July 7, 1947

Mr. Charles P. Kindleberger
Department of State
Washington D. C.

Dear Charlie:

Enclosed is our rough and tentative paper on European financial arrangements on which we hope to devote a good deal more thought as to its content and method of exposition. You will note that the introductory paragraph mentions a Part II dealing with European external financial relations, which is to follow when we can get it ready.

Sincerely yours,

J. Burke Knapp,
Assistant Director,
Division of Research and Statistics.

JBK:mmm

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A Program for European Self-help--
Suggestions for Implementation in the Financial Field

The following memorandum presents a tentative sketch of measures which European countries might take in the financial field to implement the principle of European self-help enunciated in Secretary Marshall's recent address at Harvard University.

Part I, dealing with intra-European financial arrangements, discusses various ways of promoting through financial devices a more effective and constructive flow of trade within Europe. At various points it postulates some kind of central financial agency for Europe which, under the final suggestion for a central European clearing mechanism, would be endowed with considerable administrative authority. It does not appear that the functions of this agency would be appropriate for the International Monetary Fund or a European subsidiary thereof; yet the agency should clearly be brought into a close consultative relation with the Fund. Consideration might be given to reorganizing and adapting the Bank for International Settlements in Basle to perform the proposed functions.

Part II of the memorandum1/ points out ways in which such a central financial agency for Europe could provide assistance in coordinating the <u>external</u> financial relationships of the area. It is suggested that the agency could perform an important role in administering financial aid to the area from the United States, as well as in directing the use of the independent foreign exchange resources of European countries.

A third subject, beyond the scope of this memorandum although it might be subsumed under the title, is the financial measures which European countries might take in their domestic monetary and fiscal policy which would promote in each country more effective employment of indigenous resources for reconstruction and recovery. Although consideration of this subject raises the question of the extent to which the United States desires to invade the province of domestic administration in countries receiving United States aid, it is believed that the subject merits close and continuing attention, especially in view of the precarious nature of internal financial equilibrium in many (even most) European countries.

1/ To follow shortly.

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I. Intra-European Financial Arrangements

The first condition of an expansion of intra-European trade is the growth of production in European countries to a point where exportable surpluses are developed. But even after surpluses over essential domestic requirements appear, these are likely to be exported only where there is an immediate prospect of compensating imports. That is, exporting countries expect to be paid by importing countries in goods or in currencies which can be used to procure goods elsewhere. European countries are not interested in exporting for the sake of stimulating domestic income and employment or (in general) for the sake of merely maintaining a market.

Under these circumstances it was natural that after the liberation a large part of intra-European trade proceeded within the framework of bilateral clearing and payments agreements. There is little doubt that in the period following the end of hostilities bilateral trade and payments arrangements provided the most promising and in fact the only available method for quick resumption of the flow of goods among European countries. In view of the general disruption of trade channels, attempts at an immediate reconstruction of the network of multilateral trade in Europe were out of the question. Nevertheless, the beneficial effects are rapidly receding into the background before the detrimental effects of bilateralism in trade.

To the extent that such bilateral arrangements are successful in the sense that values of exports and imports of any pair of countries have been kept equal, further expansion of trade is rendered increasingly difficult. Once the volume of trade has exceeded a certain minimum, continued matching of exports and imports on a bilateral basis becomes an arduous task. While Country A may be greatly interested in an increasing flow of imports from B, the latter may find little that it needs to import from A. Very often in this process attempts at bilateral balancing of exports and imports fail. Then either trade does not grow at all or clearing balances develop which represent involuntary loans from the export surplus to the import surplus country and which must be dealt with if trade is to continue on the expanded basis. The task therefore is to liberate Europe's internal trade from the requirement of bilateral balancing.

If, then, trade is to flow freely among European countries, any net balance in the bilateral trade of two given countries must be settled:

(a) by the net importing country paying for the difference in U.S. dollars, gold, or a currency freely convertible into dollars, or

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(b) by the net importing country paying for the difference in a currency which, while inconvertible, can nonetheless be used by the net exporting country in triangular or multiangular settlements (for example, the net importing country (A) may pay the net exporting country (B) in the inconvertible currency of a third country (C) which happens to be usable by B for payments to C; or A may be able to pay B in A's inconvertible currency provided that B can use it for payments to another third country (D) which can in turn employ it for payments to A; other more or less intricate settlement possibilities may be conceived);

(c) by the net exporting country granting credit to the net importing country, e.g. by accepting and agreeing to hold the currency of the net importing country; or

(d) by the establishment of some multilateral clearing system for Europe combining the functions of multiangular settlement and the extension of credits within the group.

To the extent that the foregoing conditions are not satisfied, a country which might have provided exports to its trading partners in Europe if goods flowed independently of payment problems, will in fact reduce its exports to the level which can be accommodated by payment possibilities. This tendency toward reduction to the least common denominator obviously militates against the free interchange of supplies in Europe and the maximum degree of self-help from European resources.

How then may conditions (a), (b), (c), and (d) be more effectively achieved?

(a) The acute demand in Continental Europe for extra-European imports, which in general must be paid for in dollars or in media of exchange convertible into dollars (i.e. gold, Swiss francs, and £ sterling), has created an acute demand for such currencies. This demand now extends to pounds sterling since from July 15 foreign acquisitions of pounds will be freely convertible into dollars; pounds will therefore be just as "hard" a currency as dollars, except, of course, for the frozen portion of accumulated sterling balances which will become entirely unavailable for current transactions. Meanwhile, the British, because of convertibility demands upon them plus their own urgent need for dollar imports from the Western Hemisphere, must seek every opportunity to obtain dollars. Hence

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sterling is universally acceptable as a means of payment on the Continent, and dollars throughout Europe including the United Kingdom. It would be possible, therefore, to develop a multilateral payments system based upon the use of sterling or dollars to the extent that countries having bilateral deficits to meet were supplied with these currencies.

Indeed the British are consciously striving to establish the pound sterling as the medium for multilateral settlements in Continental Europe. In a series of recent payments agreements negotiated by the British to implement their obligation to make sterling convertible for current transactions as from July 15, a wide number of European countries (e.g. France, Belgium, Netherlands, Norway, Czechoslovakia, Italy, Spain, and Portugal) have undertaken (1) to carry specified minimum working balances in London, and (2) to accept payment for their exports in pounds sterling not only from countries in the sterling area, but also from all other countries with which the United Kingdom has negotiated such payments agreements. The British will benefit if the pound sterling becomes the medium for multilateral settlement among other countries for the reason that (1) this would lead foreign countries to hold working balances in London (this amounts to a loan to the United Kingdom, incidentally on very advantageous terms) and (2) this would lead countries to employ British financial services (banking, insurance, etc.). In view of the United States interest in bolstering the British position, we should presumably be sympathetic to this development.

Obviously the same kind of clearing system could be built up with the use of dollars as the medium of exchange. The difficulty is, however, that these hard currencies are also required for payments outside Europe (sterling as much as dollars since it is freely convertible into dollars). Hence there is an inescapable tendency for them to be used to pay for overseas imports rather than to meet obligations in Europe. If all bilateral deficits between European countries were to be met directly in dollars, very large sums would have to be supplied from the United States to support the system. It would be far preferable to establish a procedure under which payments were cleared so far as possible within Europe, only the intractable net balances being taken care of eventually with the aid of U.S. dollars. Such procedures are considered in the following paragraphs.

(b) The first step directed toward elimination of bilateral restrictions on trade must therefore be promotion of triangular or multiangular settlements in inconvertible currencies. The opportunities for a single country to carry out such settlements are usually limited. The import surplus country (A) may indeed be willing to offer its clearing partner (B) a credit balance which A has accumulated in a third country (C). But such a balance may be of little use to B unless it can be exchanged for a credit balance in a fourth

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country (D). Sometimes even longer and more intricate processes of successive swapping of balances will be necessary. The greater the number of countries that must be involved in such an operation, the greater is the probability that its success will be thwarted through various resistances appearing at one or the other point of the circuit. Countries may hesitate to acquiesce in the settlement process because they may think, rightly or wrongly, that special advantages might accrue to them through skillful exploitation of their debtor position. Lack of cooperation on the part of one important trading country may jeopardize the settlement of balances for several countries. To break through such resistances will require establishment of some international machinery based on agreement among a significantly large group of European countries under which the parties to the agreement undertake to submit to a central European financial agency, at regular intervals, such balances as have accumulated among them in their bilateral dealings. A special set of rules for the scaling down of competing balances would need to be elaborated. The operation, however, should not extend to balances which both the creditor and the debtor country wish to have exempt from the settlement.

If the process of multiangular balancing were to be fully carried out, the still uncleared balances would represent simply the net balances of each participating country in its intra-European trade.

(c) Probably the best immediate opportunity for developing financial self-help by European nations lies in the direction of the mutual interchange of lines of credit in the form of commitments to accept each others' currencies as a temporary form of settlement. Such arrangements are at present the basis for a large number of intra-European payments agreements establishing such lines of credit for limited (generally quite moderate) amounts. But most of these arrangements have been entered into reluctantly. Again it is repeated that European countries have little if any interest in promoting exports for exports' sake. The extent to which this form of agreement can be developed is seriously limited by the general principle that most European countries must obtain compensating imports so far as possible for their exports. If a particular country is unable to offer compensating imports (or currencies which can be used to procure such imports) other countries are naturally inclined to divert their exports elsewhere rather than to export on credit terms.

Nonetheless, an effort might be made to encourage European countries to grant more such lines of credit to each other and in greater amounts (it is assumed that the lines of credit could be actually employed, i.e. that they would not be rendered meaningless by unduly restrictive export quotas imposed by the countries granting the credits). It could be

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pointed out to them that if such credits were rather generally extended, many more opportunities would probably develop for triangular and multi-angular settlements as described in (b) above. The development of such settlements would in turn encourage the extension of new credits. In particular it should be noted that intra-European trade could be much more readily expanded in this manner than by the negotiation of detailed commodity barter arrangements.

Definite encouragement might be given by the United States to the development of a pattern of credits along these lines if the United States should undertake to make loans to debtors for the purpose of repaying "intractable" balances accumulated under such agreements, i.e. balances which the creditor country found impossible to liquidate through purchases in the debtor country or through transfer to third countries. The creditor country might be required to guarantee the debtor's obligation to the United States (at least as to principal), although to the extent that creditors were required to underwrite such obligations they would be less prepared to let the credits accumulate in the first instance. If the creditor were to be freed of obligation, it might be necessary for the United States to stipulate that it would make loans to repay clearing balances only if they had arisen from a constructive flow of essential goods; otherwise, creditor countries might artificially expand shipments of non-essential goods on credit terms in order eventually to realize dollars from them. Probably a further condition of any U.S. aid in mobilizing intractable balances should be that the creditor country has genuine need for dollars in meeting its balance of payments; Switzerland, for example, might be prevailed upon to accept some such balances, without underwriting by the United States, as a contribution to general European reconstruction.

(d) Solutions (b) and (c) are inherently cumbersome because of the bilateral character of the underlying transactions. This leads to the more ambitious suggestion that some form of central multilateral clearing might at some point be introduced among European countries. This might take the form of a commitment on the part of each country to accept in payment for its exports a given global amount of the currencies of other participants in the program. An alternative method, which mechanically would be simpler, would be for each country to contribute a given quota of its <u>own</u> currency to a common pool under the administration of a central European financial agency. Each member could then use its own currency to purchase from the pool the currencies which it required to make settlements on current trade within the group. The analogy with operations of the International Monetary Fund is apparent—the initial currency contributions might be made proportionate to, although presumably smaller than, the Fund quotas of the participants. It is suggested, however, that in this case the central pool be utilized only to finance trade among the members which they find by common agreement to represent a constructive flow of essential goods. In this case, there need be no quantitative limitations upon the amounts which member countries could draw from the pool. To a considerable extent, such

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a system would marry the operations described in (b) and (c) above and put them on a multilateral basis under the management of a central financial agency. So far as essential current trade was concerned there would be an automatic clearing of offsetting triangular and multiangular obligations; each country's net position vis-a-vis the aggregate of the other members would be reflected in the net increase or decrease of the holdings of its currency by the central pool. It would remain for the central agency to facilitate ad hoc arrangements for the triangular or multiangular offsetting of pre-existing currency holdings or other obligations among the participants, including balances arising out of non-essential trade.

Under a general agreed directive, the central agency might assume responsibility for determining in detail what transactions could be financed by member countries through the pool--i.e. whether proposed expenditures were for constructive imports of essential goods. Furthermore, with the granting of credits now removed from bilateral channels, the central agency might undertake to allocate available credit among competing demands. If the currency of A tended to be drawn out of the pool in payment for A's net exports to the rest of the group, the central agency might be authorized to ration it to prospective purchasers in accordance with the "essentiality" of their needs for it. Or as A's currency became scarce in the pool, the central agency might ask A to supply further amounts, either as a further credit contribution or in exchange for dollars (again including equivalents).1/

The requisite dollars might be supplied to the pool

(a) through having countries whose currencies had accumulated in the pool in excessive amounts repurchase such excess holdings against dollars, possibly dollars loaned by the U.S. to such countries; or

(b) through U.S. loans directly to the pool, secured by the pledge of its currency holdings and/or by a collective guarantee from the members of the pool on some pro rata basis. Since the pool's currency holdings would tend to become exclusively those of the debtor countries, a collective guarantee would be necessary if the creditor

1/ Conceivably, the central agency might be able to use some of its currencies in excessive supply to purchase supplies of A's currency held by third countries; these might be countries outside the pool, or countries in the pool which had held A's currency before the pool was launched or had accumulated it in transactions outside the pool (non-essential trade, capital movements, etc.).

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countries in the pool were to share in the obligation to the United States. Such sharing would not be necessary to avoid abuse of the proposed system (ref. page 6 above) since the system would be confined to financing essential trade; it might still be desirable in some degree in recognition of the common European interest in promoting the recovery of each of its members through a growth of intra-European trade.

II. External Financial Arrangements

In conducting their external financial arrangements, it may be assumed that as a minimum European countries participating in a joint recovery program will establish some advisory body to coordinate import programs, to ascertain prospective dollar deficits, and to certify to the United States on behalf of the group the need of individual European countries for dollar aid. These countries may be expected also to consult on measures of mutual advantage vis-a-vis outside countries—e.g. through a central financial agency they might seek opportunities for triangular and multiangular offsets of financial obligations, especially with a view to finding uses within the group for inconvertible extra-European currencies acquired by certain members of the group.

At the other extreme, a maximum coordination of European external resources would call for the pooling in one agency of (a) existing European holdings of gold, dollars, and other extra-European currencies and investments; (b) the proceeds from current exports to extra-European (which we may term roughly, overseas) areas, and (c) the proceeds of credits or grants from such areas, whether disbursed under previous or under new commitments. In this case, the central agency would allocate overseas exchange to member countries in the same manner that a national exchange control allocates foreign exchange to different sectors of a national economy.

Clearly such a full integration of the external relationships of the European economy is not to be expected. But what half-way house may exist which the United States might appropriately encourage if it is to provide major assistance for European recovery?

(To be concluded)

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Division of Research and Statistics,
Board of Governors of the Federal Reserve System.

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