CONFIDENTIAL Federal Reserve Bank of Philadelphia

M E M O R A N D U M

CURRENT PROPOSALS FOR INTERNATIONAL CURRENCY RECONSTRUCTION

(Preliminary Draft)

The monetary chaos that followed the last war developed in an atmosphere described by the Comptroller of the Currency in his annual report of 1919 in these words: "The responsibility is not and never will be in this country of maintaining the parity of gold and paper money in any European or any foreign country... Each country...must work out its salvation for itself." This was the narrow, negative point of view that dominated the thinking of the period.

In illuminating contrast, current proposals for post-war monetary reconstruction are based upon a much broader, positive attitude. The sense of irresponsibility of countries for each other's welfare played an important part in the economic collapse of weaker countries which led ultimately to collapse in the initially strong countries as well. The creative attitude which has arisen out of these bitter experiences is strongly influenced by a sense of responsibility - among other things - for the value of foreign currencies, and a determination to see that this responsibility is wisely discharged.

The increasing sense of social responsibility is one of the most significant developments of recent times. It would, in fact, be futile to discuss specific proposals for post-war monetary reconstruction were one to adopt the view held by the

Comptroller in 1919. It would be equally pointless to adopt the view of those who believe that we shall revert to the pre-1914 world or of those captious critics whose chief objective seems to be to uncover detailed errors of fact or reasoning in a specific plan. Profitable discussion can proceed only from the basic assumption - which is a matter of active faith, of imaginative daring - that the application of intelligence is useful in the solution of human problems and that ideas are not necessarily wrong merely because they represent departures from customary practices. The objective of discussing post-war currency proposals is to construct the best plan that can be devised through the democratic process of give-and-take. All current plans have been proposed specifically as points of departure; none has been presented as a final product. It is the function of discussion to improve them through deletions, additions, amendments, or substitution.

Monetary reconstruction, as the introductory statements of both the Keynes and the White plans indicate, is only one of the conditions for satisfactory economic and political rehabilitation and development of the world. But one need recall only the devastating dislocations resulting from a faulty monetary system during the inter-war period to realize that it is a condition of paramount importance. No one denies that - next to solving certain emergency problems - nothing will be more important in the post-war period than to restore people to productive occupations, to produce the things they need and want, to replenish stocks, to rebuild old industries and to develop new ones. But as George Roberts wrote recently in the National City Bank Bulletin, "If people are to do business with one another, and especially if they are to have the basis for the advance planning essential to full recovery of trade and employment, they must have faith in the money they use."

The Federal Reserve System has a paramount and immediate interest in any international currency plan proposed by responsible agencies, because such plans inevitably deal with bank reserves. For example, both the Keynes and the White plans envision increases in internationally liquid means of payments. The Federal Reserve System, which is assigned the duty of managing the bank reserves of this country, must assess the effects which adoption of either plan would have. The dangers of excessive increases in reserves were demonstrated in the 1930's when increases of gold reserves exhausted the System's powers of control.

I. Functions of an International Monetary System

An international currency performs in the international sphere the same essential functions of facilitating economic adjustments that national money performs in the domestic sphere. It promotes the flow of goods and services by facilitating payments that arise from myriads of transactions: imports and exports of merchandise, loans, investments, interest and dividend payments, commissions, premiums, services, tourist expenditures, etc. The condition of international monetary equilibrium is that payments into the several countries be equal to payments out - that there be no tendency for claims to accumulate against one country or another.

Claims may accumulate against a country for a number of reasons. They may arise for short periods because of seasonal fluctuations, failure of an important crop, or other temporary maladjustments arising out of the maze of crisscrossing international transactions. Since, by definition, such accumulations are transitory, they can be met through a device which will give the embarrassed debtor country a period of grace. Traditionally they were met by gold shipments or temporary credits. Both the Keynes and the White plans make adequate provision to handle such temporary deficits.

The major problems of international economics, however, arise from maladjustments which result from more deep-seated causes. The first of these consists of an unstable political and economic background, which may include such factors as fear of war (Europe before 1939), doubts regarding the value of the currency, and excessive tariff and other trade restrictions. Mere monetary arrangements are clearly inadequate to remedy such causes. Monetary arrangements, however, can help to remedy the second fundamental cause for international disequilibrium, namely, international differentials in costs and prices.

Since the ultimate success of any international monetary arrangement depends upon the effectiveness with which it removes this cause of disequilibrium, the nature of such disequilibria will be described briefly. Claims accumulate against a country because its markets attract too many sellers and not enough buyers. When this occurs, there are two fundamental ways in which international market equilibrium may be restored. Either the country can reduce its prices or it can offer more of its own money for a unit of foreign money - it can deflate its price level or it can depreciate its currency. Neither is a pleasant alternative, especially politically, and countries have been tempted to adopt other devices such as tariffs, quotas, bilateral agreements, and exchange controls to reduce their purchases from foreign countries. Such palliatives obviously tend to strangle or even destroy foreign trade and all the gains that arise from it. In addition, they result in retaliation and international economic and political disturbances.

One of the rules of a metallic standard, to which most countries adhered for a century prior to 1914, is that a country should restore international equilibrium by reducing its prices rather than by depreciating its currency. During the inter-war period, however, and especially during the depression, countries - quite properly - were unwilling to restrict credit, thereby increasing unemployment merely to restore international equilibrium. One after another they adopted the other alternative of depreciating their currencies by abandoning the gold standard. Indeed, the 1930's were marked by a competitive race not only to restore equilibrium but to gain advantage in international markets by over-depreciation.

The most difficult problem with which any program of international monetary reconstruction will have to deal is that of setting the exchange rates of the participating countries. The relative advantages of the several national markets will depend upon these rates together with the domestic price structures. Even a group of disinterested experts will have difficulty in ascertaining equilibrium rates of exchange because of the enormous changes that are taking place. The factors that usually weigh heavily in ascertaining such rates - price levels, cost of living - are subject almost universally to official controls and have lost much of their meaning for this purpose. To be objective one must anticipate that errors of considerable magnitude will be made in establishing the original rates. Any plan, therefore, should not be too rigid to permit adequate and prompt adjustments in rates, especially in the early years. The importance of securing a genuinely disinterested body to establish these rates can hardly be overestimated. Since the future of the foreign trade of a country will be conditioned in considerable part by the rates actually assigned, there will be a strong temptation for its "experts" to attempt to secure "favorable" exchange rates.

The fundamental problems that any sound international monetary arrangement must solve are, therefore, the following:

1. To establish initial rates of exchange among the various national currencies

2. When claims accumulate against a country, to determine whether the accumulation is temporary or the result of fundamental disequilibrium.

3. To determine an appropriate course of action

    a. for the agency
    b. for the government and central banks of the country.

Disagreements between the agency and the member governments are most likely to occur over the actions to be taken to restore fundamental equilibrium. The two major devices available are (1) to reduce prices and (2) to devalue the currency. The country in question is apt to oppose the former because of its attendant unemployment and depression; the remaining countries are likely to oppose the latter for fear the country in question may gain competitive "advantages" in world markets.

II. Methods of Approach to International Monetary Reconstruction

There is no disagreement as to the need for international monetary reconstruction in the post-war world; but there is disagreement as to the procedure. One body of opinion favors an over-all or inclusive approach and would include virtually all nations at the outset. Another adopts a piecemeal approach and holds that agreement should be sought initially only among the major countries - the United States, Great Britain, Russia, and possibly China and Brazil. The objective of this section is to present the arguments that have been advanced by these two groups. The relative merits of the arguments are properly a matter for discussion.

The inclusive approach Those who favor the inclusive approach recognize that it might be more difficult to secure adoption of a proposal because a universal plan would be somewhat more complex and because agreement would have to be secured from many more countries. They feel, however, that the additional effort is warranted because it would bring all nations into a genuine rather than merely a nominal partnership. Orations as to the brotherhood of man are sterile if the overwhelming majority of the world's population is to be ignored in world affairs merely because it lives in economically weak countries. A genuine copartnership would minimize suspicions and grievances, whether real or fancied. Such a plan would be most effective in the maintenance of a durable peace. The added difficulties that the over-all approach may involve are minor compared with the gains to be derived from achieving this goal.

An approach along inclusive lines is necessitated by the developments in the world since the last war. Improvements in communication and transportation have minimized time and space. From an engineering point of view the primary materials of the world are universally accessible. The economic interdependence of all nations should be reflected in a monetary system which will facilitate the exchange of these materials and so contribute to the welfare of all.

Finally, those who favor the over-all approach feel that now, when the world finds itself in a radically changed situation, is the ideal time to act boldly and with imagination, unfettered by past fetishes. The traditional or piecemeal approach may have somewhat less likelihood of complete collapse; but it also is incapable of really outstanding and permanent results.

The opponents of this approach feel that the additional effort necessary to secure virtually universal acceptance of such a plan is not warranted by the differences in purely <u>economic</u> results. Small nations have virtually no financial power in international affairs and of necessity much adjust themselves to the policies of the great powers. Furthermore, to be effective with many nations any plan must be rather complex and rigid. Members must be willing to abandon a greater degree of sovereignty than would be necessary if a few major countries entered into informal agreements subject to continuous or periodic modification.

<u>The major country approach</u>

Those who favor the piecemeal approach feel that since the behavior of the truly international currencies dominates and determines what happens to all the others, the stabilization of these currencies "with reference to each other, combined with cooperation among the countries concerned for the promotion of their own internal stability, would be the best foundation for monetary and economic stability throughout the world." The proponents of this approach ignore as economically unimportant the opinions of the peoples in all the lesser countries. They adopt the economically efficient view of the benevolent despot.

It is argued that from an economic point of view the international world actually operated in this way during the inter-war period, and that this experience should be used in the development of a post-war system. It is felt to be more practical and that the necessary agreements among the major powers would be easier to secure.

Opponents of this approach feel that the operation of the international monetary machinery during the inter-war period was not sufficiently successful to serve as a model - that the tripartite agreement of 1936 was but a literary expression of a noble experiment. They feel also that the smaller countries may resent the despotism of the great, even though it is benevolent. Resentment breeds jealousies and produces the environment in which larger or even major countries scheme and machinate to bring lesser countries within their orbits. Such an atmosphere generates war.

III. The White and the Keynes Plans

The plans for international monetary reconstruction that have received greatest discussion are those of Lord Keynes, published by the British Treasury, and of Dr. Harry D. White, published by the United States Treasury. Some of the discussion has been heated and emotional and has not contributed to the solution of the real problem, which is to devise an effective international monetary arrangement for the post-war period. Most of the discussion, however, has accepted in good faith the spirit in which the plans were submitted. This spirit is that the plans are not finished documents but tentative proposals submitted with the hope that interested and qualified persons will improve them or devise a better plan. Many of the most competent people in the field have offered constructive suggestions. In this sense the plans illustrate par excellence the democratic process in operation.

The two plans have much in common. Both are varieties of the inclusive approach described in the preceding section of this memorandum. The primary result of each would be to establish and maintain a system of stable exchange rates despite recognition that there are circumstances which warrant adjustments. Each envisions a new international agency with some measure of control over the levels of exchange rates of national currencies.

As John Williams has pointed out, the fundamental monetary mechanism of both plans is that of the gold standard:

1. Both fix the relationships among currencies through the intermediary of a common unit of account. (In the case of the gold standard the unit is the grain of gold; in the White plan it is the Unitas; in the Keynes plan it is the bancor.)

2. The functions performed by gold movements under the gold standard are performed by currency transfers in the stabilization fund under the White plan or by transfers of debits and credits on the books of the clearing union under the Keynes plan.

3. Transfers in the fund or in the union affect bank reserves precisely as the movement of gold affects them under the gold standard.

4. Variations in bank reserves are expected to have the same monetary and price effects as under the gold standard.

Nature of the agencies

The agency proposed in the White plan is called "A United and Associated Nations Stabilization Fund." The plan is based upon the principle of bank deposits and contemplates an actual fund consisting of gold, currencies of member countries, and securities of member governments. The unit of account would be the Unitas consisting of 137 1/7 grains of fine gold ($10). Each member country would be required to subscribe its quota to the fund, the aggregate of all quotas to be the equivalent of at least $5 billion. These quotas would be based upon such factors as a country's holdings of gold and foreign exchange, the magnitude of the fluctuations in its balance of international payments, and its national income. Half of the quota would be paid in initially and the other half subject to call. One-fourth of the initial payment would be made in gold, one-fourth in local currency, and one-half in government securities except that countries with small gold holdings would be permitted to substitute limited amounts of local currency for part of the gold.

The agency proposed in the Keynes plan is called an "International Clearing Union." The plan is based upon the principle of the overdraft and would not have any initial assets; accounts would be settled through debit and credit entries on the books of the union. The unit of account would be the bancor, fixed (but not unalterably) in terms of gold. Each member country would be assigned the quota that would determine the extent to which it would have the right to enjoy the credit facilities of the agency. It is suggested that the initial quotas might be 75 per cent of the total volume of exports and imports of the member. The total of all the quotas, if all who are eligible for membership participate, is estimated at $35 billion.

Governing board

The names given to the proposed agencies indicate differences in underlying conceptions which may account for differences with respect to the distribution of authority in the governing boards, which is roughly in proportion to the quotas. The term "fund" in the White plan implies an emphasis upon gold and other financial resources according to which it is proposed that the votes be distributed. The plan requires that major decisions be made on the basis of a 4/5's majority. Any country or block of countries able to muster 20+ per cent of the votes would possess a veto power. The term "clearing" in the Keynes plan implies an emphasis upon trade, according to which the votes of members are roughly determined.

The fact that the British plan would give the largest voice in administration to the British while the American plan would give the largest number of votes to the United States is scarcely sufficient support for the cynical comment that both plans are merely illustrations of the selfish realism that dominates international politics. Such comments credit the authors of the plans with less subtlety than they are known to possess. Jacob Viner writes: "It goes without saying that neither formula deserves serious consideration." He also touches the heart of the problem of control when he says that "there will be either substantial agreement on important issues, or restriction of the operation of the plan to the area in which substantial agreement is obtainable, or collapse of the plan."

Determination of exchange rates

For reasons advanced in Section I of this memorandum the crucial provisions in any international monetary agreement are those that relate to the determination of rates of exchange or the value of one in terms of other currencies. The White plan proposes that the initial value of the currency of each member be fixed by the fund in terms of gold or Unitas. The Keynes plan proposes that the member States agree between themselves (sixty or more countries may be eligible for membership!) as to the initial values of their own currencies in terms of bancor. As Viner suggests, the obscure treatment of this key issue probably reflects the inability of the authors to suggest a practicable procedure for ascertaining equilibrium rates. Some of the difficulties involved were mentioned in Section I of this memorandum, where it was suggested that the initial rates might reasonably be expected to depart considerably from equilibrium rates.

One might, therefore, expect that the plans would provide for considerable flexibility of rates - at least in the early period of operation. Under the White plan, however, the value of a member's currency could not be reduced except upon its own initiative and with the approval of 4/5's of the votes of the board. Unauthorized depreciations would subject the offending member to suspension by majority vote. In practice, for reasons mentioned in Section I, it is unlikely that approval could be secured. The probable result of the adoption of the exchange rate provisions of the White plan, therefore, would be to freeze them to their initial levels. The Keynes plan empowers a member at its own discretion but under stated conditions to reduce 5 per cent the initial value of its currency in terms of bancor. But subsequent reductions would require the consent of the governing board. For reasons already mentioned it is unlikely that such consent could be secured. In practice, both the Keynes and the White plans would result in extremely rigid exchange rates at initial levels that might be in serious disequilibrium. Modification of these provisions is imperative.

The position of gold

Gold plays a more significant part in the White than in the Keynes plan. Under the White plan gold would be accepted at fixed monetary value in settlement of international balances. Part of the assets of the stabilization fund would be in gold, in which a minimum of one-fourth of the initial payment of quotas must be made. The fund is empowered to buy, sell, and hold gold. Charges imposed would be paid in gold. The monetary unit of the fund, the Unitas, is defined in terms of a specified amount of gold and Unitas deposits may be made in gold. The position of holders and producers of gold would be even stronger under the White plan than under the traditional gold standard since gold would have internationally guaranteed monetary value in addition to retaining its traditional monetary purposes.

The purpose of the clearing union envisioned in the Keynes plan "is to supplant gold as a governing factor, but not to dispense with it." The value of the bancor in terms of gold would be fixed by the governing board of the union and could be changed freely, upward or downward, at its discretion. Member States would also be permitted to use gold to obtain a credit balance in terms of <u>bancor</u> but no country would be entitled to demand gold from the clearing union. The union, however, would be empowered to distribute gold in its possession among countries with credit balances. Under the Keynes plan although a member State is entitled to secure a credit in its clearing account through payment of gold, the position of producers and holders of gold is not as strong as it would be under the gold standard because the union could vary the price.

<u>Commercial banks</u> Neither plan contemplates that the agency would handle the countless individual transactions in foreign exchange that arise between customers and their banks. The powers of the stabilization fund are limited to dealing with or through (1) treasuries, stabilization funds, or fiscal agents of member governments; (2) central banks - only with the consent of the member of the board representing the country involved; and (3) any international banks owned predominately by member governments. The union is designed for the clearing and settlement of the ultimate outstanding balances between central banks.

<u>The Federal Reserve System</u> Although the operation of either plan would depend upon the operations of the Federal Reserve System in many points, the crucial issue is the relationship between the extent to which reserves might be increased and the powers of the Reserve System to counteract the effect of such increases. The extent to which the Reserve System could now counteract the powers of the agencies is equal roughly to the amount by which it can absorb excess reserves through increases in requirements plus the amount by which it can absorb reserves through reductions in earning assets. At present this total is between $8 billion and $9 billion. The maximum possible powers of the fund and of the union to create dollar reserves will be discussed, even though it might never be used and even though an objective of both

might be to prevent its use. A prospective member nation should consider before it joins the maximum obligation that membership might entail. The power of the stabilization fund against any country is equal to its holdings of that country's currency. The power of the clearing union is equal to the country's credit balance. The power of the central agency would be in addition to what Lord Keynes calls "the remnant of gold reserves held outside the United States." This "remnant", incidentally, is about $11 billion as against $6 billion in 1929.

The stabilization fund would be established with paid-in subscriptions of $2½ billion, with the United States providing possibly 40 per cent. It may, however, extend credits to an amount four times the paid-in quotas; 40 per cent of this larger sum would be $4 billion. The quota set by the clearing fund - 75 per cent of the participating countries' average trade in the last three pre-war years - is roughly $35 billion. Should every other country draw its quota to the limit, the United States would acquire approximately $31 billion of credit balances. This condition, of course, could arise only if every other country uses its full quota entirely against the United States and the United States fails to make any use of its credit balances.

The present power of the Federal Reserve System to absorb additional reserves is between $8 billion and $9 billion. Against this the upper limit to the creation of new reserves under the White plan would be the $11 billion "remnant" of gold held outside the United States, the $4 billion maximum holding of the stabilization fund, and such amounts of currency as might return from the present circulation of $17 billion. The possible increases from imports of gold and from reductions in circulation would be the same under the Keynes plan, but it would create approximately $31 billion in addition.

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