

Chapter IVFINANCIAL RELATIONS WITH CANADA *

Second only to the United States in providing financial aid to the U.K., it is less easy to give a consecutive account of arrangements with Canada. With the U.S.A. there were fairly well defined phases in the development of negotiations and what may perhaps be called the evolution of understanding. With Canada, too, early failures to see eye to eye were eventually overcome; but so many things, especially during the first two years or so of war, were happening concurrently that it will be necessary to treat several of them as distinct problems if they are to receive due attention: though they were, of course, all parts of the same structure in building at the same time. The British Purchasing Mission, the Air Training Scheme, Canada's sterling balances, her programme for repatriating securities - all these were demanding close attention practically from the outbreak of war.

Preliminary

Just after "Munich" (September 1938) the Bank of Canada, anticipating legislation which would become necessary in the event of war, asked the Bank of England whether they would outline in a memorandum (to be treated "very confidentially") the kind of financial arrangements they had in mind for the United Kingdom in the same contingency. The Governor replied fairly fully, giving in particular a summary of proposed Exchange Control procedure. (Letters 26.10.1938 and 12.1.1939).

In April 1939 the Treasury decided that it would be advisable to open discussions with the Canadian Department of Finance on possible solutions of the difficulties which the U.K. anticipated in purchasing supplies from Canada in the event of war.

Financial plans in general and the extent and character of U.K. requirements of food and raw materials also needed to be explored. The Canadian Government had not been very forthcoming in the matter of our need for supplies, although the position had improved a little after the German occupation of Czechoslovakia.

* *Some figures in dollars, except where stated otherwise, will all be in \$ Canadian.*

The Treasury

move for political reasons: the relations between the United Kingdom and the U.S.A. might be adversely affected. The idea was therefore abandoned for the time being.

Repatriation was also judged to be impracticable as a Dominion Loan of \$50 million issued in May was only moderately successful, and in any case the Government would have to borrow again in the Autumn.

Life Insurance Companies and Two and Three Market Bonds

A few Canadian life insurance companies in the United Kingdom held bonds of this character. The Companies might be given sterling bonds in exchange, while the bonds taken over could perhaps be extinguished by a Dominion domestic issue. The amount involved, however, was comparatively small, the probable attitude of the companies uncertain, and after the outbreak of war the securities could be commandeered. As a pre-war operation, therefore, this possibility seemed undesirable.

Direct Borrowing

Although the reluctance of the Treasury to adopt this form of borrowing appeared, by the end of April, to have been strengthened, the Canadian authorities were somewhat inclined to favour it. A Market Loan would demonstrate to the world Canada's willingness to co-operate forthwith, and would establish a precedent, both with the Canadian Government and its possible successor and with the Market, without which such an operation might not be practicable on the outbreak of war. Pre-war borrowing might be cheaper - though probably at a somewhat higher rate than that obtainable for a similar Canadian Government maturity - and would give a valuable basis for pricing any subsequent issue. Canadian investors were thought to be surfeited with Canadian Government Loans and might be glad to diversify their holdings.

The maximum which the Market could take and the minimum from the point of view of the U.K. prestige was in the opinion of the Canadians \$100 million.

There was to be an Election in the Autumn and it was thought not unlikely that the Liberals would lose seats and that the new House of Commons might be more isolationist in tendency: but it was hardly likely that any Canadian Government would place obstacles

in the

The Treasury selected as their representative a Bank of England official*, who was given a letter from the Chancellor to the Minister of Finance (Mr. Dunning) and was to have some assistance from the High Commissioner.

The Treasury representative's Report is dated 2nd June 1939 and is of interest as affording some comparison of the reactions of the Canadian Government before and after the outbreak of war.

The questions raised with the Minister were not taken further. Mr. Dunning said that the Canadian Government as a whole would be entirely anxious to help the U.K. in the matter of finance, but that the discussion of hypothetical questions by the Cabinet would not be likely to produce any useful result.

Pre-War Borrowing

Among the immediate possibilities of securing exchange that were to be explored was that of selling short-term dollar securities of the U.K. Government in Canada, although unless the prospects were really favourable this method of borrowing was not favoured. Another method would be for Canada to pay off debt due or callable in the U.K., either from her own resources or by borrowing in the U.S.A.

Re-financing or Repatriation

The Bank of England had suggested calling all or part of two Canadian Sterling Loans, \$60.8 million Grand Trunk Railway Company 4% Perpetual Guaranteed Stock and \$137 million Dominion of Canada 3½% Registered Stock. (The latter was in fact repatriated in October 1939). The Bank of Canada had considered calling the former to be re-financed in New York, but their advisers there thought this would be a dangerous
move

*Mr. J. A. C. Osborne, ex-Deputy Governor of the Bank of Canada. Mr. Osborne left for Canada in May and returned after a few ^{weeks} ~~weeks~~ to report. He sailed again in September, this time with the nucleus of the British Purchasing Mission (see below).

long run the Canadian dollar would return to parity might, however, attract speculative buying from the U.S.; on the other hand, Canadian dollar bonds might not easily be realisable in U.S.dollars in view of the foreign exchange control which would doubtless be set up in Canada.

As regards the refinancing of Canadian Government sterling loans in the U.S.A., it was thought that this might be possible at a time when the U.S.might be unable to lend to the U.K.

British investments in Canada were estimated at £440 million nominal, of which £301 million were bonds and the remainder equities. Of bonds and equities only about \$500 million appeared to be denominated in Canadian dollars.

The use of Canadian dollar securities as collateral for borrowings in Canada appeared to be a possibility in the minds of the Canadian authorities, though no collateral ^{had seen} ~~was~~ put up in the last war. But at that time Canada was borrowing large amounts from the British Government, which constituted an offset.

It was expected that British exports to Canada, which fell by nearly 50% in the last war, would again decline. But Mr.Dunning referred to the probability of rather large purchases of aeroplanes by Canada in the U.K., and to the possibility of a Canadian Expeditionary Force.

The opportunity was taken to interest the Department of Finance in the negotiations which had been proceeding between the British and Canadian Governments since January 1938. The difficulties which the U.K.Government had been encountering were explained, and a new and much stronger Canadian inter-departmental committee was set up. There was a probability that control of the sale and export of a number of commodities in which the U.K.were interested would be instituted on the outbreak of war, or perhaps before if public opinion permitted the Canadian Government to take action.

The formation of the new committee referred to was doubtless helpful. As regards finance the Treasury and the Bank decided finally against any attempt at pre-war borrowing.

in the way of direct Market borrowing, whereas a direct Canadian Government credit to the U.K. would not be possible even for the existing Liberal Government, who would not be prepared to introduce the necessary legislation and face the criticism and opposition which might ensue.

Two major objections to a Market Loan, however, were that it would probably attract subscriptions from the U.K. - to this extent defeating its object - and that \$100 million, the maximum suggested, would probably be, in the British Government's view, too little for U.K. prestige.

An alternative form of direct borrowing would be a banking credit for, say, \$25 million on six months' Treasury Bills (rediscountable at the Bank of Canada), renewable if desired. This would be a possible compromise to cover immediate purchases.

War-Time Borrowing

It was naturally difficult to obtain any definite opinions on a conjectural state of affairs. It was suggested that the U.K.'s needs might be about £100 million a year, this being about the amount lent by the Canadian Government to the U.K. in 1918 and 1919. The Finance Minister gave only a general assurance of all possible assistance, and doubtless remembered that U.K. advances to Canada during the last war were nearly as large as those afforded by Canada herself.

The Bank of Canada thought that borrowing should be both direct and indirect, the first loan to be indirect and for, say, \$100 million. Maturities offered should not run for more than ten years, callable at par after, say, five or seven years, or at a premium if called earlier. There might at first be a differential yield which would make U.K. securities attractive; later, the yield on each Government's bonds would tend to approximate. It was not thought that much U.S. money would be attracted if Canada were in the war and the United States were not: there might be depreciation, or fear of depreciation, of the Canadian dollar, which might deter the ordinary U.S. investor. The expectation that in the long

On the other hand the U.K. failed to keep the Canadians informed about their resources and the character of their difficulties. Nor did the Treasury or the Bank disclose them either to the Treasury representative or to the High Commissioner in Canada. With this lack of background, it is not surprising to learn ^{that} when U.K. dollar funds ran out the Bank's short telegrams seemed (for the first time) all but unintelligible to the Bank of Canada. Misunderstandings of this kind were not cleared up until a visitor* from the Treasury had an opportunity of a long talk with Dr. Clark at the beginning of 1941.

One ^{main} cause of the Treasury's annoyance seems to have been Canada's unwillingness to sell for sterling in the absence of a guarantee - with a free and fluctuating pound an apparently reasonable objection. To ask Canada to accept sterling without limit would have been tantamount to asking her to abandon her own currency standard.

In October 1939 a guarantee was offered in connection with sterling in excess of a comparatively small working balance..... "Any balance of Bank of Canada's sterling account with Bank of England in excess of a normal working balance, say, £500,000, to be transferred to a special Money Employed account in some round multiple Amount transferred to this account would bear an exchange guarantee at the rate ruling on the day of transfer....." Gold would be set aside against sterling on this account in excess of £25 million. Sterling could be re-transferred should Canada find herself short of it.**

The conditions which this offer was intended to meet did not arise until the Autumn of 1941, when it became important because Canada's holding of sterling looked like being very large in the future. References by the Canadian Government to the 1939 offer then led to a long dispute, which is recorded below under "Canadian Sterling Balances."

* Mr Playfair (10.1.1941).

** No copies of original cables in the Bank: the above is quoted in No.374, Phillips to Osborne (19.10.1939).

Early Difficulties

Throughout the greater part of the War relations ~~with~~ ^{with} Canada were so cordial that the earlier period, down at least ~~to~~ ^{to} the Spring of 1941, when they were less so, is apt to be ~~forgotten~~. ^{to} ~~forgotten~~ The fault perhaps lay more with Canada. Her financial authorities were not prepared to take steps seriously ~~inconvenient~~ ^{inconvenient} to her internal position (through inflation and associated troubles) until after Lend-Lease had given a lead and the war had begun to go so badly that even Canada might be threatened.

Towards the end of 1939, at a full and formal meeting between Canadian ministers and representatives of the U.K., Mr. Mackenzie King told Lord Riverdale (of the Air Mission) that Canada had "entered the war as a chivalrous gesture". There is little doubt that this represented his own feelings at the time, although he was speaking under provocation. And later his attitude and that of his Government changed greatly. The Canadian ^{Deputy} Minister of Finance (Dr. W. C. Clark), and also the Bank of Canada at first, felt that the Canadian public could not be expected to accept the degree of sacrifice possible in the U.K., so much more nearly affected by the war. The Bank of England accepted this view, too.

But when Dr. Clark, as an economist, worked out (from statistics of the National Income which later proved to be an under-estimate) what he considered to be the maximum proportion ~~of~~ (41-42%) which could be diverted ^{to} ~~for~~ war expenditure, and translated that into possible assistance to the U.K. of Canadian \$237 million in the first year of war, H.M. Treasury were not unnaturally impatient with his use of such statistics; and the Bank agreed with them. Mr. Osborne's comment from Ottawa suggested a more rational view of probabilities.... "I imagine that a country which is making its real maximum effort spends what it must, fills up the gap between expenditure and revenue with inflation, and leaves it to post-war statisticians to work out what proportion of the nation's income was directed to war purposes."

On the

In August 1941 some misunderstanding arose on the Canadian side with regard to the replacement by Lend-Lease requisitions of the kind of orders which had hitherto been placed in Canada. The Canadians suggested that this seemed to offer no particular financial advantage to the U.K. The Treasury were in no two minds, however, and in a memorandum (May 1942) stated their considered view that ... "it is preferable from the financial point of view that orders should be placed under Lend-Lease rather than in Canada, when this is consistent with the assurance given to the Canadian Government, e.g., in cases where plant capacity has not been and is not being already built, but would have to be created"

One other (earlier) cause of friction was the failure on the part of Canadian farmers to realise the motive for large U.K. purchases of wheat from neutral countries (implying so much less from Canada): there were of course stronger claims on a limited supply of dollars to pay for other much needed things from Canada. With a view to dispelling this uneasiness, on 19th October 1939 the Governor wrote to the Dominions Secretary (Mr. Eden) who replied that he had cabled fully to Canada emphasizing the exchange and financial aspects of the matter.

British Purchasing Commission (Mission)

When war was declared, and Canada among other Dominions had pledged her full support for the U.K., one of the first requirements was the setting up of a body which should ensure the supply from Canada of things vitally necessary to the U.K. The nucleus of a British Purchasing Commission in Canada (B.P.C. later B.P.M.), at first under the administration of Sir James Rae (an Under-Secretary to the Treasury) and Colonel Greenly, with Mr. Osborne attached, left for Canada in the middle of September 1939. The Commission's headquarters were in Ottawa, and a War Supplies Board was set up by the Canadian Government to act as their

their agents.*

Two subsidiary organisations helped to ensure smooth financial working: the Department of Munitions and Supply (D.M.S.-Canadian) which made payments to Canadian contractors etc. providing armaments for the U.K.; and the United Kingdom Purchasing Office (U.K.P.O.), which transferred the necessary dollars to the D.M.S. and also paid for purchases outside the range of that organisation.

On the 22nd September Mr. Osborne's duties were more clearly defined in a letter to him from the Treasury (Sir Richard Hopkins). He would discuss, on the Treasury's behalf, with the Canadian Government what assistance they could give the U.K. either by loan or otherwise; would act as their financial representative on the Greenly Commission; and in particular would "consider himself the contracts placed by the Commission from an exchange and financial point of view". The Commission, it will be noticed, had now passed into the charge of Colonel Greenly.

Early considerations of the Mission were to include estimates of U.K. requirements in Canada in the first year of war and arrangements with the Canadians for the repatriation of Canadian securities held by U.K. residents. Within a few days of their arrival in Ottawa the Commission reported to London on talks they had had with the Governor of the Bank of Canada (Mr. Graham Towers) and Dr. Clark. All seemed convinced that all credit facilities should be arranged through the Canadian Government and, except where Canadians genuinely needed sterling, Canadian exporters to the U.K. should be paid in Canadian dollars. The proposed arrangements (i.e. blocked or unguaranteed sterling) "really constitute forced loans and must in our opinion tend to reduce the very great willingness which the Canadian

Government

*Purchases in the U.S.A. for the U.K. could not be made from Canada. A separate organisation, the British Supply Board, was set up in New York under the Chairmanship of Sir A. Purvis. An Anglo-French Purchasing Board (under the same administration) was superseded in 1940 by a small control in London under the Hon. T. H. Brand. Arrangements for drawing powers etc. are described in the chapter on "Relations with Government Departments" in Part IV.

Government is shewing to co-operate to maximum extent" The Treasury agreed, and suggested that payments for Government contracts should be cleared through the two Controls, i.e., payment in sterling to Bank of Canada account at the Bank of England, the Bank of Canada to pay out the equivalent in dollars at current rates. This could also take care of any sterling already credited to blocked accounts (e.g., for certain base-metal producers). The Canadian Government were certainly unhappy about payment in Blocked Sterling, but H.M.Treasury still thought that several Canadian producers would find uses for it.

Meanwhile (26th September-11th October) an exchange of telegrams which did much to clear up misunderstandings on both sides had been taking place between the two Central Banks.

The Mission had stated, tentatively, to the Canadians that £100 million might be a very conservative estimate for U.K.financial needs in Canada in the first war year. The Treasury confirmed that they would amount to £73-90 million "at least"; but Sir F.Phillips thought * that our proper line of attack was to ask for £73 million (our minimum figure) less £10 million which the Canadians were to spend on their Expeditionary Force, i.e., £63 million. Canada's latest offer was about £55 million.**

Estimates were, of course, constantly under revision, and a telegram*** from Sir F.Phillips to Mr.Osborne after six months of war raised the final figure to "nearer 80 than 70".

During the first year and a half of war the U.K. deficit with Canada was met by sales of gold, the accumulation of sterling by the Canadian Foreign Exchange Control Board (held on Bank of Canada account at the Bank of England) and by sales of

securities

*Letter to Deputy Governor 11.11.1939

**\$237 million (cable 7.11.1939 from High Commissioner)

***Bank copy undated, but about end of March 1940.

securities in roughly equal proportions. The securities represented both permitted sales of privately-owned dollar securities and repatriations of Canadian sterling securities*:-

September 1939-February 1941

£ million

Sales of Gold	55.7
Dollars against sterling (net)	60.2
Sales of securities (dollar)	25.5
Repatriation of securities (sterling)	<u>36.9</u> 62.4

(A further £5 million of gold was sold in 1942)

The repatriation of Canadian securities as a means of providing the U.K. with dollars in the event of war was examined well in advance of its outbreak, and views in Canada, contained in Mr. Osborne's Report of 2nd June 1939, have been referred to earlier in this chapter.**

It was soon clear that repatriation would play a very large part in the Canadian Government's plans for financing the U.K. deficit with Canada, and that the securities called would be confined to obligations of the Government or those with a Government guarantee (and perhaps other securities readily marketable in Canada). If the U.K. should run short of dollars in advance of the repatriation programme - or rather of the stages in carrying it out - the Minister of Finance was empowered to authorise further accumulation of sterling by the F.E.C.B. to bridge the gap temporarily.

Up to March 1942, when the policy of repatriation was halted and a change of technique adopted, the Canadian Government undertook five separate repatriation operations.*** They opened their programme on the 14th October 1939, by calling the \$137 mn.

of

*Note (21.3.1941) Exchange Economy Section: O. & F.

**Total U.K. investment in Canada (Lord Kindersley's figures, given to the Bank confidentially in April 1939) was estimated at £440 million, of which £115 million was in Government and Municipal Loans. (O. & F. 396 fo. 44a)

***In July 1940, to deal with securities sent to Canada, a special office was set up under Bank of England administration (the U.K. Security Deposit) an account of which is included in an Appendix dealing with Exchange Control Administration.

to the chapter

of Canada 3½% Registered Stock (1930-50), of which the U.K. Control had vested some £17 million of U.K. holdings. Between June 1940 and January 1942 there were four further operations. Particulars* follow:-

<u>Date of Order</u>	<u>Securities</u>	<u>Nominal Amount surrendered</u>	<u>Cost to H.M.T.</u>
1939 14 Oct.	Canada 3½% (1930/50)	£17,500,000	£17,600,000
1940 15 June	Canada 4% (1940/60)	13,900,000	14,000,000
26 Oct.	Grand Trunk Railway 4% Perpetual	23,100,000	24,100,000
1941 15 Aug.	Canada 4% (1953/58))		
	" 3½% (1950/55))		
	" 3½% (1958/63))	28,400,000	30,400,000
	Province of Ontario)		
	4½% (1945/65))		
	" 4% (1947))		
1942 26 Jan.	22 Securities	48,400,000	49,900,000
	57 Securities (some)	5,800,000)	17,500,000
	with dollar)	\$45,700,000)	
	option))		
			<u>£153,500,000</u>

Canadian dollars realised were the equivalent of just under £153 million.

Canadian "Contribution" and Loan

By the end of March 1942 Canadian sterling balances had risen to well over £200 million. Canadian policy for the coming financial year was then revised in favour of a new technique. Accumulated sterling (equivalent of \$700 million) was first converted into an interest-free loan, the rate of interest and future terms of which were left for decision after the war. No collateral was for the time being to be deposited, ~~but the~~

but the

* Securities Control Office

but the proceeds of any future sales by U.K. residents of Canadian dollar securities to non-residents or of redemption or sales of any Canadian securities owned in the U.K. were to be applied to repayment of the loan.

Further, the Canadian Parliament voted an outright gift, to meet U.K. war expenditure in Canada, of \$1,000 million. Only about \$920 million of this was in fact available for future purchases, since as a condition of the gift \$76 million was sold back to Canada against her remaining sterling balances.

The free gift, commonly referred to as the Canadian Contribution, was exhausted ⁱⁿ ~~in~~ nine months, some having been sold to other countries (e.g. Australia and New Zealand) in need of Canadian dollars. In the three months or so intervening before the next Budget the U.K. Canadian dollar deficit was met partly in U.S. dollars (the equivalent of Can.\$165 million) and partly by Canada's purchase of British Government investments in Canadian war plant, made early in the war (Can.\$40 million).

At this stage, approximately, the period of Canadian Mutual Aid was entered, and Canada's method approached more closely to U.S. Lend-Lease procedure: her aid was intended to take the form of goods and services delivered to rather than of money placed at the disposal of the U.K. The Canadian Mutual Act (20th May 1943) granted an appropriation of a further \$1,000 million. This, however, was controlled by a Board (Five Canadian/^{Cabinet} Ministers) by whose decisions war materials supplied under the Act could be allocated to any of the United Nations.

An agreement between the Governments of Canada and the U.K. established arrangements "to facilitate the operations of the Canadian Mutual Aid Board", important among which was the opening (on 1st December 1943) of an "United Kingdom Suspense Account", fed primarily by all payments by the Canadian to the U.K. Government which did not have to be made in sterling*. This account was opened in the name of H.M. Government (ensuring retention of British-owned dollars until they were actually paid over), and was included in E.E. Account assets. From this account the Mutual Aid Board

*See further in Appendix "Canadian Mutual Aid".

made payments to the appropriate Canadian Government Departments for the procurement and transfer to H.M. Government of supplies outside Mutual Aid appropriation. It was laid down that no such payment should reduce the combined balances of the Suspense Account and the Bank of England account at the Bank of Canada below \$15 million. Since the latter account was maintained as a working balance only, H.M. Government undertook to transfer any excess over an agreed maximum of \$20 million on the Bank of England account to the Suspense Account.

The above arrangements were incidental to the change in method now adopted by Canada in assisting Allied nations to obtain Canadian supplies. Previously Canada had provided dollars for the U.K. alone, as holder of the Sterling Area dollar pool; now the assistance was to be direct, and to reach any of the United Nations. But one principle, at least, remained: Canada would provide Mutual Aid only to the extent that countries were unable to provide Canadian dollars for their requirements from Canada. Conversely, Canada would not seek Reciprocal Aid when she was able to buy her needs.

With the experience of two years of American Lend-Lease (and a year of Mutual Aid) behind them, the Canadian and British Governments were able to take much for granted when principles of "essentiality" and other criteria for admission to Canadian Mutual Aid came up for discussion. The similarity of the articles in the Agreement of May 1943 (definitions of War Supplies, etc.) to those in the Lend-Lease Act of March 1941 is not surprising.⁴ Likewise the Agreement (11.Feb.1944) between the Governments of Canada and the U.K. on the principles applying to the provision of Canadian supplies embodied concepts and classifications largely accepted already.

Canadian Mutual Aid did not begin to be effective until the summer of 1943, and the dollars required by the U.K.

⁴The Canadian Mutual Aid Board's first report (down to 31.3.44) states that "in order to deal with certain Mutual Aid problems, an organised and continuing agency of consultation with the U.S. Government was necessary".

were provided by the Canadians' taking over the balance of British Government war plant in Canada (a further \$165 million), also working capital in connection with the same, and by various other means (including an increase, in March, of over £12 million in F.E.C.B. sterling). Only \$85 million came from Mutual Aid.^f

Thenceforward Mutual Aid was intended to take care of the gap in the deficit (after Oct. 1943 Canadian sterling balances did not exceed £10 million again until April 1946), and Mutual Aid disbursements had amounted to \$723 million by 31 March 1944. The amounts disbursed in the two following financial years were very similar, viz., \$719 million and \$670 million.^g

1944 Agreement

The financial arrangements with Canada continued on such generous lines (much more generous, in fact, than those followed by any other member of the British Empire) that the British Treasury came to regard the accounting basis almost as a domestic Canadian affair. In time, however, this led to anomalies which caused difficulty to both Canadian and British Treasuries. In particular, Canada's interpretation of her own declared responsibility for the financing of her own direct war effort at times allowed her to meet its cost not through her internal Defence appropriation but through Mutual Aid appropriation, which of course purported to be a financial contribution to the Allied war effort. The Mutual Aid appropriation consequently tended to be inflated to a degree which might in public opinion appear to be out of proportion and politically difficult to defend.

British Treasury representatives, in the U.S.A. at the time of the Bretton Woods Conference (summer 1944), suggested that the accounting basis of Canadian Mutual Aid should be examined, in particular as to various respects in which the British

^fSee O. & F. 396.01 Vol. 2 fo. 160 "From Contribution to Mutual Aid", for an account of this finance down to July 1943.

^gFinal report of C.M.A.B. of 1946.

Exchequer appeared to be bearing costs which should really have fallen to Canada. They felt that the outcome of this examination might provide means for liquidating the apparent excess of U.K. requirements over the Mutual Aid appropriation.

The Canadian estimate of the U.K. deficit for the financial year ending 31 March 1945 (after Mutual Aid appropriation, carried-over and new)* was \$1,120 million. This was suspect as inflated for the reason just given, and the British estimate was \$895 million. The Canadians accepted proposals that they should pay the cost of additional R.C.A.F. squadrons in Britain, and also for the revision, in our favour, of capitation rates for the maintenance of Canadian personnel,** to operate retrospectively from July 1943. These adjustments would reduce the gap to \$665/695 million.

Principles, proposals and counter-proposals are discussed in a long series of cables July/August to and from Sir Wilfrid Eady of H.M.Treasury† which refer also to discussions between Sir Wilfrid Eady and Lord Keynes and the Canadian Treasury. It is perhaps worth while quoting (from cable outwards, 21. 7.44) the following as an underlying principle in the U.K. attitude:

"We must surely use, and stress to the utmost the general argument. In the field of production we, the U.S. and Canada have pooled our resources for the efficient prosecution of the war. We ourselves have necessarily put a relatively higher proportion of our manpower to direct war purposes at the expense of industry and have looked to North America for the supplies we required. There is no need to recapitulate the reasons for this. But the decisions have been taken by agreement among us for the most efficient prosecution of the war; and in implementing them we, for our part, have disregarded our own long-term interests in the common immediate interest. We evidently cannot unravel at short notice the position thus reached.

We can thus see no likelihood of our reducing our demands on Canada at the present stage"

The Bank also stated its views quite strongly. They were in favour of bridging the gap by a transfer of gold, to be followed by a reduction of purchases, if necessary, rather than by

* At the time put at \$540 million, later raised to \$596 million, but recorded at over \$700 million in the M.A.B.'s final report (1946).

**This matter, however, was still unresolved in the autumn of 1945.

† See O.& F.396.01 Vol.4

running up debt in the form of book credit or by the accumulation of further Canadian sterling. Book credit had "all the disadvantages of a formal loan as a precedent for the U.S.A., with the added disadvantage that we are running up an account without knowing what the real liability is" Accumulation of Canadian sterling was for Canada a free asset, unlike a Sterling Area country's accumulation of which a substantial part would be tied up by local (e.g., Bank Note) regulations and banking custom. (Letter 18. 7.44 C.F.C. to Treasury.)

A new financial settlement was approved by the Canadian Cabinet on 14 August and its terms accepted by the British Chancellor of the Exchequer in a cable (28. 8.44) to the Canadian Minister of Finance (Mr. Illsley). Its basis is shown by the following additional payments which Canada agreed to make:-

	\$ millions
Revised capititation*	140
Advanced air training in U.K.	75
Canadian proportion of stocks of munitions etc. in reserve and in transit to forces overseas (150 + 150)	300
Tax refund for current year	80
Tax repaid on Mutual Aid contracts	<u>60</u>
	\$655 millions

The remaining gap, after revised Canadian estimates of their Air Force payments, was now reduced to \$555 million, so that the above provision left a margin of \$100 million. A payment of 80 million U.S.dollars (\$88 Canadian)**, together with a tax refund of \$35 million for the previous year and a proposed cut of \$25 million in U.K. expenditure on food, raised this margin to about \$250 million - a figure to be regarded as precarious in view of the many doubtful estimates in the calculations.

The new Agreement was intended to run until 31 March 1945, after which Stage 2[†] was deemed to begin for the purposes of Canadian Mutual Aid.

*At a tentative 25/- per day, subject to further clarification of the principles of assessment.

**A final payment for U.S.components in Canadian munitions contracts. See also (end of) Appendix "Hyde Park Agreement".

†The Stages are referred to in the chapter on the U.S.A. where Stage 2 was due to begin on 1st January 1945.

In the summer of 1944 Lord Keynes also outlined to the Canadians an arrangement whereby the supply of munitions to the U.K. would be covered by the Canadian Government as part of their own war expenditure, so that the politically difficult Mutual Aid vote would have to bear non-munition supplies only. By November it looked (to Lord Keynes in Washington) as though this arrangement ^{was} ~~were~~ unlikely to be acceptable to Canada: at the same time he doubted the possibility of securing a Mutual Aid vote for more than \$7/800 million, in which case the programme of munitions from Canada would have to be cut.

The Dominions and India were heavy elements in the total Sterling Area Canadian deficit. Moreover, the release of some Canadian capacity from war production had made more consumption goods available, which Canada thought might be readily saleable in India and the Dominions. Recently the Canadians had shown some restiveness when abnormal Sterling Area requirements of dollars had arisen, and H.M.G. had apprehensions (not apparently very well founded) that they might wish to sectionalise their dealings with the Sterling Area. In a cable to Lord Keynes (15.11.44) the Treasury expressed the hope that Canada would continue to accept settlement for consumption goods "in Sterling Area Canadian dollars in the ordinary way" (i.e., through London). H.M.G. attached great importance to the preservation of existing Sterling Area machinery. They hoped that Canada would not at this stage offer direct credit to the Dominions or India. There was of course no question of vetoing direct credits indefinitely.

In November Lord Keynes asked the Chancellor and the Minister of Production to agree to a basis on which he could negotiate. He was instructed to tolerate a gap up to \$150 million between expenditures and revenues; a gap up to \$300 million would involve adjustment of the U.K. programme; and a gap greater than that might mean deadlock - if it did, decisions should preferably be deferred until expiry of the existing agreement on 31st March 1945.

By the end of November (cables 30/11 and 2/12/1944) Lord Keynes had reported back that \$1,200 million seemed to be a minimum for total Sterling Area requirements for 1945/6. This figure would be politically difficult for the Canadians, discussions with whom had been entirely frank. They had no criticism of our physical requirements, and the money would be found "by one means or another"; probably through further pooling or by removing certain items from U.K. responsibility.

Deliberations in Canada were thus inclined to weigh the convenience and simplicity of more Mutual Aid against its political possibility; while on the British side it was felt that a definite assurance from the Canadians of their intention to see us through would reassure us to the extent of not pressing for immediate settlement of the exact form which their help should take.

During these discussions the Canadians expressed a desire to import more British goods and also their anxiety lest the U.K. should take advantage of Mutual Aid to direct exports elsewhere. Lord Keynes, aided by some statistics, was able to reassure them that this was far from being true.

By the beginning of 1945 it became evident that the (doubtful) cash surplus of \$250 million at the end of March, provided for by the August agreement and already reduced by interim revisions* to \$75 million, was likely to become a deficit of about \$70 million. The hoped-for general assurance was not forthcoming, however, until 23rd February, when a cable stated that the Canadian Government was prepared to recommend to the Canadian Parliament the continuation for the time being of Mutual Aid.

The message introduced a new note by adding that the Canadian Government felt it necessary to emphasise Canadian expectation that Mutual Aid, and similar arrangements extended by the U.S.A., the U.K. and other nations, would make international transfer

*Among these the most important were rebates for the Lend-Lease element in munitions supplied by the U.K. to Canadian Forces abroad during the four fiscal years ended 31st March 1945. Munitions had been delivered (irrespective of origin) to these Forces, on a gross basis, and for cash settlement. Their U.S.dollar content was estimated on the proportion of Lend-Lease element in the total supply of munitions to H.M.G. during the four years. The provisional figure at this time was Can.\$244 million.

of war supplies possible in such manner as not to "burden post-war commerce, or lead to the imposition of trade restrictions, or otherwise prejudice a just and enduring peace".

A more particular reference to "discrimination" followed. In view of their undertaking and the magnitude of Mutual Aid being provided, the Canadian Government would view a general policy of discrimination by the Sterling Area against Canada as "unnecessary inappropriate and inconsistent with the spirit of Mutual Aid". The U.K., they assumed, would not wish to add to their already heavy burden of sterling liabilities by further imports from Sterling Area countries on the grounds that similar imports from Canada could not be justified. The probable small excess of requirements not provided for by Canadian Mutual Aid and current receipts from Canada could surely be met by the U.K. and other Sterling Area countries from their own resources? But if the excess threatened again to be unmanageable the Canadian Government, still assuring the U.K. Government of its co-operation, would consult with them and other authorities with a view to finding possible measures to meet the situation.

In the five months from 1st April 1945 until 1st September, when it ended, the U.K. received from Canada \$670 million (out of \$697/^{million} for the whole Empire) further Mutual Aid.

At mid-September the machinery of the U.K. Cash Receipts Account and the U.K. Suspense Account (with total credit of \$5 million, returnable under the Mutual Aid Agreement to the Bank of England Account) was suspended*. All payments due from Canadian sources were henceforth to be made to the Bank of England Account at the Bank of Canada, and the Canadian Government would be reimbursed (by U.K.P.O.) from the Bank of England Account for payment of bills to meet British Government needs.

According to a Canadian official note of similar date, their figures, which were likely to be the least favourable to the U.K., left us with a balance of just under \$80 million to

*Functions described in Appendix ... of "Canadian Mutual Aid".

meet current requirements of munitions and the balance of a contract for locomotives for India*, to build up working balances and tide over the interim period to March 1946. This balance was expected to last until the end of 1945. Income from Canadian Forces would continue, but tended to be in arrears. There were soon, in fact, indications that the Bank of England Account was running low. Government payments, it was assumed, could be temporarily held up, but the position of commercial transactions was less clear. Assurance was therefore sought that purchases of sterling by the Bank of Canada would continue; and a minimum balance of \$5 million on the Bank of England Account was suggested (cable 4/10/1945). The Canadian Government agreed (8/4/1945) and paid about \$11 million capitulation money**. The Bank of Canada had already provided a small amount of dollars against sterling to meet immediate bills.

Among the difficulties in the clearing-up period of Mutual Aid was the question of ownership of stores delivered to the Ordnance Depot at Longue Pointe up to midnight on 1st September. Whereas the U.K. programme had assumed that the stores could be drawn upon, according to the relevant Article in the Agreement ownership reverted to Canada. H.M.G. did not feel able to contest rejection by the Canadians of their claim, but pressed for an arrangement by which they should be given credit for stores which could be regarded (on a statistical basis) as having been financed from the U.K. Cash Receipts Account, a more accurate estimation to be made later. This was not conceded.

In similar manner to the settlement of all outstanding war claims with the United States, embodied in the Agreements of 6th December 1945, claims between the Governments of the United Kingdom and Canada were settled by the Financial Agreement of 6th March 1946 signed by the Canadian Minister of Finance and

*A matter in which, over a long period of discussion, we had strenuously discouraged, on principle, a Canadian loan to India; locomotives were not eligible for Mutual Aid.

**There was an argument outstanding as to what the appropriate daily rate should be.

H.M.High Commissioner in Canada for their respective Governments. It received the Royal Assent in Canada on 28th May and in the U.K. on 30th May, but did not appear as a White Paper*^{until} ~~after~~ September after awaiting a Royal Proclamation for two of its Articles and the approval of the U.S.Congress to the U.S.Agreements of 6th December 1945.

Both the Financial Agreement and the Agreement for Settlement of War Claims followed lines similar to those of the agreement with the United States.

Under the Financial Agreement the Canadian Government granted to the Government of the U.K. a credit of \$1,250 million to be drawn upon at any time before 31st December 1951, the amount so drawn by that date to be repaid in fifty annual instalments** (from 31st December 1951) with interest at 2% per annum.

A waiver clause released the U.K. Government, on request to the Canadian Government, from payment of interest due in any year in which -

- (a) the U.K. Government found the waiver necessary in view of present and prospective conditions in international exchange and the level of its reserves of gold and foreign exchange;
- (b) the International Monetary Fund certified that U.K. income from domestic exports plus net income from invisible current transactions was less, over the average of the five previous years (or fewer if the waiver is requested before 1955) than the average annual amount of U.K. imports in 1936-38 (£866 million) adjusted for price changes; and
- (c) interest payments are also waived in that year on any credit available to the U.K. Government, to which similar waiver provisions apply. (This clearly has reference to the U.S. credit.)

The Agreement further cancelled the amount, agreed between the two Governments at \$425 million, owing by the U.K.

*Cmd. 6904

**Interest computed for 1951 on the amount outstanding on 31st Dec., and for subsequent years on the amounts outstanding on 1st Jan. 49 instalments were to be equal and the 50th at a slightly higher figure (\$3,182,300 and \$3,184,074 for each \$100 million of credit drawn by 31/12/1951). The U.K. Government may accelerate repayment.

Government ^{with} respect of the British Commonwealth Air Training Scheme.

The two Governments agreed to give each other most-favoured nation treatment in respect of operations of exchange controls and arrangements and quantitative import restrictions. They further agreed that the interest-free and other provisions of the 1942 Loan should continue until 1st January 1951, before which date they will enter into discussion regarding those questions. They finally agreed to consult together, as either may consider necessary, regarding either the working of any of the provisions of the agreement or changes deemed necessary through any major change in the international financial situation.

The "Agreement on the Settlement of War Claims etc." first provided for a payment of \$150 million by the U.K. Government to the Canadian Government to cancel (with exceptions, below) all claims, whether known or unknown, against each other arising between 1st September 1939 and 1st March 1946 "in respect of supplies, services, facilities and accommodation furnished during that period". The balance in the U.K. Suspense Account was to be paid to the U.K. Government and that in the U.K. Cash Receipts Account to the Canadian Government.

The exceptions to the main agreement were: the 1942 Loan and cancellation of the \$425 million to be paid by the U.K. Government on the Air Training Plan, both of which were dealt with by the Financial Agreement; claims of the two Governments arising out of the sharing of military relief expenditures, to be dealt with in accordance with procedures already established or to be established; certain periodical routine settlements (e.g. pensions, war service gratuities, reimbursement for salaries, etc., on an individual basis); and the settlement of accounts between postal administrations.

Canadian Sterling Balances

From a modest working balance in the early stages of the war Canadian-held sterling was to assume, as we shall see, much greater importance as U.K.requirements from Canada outran the provision for their finance agreed in advance between the Canadian and U.K.Governments. The position became acute with the approach of American Lend-Lease in March 1941, pending the Canadian Government's decision as to what their future aid to Britain was to be. Thereafter the Canadian accumulation of sterling was on a large scale for more than a year.

In the first year of war, to the sterling accumulated from various payments to Canada not payable in dollars, which eventually reached the Bank of Canada's account with the Bank of England, there were periodical allocations by the Canadian Government, through the repatriation of Canadian securities, to make up agreed amounts by which the Canadians were to finance U.K. requirements from Canada for fixed periods, usually 6 months at a time.

Thus, in July 1940, it was agreed* that Canada should provide \$150 million "by repatriations and accumulation of sterling balances in the 6 months starting 1st August 1940" (Canada, at the time, could not indicate a minimum figure for a full year). The Treasury thought that the U.K. deficit might well be \$250 million for the first 6 months, and it was agreed that if this latter figure should be substantially exceeded the U.K. should have the right to raise again the question of what Canada could provide. The amount of Canada's assistance for the 6 months beginning 1st February 1940 was to be left for decision towards the end of the year.

On 30th October Mr.Towers cabled that, including net purchases of sterling in the Canadian market, the full \$150 million had already been completed. According to latest estimates the deficit was now running at about £180 million a year. There

*Note (by Bewley) of meeting between representatives of H.M.T. and Bank of Canada. (W.143: fo.188).

followed an exchange of cables in which H.M.T., recognising that the terms of the July Agreement would mean our acquiring further dollars by selling gold, asked whether, in view of the critical gold situation, the Canadian Government could see their way to purchase further sterling, make further repatriations or possibly grant a small loan. By 11th November U.K. liquid assets in Ottawa were down to a few days' requirements of Canadian dollars.

The Canadian Government could only increase its repatriations at the expense of the programme for the next half year, due to start on 1st February 1941, but agreed to provide a further \$50 million against sterling in anticipation of that programme, the \$50 million to include proceeds of future sales of securities in Canada (under Mr. Gifford's direction)*.

By the beginning of 1941 it looked as though this ^{million} further \$50/would be exhausted by mid-January; moreover, there had been no suitable opportunity to decide the amount of Canada's help during the following 6 months. Canada was accordingly approached once more, with the explanation that, pending the putting into effect of President Roosevelt's Lend-Lease plan, the last of our gold and U.S. dollar reserves were required to meet our needs in the U.S. (Cable 3. 9.41). Matters were so pressing that the Bank of Canada sold us \$10 million for sterling on 13th January, while the Canadian Government were in the course of deciding to allocate \$25 million on the same terms as the previous \$50 million, with the additional understanding that if U.S. relief enabled us to assign gold to Canada before the \$25 million were exhausted we should begin to do so. (Cable 16. 1.41).

In fact, a payment of \$10½ million to the Ministry of Supply's account in Ottawa made us overdrawn, and the position was only sustained by sales of £1 or 2 million sterling at a time until, on 16th February, the Canadians authorised the F.E.C.B. to accumulate sterling up to the equivalent of a further

*In the event about \$20 million were received from the sale of securities and \$30 million against sterling.

\$40 million to meet requirements during the remainder of the month.

But the Minister of Finance stated that he was not in a position to forecast the extent of further assistance in the next 6 months "It would, therefore, seem necessary to deal with the situation as it arises from time to time in the light of our own expenditure and commitments and the possibility of raising funds in this market".

The Finance Minister's disclosure notwithstanding, it was essential to come to some understanding about the future, and for March at least fairly soon. On 27th February, in a cable to Mr. Towers, the Governor said "In Canada I do not as yet see in what way the U.K. commitments over the next 6 or 12 months are to be met. Do what we may it would seem that the U.K. Government are likely to have to depend on accommodation from your market to an extent which may be the cause of some strain to yourselves" While awaiting the passage of the Lend-Lease Bill, which might give both the U.K. and Canada some relief, the fullest understanding was necessary. Could we help by giving Ottawa more regular information as to our balances? Mr. Towers assured the Governor that he had not been expecting more information on needs and prospects. What was lacking was full liaison with Washington. Clark and Osborne were, however, there at the time for discussions with Phillips and Morgenthau; pending the result of which the Canadian Government agreed to continue to accumulate sterling.

Meanwhile the U.S. Treasury had published, in connection with the Lend-Lease legislation*, official figures showing that the British Empire would meet a trade deficit with Canada by the payment of \$620 million in gold. That gold was being paid to a belligerent while the U.S. were (now) providing munitions free was a fact which came in for criticism both in the U.S.A. and Britain.

In Ottawa the Finance Minister made it clear in Parliament (20. 3.41) that the \$620 million was a residual item in the Empire balance sheet, for which payment solely in gold had

*Lend-Lease Act was signed on 11th March 1941.

never been anticipated. He went on to point out that Canada had put more than \$150 million at the disposal of the U.K. in the previous 10 weeks, and gave an unqualified pledge of further assistance "It has been and will continue to be the policy of the Government to see that United Kingdom purchases in this country are not hampered by reason of any lack of Canadian dollars."

It is at this point that Canadian sterling enters the phase which ended a year later with the Canadian Loan and Free Gift. Almost immediately the Canadian Government, on the prospect of holding an unknown and much larger amount of sterling, raised the question of an exchange guarantee, and referred to H.M.Treasury's offer in October 1939 (cable 27. 3.41). After taking the view of the Bank, who were anxious to avoid giving a guarantee, the Treasury replied saying that circumstances had entirely changed since the 1939 proposal; our gold and dollar reserves were overdrawn; and Lend-Lease had made it theoretically possible to switch orders to the U.S.A. and obtain goods without payment "Canada's unwillingness to hold sterling without a guarantee would become known and certainly offset the present willingness of India and the other Dominions who had built up larger sterling balances since 1939. There are no means in sight of discharging any guarantee which we might give to make repayment in dollars". (Cable D.O.14.4.41).

The Canadian reply (H.Com.21. 4.41) referred to an earlier guarantee of 4th April 1939* given by the Prime Minister (Mr.Chamberlain) to Mr.Mackenzie King and apparently construed by Canada as unconditional.

At this stage an agreement that neither side would alter its exchange rate without previous consultation with the other was as far as H.M.Government were prepared to go. They could not in present circumstances agree to "fixing the present and accruing sterling balances of Canada in terms of Canadian dollars undertaking a liability which we can see no way of meeting". (Cable 10. 5.41).

*No copy in the Bank.

Discussions in Canada* continued intermittently. The Canadian Prime Minister reaffirmed, in a speech in New York, the Canadians' contention "to find, for Britain's Canadian purchases, Canadian dollars out of Canadian pockets".

The Canadians next introduced (cable 11. 7.41) another element into the proposed formulation of their joint undertaking, viz., that the two Governments recognised that while Canada made dollars available at a rate of 4.45, they were each "assuming that no changes relative to the economic or financial conditions in the two countries will take place which will prejudice substantially the equity in terms of goods and services of converting sterling balances into dollars at that rate when repayment comes about".

H.M.Government did not find this formula acceptable. It seemed to make assumptions about relative price movements which were not justified and which would lead to future misunderstanding. They suggested a reversion to the principle of consultation before action but with the provision, if any action were taken, for further consultation to make such adjustment in regard to Canadian sterling as might be practicable and equitable in the circumstances.

By early autumn, after American Lend-Lease had been established for some months, if not yet on a very large scale, the official mind in Ottawa was doubtless already considering action of a similar kind**, even though Canadian Mutual Aid needed another year and a half to take shape. At all events the idea of a guarantee seems to have been pursued no further; while throughout 1941 Canadian sterling accumulated at an average rate of £16 - £17 million a month. The peak was reached on 23rd March 1942, at £242.3 million. Its conversion into the interest-free loan had reduced the level to £5 million by June.

In 1943, before Mutual Aid became effective, the Canadian balances again began to rise, and reached nearly £17 million in June. After 1943 the level did not rise above £3 million again during the war.

*And with Sir Frederick Phillips, Mr. Towers and Lord Keynes, all in Washington at the time.

**A prominent member of the F.E.C.B. admitted as much in private conversation with Mr. Thompson-McCausland in Ottawa in the autumn of 1941.

Canadian Sterling Balance at Bank of England

(£ million)

<u>End of</u> <u>Month</u>	<u>1940</u>	<u>1941</u>	<u>1942</u>	<u>1943</u>	<u>1944</u>	<u>1945</u>	<u>1946</u>
Jan.	2.6	27.3	209.2	2.3	2.2	2.2	2.9
Feb.	4.3	37.1	225.1	8.1	1.8	1.5	2.2
March	3.8	48.5	203.0	12.2	2.1	1.1	9.0
April	3.0	65.4	190.5	11.7	1.0	1.6	14.1
May	8.6	87.2	184.6	6.3	1.6	1.9	21.5
June	15.5	109.6	5.0	16.8	1.8	1.2	10.6
July	5.5	125.4	1.7	4.1	3.0	1.6	5.1
Aug.	5.7	143.3	1.4	5.9	1.6	1.8	4.6
Sept.	16.6	157.1	2.1	5.3	1.9	1.9	3.7
Oct.	30.1	146.9	3.5	11.4	1.5	6.5	3.0
Nov.	30.6	165.7	2.8	5.8	.6	3.9	3.7
Dec.	22.5	186.3	2.3	2.5	1.6	3.7	2.2