kirshner's Drezner, D. W. (2010). "Will Currency Follow the Flag?" International Relations of the Asia-Pacific **10**(3). edited volume *The Future of the Dollar* provides an excellent discussion of whether or not the dollar will retain its reserve currency status. Eric Helleiner & Jonathan Kirshner (eds). *The Future of the Dollar.* Ithaca: Cornell University Press, 2009.

[9] For an excellent discussion of the shift from autarkic defense production to a globalized one see Brooks, S. G. (2005). *Producing Security: Multinational Corporations, Globalization, and the Changing Calculus of Conflict*. Princeton Princeton University Press, page 56 and Chapter 4.

systems depend…on Japanese and European technology, parts, and components. Interdependence of the defense industries is a fact of life" (Brooks 2005). A 1991 General Account Office analysis reached a similar finding: "Foreign sources of supply, manufacturing, and technology abound in both the commercial and defense sectors" (Brooks 2005).[10] One implication of this shift is the need for currency reserves to continue purchasing said inputs. The United States is potentially in a new period of vulnerability as the US increasingly comes to depend on foreign inputs for war.

The rest of this article proceeds in four parts. First, I revisit the economic statecraft literature. Second, I provide my theory of XXX. Third, I look at British experience as both a creditor and debtor during wartime over a hundred-year period. Finally, I discuss the implications of my findings on American power.

**The Study of Economic Statecraft and Military Power during Wartime**

Economic statecraft is an instrument used by policy makers to exercise power, i.e. to get others to do what they would not otherwise do, relying primarily on resources that have a reasonable semblance of a market price in terms of money.[11] The literature on economic statecraft is vast and comprehensive. However, its emphasis on peacetime conditions, wartime denial, and XXXX do not adequately address the ability to engage in and or deflect economic statecraft during wartime. I will build upon these various works, in particular those that address economic bases of military power and monetary dependence, to help explain the unique wartime dependencies.

The majority of scholarly literature on the subject has emphasized exercising economic power in peacetime conditions. These works study the ability to exercise economic statecraft as

[10] The report examined a selected set of items from the M1 Abrams tank finding foreign subcontracting occurred for each of these items: a portion of the seal connecting the engine and the air intake system; the ammunition storage racks; an extrusion used in the louvers of the tank's ballistic doors; the optical glass in the gunner's primary sight; and the tanks ballistic computer. The Canadian company that built the ballistic computer was also found to rely on foreign subcontracting of a number of core technologies. Brooks, S. G. (2005). Producing Security: Multinational Corporations, Globalization, and the Changing Calculus of Conflict. Princeton Princeton University Press.

[11] Definition taken form Baldwin's seminal 1985 work Economic Statecraft, Chapter 2 and 3. For works the review the economic statecraft literature see Manstanduno (two articles), Klaus Knorr Economic Interdependence and National Security in Knorr Trager Reader, and Norrin Ripsman – The Political Economy of Security: A Research And Teaching Agenda, and Cohen "Money and Power in World Politics," in Thomas C. Lawton, James N. Rosenau, and Amy C. Verdun (eds.), *Strange Power: Shaping the Parameters of International Relations and International Political Economy* (Ashgate, 2000).

a substitute for military action [citations]. The vast literature on sanctions is a prime example of this [citations]. These works do not account for political and economic dependencies that are unique to wartime – state survival, role of substitutes, survival of leadership. . . .

When economic statecraft during wartime has been discussed it has emphasized either economic warfare or denial. The goal of these works such as [Wu – Economic Warfare] and XX was to understand how states can use their economic resources to undermine the enemy's war effort in order to win the war (Baldwin EC pg 55). Economic warfare of this nature concerned attempts by national strategists to deny the enemy access to their own strategic resources and manufactures through export embargoes, depriving the enemy of imports from important neutral states by using diplomatic and military means to dissuade neutrals from exporting to the enemy, as well as pre-emptive buying to divert supplies from the enemy, (NORRIN) or denying financing (Miller, Japan). When wartime it is emphasized the relationship explored is one between belligerents. That is, how state A can . . . . (ADD: Kirshner Wartime C&C here)

i. Add Hirschman - Hirschman – National Power and the Structure of Foreign Trade – Supply effect on military potential. Still, emphasis is coercion via trade, during peacetime (german 1930s)

All discussions of economic statecraft are based on dependencies, vulnerabilities, and the ability to exploit said relationships.[12] During the 1970's the works of Klaus Knorr highlighted the realationship between economic bases of military power and the ability of the state to wage war (Knorr Power of Nations; Knorr Chap 7 in K&T). Knorr emphasis on prewar mobilization / national security . . . Emphasis on Supply (i.e. securing raw materials in peacetime) and not ability to procure supply . . . Knorr pointed out to the potential vulnerability for a state to exploit these dependences but did not study under what conditions they could be exploited and the ability of the state to XXX.

Monetary Statecraft and War . . .

b. Wartime unique set of conditions
    i. Unique vulnerabilities
    ii. Unique strains on the state and ability to take measures to protect itself
c. Understanding today's challenges
    i. Globalization of supply
    ii. Ability to run Bal of Pay deficits more important than ever
    iii. The dollar

*Variation in Power: Autonomy to Statecraft*

Under what conditions are state's able to exert their economic power during wartime? How can states maintain or change the balance of power amongst states in the international system during wartime via economic means? Before we can answer these questions we must first understand what we mean by power, one of the muddiest concepts in the study of international

[12] Baldwin Paradoxes of Power, monetary power: Cohen, macro foundations of monetary power . . . .

relations. At the most general level, power in international relations is relational. It is defined as the ability to control, or at least influence, the outcome of events (Cohen 2006). However, this definition is too limiting for the purposes of this paper as I am also interested in which states can deflect other state's influence. Thus, I use a power continuum. On the low end, power, is the ability to exercise policy independence, i.e. autonomy. That is to say, power does not mean influencing others, it means not allowing others to influence you (Cohen 2006). The traditional way of thinking about power, A influencing B, to do something it would otherwise not want to do, is in the middle of the power continuum. At the high end is structural power. Structural power, by contrast, is "the power to shape and determine the structures of the global political economy . . . the power to decide how things will be done, the power to shape frameworks within which states relate to each other" (Strange 1988, Cohen 2013). This work lies at the middle to lower end of the continuum, concerned with influence and autonomy, with implications for structural power.

Strange states that the sources of structural power are: control over security; control over production; control over credit; and control over knowledge, beliefs and ideas (pg 26). Structural power lies with those in a position to exercise control over (i.e. to threaten or to preserve) people's security, especially from violence. It lies also with those able to decide and control the manner or mode of production of goods and services for survival. Thirdly, it lies with those able to supply and distribution of credit. Such control of credit is important because, through it, purchasing power can be acquired without either working for it or trading for it, but is acquired in the last resort on the basis of reputation on the borrower's side and confidence on the lender's. (pg 26-28). The first three of Strange's sources—security, production of goods for survival, and credit—directly relate to the ability to the ability to implement the form of economic statecraft discussed in this paper. In other words, the ability to mobilize and sustain warfare as well as deny this ability via the procurement of inputs for war. Thus, state's that are in the best position to ensure their policy independence and influence others are those that have structural power. On the other side of the coin, states that are in a position of structural power, i.e. the US, who are so dominate military, are also the best targets of the version of economic statecraft proposed in this article if it is waged successfully. Given that these state's are so powerful militarily, taking power at the margins, might be the only way to shift power in the international system.

Strange: "The greater the perceived threat to security, the higher price will be willingly paid and the greater risk accepted that the same defence force that gives protection will itself offer another kind of threat to those it clames to support" 29

*Sources of Economic Power During Wartime*

The ability to exercise influence and or ensure autonomy is contingent on dependency and the ability to exploit this dependency. In the words of Klaus Knorr, "The coercive power that actor A can derive from asymmetrical economic interdependence over actor B depends upon three factors: First, A must have a high degree of control over the supply of something B values . . . Second, B's need for this supply must be intensive. Third, B's cost of compliance must be less than the costs of doing without the supply" (Knorr 1977). I build upon Knorr's framework and that of other's studying economic statecraft during peacetime and argue wartime creates unique dependencies. These unique dependencies lie within the relationship between wartime creditor-debtor state dyads.

Creditor-debtor wartime state dyads consist of two states, in which at least one is at war, the debtor, and one is a creditor.[13] In order to understand the ability of a state to exercise power, I limit this study to interstate loans extended from State A to State B. They may be serviced by a private creditor but are made either at the request of or in conjuction with the state.[14] Thus, I exclude sovereign debt extended by foreign private creditors independent of their state of residence.[15] I do not limit this study to the type of loan extended or the terms of the contract. The terms of the contracts, typically determined by the creditor, are one of the primary mechanisms the creditor state can extract concessions from the debtor state. [MORE HERE?]

Why is this relationship unique, Why sovereign creditor-debtor relationship? Vs. sovereign private vs. trade . . ..

War creates a unique vulnerabilities and dependencies that do not exist during peacetime. Dependency during wartime is contingent on three variables: the source of war inputs, the structure of the states economy – particularly its ability to cope with a balance of payments problem, and war intensity.

Dependency during wartime is contingent on three variables:

1. Source of War Inputs
2. Structure of Economy
3. War Intensity

War Procurement Dependency

Roughly speaking, rulers have three main ways of acquiring concentrated means of coercion: they can seize them, make them, or buy them.[16] When a state can supply its entire war effort via domestic inputs, there is no need to procure weapons or other war inputs from abroad. However, when a state is unable to supply its war effort domestically, it will need to look outside its borders. In order to purchase inputs for the war effort from abroad, the state needs either gold or the currency of the supplier state.[17] A problem arises when the necessary currency diminishes to critical levels while the belligerent state needs to continue to purchase goods to maintain the war effort, i.e. a balance of payments problem.[18]

The difficulty of purchasing goods from abroad cannot be overstated. During wartime, exports often become severely limited through decreased trade or a shift in production to

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[13] For the purposes of this study it does not matter of the creditor is also a belligerent in the same war (i.e. US and Britain during the second half of WWI) or not (i.e. US and Britain during the first half of WWI).

[14] EXAMPLE. France and the russo-japanese war – loans to Russia dictated by the state but mediated by X. Vs.

[15] EXAMPLE

[16] Charles Tilly, ed., *The Formation of National States in Western Europe* (Princeton: Princeton University Press, 1975), p. 84.

[17] It should be noted that the ability to raise revenue domestically, either though taxation, domestic debt, or printing, will not suffice when procuring inputs from abroad, unless the other state is willing to accept said currency.

[18] A country's balance of payments is the record of all economic transactions between residents of one country and residents of other countries, including governments.

wartime needs. A state may redress the imbalance by encouraging exports, prompting the flow of currency into the country, or reducing imports, keeping needed currency from flowing out of the country. However, war can decrease a state's ability to trade, either because its trading partners are hurt by the war or industries that normally export are needed for the war effort. Simultaneously, the need to import goods increases exponentially as the state needs to supplement goods that the state is no longer able to produce and supply the armed forces. The decrease in exports results in a decrease of reserve currency while the increase in imports increases the need for it.

The need for reserve currency further increases when a state is maintaining forward operating bases and/or fighting abroad. Traditionally, in order to maintain a forward base, the state needs local currency.[19] Klaus Knorr, writing in response to American financial overextension when fighting the Vietnam War, argues "a strong position of international liquidity is an asset that is part of the military potential of great powers interested in using military strength in distant lands and oceans."[20]

Non reserve currency states are vulnerable during wartime if they are unable to secure vital imports for the war effort. These states, unable to run a balance of payments deficit and secure vast amounts of cheap external finance, are forced to rely on a reserve currency state to continue financing the war effort. Given the pressures of losing the war, these states are at the whim of the reserve currency states' demands. The result is the ability of the reserve currency state to extract large concessions from the ally.

Reserve currency states are in a unique position to avoid these financial difficulties as they are characterized by a unique ability to run a balance of payments deficit. The demand for a state's reserve currency status provides the state with a unique ability to accrue other national currencies. Benjamin Cohen explains that the country issuing a reserve currency "may be able to finance payments deficits through voluntary accumulations of liabilities abroad rather than through losses of gold or gold-exchange."[21] The result is that the reserve currency state is able to run a greater cumulative deficit than would otherwise be possible. In effect, the country obtains a kind of 'free' command over real resources that can be used to enlarge its purchase of foreign goods, services, and assets (including interest-paying reserves).[22]

Reserve currency status not only allows the state to run a balance of payments deficit but also provides insulation from market forces. Traditionally, when a state's balance of payments deficit becomes extensive, foreign users and holders may begin to doubt the government's ability

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[19] The extent that a state relies on the local economy to support its forward operating base may vary. A state may bring into theater all of its supplies, including subsistence, textiles, individual equipment, petroleum, construction material, energy, water, and labor, rather than source anything locally. Under this scenario, there is no need to purchase goods in theater, use reserves, and disturb the state's balance of payment position. Conversely, a state that chooses to source locally will need local currency, potentially placing pressure on the state's balance of payments position.
[20] Knorr, *The Power of Nations*, p. 61.
[21] Benjamin J. Cohen, *The Future of Sterling as an International Currency* (London: Macmillian Press, 1971), p. 35.
[22]Ibid.

to maintain convertibility of its currency at a fixed exchange.[23] Investor wariness is heightened during wartime as economic uncertainty is increased. Traditionally, in order to maintain investor confidence, the government will have to eliminate the deficit.[24] Reserve currency states have more time and scope to deal with a payments deficit given other states' desire to voluntarily hold their currency. Thus, financiers, more confident in the state's economy, are less likely to place pressure on the state and force readjustment.

Currency Dependency

War Intensity

*The Limits of Power: Variation in Reserve Currency Status*

While I argue that reserve currency states are better able to fight a war than non reserve currency states, it should be noted that reserve currency status takes various forms that may affect the ability to fight a war.[25] Here, I borrow from Susan Strange's reserve currency taxonomy.[26] Her taxonomy emphasizes how widely held the currency is and the degree of economic or political coordination and coercion necessary to maintain or expand that status. A *top currency* is the most widely used currency for international monetary transactions and the choice of the world market. Its status derives from the issuing state's position of economic leadership that inspires monetary confidence. The decision for states to hold a top currency is primarily economic in nature rather than due to coercion. *Master currency* use is imposed by a hegemon, while *negotiated currency,* on the other hand, is characterized by the need of the issuing state to bargain or negotiate diplomatically with the users about the terms and conditions of use. It is commonly a currency in a weakened position or in decline.

The degree to which a currency is held and its status affects the extent of the state's power when fighting a war. Top currency states will have the greatest advantage, as they have the deepest markets and, therefore, most stable and cheapest debt. Moreover, these states will rarely, if ever, be subject to a balance of payments problem given the almost global use of their currency. Thus, regardless of the location of inputs for the war effort, a top currency state will be able to purchase those inputs in its currency. A master or negotiated currency is limited, as fewer states are willing to hold vast sums of their debt and accept the currency as payment. Consequently, top currency states are better able to finance their wars, will less likely be constrained by a balance of payments problem, and have more power vis-à-vis their allies relative to states characterized by master or negotiated currencies.

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[23] David Andrews and Benjamin Cohen both argue that the risk of unsustainable payment disequilibrium represents a constant threat to policy independence and that excessive imbalances automatically generate mutual pressures to adjust towards equilibrium. Andrews, "Monetary Power"; Benjamin J. Cohen, "The Macrofoundations of Monetary Power," in D.M. Andrews, ed., *International Monetary Power* (Ithaca: Cornell University Press, 2006).

[24] Cohen, *The Future of Sterling,* p. 40.

[25] In the words of Susan Strange, "the description 'reserve currencies' only describes their function. It does not indicate at all their real distinction, from the point of view of international relations and politics, which is that their international use involves the issuing state in offering special inducements—political, military, economic, and financial—to the holders." Strange, *Sterling and British Policy*, p. 17.

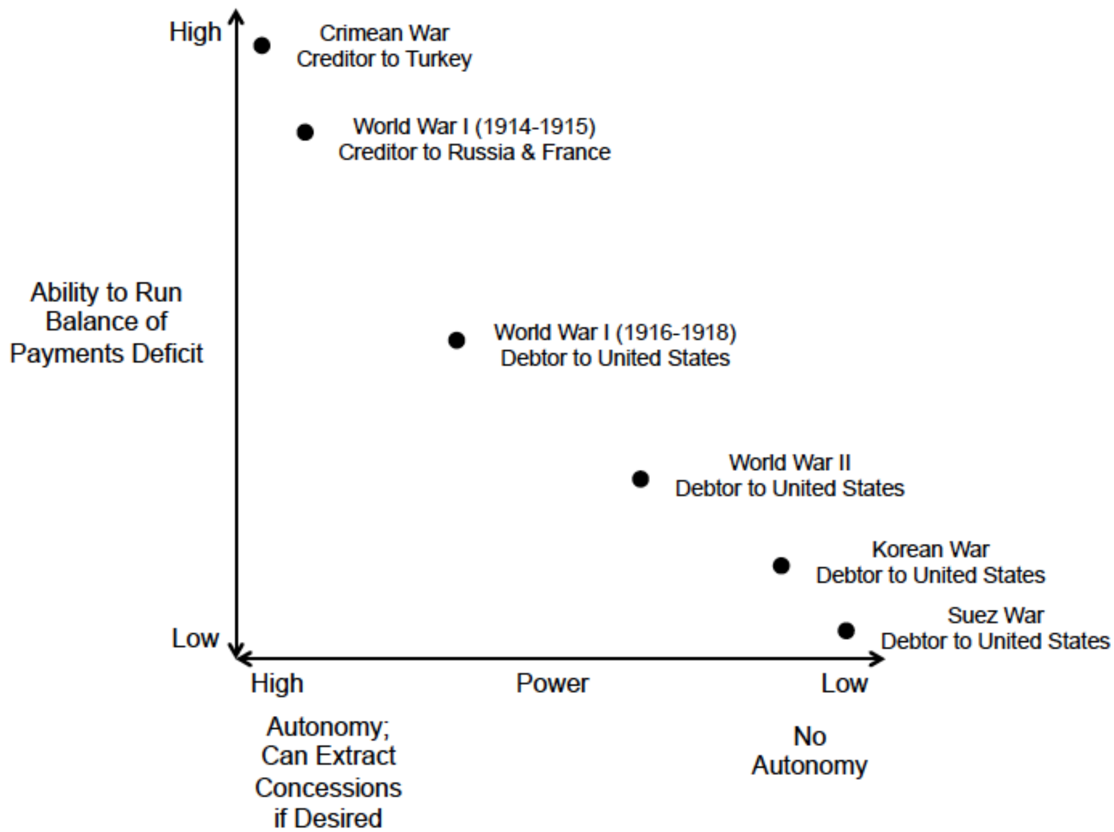
[26] Ibid.

**Creditor – Debtor Dyads: The Case of Britain**

In order to test my argument, I compare British power and war fighting ability across its various wars. I use the various British creditor-debtor relationships in order explore the full range of variation on both the dependent and independent variables while also controlling for [XXX].[27] At the height of British economic power in the 1850s the state was able to run a large balance of payments deficit. At the same time it was fighting lower intensity conflicts supplied almost entirely via domestic production. Economic prowess combined with low intensity conflicts and domestic defense production not only enabled Britain to fight its wars without threat to autonomy; it was able to extract concessions from other states. British power began to wane during the latter years of World War I. The war affected the state's ability to run a balance of payments deficit and its intensity forced the state to procure inputs from abroad. The result was a shift to creditor vis-à-vis the United States. By the end of World War II, Britain was unable to fight a war and preserve its autonomy.

[27] [ Cut? - While the motivation for this paper as well as the conclusions to be drawn from it are in the hope of influencing American policy makers, I chose Britain and the sterling as a case study (versus the dollar) for two reasons. First, the dollar has yet to experience a decline similar to the sterling. The goal of this paper is to understand how reserve currency status is a power multiplier during wartime as well as under what conditions war can cause a decline in a currency's status. Only by studying the sterling will I be able to complete the latter. Second, by studying the decline in the sterling, I am able to contribute to our understanding of the rise of the dollar. The differences between the sterling and dollar and implications of these differences will be addressed in the conclusion.]

**Figure 1: British Experience as Creditor or Debtor During Wartime, 1853-1956**




*Sterling Supremacy and the Purchasing Power Advantage: The Crimean War*

The period surrounding the Crimean War was the heyday of the sterling.[28] By the time of the Crimean War, the British economy dominated the world both industrially and financially. World demand for British goods skyrocketed during the 1850s. The value of British exports in 1848 was £53 million. In nine years, this figure more than doubled to £122 million in 1857.[29] At the same time British exports were increasing, Britain profited from an 1848 gold discovery in California and an 1851 discovery in Australia. Gold was flowing into the country at a rapid

[28] The Crimean War was a two-and-a-half-year conflict in which England and France joined forces with the Ottoman Empire and Sardinia against Russia. The war cost the British Government around £70 million. At the height of the war in 1855, military expenditures were 56.8 percent of total government expenditures [Jonathan Roberts Tyson Hughes, *Fluctuations in Trade, Industry, and Finance* (Oxford: Oxford University Press, 1960), p. 26-27.]
[29] Hughes, *Fluctuations in Trade*, p. 4.

rate and Britain quickly became the global center for its distribution.[30] The implications of this financial dominance were two fold. First, most countries at the time were trading with or in Britain. That meant that these countries were using pounds to complete these transactions. Due to the high volume of transactions, the pound sterling became a top reserve currency. Second, as the top currency, other states were willing to accept pounds for market transactions. The breadth of states using sterling as a reserve currency afforded it top currency status that provided the state advantages when fighting the Crimean War.

While the majority of the inputs for the war effort were procured in Britain, the British had to purchase meat and fodder from Turkey as well as pay for mercenaries primarily from Sardinia.[31] How did Britain pay for these goods? When a state purchases a good from abroad, it typically must sell its currency and buy the currency of the exporting state in order to finalize the purchase. However, given Britain's reserve currency status, the Turkish Government accepted pounds instead of Ottoman lira.[32] Thus, the British did not need to call upon its Turkish currency reserves or engage in an external loan with the Ottomans to pay for these supplies. Not only did the British not need to use its reserves, it extended a £5 million loan to Turkey to allow the Turkish Government to purchase cotton and other goods for its war effort from Britain.[33]

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[30] Ibid., p. 12.

[31] The reason for procuring inputs abroad was not due to insufficient British production but to shipping. When the war began, Britain was shipping meat and fodder from the British Isle to Crimea. However, in the late fall and winter of 1854, the British began to encounter serious shipping constraints. The first disaster was a storm on November 14, 1854, when four-fifths of the pressed hay on board was lost. This supply disaster was followed by harsh winter weather that rendered sailing vessels useless. Therefore, in order to feed the troops and animals, the British purchased these goods from the Ottoman Empire (1856). Report of the Board of General Officers. London, Her Majesty's Stationary Office..

[32] A letter from the commissariat officer in Constantinople describes the financial details: "…we offer as a substitute for oxen (which is out of our power to supply) an equivalent number of sheep reckoning ten sheep to one ox…at the rate of 5*l*. sterling for ten sheep…Should the total stipulated number of sheep not be accepted by the commissariat within two months from the date of the contract, or by such a date as may be fixed therein, the sum of 1*s*. sterling per day for every ten sheep to be paid for their keep, and after the stipulated term all losses by death to be for the account of the Government ibid..

[33] Hughes, *Fluctuations in Trade*, p. 84.

In addition, the British paid for their mercenaries not in Swiss francs, Prussian thalers, or lira but sterling.[34] In Switzerland and Germany, recruits were to be paid a bounty of £10. Of this sum, £6 was payable on enlistment and the rest was withheld until disbandment in order to cover the cost of possible damage to barracks and equipment.[35] In addition to troops, the British also had to hire and pay a recruitment committee to find and enlist men. Each committee member would be paid £1 per day and £5 per each person they persuaded to enlist.[36] Finally, the British began to recruit Swiss and German officers. The pay for each of the officers enlisted was negotiated individually; all were paid in pounds.[37]

Unlike German and Swiss mercenaries, the Sardinian Government had ulterior motives to fight on behalf of the Anglo-French alliance. At the time of the Crimean War, Austria controlled the Lombardy region of northern Italy. The Sardinians hoped that fighting in the Crimean War would increase their leverage vis-à-vis the Austrians with the end goal of gaining independence in order to unify Italy. As a consequence, the Sardinian Government did not want the British to pay for its troops. It was believed that accepting financial help from Britain would place Sardinia in the embarrassing position of supplying what were virtually mercenaries instead of an equal ally.[38] Thus, the costs of the troops were to be borne by the Sardinians. However, unable to pay for the troops outright, they negotiated a loan from Britain. On January 26, 1855, Sardinia signed a military convention with Britain and France. According to its terms, Sardinia was to furnish 15,000 men "under the command of a Sardinian general" and Britain was to lend Sardinia £1,000,000, half of which was to be paid at once, and the other half six months later; the

[34] The cost for the German, Swiss, and Italian mercenaries totaled £1,119,141 [C.C. Bayley, *Mercenaries for the Crimea: The German, Swiss, and Italian Legions in British Service, 1854-1856* (Montreal: McGill-Queen's University Press, 1977), p. 149-150.]
[35] Ibid., p. 100-101.
[36] Ibid., p. 100.
[37] Ibid., p. 85.
[38] Harry Hearder, "Claredon, Cavour, and the Intervention of Sardinia in the Crimean War, 1853-1855," *The International History Review*, Vol. 18, No. 4 (1996), p. 829.

interest on the loan was to be 4% and Britain was to pay for all the transport needed by Sardinia.[39]

The status of the sterling provided the British advantages during the Crimean War that was not afforded to the other belligerents. The British were able to purchase inputs for the war from abroad in sterling, placing no pressure on the state's balance of payments position. There was no doubt regarding British ability to supply the war effort and Britain was able to preserve state autonomy, as it did not need to engage in loans with other states for currency. Most importantly, while the Crimean war was a costly endeavor, the British were able to procure a majority of imports for the war at home. Thus, there was no pressure placed on the sterling's status as a top currency.

*Reserve Currency and High Intensity Warfare: The World Wars*

The advantages afforded to Britain during the Crimean War were partially present during World War I and absent during World War II. At the onset of World War I, the sterling was a top currency. Consequently, Britain was able to wage economic statecraft against its allies. Russia and France, in need of sterling to finance their respective war efforts, were at the whim of British demands. Against their desires, both states surrendered vast amounts of gold to meet the British goal of preserving London as the world's financial center. By 1915, however, the benefits of top currency status afforded to Britain were beginning to wane. The British needed dollars and gold to finance badly needed inputs for the war purchased in the United States. Facing a balance of payments problem, the British were no longer able to act unilaterally as they had during the Crimean War. The country was now at the whim of American financiers and

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[39] Ibid., p. 834. According to Bayley, interest on the loan was 3%. However, both Bayley and Hearder are consistent in that the amount of the loan was £1,000,000 and Britain would furnish troop transports at her own expense to carry the force to Crimea (Bayley, *Mercenaries for the Crimea*, p. 76).

policymakers.  More importantly, in order to finance such a high intensity war with a vast amount of purchases from the United States, Britain had to overextend itself financially through the selling of foreign assets, saturating private U.S. markets with sterling in order to purchase dollars, and becoming indebted to the American Government.  This overextension resulted in a decline in the sterling's status as a top currency.

The events of World War II mirrored World War I and placed further pressure on the sterling.  Now a negotiated currency, the British pound experienced a drastically weakened purchasing power.   Again, in order to effectively fight the Germans, the British needed to import goods from the United States.  The British, however, did not have enough reserve currency to finance these purchases.  As a result, Britain, now subject to American demands, had to engage in an economically and politically costly loan.  The British once again sold its foreign assets to finance the war and become heavily indebted to the United States.  By the time the war was over, the sterling lost convertibility and was a narrowly held, negotiated currency.

## World War I: The Sterling Advantage and Dollar Disadvantage

For Britain, the war began with a financial rather than military bang.  The last days of July and early days of August 1914 were wrought with financial crisis.  The Vienna stock exchange had been troubled since the assassination of Franz Ferdinand, but it was not until the Austrian ultimatum to Serbia on July 23 that anxieties spread to other European bourses.[40] Fearing a gold outflow, the Bank of England raised interest rates and by August 1, rates hit a high of 10 percent.  By August 6, the ineffectiveness of high interest rates had proven itself and the bank suspended convertibility.

[40] Martin Horn, *Britain, France, and Financing the First World War* (Quebec: McGill-Queen's University, 2002), p. 28.

The financial crisis was a challenge to Britain's primary goal throughout the war: to preserve London as the world's financial center. The linchpin of Britain's preservation strategy was the maintenance of the gold standard.[41] In order to do so, Britain needed to import gold into the country. However, given that other states were hoarding their own gold stocks, Britain was unable to procure any on a voluntary basis.

Fortunately for Britain, the sterling's currency status allowed the state to wage economic statecraft against its allies to pursue its goal. France and Russia needed sterling to purchase goods to fight their respective war efforts. The loss of industrial areas early in the war meant that Russia would need to import goods to fight the war but was unable to pay for them.[42] In France, the loss of much of France's coal, steel, and iron-producing regions to Germany meant that the French were forced to rely on Britain for these products.[43] Thus, while Russian and French exports to Britain plummeted due to wartime circumstances, imports from Britain skyrocketed to supply the war effort.[44] If these countries were going to effectively fight the Germans, they were dependent on Britain for sterling.

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[41] A few sources that discuss the importance of maintaining the gold standard to the British are: Kathleen Burk, *Britain, America, and the Sinews of War, 1914-1918* (Boston: George Allen & Unwin, 1985), p. 62; William Adams Brown, Jr., *The International Gold Standard Reinterpreted, 1914-1934* (National Bureau of Economic Research, 1940). The maintenance of the gold standard was also of importance to the United States. In June of 1917, the British were still facing a balance of payments problem. The American Ambassador in Britain wrote to the Secretary of State, "…British agents in the United States now have enough money to keep the exchange up for only one day more. If exchange with England fall, exchange with European Allies also will immediately fall and there will be a general collapse… Unless we come to their rescue we are all in danger or disaster. Great Britain will have to abandon the gold standard." Memo, The Ambassador in Great Britain (Page) to Secretary of State, 28 June 1917, *FRUS, 1917 War Supplement,* II: 532-533.

[42] Peter Gatrell, "Poor Russia, Poor Show: Mobilizing a Backward Economy for War, 1914-1917," in S. Broadberry and M. Harrison, eds., *The Economic of World War I* (Cambridge: Cambridge University Press, 2005), p. 239-250.

[43] Coal imports were the largest item on the trade balance, constituting 36% of all imports in 1915 and 1916, and 33% in 1917. Steel and iron imports were the second largest, amounting to 12% in 1915, 16% in 1916, and 15% in 1917. Collectively, they accounted for approximately half of all French imports from Britain from 1915 to 1917. For an excellent discussion of France's war economy and other sources of imports and exports, see Pierre-Cyrille Hautcoeur, "Was the War a Great Watershed? The Economic of World War I in France," in S. Broadberry and M. Harrison, eds., *The Economic of World War I* (Cambridge: Cambridge University Press, 2005).

[44] Morgan, *Studies in British Financial Policy, p. 312.*

Britain agreed to lend its currency contingent on Russian and French gold shipments to London. While both allies were against shipping their gold, the urgency of the war forced them to acquiesce to British demands. France particularly resisted shipping their gold. As early as 1915, the Bank of France declared in its annual report that further demands for gold would endanger the safety of the French banking system.[45] Unfortunately, the French need for sterling was so great that it ended up shipping more gold to Britain than any other ally.[46]

As early as 1915, the sterling's status as a top currency began to wane. If Britain were to effectively fight the expanding war, it would need to purchase goods from the United States. The British need for American imports was compounded by British support for the allied powers. The virtually unchecked drop in the ruble destroyed any hope of Russia financing its purchases in the United States. Initially, the British and the French agreed to equally support Russia. However, by May 1916, Britain had to take over the financing of both Russian and French purchases in the United States. Christopher Addison, Parliamentary Secretary for British Minister of Munitions Lloyd George, wrote that

> Ribot [French Minister of Finance] was over here last week almost in tears, saying that they themselves could not find in America what would be accepted as payment and that we must take on their commitments there, as well as our own, the Russians' and the Italians'…Allies' orders amount to nearly ½ of the sum mentioned about [$1,200,000,000 to be found by the end of September, if all orders were delivered].[47]

Imports to Britain swelled so much that by 1918, American goods represented 39.2 percent of all British imports, compared with the prewar figure of 18.2 percent.[48]

Unfortunately for the British, their purchasing power was in rapid decline. Unable to pay for these goods in sterling, they needed scarce dollars. The rapid decrease in exports to the

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[45] Brown, Jr., *The International Gold Standard Reinterpreted, 1914-1934*, p. 102.
[46] Horn, *Britain, France, and Financing*, p. 91.
[47] Burk, *Sinews of War*, p. 78.
[48] Horn, *Britain, France, and Financing*, p. 87.

United States compounded this balance of payments problem. The balance of trade deficit with the United States grew from £74 million in 1914 to £227 million by 1916.[49] In addition, the volume of imports placed a decreasing pressure on the sterling-dollar exchange rate, making it more difficult to pay for American goods and a potential threat to the gold standard.[50] If Britain were to continue purchasing goods in the United States, they would need a dollar loan.

Unable to procure a direct loan form the American Government due to neutrality, the British were forced to purchase costly private loans, sell their American assets, and ship gold from Canada. From the opening of the war until April 1, 1917, the Allies purchased $7 billion of goods from the United States. In payment, $1,600 million of visible and normal invisible items were imported, together with $1,100 million in gold. The liquidation of $500 million of American short-term debt abroad, the sale of $1,400 million of American securities and other assets, collateral loans of $1,400 million, and unsecured loans of approximately $1 billion provided the balance.[51]

By 1917, orders were increasing and the British were dollar bankrupt.[52] More importantly, they were unable to secure enough credit quickly enough in saturated U.S. markets to meet their dollar needs. In the first months of 1917, still unable to secure a loan from the American Government, the British cancelled placed orders, resorted to a $50 million loan issued in Japan for American credit, persuaded Bethlehem Steel to take British Treasury notes for payment, and continued to overdraft at J.P. Morgan.[53] As of April 1, 1917, Britain only had

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[49] E.Victor Morgan, *Studies in British Financial Policy, 1914-1925* (London: Macmillian & Co. LTD, 1952), p. 309.
[50] For a discussion of the deterring exchange rate through the spring and summer, see Burk, *Sinews of War*, p. 62-67 and Brown, Jr., *The International Gold Standard*.
[51] Brown, Jr., *The International Gold Standard*, p. 64-65; Morgan, *British Financial Policy*, p. 324-333.
[52] The adverse trade balance with the United States in 1917 was £316.2 million and rose to £487.6 million by 1918 (Morgan, *British Financial Policy*, p. 309).
[53] Burk, *Sinews of War*, p. 91.

enough dollars to last three more weeks.[54] It was clear: Britain no longer had control over its own financial affairs and was at the mercy of the American Government.

April 6, 1917 could not come soon enough for the British. With the declaration of war, the U.S. Government could now extend direct credit to Britain. The British were quick to place an order. On April 23, British Ambassador Spring Rice wrote to the American secretary of state, asking "to borrow at the earliest practicable date, the sum of $200,000,000 from your Government."[55] By May 7, the British Government borrowed $250,000,000, asked for $150,000,000 more for the month, and stated that it expected that it would need to borrow $1,500,000,000 over the next six months.[56]

While funds were forthcoming, British hardships were not fully eased. The British wanted a larger loan from the Americans in order to support the rate of exchange. The British, however, were completely dependent on American policymakers:

> At the present time we are supporting exchange only by means of dollars supplied by the United States Government. Only so long as such assistance is forthcoming can exchange be supported. We have no resources of our own except a trifling amount, which would possibly be obtained by the sale of securities.[57]

Fortunately for the British, the American Government was willing to extend more aid. As shown in Table 2 below, between 1915 and 1918, British external debt to various sources with the United States had increased exponentially.

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[54] Britain had $490 million worth of securities in the United States, but this was balanced by an overdraft of $358 million; there was $8 million in gold, making a net total of $219 actually in New York, but expenditure was at the rate of $75 million a week, so it would only last three weeks (Ibid., p. 95).

[55] Memo, British Ambassador (Spring Rice) to Secretary of State, 23 March 1917, *FRUS, 1917 War Supplement,* II: 524.

[56] Memo, Secretary of the Treasury (McAdoo) to Secretary of State, 9 May 1917, *FRUS, 1917 War Supplement,* II: 527-528.

[57] Paraphrase of a telegram message to Mr. Balfour dated August 2, 1917, 3 August 1917, *FRUS, 1917 War Supplement,* II: 559.

| Table 2: External Debt of the United Kingdom (£ million) | | | | | |
|---|---|---|---|---|---|
| **Description of Loan** | **Amount Outstanding at End of Financial Year** | | | | |
| | **1915-16** | **1916-17** | **1917-18** | **1918-19** | **1919-20** |
| Anglo-French Loan | 51.4 | 51.4 | 51.4 | 51.4 | 51.4 |
| U.S. Government | - | - | 513.7 | 840.8 | 865.7 |
| Collateral Notes | - | 143.2 | 122.3 | 53.3 | 47.4 |
| 20-Year Bonds | - | - | 0.2 | 29.5 | 29.5 |
| $ Treasury Bills (Dutch Petroleum Co.) | - | 2.9 | 2.9 | 2.9 | - |
| Rifle, etc., notes | - | 8.3 | 14.6 | 6.7 | - |
| J.P. Morgan's Loan | - | 73.0 | 26.5 | 14.9 | - |
| $ Treasury Bills | - | - | 18.3 | 19.2 | 9.3 |
| Central Argentine Railway | - | 3.1 | 3.1 | 3.1 | 3.1 |
| Danish Government $ Loan | - | - | 3.3 | 5.5 | - |
| 10-Year Bonds | - | - | - | - | 30.5 |
| English Sewing Cotton Co. | - | 1.0 | 1.0 | - | - |
| London Exchange Committee Loan | 10.3 | 10.3 | - | - | - |
| Maitland Coppell | - | 0.8 | - | - | - |
| Dupont | - | 9.6 | - | - | - |
| TOTAL | 61.7 | 303.6 | 757.3 | 1027.3 | 1036.9 |
| Morgan, E. V. (1952). Studies in British Financial Policy, 1914-25. London, Macmillan & Co. LTD, 320. | | | | | |

World War I resulted in a bizarre triangle between Britain, Russia and France, and the United States. In need of sterling in order to purchase badly needed goods for the war effort, Russia and France were subject to British demands. The British, in turn, were able to wage economic statecraft vis-à-vis its allies in order to fulfill its goal of preserving the gold standard. Simultaneously the British Government, in need of dollars to purchase inputs for the war effort, was at the whim of American policymakers.

While the British, along with the Allied Powers, were able to successfully defeat the Germans, they were unable to preserve the sterling's top currency status.[58] The financial overextension forced Britain to extend convertibility, an essential component of a reserve

[58] For an a more holistic discussion of the impact of the war on Britain's external account vis-à-vis the United States, see Stephen Broadberry and Peter Howlett, The United Kingdom During World War I: Business as Usual?" in S. Broadberry and M. Harrison, eds., *The Economic of World War I* (Cambridge: Cambridge University Press, 2005). For an excellent discussion of Britain's attempt to restore convertibility and its status as a top reserve currency, see Brown Jr., *The International Gold Standard*, Book Two.

currency. Not only did the financing of the war drain Britain of its assets, it caused the rise of a reserve currency competitor: the United States.

> In terms of the credibility of its gold-convertibility pledge, the pound did not have any advantage left at all; indeed, it was at a disadvantage. For when Britain returned to gold in 1925, she did so at the pre-war parity of $4.86 to the pound, which was, in view of the intervening changes in national price levels, a manifestly overvalued exchange rate. The dollar and franc, meanwhile, were both undervalued, the former slightly, the latter excessively…Capital flight was now a constant threat. Moreover, London was no less well placed to discourage a capital flight or to offset it by short-term inflows or by compensating improvement of the terms of trade. Now there were rival financial centers where funds could be lodged or where trade could be financed.[59]

Immediately apparent at the onset of World War I, and perhaps more important to British ability to project military power in the future, Britain "no longer enjoyed an extra degree of flexibility in dealing with payments imbalances. Indeed, by the late 1920s there could be little doubt that it was now the constraint disadvantage that predominated, not the flexibility advantage."[60] In sum, the need to procure such a high volume of imports from abroad to fight a high intensity war resulted in the decline of the sterling.

World War II: Lend Lease and the Balance of Payments Nightmare

The financing of World War II was essentially a continuation of the British American relationship that had emerged by the end of World War I. This time, however, the British were in a worse financial position, as the sterling's status was no longer a top currency. Consequently, the British had to surrender autonomy to American policymakers in order to secure badly needed dollars to fight the war.

In order to effectively fight the Axis powers, Britain not only had to supply itself but also the war effort of the Empire. In the first fifteen months of the war, the United Kingdom supplied

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[59] Cohen, *The Future of Sterling*, p. 64.
[60] Ibid., p. 64-65.

90.7 percent of the Empire's munitions and a total of 69.5 percent of munitions throughout the course of the war.[61] While this figure is impressive, taken in a comparative perspective, British war production was no match for Germany. Germany out produced Britain in almost every aspect of war supply until 1941.[62] In addition to weapons, the British were also in great need of raw materials. Military events during the first year of the war compounded the need for a number of important strategic resources. The defeat in Norway in April 1940 deprived Britain of its main peacetime source of timber, papermaking material, and iron ore. In the summer of 1940, with North African contracts broken due to the war, Britain found itself deprived of a large proportion of its imported steel-making materials, of phosphates, flax, hemp, pit prompts, and a number of other essential commodities. Finally, with the closing of the Mediterranean route, trade with the Balkans was disrupted, removing another source of timber and materials.[63] The primary external source for both war supplies and war materials was the United States.

From the start of World War II to May 1940, the British bought war supplies from the United States with British currency reserves under the U.S. policy of "Cash-and-Carry." The U.K. had to purchase all goods from the United States in cash and was responsible for transporting those goods across the Atlantic. Even pre-war contracts had to be paid in full before the goods could leave American ports.[64] This period of self-reliance was short-lived. The ability to purchase goods in dollars was made difficult due to short dollar supply, a worsening balance of payments position, and the inability to float debt on the U.S. market.[65]

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[61] William Keith Hancock and Margaret Growing, *British War Economy* (London: His Majesty's Stationery Office, 1949), p. 373.
[62] For an excellent chart comparing British and German war production throughout the war, see Mark Harrison, "The Economics of World War II: An Overview," in Mark Harrison, ed., *The Economies of World War II: Six Great Powers in International Comparison* (Cambridge: Cambridge University Press, 1998), p. 15-16.
[63] Michael M. Postan, *British War Production* (London: Her Majesty's Stationery Office, 1952), p. 155.
[64] Hessel Duncan Hall, *North American Supply* (London: Her Majesty's Stationery Office, 1955), p. 102.
[65] According to a State Department memo in 1938, U.K. exports to the U.S. were as low as they had been four years earlier. Moreover, it was forecast that the sterling area would have a negative balance of payments with the United

In order to purchase badly needed goods, the British began an internal campaign to both promote the flow of dollars into the country and keep any they had from flowing out. The Government did this through a series of import controls and export promotion. On September 1, 1939, the House of Commons passed the Import and Exports Customs Powers (Defense) Act which limited the "imports of luxuries and of goods of which there are sufficient home supplies in order to conserve exchange for the additional purchases of other products required in war time."[66] Besides import reduction, the British sought to promote exports to the United States. The Government encouraged exports of jute, rubber, tin, whisky, and furs as they were recognized as good dollar earners.[67] Moreover, the Government forced exporters to bill clients at the official sterling-dollar exchange rate, which was higher than the free rate that was currently being used. Finally, the British Government also enforced 'dollar-invoices,' versus the often-used sterling-invoices. The goal was to bring in as much hard currency from the bulk of certain exports with as little administrative interference as possible.

Unfortunately, even before the supply disaster at Dunkirk, the British system of import and export control was proving itself to be inadequate. First, the British underestimated the amount of imports needed from the United States. Moreover, the strategy of importing unfinished materials was failing; they needed the more expensive furnished munitions.[68] Second, in order to fight the war, Britain had to focus all of its manufacturing on the war effort, forcing it to abolish its export drive.[69] Thus, by March 1st, the British reported that at the current rate of

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States for the first year of the war of £117 million sterling or $470 million. Memo, The Department of State to the British Embassy, 21 February 1940, *FRUS, 1940,* III: 97-98.

[66] Ambassador Joseph Kennedy to Secretary of State Cordell Hull, 3 September 1939, *FRUS, 1939*, VII: 214.

[67] Robert S. Sayers, *Financial Policy, 1939-1945* (London: Her Majesty's Stationery Office, 1956), p. 241.

[68] Hall, *North American Supply*, p. 111-112.

[69] In July 1940, the British Embassy sent the State Department a memo explaining their need to abolish the export drive: "The natural tendency of all democracies engaged in rearmament is to believe that it is possible to expand the production of guns and to enjoy a full supply of butter at the same time. His Majesty's Government has found by bitter experience that this is not true and that full production cannot be secured solely by expansion and development

purchases, within two years the U.K. would have given the United States all of its dollar assets.[70] On March 15, 1940, the eve of the Battle of Dunkirk, British Prime Minister Churchill told President Roosevelt that "We shall go on paying dollars for as long as we can, but I should like to feel reasonably sure that when we can pay no more you will give us the stuff all the same."[71]

The events of late May and early June of 1940 drastically changed British war finance. The fall of France and the evacuation of Dunkirk forced the British to assume a far greater share of the responsibility for defeating Germany than they had previously estimated. First, when the British evacuated the continent, they left all of their newly produced war supplies.[72] Second, the British assumed all of France's contracts with the United States.[73] Third, the British now realized that the war was widening and needed as many inputs as they could procure to fight the Germans. Instead of rationing currency and conservative purchases, the British threw all the dollars they had into the war in the hope that the United States would continue providing

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of munitions and auxiliary industries, other industries being left unaffected. The establishment of requisite priority for labor, materials, machines tools, etc., necessarily involves the early curtailment of production for domestic civil consumption." Aide-Memoire, the British Embassy to the Department of State, 3 July 1940, *FRUS, 1940,* III: 43.

[70] "As a result of the war United Kingdom purchases in the United States will increase very largely. The pre-war average was about $460 million a year. Present estimates are that purchases will amount to at least $720 million in the first year of the war, and well over $2,000 millions in the first two years of the war. These are only minimum figures; substantial new requirements are bound constantly to arise and are already arising. The increase in purchases will be repeated in the main by aircraft, engineering products and munitions. There will be no equivalent increase in the United States purchases of British goods…If the war goes on for much more than two years the United Kingdom will have transferred to the United States all of its easily negotiable dollar securities, most of its gold and a part of its "direct" investments in the United States and of its assets in other countries outside the United Kingdom" Memo, British Ambassador (Lothian) to Secretary of State Hull, 1 March 1940, *FRUS, 1940*, III: 106-107.

[71] Hall, *North American Supply*, p. 243.

[72] "We had lost," Churchill wrote, "the whole equipment of the Army to which all the first fruits of our factories had hitherto been given: 7,000 tons of ammunition, 90,000 rifles, 2,300 guns, 120,000 vehicles, 8,000 Bren guns, 400 anti-tank rifles…We had very little field artillery, even for the Regular Army. Nearly all the new 25-pounders had been lost in France. There remained about five hundred 18-pounders, 4.5 inch and 6-inch howitzers. There were only 103 cruiser, 132 infantry, and 252 light tanks. Fifty of the infantry tanks were at home in a battalion of the Royal Tank Regiment, and the remainders were in training schools. Never has a great nation been so naked before her foes" Sayers, *Financial Policy*, p. 133;

[73] Outstanding French commitments to the United States totaled over $500 million. The French had thousands of contracts for planes, machine tools, raw materials, trucks, powder, explosives, and guns. Many of the contracts covered supplies the British needed to fight the war. Others were for special French equipment, unhelpful for the British war effort. There was no time to sort through the contracts to figure out what was needed and not needed. Thus, the British decided to take responsibility for all of them. Edward Stettinius Jr. (1944). Lend-Lease: Weapon for Victory. New York, The Macmillan Company, p. 30.

supplies once they ran out. The drain on dollars was happening so fast the British believed that they would run out by Christmas.[74] The British were no longer able to finance the war on their own.

In order to help its ally, the Roosevelt Administration introduced the Lend-Lease Bill, H.R. 1776, to Congress on January 10, 1941. In order to ensure passage of the bill by a reluctant American Congress, the British Government, against its will, had to demonstrate its financial direness. In order to prove that it was dollar bankrupt, the British Government was forced to strip its assets. United States Treasury Secretary Henry Morgenthau began a campaign to ensure and demonstrate the British were broke. First, he exerted pressure on London to begin liquidating British-owed direct investments located in America, ship South African gold to the United States, and force French gold held to Canada turned over the United States.[75] He even suggested that a 'liquidator' be sent from London to the United States with the power to make sales.[76] Moreover, he suggested that the British should provide a further $2,000 million in cash before arms began to be supplied under Lend-Lease.[77]

Morgenthau's requests were resented in Britain. Prime Minister Churchill messaged President Roosevelt, not only reminding the president of Britain's financial position but also suggesting that forcing British to sell its assets was morally wrong.

> While we will do our utmost and shrink from no proper sacrifice to make payments across the exchange, I believe that you will agree that it would be wrong in principle and mutually disadvantageous in effect if, at the height of this struggle, Great Britain were to be divested of all saleable assets so that after victory was won with our blood, civilization

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[74] Hall, *North American Supply*, p. 251.
[75] Warren F. Kimball, *The Most Unsordid Act: Lend-Lease, 1939-1941* (Baltimore: Johns Hopkins Press, 1969), p. 159; Sayers, *Financial Policy*, p. 370-371, 383-384; For pressure exerted by Morgenthau for the British to sell their direct investments in America to aid in the passage of the Lend-Lease bill, see John Morton Blum, *From the Morgenthau Diaries: Years of War, 1941-1945* (Boston: Houghton Mifflin, 1967), p. 220-223.
[76] Hall, *North American Supply*, p. 273.
[77] Ibid., p. 268; Memorandum of Conversation, by the Secretary of State, 11 January 1941, *FRUS, 1941*, III: 5.

> saved and time gained for the United States to be fully armed against all eventualities, we should stand stripped to the bone.[78]

Unfortunately, the British hands were tied. They needed dollars desperately. Aware of their dollar position, the American Government no longer allowed them to place orders for goods freely. Every order had to be consulted with the State Department. In mid-December the British reported that their reserves were now down to $574 million and payments of at least $1,005 million were due before the end of February.[79] By December 30, the British dollar position deteriorated further. The British began to liquidate their assets, both to continue purchasing goods in cash but also to do anything they could to aid the passage of Lend-Lease.

British inability to cope with a balance of payments problem due to its loss of status as a top currency resulted in great economic and political cost. The British were stripped of their dollar assets and badly needed gold and dollar reserves to resume life after the war. Moreover, they were straddled with an enormous amount of dollar debt that would take over 50 years to pay back; the last payment was made on December 29, 2006.[80] Lacking reserve currency or the ability to pay in sterling cost Britain its autonomy. Throughout the war, the British Government was forced by the United States to prove that the country was really dollar bankrupt against its desires.

The financing of World War II also cemented the sterling's decline. In 1945, the British Government published a report to Parliament, which estimated that the country lost roughly 25 percent (£7,300 million) of its estimated pre-war wealth (£30,000 million). Within this overall figure, internal disinvestment in non-essential industries amounted to £885 million. Internal disinvestment was dwarfed by external disinvestment in the form of selling British overseas

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[78] The British Prime Minister (Churchill) to President Roosevelt, 20 December 1940, *FRUS, 1940*, III: 25.
[79] Hall, *North American Supply*, p. 260.
[80] Finlo Rohrer, "What's a Little Debt Between Friends?" *BBC News*, May 10, 2006.

investments in order to pay for essential imports during the war (£4,200 million) and the destruction of buildings, capital goods, and shipping due to war damage (£2,200 million).[81] These figures make clear British inability to run a balance of payments deficit during World War II drastically hurt the sterling's status once the war ended. In 1950, at a meeting to discuss the problem of sterling balances, the British Ambassador to the United States Sir Oliver Franks opened the discussion by

> referring to Great Britain's position during the 19th century, emphasizing the close relationship between Britain's position as a world banker and her position as a strong military and political force. He stressed the importance which capital investment had played in Britain's key position in the world. Recognizing that Britain could no longer function as world banker, he felt it important that the role be filled and indicated that this might take the form of some joint arrangement among the US, Britain, and Canada.[82]

Thus, by the time of the Korean War, the sterling was a narrowly negotiated currency.[83]

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The effect of the sterling's new status was a retrenchment in its military spending abroad.[84] Owing to balance of payments difficulties, it was much more difficult to maintain forward operating bases. The pay and maintenance of these forces—especially since no limit was ever put on their cash spending in local currencies—was a major item in British military

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[81] Till Geiger, *Britain and the Economic Problem of the Cold War—The Political Economy and the Economic Impact of the British Defence Effort, 1945-1955* (Burlington: Ashgate, 2004), p. 219.

[82] Memorandum of Conversation, by the Director of the Office of British Commonwealth and Northern European Affairs (Labouissee), 6 January 1950, *FRUS, 1950*, Western Europe III: 1598-99.

[83] The impact of the war on sterling and the decline of the sterling in the post-war period is excellently discussed by Judd Polk, *Sterling: Its Meaning in World Finance* (New York: Harper and Brothers, 1956) and Catherine R. Schenk, *The Decline of Sterling: Managing the Retreat of an International Currency* (Cambridge: Cambridge University Press, 2010), Chapters 2-3.

[84] On January 24, 1950 the Assistant Secretary of State for European Affairs, George Perkins, wrote to U.S. Secretary of State Dean Acheson regarding the climate in Britain. "It is clear that they [the British] are obsessed by the feeling that they must cut their overseas and defense expenses, sterling as well as dollar expenses, so as to save every possible penny." Memorandum by the Assistant Secretary of State for European Affairs (Perkins) to the Secretary of State, 24 January 1950, *FRUS, 1950*, Western Europe III: 1610.

spending overseas in terms of foreign exchange costs.[85] In addition to overall retrenchment, the sterling's position and the inability to overcome a balance of payments problem made it impossible to fight a war abroad unless it was funded entirely by sterling. Thus, when it came time to finance Britain's involvement in the Korean War, the country was limited to sterling purchases. As a result, Britain was completely reliant on the United States to fund a significant portion of its war effort.

As early as August 1950, the British made it clear to the Americans that while they were willing and able to contribute to the war effort, their contribution was contingent on the continued stability of the sterling and an inflow of dollars. At a European Recovery Act (ECA) mission working party on U.K. defense expenditures, the British stated that their rearmament program as well as participation in the Korean War

> Could be accomplished only on assumption of continued European Recovery Program (ERP) assistance…plus U.S. aid amounting to dollar equivalent of between £550 million and £600 million over program period…£200 million of U.S. aid would be used for dollar imports required for Additional Military Production (AMP) and remainder available as free dollars unexpended portion of which could accrue to reserves available for later use to off-set obligations resulting from adverse trade balance expected result form AMP effort.[86]

A week after this meeting, the American Ambassador in Britain cabled that Britain was fearful of a decrease in exports due to a shift in production towards armaments:

> [The] basic British argument is that equipment must come from industries producing for export or domestic investments, that production for those purposes cannot be appreciable expanded because of labor shortage, and that increased military production therefore reduces exports and results in balance of payments deficit for which heavy U.S. aid is required.[87]

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[85] Strange, *Sterling and British Policy*, p. 184.

[86] Ambassador in the United Kingdom (Douglas) to Secretary of State, 2 August 1950, *FRUS, 1950*, Western Europe III: 1670. According to FRUS, "Gaitskell and Attlee defined the phrase 'free dollars'" to mean "'dollars that can be expended by HMG without prior consent or supervision of the US or even post accounting anywhere in the world, or alternatively that can be put into reserves for the sterling area." Ambassador in the United Kingdom (Douglas) to Secretary of State, 9 August 1950, *FRUS, 1950*, Western Europe III: 1677, ftnt 2.

[87] Ambassador in the United Kingdom (Douglas) to Secretary of State, 9 August 1950, *FRUS, 1950*, Western Europe III: 1675.

By December 1950, even though there was an improved balance of payments position, the British were anxious and believed that the trend would reverse, making impossible the undertaking of inevitable heavy defense expenditures without substantial U.S. assistance.[88]

The British feared that rearmament would exacerbate sterling imbalances and foster further dependence on the United States, resulting in a loss of British autonomy. On December 3, 1950, the Chargé in Britain wrote to Secretary of State Acheson. He suggested that one of the principal concerns of the British was the

> desire to end dependence on [the] U.S. [The] British feel themselves intractably bound to [the] US…They wish, however, to stand on their own feet as soon as possible. In our view financial factors are root this to dependence. [The] British [are] also very sensitive to what they regard our tendency to treat them as [a] 'junior partner.' [The] Rearmament program has caused [the] prospect[ive] end [of] financial dependence to recede with divergence U.S.-U.K. Far Eastern policies and most recent developments Korea have made Labor and Conservatives alike feel that view HMG not being given appropriate weight in policy decisions.[89]

In the following telegram, the message was repeated,

> Also influencing British economic thinking is their sincere desire to lessen their dependence upon U.S…British find themselves in [a] paradoxical position of wanting and needed substantial U.S. aid and at the same time endeavoring [to] free themselves from [a] condition of direct dependence which bilateral aid arrangements inevitably foster.[90]

The British, fighting under the British Commonwealth Occupation Force (BCOF), shared the message regarding balance of payments problems with other Commonwealth countries. In August 1950, the British told the Australians, who were responsible for the BCOF accounting system, that they did not wish "to be committed to any system which might result in [the

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[88] The Chargé in the United Kingdom (Holms) to the Secretary of State, 3 December 1950, *FRUS, 1950*, Western Europe III: 1705.
[89] The Chargé in the United Kingdom (Holms) to the Secretary of State, 3 December 1950, *FRUS, 1950*, Western Europe III: 1699.
[90] The Chargé in the United Kingdom (Holms) to the Secretary of State, 3 December 1950, *FRUS, 1950*, Western Europe III: 1704.

accumulation] of further sterling balances," and that therefore they were "opposed to the setting up of a general fund which presumably would involve [the] Commonwealth in liability to contribute."[91] If such a liability could not be avoided completely, however, it was considered desirable for British forces to rely upon the resources of BCOF, since these at least remained within the sterling area and did not, therefore, involve a dollar commitment which would otherwise be the case if British forces relied upon the American supply line.[92]

Unfortunately, self-sufficiency of the BCOF was impossible. While most basic equipment was British, the BCOF drew heavily from American equipment and services. Infantry units drew such items as flamethrowers and 3.5-inch rocket launchers from the American Army, as well as support from American engineer, signal, and medical services, and some rations were also supplied from U.S. Army sources. Specialized equipment, such as winter clothing, was entirely drawn from the Americans, as were supplies of petrol, oil, and lubricants.[93] If the British were to continue the war effort, they would need to once again engage in a dollar loan. In a cable on December 15, 1951, the British, citing a precarious dollar position, requested their agreement to indefinite postponement of the settlement of accounts with the United States.[94] The bill was not finally settled until 1958.

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[91] During the Korean War, the British fought alongside the Commonwealth countries. Given the sharing of resources among the BCOF, the Korean Operations Pool Account (KOPA) was set up. Led by Australia, the cost of maintenance of contingents, essentially all non-sterling purchases, were pooled across countries and split between them in proportion to the size of contingents. Each Commonwealth country was responsible for pay and allowances of its own forces, cash grants from public funds for the maintenance or supplementation of amenities, cost of transport, and cost of initial equipment. Stores for maintenance, barrack stores, local procurement, and local civilian labor was charged to the Pool account [Anthony Farrar-Hockley, *The British Part in the Korean War*, Vol. II (London: HMSO, 1995), p. 487-489.]

[92] Grey, J. (1988). The Commonwealth Armies and the Korean War. Manchester, Manchester University Press..

[93] Jeffrey Grey, *The Commonwealth Armies and the Korean War* (Manchester: Manchester University Press, 1988), p. 172.

[94] Farrar-Hockley, *British Part*, p. 487; Grey, *The Commonwealth Armies*, p. 177; Between August 1950 and December 1951, the British and Americans discussed the relationship between British military purchases and a worsening balance of payments position. For a discussion of dollar aid when Sterling balances were rising in the first half of 1951, see: The Ambassador in the United Kingdom (Gifford) to the Secretary of State, 9 March 1951, *FRUS, 1951*, *Europe: political and economic developments*: 916-7; The Chief of the ECA Mission in the United

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Kingdom (Batt) to the European Cooperation Administrator (Foster), 21 March 1951, *FRUS, 1951*, *Europe: political and economic developments*: 923-4; The Secretary of State to the Embassy in the United Kingdom, 30 March 1951, *FRUS, 1951*, *Europe: political and economic developments*: 925-6Memorandum of Conversation by Alexander M. Rosenson of the Monetary Affairs Staff, 6 April 1951, *FRUS, 1951*, *Europe: political and economic developments*: 930-1. By the fall of 1951, the British dollar position drastically worsened, see: The Chargé United Kingdom (Holmes) to the Secretary of State, 27 August 1951, *FRUS, 1951*, *Europe: political and economic developments*: 955-8; The Ambassador in the United Kingdom (Gifford) to the Acting Secretary of State, 4 September 1951, *FRUS, 1951*, *Europe: political and economic developments*: 959-60; Memorandum of Conversation by the Assistant Secretary of State for Economic Affairs (Throp), 6 September 1951, *FRUS, 1951*, *Europe: political and economic developments*: 961-8; The Economic Cooperation Administrator (Bissell) to the Embassy in France, 3 December 1951, *FRUS, 1951*, *Europe: political and economic developments*: 989-90;

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