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BANKING

How India Paid to Create the London of Today

BY KANNAN SRINIVASAN ON 20/04/2017 • 3 COMMENTS

A sudden change in the currency with which old debts to the colonies had to be paid helped Britain consolidate its status as a financial centre.

London skyline. Credit: London Eye/Twitter

The UK is a tax haven closely connected to other tax havens it has set up. Its trade deficit is therefore offset by the money pouring in from its own (https://thewire.in/110293/looking-hidden-black-money-london-might-place-start/) tax havens. Almost 90% of net capital inflows to the UK come from just Guernsey, Jersey and the Isle of Man. So far, there has been no decline in such funds with the news of Brexit. Britain enjoys a significant measure of protection from the consequences of leaving the EU by virtue of this rush of cash.

How did London achieve this status of being a major financial centre? Knowing this history might be useful, especially for Indians, as the country played a role in it, thanks to the steps taken by Prime Minister Clement Attlee's Labour government in 1947, employing the resources of newly independent India.

As war broke out in 1939, the trade surpluses run up by India, Egypt, Brazil and others trading primarily in sterling, were withheld by Britain. Total debt to all such creditors (excluding the US, which obtained British businesses and naval and aircraft bases in return for cash) amounted to £3.48 billion. In addition, two and an half million Indian soldiers fighting in Italy, North Africa, the Middle East and the Far East were paid salaries; when any died, their widows were to be paid pensions by the government of India, which remained uncompensated even as the war ended. All this made India (which included the future state of Pakistan) the largest Allied creditor after the US. Britain owed her £1.335 billion ($5.23 billion, which is about $59 billion today). Britain owed the next largest creditor, Egypt, £450 million. At a conservative estimate, the debt to India amounted to about a fifth of the UK gross national product, or seventeen times the annual government of India revenue at highly depressed prices.

India, and other such creditor countries, expected that their future economic development could be significantly financed by the money owed by Britain. But with a run-down industrial economy in 1945, the UK had little that such countries needed.

What the creditors wanted was dollars. They expected, with the money to be released by Britain, to import the plant and machinery they needed from the new leading industrial power, the US.

White plan

There seemed, at first, to be a way to get such convertible currency. Harry Dexter White, the chief adviser to US treasury secretary Henry Morgenthau, framed a scheme for the purchase of these balances, in stages, by the new fund to be set up after the war, the subsequent injection of liquidity, and re-purchase.

But, as White was aware, if Britain honoured her enormous debts in this way, that might have meant a more rapid disbanding of the British occupation of Aden, Greece, Malaya and many African countries. The Royal Navy would not have had the resources to play a role of any significance, nor would Britain become a nuclear weapons state. India, Egypt, Brazil and others might have fared far better than Britain did. And, as will be become clear, London would not have become the new hub of international finance.

The celebrated economist John Maynard Keynes had been appointed by the UK government to negotiate post-war arrangements with the United States and other countries. He fiercely resisted this White Plan. He set out to make sure that the sterling balances could somehow be conjured away.

Over the next year, he lobbied effectively in Washington DC — his hard work seemed to pay off. So when the great conference took place at Bretton Woods in 1944 to lay out the post-war reconstruction of the global economy, and the sterling issue was raised by Egypt and by India, the US treasury team abandoned its own commitment to “liberate blocked balances”.

Another ray of hope

Yet after these creditor countries lost out at Bretton Woods, they drew hope from a key provision of the Anglo-American Loan Agreement. Under that treaty, the US provided a credit of $3.75 billion repayable over 50 years at 2% on the specific condition that Britain made the pound sterling convertible into any other currency for current transactions. Accordingly, the pound sterling was made convertible the July 17, 1947.

So as India negotiated the terms of these sterling balances in London over the course of August 1947, her team expected to convert their assets into dollars.

Hope betrayed

But the Indians were unaware how much had changed in Washington DC. The new president, Harry Truman, had changed virtually the entire cabinet he had inherited from Franklin Roosevelt. The people India had thought it could count on to keep Indian interests in mind had been replaced by determined Cold Warriors entirely unsympathetic to India, such as Dean Acheson. At the same time, these new hawkish Truman aides saw Britain – with her enormous network of bases all around the world and large armed forces everywhere – as the key ally.

Emboldened by her new status, Britain is said to have secretly sounded out the US, and received a discreet assurance that she could avoid repaying India, Pakistan, Egypt and others their wartime debt in convertible currency.

So, as India's representative, B.K. Nehru wound up India's negotiations in London for the transfer of the balances he was mystified by what his British counterpart murmured to him.

"Wilfred Eady

President John F. Kennedy meets with then ambassador to the US from India, Braj Kumar Nehru, in the Oval Office, 1961. Credit: Wikimedia Commons

..said to me (August 15, 1947), 'Watch your dollars'," Nehru has written. Nehru did not understand.

"Why should he talk about dollars when the pound had become convertible? All the sterling would become available for purchases in the dollar area, so why did he want me to watch my dollars?"

He was to find out when Britain renounced the convertibility of the pound sterling on the current account within five days of signing the agreement with India.

As Nehru ruefully acknowledged, this "immediately changed the character of the agreement which we had entered into. The pounds released were no longer usable for what we wanted to buy."

Britain then devalued the pound in 1949, diminishing the value of the claims of the creditor countries by thirty per cent.

What if?

Had Britain *not* defaulted on convertibility, many countries would have switched to the US dollar in order to finance their imports. Thereafter the central banks of the world would have cut back on their holdings, effectively exiting from the pound sterling.

It was not in Britain's interest to allow that to happen. Given that the US dollar was the premier international currency, the pound sterling now had to survive at least as the *secondary* currency for the purpose of international settlement. So default on convertibility was the absolute precondition in order to ensure a gradual drawdown on sterling.

This gave London the time to re-invent itself. Since so many central banks around the world were compelled to hold sterling and therefore trade as much as they could with the UK, Britain survived as an important financial centre. As the stock of US dollars held outside the US grew, it was bound to attract the interest of innovative financiers, and the most innovative were in London. Merchant bankers in the city first saw the potential of trade and investment in this Eurodollar market. The enormous volume of transactions in the Eurodollar market enabled London to return to its role before the First World War, as the most important centre of international finance. Post-war Britain was on its way.

In the meantime, creditor countries such as India and Egypt had to settle for occasional drawings of pounds sterling that they could convert into no other currency. They therefore had to buy goods from nowhere else but the UK. But British industry however had in many areas ceased to be internationally competitive in terms of its prices or technology. So this arrangement suited not the holders of sterling, but the UK, in that she could sell them obsolete plant and machinery at higher prices than would been possible in any free market. The UK had found a captive export market for goods that could be exported nowhere else. India's imports of the Ford Prefect, the Standard Vanguard, the Morris Oxford, the Indian Naval Ships Delhi and Mysore, all date from the golden age of sterling balances.

But as independent India faced acute food shortages, her stock of sterling could buy her none. She had to turn to the World Bank and IMF to make up the convertible currency she needed, and pay for imports of food courtesy the Aid India Consortium, composed of the World Bank and a group of countries that included, ironically, the UK.

Britain gained the opportunity to employ her former colonies, and possessions of the Crown, to organise capital flight from all around the world. The Cayman Islands, Cyprus, Dubai, Guernsey, Hong Kong, the Isle of Man, Jersey, Mauritius, Singapore and many other such tax havens enable wealthy individuals to conceal their liquid assets. Yet their close connection with London, that most efficient financial centre, enables the best possible returns for the super-rich. All this is possible because Britain avoided honouring her war time debts to India and other countries promptly, and in convertible currency. The enforced Indian loan acted as developmental finance to the UK economy. India's sacrifices during the war and after may have benefited it but little. But they certainly made possible the London of today.

Kannan Srinivasan, who is working on a book on money laundering, wrote this article at the Wertheim Study, New York Public Library. kannansrinivasan.org (http://kannansrinivasan.org/)

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