Form F.R. 468

Date October 23, 1944

To Mr. Mikesell

From A. Bourneuf

MESSAGE:

This is a revised edition of the memorandum I sent you a week ago. There have been several minor changes for the sake of greater accuracy and clarity. The material changes or additions are as follows: the paragraph running from p. 2 to p. 3, footnotes on p. 4, and the discussion running from p. 5 to p. 6.

PROFESSOR WILLIAMS AND THE FUND**

In his article on the Bretton Woods plans in the October issue of "Foreign Affairs",* Professor Williams renews his criticism of the International Monetary Fund and at the same time raises a number of interesting questions with respect to its mechanics. In the opinion of this writer his provocative discussion is in certain respects misleading and tends to give the reader an erroneous impression of the workings of the Fund. Several of the objections to the Fund which Professor Williams raises on other accounts, I think also are not as decisive as his argument suggests.

I. The Mechanics of the Fund

Professor Williams' questions on the mechanics of the Fund all relate to the possible development of a shortage of dollars. It is essential to recognize the fact that the Fund by itself can not prevent the development of a shortage of dollars. There will be a shortage of dollars if payments foreigners want to make in this country exceed payments by United States' residents to foreigners. The balance of payments of the United States after the war will depend on such factors as post-war debt settlements, the level of employment and income here and abroad, the extent and nature of trade barriers, the way in which relief and reconstruction needs are financed, the extent of American foreign lending, the degree to which speculative capital movements are controlled, the pattern of exchange rates, the degree of exchange stability, and the shifts in demand and changes in production techniques in this and other countries. Many of these factors are obviously beyond the scope of the Fund, except in so far as it provides an atmosphere of international co-operation; but both the Fund and the International Bank for Reconstruction and Development are designed to help prevent the development of unbalance in international transactions.

The Fund aims at stability of exchange rates, elimination of bilateral clearing agreements and exchange controls on current transactions, and control of speculative capital movements. The Fund provides for approval of changes in exchange rates when the changes are necessary for the correction of a fundamental disequilibrium, so that countries will not have to struggle to maintain a rate inconsistent with balance in their international transactions. The Fund will assist members to meet deficits in their international transactions in order to provide them with an interval in which to take corrective measures.

The Bank aims at promoting wise international lending for reconstruction and development. Countries now subject to wide fluctuations in their balances of payments, because, for example, they depend on one or two raw material exports to pay for necessary foreign goods

---

* "International Monetary Plans", John H. Williams, Foreign Affairs, October 1944, pp. 38-56.

** Revised version of October 11, 1944, memorandum. To appear in the December Issue of American Economic Review.

may be helped to broaden their economies. They may be helped to develop new exports, or to produce domestically goods formerly exported, and thus to reduce their dependence on foreign goods or to improve their chances of paying for them.

Not only are the Fund and Bank intended to assist in preventing the development of unbalance leading to a shortage of dollars or of any other currencies but also to assist in meeting shortages that do develop. There are several provisions in the Fund plan that are designed to keep the Fund itself from running out of a currency that is in demand. Countries with reserves in excess of their quotas must use their reserves at the same rate that they draw on the Fund; countries already with reserves in excess of their quotas that are gaining reserves must use half of the increase to repay past borrowings from the Fund; countries borrowing from the Fund must pay interest charges and the charges rise with the amount borrowed and the duration of the borrowing; and, finally, the Fund can refuse to lend to any country that is not using the time gained to correct its international position. If dollars in the Fund are tending to become exhausted -- in spite of the efforts of the Fund to promote international balance and in spite of the arrangements designed to prevent the Fund from running out of dollars -- the Fund can declare the dollar a scarce currency and can apportion its existing and accruing supply among member countries. Members can then take steps to allocate dollars among their nationals to the extent necessary to equate the demand and supply.

1. Professor Williams argues that a mechanical difficulty in the Fund plan will lead to a shortage of dollars in the Fund, and presumably therefore to dollars being declared scarce, when there is no actual world shortage of dollars, i.e., when the United States has an even balance of payments position.* If this argument were correct it would be a very serious criticism of the Fund. It implies that the Fund would lead to restrictions on transactions with the United States when there was no underlying shortage of dollars and when restrictions otherwise would not be imposed.

It is difficult to see how the Fund's dollars would come to be used at all if the demand for and supply of dollars outside the Fund at a given pattern of exchange rates tended to equal each other, as they would if the United States were in an even balance of payments position.** The monetary authorities of foreign countries will borrow dollars from the Fund only when there is a pressure on the dollar rate that would otherwise lead to a loss of gold. If dollars offered for sale tend to

---

* "Thus even though this country had an even balance of payments position, the Fund's holdings of dollars would be rapidly exhausted." Ibid., p. 46.

** The phrase "even balance of payments" is used in the sense of a balance of international payments such that, if there were no Fund, there would be no tendency for gold to flow in either direction.

equal dollars demanded in the world as a whole there will be no special pressure on the dollar rate even in a country that buys more from the United States than it sells, and the monetary authorities will have no reason to borrow dollars from the Fund. Temporary shortages of dollars on account of seasonal elements in the balance of payments would tend to be ironed out in the exchange markets.

Assume that, in the course of a period of two or three years, Europe has excess payments of $1 billion due to the United States and assume that Latin America, on the other hand, has excess receipts of $1 billion due from the United States. If Latin America sells the $1 billion of excess receipts to Europe then Europe has no reason to come to the Fund for dollars.

Professor Williams' argument implies that dollars would be drawn from the Fund because of a mechanical difficulty in the plan. "The great weakness of the Fund from a mechanical standpoint is that while other countries in paying for our exports would use up the Fund's supply of dollars, our own payments for imports would not replace these dollars."* And this in turn is due to the fact that the Fund plan, he believes, does not recognise that the dollar is a key currency and that foreign countries want payment in dollars. As a result the United States is not able to use the Fund in paying for its imports.

In the example given above it is assumed that the United States has an adverse balance with Latin America and a favorable balance with Europe. In this case Europe will not come to the Fund for dollars unless Latin America is not selling the $1 billion excess to Europe but is accumulating dollar balances instead. But if Latin American countries are accumulating $1 billion in dollar balances the United States balance of payments position is not even, it is uneven. In the world as a whole there is an excess demand for dollars of $1 billion, that is, a shortage of dollars. Under these circumstances there is no reason why the United States monetary authorities should go to the Fund for Latin American currencies even if Latin American countries were accustomed to receiving payment for exports in their own currencies. If Europe borrows dollars from the Fund, it is not because of a mechanical defect in the Fund, or because the Fund fails to take account of the fact that the dollar is a key currency, but because there is a world shortage of dollars.

2. Even if the United States balance of payments position is uneven, and there is a world shortage of dollars because Latin America is accumulating dollar balances of $1 billion, it does not follow necessarily that the dollars in the Fund will decline by $1 billion. If Europe's total adverse balance of payments is $1 billion, Europe can probably not borrow much more than $500 million from the Fund because countries that have reserves in excess of their quotas must draw on their reserves at the same rate that they draw on the Fund.** Furthermore, Europe can not go

---

* Ibid., p. 46.

** The countries with large quotas and the countries which are apt to have large adverse balances almost all have reserves in excess of their quotas.

case for some time to come. There seems to be a greater possibility that a shortage of dollars will come about as a result of almost all countries having huge demands for foreign goods and equipment. Indeed, should relief and reconstruction be financed on a permanent or long-run basis, and loans be forthcoming for industrial development programs, it is still doubtful that many countries will be able to accumulate large dollar balances.

There is every reason to think that the existence of the Fund will tend to decrease the desire to hold dollars, in any case. Dollars have been held in the past partly because they were readily convertible into other currencies. Since other currencies will be obtainable through the Fund when needed there will be less inclination to hold dollars.

4. Elsewhere Professor Williams suggests that the main difficulty in the Fund plan is a mechanical difficulty of another sort. "The trouble in the present scheme lies in the discrepancy between the relatively large demand for exchange as represented by the quotas and the limited supply of dollars with which to meet it."* Professor Williams says this difficulty is another instance of failure to recognize the key currency problem. A workable mechanism must, in his opinion, "provide assurance that the currencies that are actually used as means of international payments will be available to meet a world demand which arises not merely out of the trade of all the other countries with the key countries but out of the settlement of trade of all the other countries with each other."** I am not sure what Professor Williams has in mind. If dollars now held by foreign countries are passed from one country to another, there is no drain on the Fund's dollars.

At one point in the argument it appears that Professor Williams may be concerned about the initial gap between foreign quotas and the Fund's gold and dollar holdings because he thinks it will lead to the accumulation of dollar balances by foreign countries. He says the effect of the gap is bad psychologically as well as mechanically, and in the following sentence refers to "dollar hoarding round the world."*** I have already discussed the reasons why I believe there is little danger of a serious drain on the Fund's dollars as a result of such accumulations as may occur.

But Professor Williams may have in mind a different problem. If foreign countries, fearing that their ability to borrow dollars from the Fund was endangered by the existence of the gap, consciously adopted

---

* Ibid., p. 50. The total initial discrepancy is about $3 billion. Foreign-borrowing privileges, which are equal to their quotas plus their gold contributions, total $7 billion roughly and the Fund has, at the outset, almost $4 billion in gold and dollars.

** Ibid., p. 44.

*** Ibid., p. 50.

domestic monetary policies and foreign trade policies, that they would not otherwise adopt, leading to adverse balances on current account with the United States, the gap itself would encourage purchases from the United States that would otherwise not be made and lead to the development of a greater dollar shortage than would otherwise exist. The possibility of such action seems to me remote. It is true that a country may find it possible, because it can borrow from the Fund to meet temporary deficits, to avoid deflationary measures or restrictions on trade. But the domestic monetary policies pursued by member countries will be framed, barring being stopped short by a lack of international reserves, with a view to the level of employment and real income. And it does not seem reasonable that a country would consciously adopt or pursue policies leading to an adverse balance on current account for the purpose of using up its borrowing privilege as quickly as possible. Countries with reserves in excess of their quotas must use their own reserves at the same rate they borrow from the Fund, so for most countries, including the countries with the largest quotas, there is no possibility of drawing on the Fund exclusively, while the Fund is amply supplied with dollars, and conserving independent reserves for later use.

In general, member countries will certainly think of the Fund as a source of credits to meet deficits when they do develop not as a Fund to exhaust as quickly as possible. And if there was a tendency for certain countries to want to draw on the Fund up to the maximum of one-quarter of their quotas year after year the Fund could protect itself by refusing further loans. If the Fund is properly managed, it will very much decrease, not increase, the amount of unbalance in international transactions.

Unless we assume a conscious effort to use up borrowing privileges ahead of other countries the existence of the gap is not of fundamental importance. Barring this assumption the Fund's supply of gold and dollars will be used at the same rate with or without the gap. Practically speaking, of course, foreign demands on the Fund will not be for dollars alone. If the Fund's dollars should approach exhaustion, I cannot see how the fact that there might remain some countries which had not exhausted their maximum borrowing privileges could be a source of added difficulty. The important fact would be that the Fund could no longer supply dollars but this would be the case even though foreign quotas were smaller and were exhausted at the same time as the Fund's gold and dollar holdings.

II. The Functions of the Fund

1. Professor Williams says that it has now been recognized that the Fund can not finance relief and reconstruction needs, or assist in the liquidation of war balances. Also it is provided that members can elect to maintain exchange controls under special arrangements for the transition period. Professor Williams wonders, therefore, what the functions of the Fund in the transition period are.

The answer, I think, is as follows. Even though relief, reconstruction, and development needs are not to be met by the Fund, the temporary difficulties intended to be met by the Fund will occur as frequently and be as serious in the transition period as at any other time. Temporary balance of payments difficulties are bound to arise in the course of

adjustments to wartime shifts in production, transportation, and markets. For this reason there is need immediately after the war not only for an international agreement to stabilize exchange rates and to provide for the orderly removal of exchange controls, but also for a fund of credits to help countries that do not elect to maintain controls and countries that are seeking to eliminate controls as rapidly as possible.

2. Professor Williams thinks that the provisions in the Fund plan concerning changes in exchange rates are reasonable but he doubts that they can be administered properly because of the fundamental difference as between British and American attitudes toward changes in exchange rates. I wonder if this difference in attitudes will prove to be as great a stumbling block to successful administration of the Fund as Professor Williams assumes. Britain operates as an important banking and exchange center for the world as a whole. The British, of course, fear the absolute power of an international body to refuse a change in the sterling rate, should England again be in a position similar to that in the early thirties, but Britain has a very real interest in maintaining sterling as far as possible at a stable rate so as not to discourage the use of London as a financial center. The United States, on the other hand, although intensely interested in stable rates, has a real interest in preventing such restrictions on trade or serious deflationary influences as might result from a refusal, in the case of a fundamental disequilibrium, to allow a change in the British rate.

3. Professor Williams is convinced that there is in the long run no general need for foreign exchange in view of the fact that many countries have large reserves of gold and dollar balances. It is true that many countries have much larger reserves than they have ever had before; but there are still many countries whose reserves are inadequate from the point of view of being able to meet a possible deficit in their balances of payments. Of the 44 countries represented at Bretton Woods, 5 have virtually no gold or dollars, 13 have gold or dollars equal to 20 per cent or less of the value of their exports in 1938, and 21 equal to 50 per cent or less of the value of their exports in 1938. Since, for example, a drop in the value of a country's exports by 10 per cent in any one year is not improbable, none of these 21 countries can export gold to meet probable deficits without fearing the effect on their total reserve position. This is all the more clear when account is taken of the fact that most countries have a large percentage of their reserves tied up in meeting legal reserves requirements.

A country facing a deficit of uncertain duration in its balance of payments may be unwilling to use its reserves and may, therefore, impose restrictions on international trade or may take steps to eliminate the deficit that results in a domestic deflation. In those cases where the underlying causes of the deficit are temporary, clearly borrowing from the Fund may obviate the need for the adoption of such measures. In these circumstances the borrowing country will tend to eliminate its indebtedness to the Fund in short order either by direct repayment to avoid charges or by other countries obtaining its currency from the Fund. If the deficit gives evidence of becoming chronic, the Fund, of course,

will not go on lending indefinitely. The Fund may lend for some time, however, in order to give the country in difficulty an opportunity to make adjustments.

Even the 23 countries with larger gold reserves in comparison to exports may be unwilling to lose considerable amounts. The absolute size of the reserves of the large gold-holding countries may, under certain conditions, have little effect on the amount of gold they are willing to lose without resorting to defensive measures. Internal reserve requirements, psychological, security, or other reasons may account for such reluctance. Should an attitude of this sort lead to defensive measures in the face of a gold outflow, it would be much better, I believe, to have the Fund lend, albeit the Fund's limit would be half the deficit.

4. Professor Williams is concerned that through the Fund credits will be obtained as a matter of automatic right by countries which do not need the credits or by countries which do not make good use of them. The Fund does not give any country an automatic right to credits. At the outset the Fund can determine, in the light of a country's ability to take corrective measures in the breathing spell afforded, whether a particular member is or is not eligible to use the Fund. Second, the Fund can determine at any time that a member has not been using the Fund in accordance with its purposes and can deprive it of future use of the Fund. Third, the Fund can be used in general only to meet deficits arising out of current transactions. The idea that a member country can, simply as an automatic right, rush ahead and borrow is without foundation.

Alice E. Bourneuf

October 21, 1944