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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

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To Chairman Eccles

From Walter R. Gardner WRG

Subject: The British proposal for an "International Clearing Union"

The Keynes plan for post-war monetary stabilization is now being put forward by the British Government for the purpose of confidential discussion with other countries. A memorandum analyzing the original plan and position and its enormous potential effects on the Federal Reserve System was prepared some time ago. It was immediately rendered out of date by the receipt of a revised copy of the plan. The memorandum itself has now been revised and is being distributed this morning in hopes that the Board members may have time to look at it before their luncheon with Henry Clay of the Bank of England. For those who do not have time for the whole memorandum, there is a brief summary on the first page.

Attachment

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CONFIDENTIAL

THE BRITISH PROPOSAL FOR AN "INTERNATIONAL CLEARING UNION"

Lord Keynes has prepared a plan of post-war finance, which, as a basis for discussion with the United States, has the blessing of the British Government. The plan directly involves the Federal Reserve System. It carries a threat to the System's control of credit through member bank reserves. It poses, therefore, some very difficult questions for the Board to decide.

Essence of the Keynes plan

In essence the plan is extremely simple. It would add to the existing 10 billion dollars of foreign gold reserves perhaps as much as 25 billion dollars of foreign reserves in the form of a new world currency convertible into national currencies. At the outset the new world currency reserves would be dealt out gratis to the participants in proportion to the total foreign trade of each. They could then be used as freely as gold in settling international transactions. While measures designed to correct the balance of international payments and render excessive use of the reserves unnecessary could be voted under the plan, the United States would have only a minority vote. Foreign countries coming out of the war with severely curtailed standards of living would be under strong temptation to follow expansionist policies and to use their enlarged powers to purchase American goods, and it is conceivable that much of the 35 billion dollars of foreign gold and world currency reserves might flow to the United States as gold flowed in the 1930's. If it did, the effects upon the American banking system would be the same. Member bank reserves in this country would be increased without the Federal Reserve System gaining any offsetting power. A considerable movement of this character might leave the System unable to meet its major responsibility of so handling the credit supply of the country as to contribute to the orderly development of the American economy.

The plan in more detail

So much for the essence of the plan. Lord Keynes' explanation runs in somewhat different terms and has nothing to say about new international reserves. He suggests that the whole arrangement is nothing but a clearing operation -- though in fact his plan deals only with the uncleared portion of the balance of payments. His proposal is that an international agency be created called the "International Clearing Union". Transactions of this Union will be in a new world unit called the "bancor", fixed in terms of gold, though not convertible into it. Bancors will be convertible into U. S. dollars and the currencies of other member countries at fixed exchange rates. Although the plan is not absolutely specific on the point, it clearly implies that the conversion into local currencies will be made by central banks without the necessity of any budget appropriation. Bancors will be handled as gold is now handled. Central banks will take them into their reserves, giving local currencies in exchange.

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To start the plan in operation each member country will be given the right to draw upon the Clearing Union for a fixed quota of bancors. Keynes suggests that the initial quotas should be 75% of the sum of each country's exports and imports on the average of the three pre-war years (1937-39) with special quotas in those cases in which the formula leads to inappropriate results. Who would determine these special quotas and by what criterion is not stated; nor is it clear whether they would be subject to revision in later years. The regular quotas would be revised annually on the basis of the average of the 5 preceding years (after a transition period).

The right to draw in bancors upon the Clearing Union is equivalent to having gold for international transactions. As England, for instance, needs dollars for stabilizing sterling it can, within the limits of its bancor quota, compel the Federal Reserve Banks to give it dollars in exchange for bancors. If the amount involved is 1 million bancors, the Federal Reserve account with the Union will be credited, and the Bank of England account debited, by that amount. The equality of credits and debits is automatically maintained.

Conceivably England might demand dollars up to the full amount of its quota of bancor, and other countries might do the same. The maximum amount of dollars that might thus have to be provided by the Federal Reserve Banks is measured by the aggregate amount of foreign quotas of bancor. If the United States, the United Kingdom, the British Dominions, and Latin America were the only members of the plan, aggregate foreign quotas would amount to more than 10 billion dollars on the formula suggested by Keynes. If the rest of the non-Axis world became members, foreign quotas would amount to 25 billion. And this amount would be increased if the Axis countries were permitted to join or if the Clearing Union were employed for certain other major types of financing contemplated under the plan (see p. 7).

Correction of unbalanced international positions

Undoubtedly Keynes would deprecate too much discussion of the maximum potential draft on the United States under his plan. His own emphasis is upon the plan's multilateral character and its power to meet temporary aberrations in the balance of payments. It is intended that steps should be taken to restore the international balance long before there is any such piling up of credits by the United States and of debits by the rest of the world as is theoretically possible. To ensure that corrective forces will come into play there are several provisions, enumerated below.

1) A country cannot use up more than 1/4 of its quota per annum without permission of the Governing Board.

2) If a country's average debit balance exceeds 1/4 of its quota for at least two years, it may at its discretion reduce the value of its currency in terms of bancor by 5 per cent. A

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lower exchange rate should improve the competitive position of the country's exporters and hinder its imports, thereby tending to eliminate the deficit in the balance of payments which has caused the country to incur a debit in bancor; but it is evident that a single 5% change -- and it cannot be repeated without permission of the Governing Board -- would exert only a moderate influence in this direction.

3) As a condition of allowing a country to increase its debit balance to more than 1/2 its quota, the Governing Board may <u>require</u> the country

   a) to use its gold or other liquid reserves first instead of bancor;

   b) to reduce the value of its currency by a stipulated amount;

   c) to control outward capital transactions;

   and the Board may <u>recommend</u> domestic measures designed to restore the country's international balance. There is also a provision that the Board may require a country using 1/2 its quota to put up suitable collateral, but this seems directed more toward insuring the Fund's assets against loss than toward checking use of the quota.

4) If a country's average debit balance exceeds 3/4 of its quota for at least a year, the Governing Board may <u>require</u> it to eliminate the excess within 2 years and may declare it in default if it fails to do so. All payments due by other members to the defaulting country then become payable to the Union toward discharge of the defaulting country's debit balance (a procedure which appears to be quite impossible under the plan as outlined).

5) The most drastic power, however, which the Board can exercise against a debtor country is that of <u>requiring</u> it to eliminate within 2 years <u>any</u> debit balance which the Board regards as excessive. This power is granted in the section which begins with the assumption that the debit balance exceeds 3/4 of the quota for at least a year; but it does not appear to be confined to such cases. Apparently in the first month of operation the Board might take the position that a country which was using 20% of its quota was running up an excessive debit balance and order it to cut the balance down to 10% within 2 years or be declared in default. Or it could require the country to adopt corrective policies specified by the Board in order to avoid having its debit balance declared excessive. If this is an accurate interpretation, this power overlaps and exceeds in scope all those outlined in previous categories and should be

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given a far more prominent position than it occupies in Keynes' presentation where it is introduced as a sort of alternative to a much lesser power in one of the categories only.

6) If a country's average <u>credit</u> balance exceeds 1/2 its quota for at least a year, it must <u>discuss</u> with the Governing Board

   a) Measures for the expansion of domestic credit and domestic demand;

   b) The appreciation of its local currency in terms of bancor, or, alternatively an increase in money rates of earnings;

   c) The reduction of tariffs and other discouragements against imports;

   d) International development loans.

The final decision on these matters, however, rests with the creditor country.

7) Both creditors and debtors must pay into the Reserve Fund of the Union

   a) 1 per cent per annum on their average credit or debit balance in excess of 1/4 of the country's quota, but not in excess of 1/2.

   b) 2 per cent on the average balance in excess of 1/2 of the quota.

These charges will provide the Union with income; but they are mainly designed to induce both creditors and debtors to correct their balance of international payments by measures of their own choosing.

If the Governing Board believes that unduly expansionist conditions are impending in the world economy, it can concentrate the full influence of this provision on debtor countries by remitting charges on credit balances and increasing correspondingly those on debit balances.

8) The Governing Board may reduce <u>all quotas by the same percentage</u> if it deems this necessary to correct an excess of world purchasing power; but no member shall be required to reduce its actual overdraft at the date of the change or be entitled by reason of this reduction to alter the value of its currency as specified in 2) above, except after the expiration of 2 years. To correct a subsequent deficiency of world purchasing power the Governing Board may raise the general level of quotas toward the original level again. These provisions are primarily designed

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to meet general world inflation (or deflation) rather than to balance international payments or curb possible inflationary effects of the plan on a single country like the United States; but any general reduction of foreign quotas would, of course, reduce the potential flow of foreign reserves to the United States.

The Governing Board

It is evident that the Governing Board will assume a position of increasing importance as the bancor quotas are used. Whether or not adequate measures are taken to balance international transactions and prevent large sales of bancor to the United States may depend largely on the Board's policy.

In addition to the measures which it may compel a country to adopt, the Board has the power to permit or prevent corrective action which an individual country may itself be contemplating in the exchange market. Without the Board's permission foreign countries will not have the right to stop selling gold and bancors to the United States if to do so would mean a drop in their exchange rates. They will be obligated to maintain their exchange rates, which apparently means that a country with a persistently adverse balance of payments will be required to use up all its gold, official balances, and 1/4 of its quota of bancor (in the first year) to maintain its exchange rate unaltered, unless it obtains permission of the Board to let the rate drop. If the Board still withholds permission, the country will then have to use up the remainder of its quota of bancor in the next three years (assuming the pressure on its currency on the exchanges to continue) with the right to reduce its exchange rate by only 5%. What happens if the central reserves of the country are not sufficient to maintain its exchange rate at the stipulated level is not stated in the Keynes plan; but presumably international assistance will be given, or the Board will approve a substantial readjustment downward of the exchange rate, long before a country's resources are entirely exhausted.

On this important Governing Board, with its power to authorize or compel corrective action, the United States will have a minority voice. Voting power is distributed in the same way as quotas of bancor -- i.e., in the proportion that the total foreign trade of a country (on the average of the three pre-war years) bears to the aggregate foreign trade of the group. Members of the Board will be appointed by the participating Governments, but in order to keep the membership down to about 12, or perhaps 15, the smaller countries will be required to appoint group representatives. The voting power of a group representative will be equivalent to the aggregate quotas of his group.

The only case in which the United States may find itself with a controlling voice will be on those presumably rare occasions when consideration is being given to increasing the basic quota of some individual country. On such proposals the voting power of each country will be measured by its existing quota plus its credit balance, or minus its debit

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balance, averaged over the past 2 years. Except for this unusual case, the United States vote will be proportional to its foreign trade alone and will be less than England's, for foreign trade of the United Kingdom in the three years before the war was greater than that of the United States. If the entire British Commonwealth is included the United States will be outvoted more than 2 to 1, and the addition of other countries will diminish the relative position of the United States still further. Only as it enlists the support of foreign countries (most of them prospective debtors) can this country be sure of a policy on the part of the Governing Board that will minimize the need for U. S. assistance to the rest of the world in the form of non-interest bearing bancor credits.

If the accumulation of credits becomes too great, the United States can, of course, withdraw from the Union; but it will have to give one year's notice (thus permitting a full year's further accumulation of credits) and it will be permitted to realize on these credits only in settling an unfavorable balance of payments with the remaining member countries.

Position of gold under the plan

The plan provides that gold will be convertible into bancors at a fixed rate; hence gold will also be convertible into all members' currencies at fixed rates. This is a stronger position than it occupied before the war. At that time the stabilization funds of most countries exercised full discretion as to the amounts of gold they would buy and the prices that they would pay for it. To be sure gold operations were closely linked with their exchange policies and, if they wished to maintain stability with the dollar, they had to deal in gold freely at the appropriate price. But whether or not to maintain a given level was for them to decide. Under the Keynes plan this discretion will be removed. Through the bancor mechanism gold will be salable to all member countries in unlimited amounts at a price fixed by the Union.

Bancors themselves will not be convertible into gold. Such conversion is quite unnecessary since they are directly convertible at fixed rates into all member currencies. The gold provisions are devised merely to assure that any country possessing gold reserves or gold mines will be able to use gold as freely as bancor. Together gold and bancor quotas will constitute the basic reserves of the world with, possibly, the addition of foreign exchange directly held by monetary authorities.

Control of capital movements

Keynes wishes to control those capital movements that neither increase production nor stabilize exchange. He suggests no criterion to determine whether or not capital is performing these functions, nor does he deal with the problems of how to get investors to respond to genuine foreign needs if it is uncertain whether they will be permitted to sell their investments and withdraw their funds when they want them at home. It is clear to him that the system will require licensing of all international transactions -- whether on merchandise or capital account --

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in order to prevent concealed capital movements. He favors general adoption of the British form of exchange control. He does not, however, regard universal control of capital movements as essential to his proposed Clearing Union. The only restrictive provision he inserts in the plan is quite limited -- viz., that the monetary authorities of one country cannot keep reserves in another country in excess of working needs unless the authorities of that country approve.

Use of the Clearing Union to finance other post-war activities

Basically the Clearing Union is a device for stabilizing exchange rates by equipping each country with huge international reserves in the form of bancors in addition to its existing reserves of gold and foreign exchange. Keynes has in mind, however, other major uses for the Union. He suggests that additional quotas of bancors might be given to countries holding blocked balances in order to enable them to release these balances without strain on their own resources. England may hold $5,000,000,000 worth of blocked balances belonging to other countries at the close of this war. He also suggests that the Union might finance international relief, investment, and surplus commodity agencies by allowing them bancor overdraft facilities in addition to those possessed by the monetary authorities of the member countries. The combined possibilities are almost without limit. Stabilization operations (the basic plan) plus liquidation of blocked balances and financing of the great international agencies that handle relief, investment and surplus commodities might easily require tens of billions of dollars from this country since foreign needs would, through the device of bancors, be automatically cloaked with buying power.

Effect on the Federal Reserve System

Keynes evidently expects these dollars to be supplied by the Federal Reserve System. The Clearing Union works by debiting or crediting the accounts which central banks maintain with it. The corresponding movements of local currencies are apparently to be effected through the central banks. There is no budget problem -- a great virtue in Keynes' eyes. "It is one thing" he says "to ask the Parliaments and the Congresses of the various countries of the world to make contributions which they may or may not be able to afford in the unpredictable circumstances of the post-war transition, and which will be in any case a charge on their tax-payers and a permanent reduction of their own resources, arousing therefore political difficulties and competing with the claims of domestic social reforms. It is quite another thing to ask them to join in a general system which, without cost to their tax-payers and without prejudice to their own expenditure, requires of them to allow the temporary employment of surplus resources only so long as they themselves do not choose to use them." The phrase "do not choose to use them" calls attention to the fact that conceivably we could use the bancor credits we accumulate under the plan to purchase more goods and services abroad than we well. But this is something that a world desperately in need of our goods, and with greatly expanded power under the Keynes plan to buy them, would hardly permit for many years to come.

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It is not, however, essential to employ dollars created by the Federal Reserve Banks in order to purchase bancor. The purchase could be handled in the regular way through the budget without resort to the Federal Reserve, providing Congress did not balk at the cost (as Keynes fears it would). The major decision that now faces the Board of Governors is whether to accept an arrangement that might require the Federal Reserve Banks to transfer many billions of dollars to member bank reserves without acquiring any offsetting open market assets in exchange, or whether to insist that the whole arrangement be financed in the regular way through budget appropriations. The Treasury could, of course, finance purchases of bancors up to 2 billion dollars out of the gold resources of its present Stabilization Fund without obtaining a fresh appropriation. This action would add a corresponding amount to member bank reserves and would be as damaging to Federal Reserve control as would a direct purchase of bancors by the Federal Reserve Banks. But it would be limited to 2 billion dollars. Beyond that point, unless the Treasury were prepared to use some of its other and less relevant money-creating powers, it would be dependent on Congressional appropriations. Congressional appropriations financed by tax revenues or funds borrowed from the public would leave member bank reserves unaffected.

Effect immaterial if Federal Reserve control of credit no longer matters

As to whether the potential effects on member bank reserves should be a matter of concern to the Board, several viewpoints may be noted. One is that the volume of money and excess reserves no longer matters. War-time controls will continue during the post-war transition and thereafter the flow of consumer goods will be so great and the tendency to save out of enlarged incomes, rather than to spend on consumption, will be so strong that rising consumer prices are most improbable. Any tendency in that direction can be checked by an appropriate fiscal policy.

Another view is that, if credit control were possible, it would be most desirable; but that it has been doomed by the System's Government bond policy. It is felt that the Federal Reserve is becoming increasingly committed to maintaining Government bonds at par. They cannot be allowed to drop below par in the post-war period. This effectively prevents any tightening of the credit situation, for that would start a decline in Government bonds and force the Federal Reserve System to reverse its restrictive policy and start buying bonds to sustain the market. Under this view the inability to apply credit control may prove a serious handicap in the fight against inflation; but nevertheless the community must plan to do without it, clinging, if necessary, to the direct war-time controls.

Under the first of these views (that which says that credit control will not be needed) the Federal Reserve might just as well pour out new funds in financing whatever international arrangements are adopted. In fact it might just as well finance directly the domestic expenditures of the Government (at a nominal cost) until the volume of taxation is diminished to the point where a further reduction would weaken fiscal policy as an instrument of economic stabilization. Under the second view (that which says that credit control cannot be exercised because of our commitments in the Government bond market) the scope of Federal Reserve financing

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in the international field would be limited only to the point at which further additions to excess reserves would reduce the return on Government bonds to less than 2 per cent — a point which might take long to reach if compensatory sales were made from our open market portfolio.

Both of these views, however, appear somewhat extreme. It seems highly probable that, if the supply of money is unchecked, the volume of active funds can outstrip production in the post-war period, particularly if a significant proportion of this production is diverted to foreign countries; and it seems too early to admit that the Federal Reserve System will be unable to regain its freedom of action in the Government bond market when the time comes to combat an excessive volume of money.

<u>If credit control does matter, international financing must not conflict with it</u>

If this is the case, if credit control is still a real resource to be brought into play along with other instruments to maintain an orderly economy in the post-war period, the question of how far the Federal Reserve System can go in financing international transactions without destroying its power to adapt the money supply to the needs of the domestic economy becomes of major importance. By this test the greater the legitimate need of the American people for currency and deposits, the farther the Federal Reserve System can properly go in providing bank reserves through its financing of international transactions.

A crude example may help to make this clear. Suppose that the national income, which was 83 billion dollars in 1929, is twice that amount in the post-war period. If the public, enjoying relatively full employment and business activity in both periods, has the same attitude toward money, then roughly twice the amount of money will be required to maintain a stable economy in the post-war period. The appropriate amount of currency in circulation will rise from 4-1/2 billion dollars in 1929 to 9 billion and checking deposits from 23 billion dollars to 46. That is, the 16 billion dollars of currency already in circulation today will prove redundant by 7 billion dollars, and the existing volume of checking deposits will prove about right. The Federal Reserve System with its present open market portfolio of less than 6 billion dollars could not absorb the redundant currency in circulation plus the present 2 billion dollars of excess reserves. Even if increases of member bank reserves and currency in circulation for the remainder of the war period are matched by increases in the open-market portfolio of the Federal Reserve Banks, this initial lack of power to deal with the post-war situation through open-market operations would persist. The System could not adequately handle the redundant currency and deposits that would exist at the end of the war except through raising reserve requirements. Under these circumstances large-scale international financing by the Federal Reserve Banks would necessitate corresponding further increases in reserve requirements of member banks in order to maintain the System's control over credit. Such increases would require new legislation, which might be difficult to obtain if drastic action was contemplated.

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The example given is intended to be suggestive only. It may be that there are strong reasons for believing that the money habits of the people will have permanently changed -- that the amounts of pocket currency and of deposits needed to maintain stability in the post-war period will be three or four times the volume of 1929 even though national income has only doubled. Or it may be that national income itself, by reason of war inflation, will be nearer three or four times that of 1929 rather than merely double. If some of these more extreme possibilities are realized, there may be room for considerable international financing by the Federal Reserve Banks in the post-war period without a change in the present legislative set-up and without creating an excessive volume of domestic funds.

In considering such possibilities many factors would have to be weighed that have not been touched upon in this memorandum. One would have to estimate, for instance, the extent to which savings bonds and short-term Government securities may take the place of time deposits, permit individuals and corporations to economize on checking deposits, and reduce the ratio of needed checking deposits to national income in the post-war years -- thus both accentuating the problem of credit control and restricting the field for international financing by the System. This and many other situations would have to be appraised. The present memorandum is intended only to suggest the importance to the Board of the whole subject and the need for a really adequate study of the probable national income of the United States after the war and of the volume of currency and deposits that will be appropriate to it. These are the things that will determine whether or not, on the basis of its present powers, the Federal Reserve System will have control of the domestic credit situation in the post-war period and also scope for new activities in the field of international financing. If it appears that the System will have no scope for international financing on the basis of its present legislative set-up, then it must consider what sort of legislation it might ask for and how far it could go in using new powers without destroying member banks as lending agencies. If the System cannot develop a range of action for itself in the international field consistent with its domestic credit control, then it will be forced here and now to refuse participation in international financing -- unless the more radical position is adopted that credit control itself no longer matters, a position which, in all its implications, would come close to depriving Federal Reserve policy of any significance. It is decisions of this basic character from the standpoint of the Federal Reserve System that are involved in the Board's participation in the inter-Departmental discussions now in progress on plans such as that of Keynes to meet the financial needs of the post-war world.

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