Form F.R. 468

Date October 12, 1944

To Mr. E. M. Bernstein

From Alice Bourneuf

MESSAGE: Board of Governors of the Federal Reserve System

I thought you might be interested in this note on the Williams article in October "Foreign Affairs".

FOR PUBLICATION IN AMERICAN ECONOMIC REVIEW

PROFESSOR WILLIAMS AND THE FUND

In his article on the Bretton Woods plans in the October issue of "Foreign Affairs" John H. Williams discusses what he calls the mechanics of the Fund. In this respect the article differs from his previous studies which were largely confined to more general implications of the proposals. Professor Williams' discussion of the mechanics is in many respects misleading and gives the reader an erroneous impression of the workings of the proposal.

I. The Mechanics of the Fund

To begin with it is essential to recognize the fact that no financial mechanism by itself can prevent a development of dollar scarcity after the war. A shortage of dollars develops whenever 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 in large part on 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 and the degree of their stability, and the shifts in demand and changes in techniques both here and abroad. Both the Fund and Bank plans formulated at Bretton Woods are designed to help prevent the development of serious unbalance in the international transactions of the United States and of all other countries. The Fund aims at stability of exchange rates, elimination of competitive exchange depreciations, elimination of bilateral clearing agreements and exchange controls which hamper world trade, 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 temporary deficits in their international transactions to provide them with a breathing spell during which to take measures to correct the unbalance in their international transactions. The Bank will promote wise international lending for reconstruction and development purposes. Countries now subject to wide swings in their balances of payments because of dependence on one or two raw material exports to pay for foreign goods on which they are dependent will be helped to broaden their economies and to develop new exports, and thus either to reduce their dependence on foreign goods or to improve their chances of paying for them.

Both the Fund and Bank not only aim to prevent the development of unbalance leading to a shortage of dollars or any other currency but also help to meet any shortage which does develop. There are several provisions in the Fund plan which are designed to keep the Fund itself from running out of a currency which is in demand. Countries amply supplied with reserves must use their reserves at the same rate that they draw on the Fund, countries gaining reserves must use half of the increase to repay past borrowings from the Fund, countries borrowing from the Fund must pay interest charges which rise with the amount borrowed and the time over which it is borrowed, and finally the Fund can refuse to lend to any country which is not using the time gained to correct its international position. If 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, dollars in the Fund are tending to become exhausted the Fund can declare the dollar a scarce currency and members can take steps to allocate dollars among their nationals to the extent necessary to equate the demand to the supply.

1. Professor Williams has the erroneous impression that a mechanical difficulty in the Fund plan will lead to a shortage of dollars in the Fund and to dollars being declared scarce even when there is no world shortage of dollars, i.e. when the United States has an even balance of payments position.* If this 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 exhausted if the demand for and supply of dollars 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. Private individuals can not deal with the Fund directly. The monetary authorities of foreign countries will borrow dollars from the Fund only when there is pressure on the dollar rate which would otherwise lead to a loss of gold. If dollars offered for sale tend to equal dollars demanded in the world as a whole there will be no special pressure on the dollar rate even in a country which buys more in this country than it sells and the monetary authorities will have no reason to borrow dollars from the Fund.

The case Professor Williams has in mind is substantially as follows. Assume that Europe has an excess of payments due to the United States of $1 billion and assume that Latin America, on the other hand, has an excess of receipts due from the United States of $1 billion.

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

Professor Williams calls this an even balance of payments position and says the dollars in the Fund may be used up nevertheless because the Latin American countries may wish to accumulate dollar balances up to the $1 billion of their excess receipts rather than sell the dollars to Europe. Professor Williams says Europe will then borrow the $1 billion it needs from the Fund and the Fund's dollars will tend to be exhausted.

This arises, according to Professor Williams, from 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 is due, according to Professor Williams, to the fact that the Fund plan does not recognize that the dollar is a key currency and that Latin American countries want payment in dollars. As a result the United States is not able to use the Fund to meet its adverse balances with those countries.

But the trouble with this example is that, as soon as Latin American countries want to accumulate $1 billion in dollar balances, as Professor Williams assumes, the United States balance of payments position is not even, as he says, but uneven. The Latin American demand for dollars is equal to its supply and the European demand exceeds the supply by $1 billion. In the world as a whole there is an excess of 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 foreign currencies even if Latin American countries were accustomed to taking payment in their own currencies. The dollars are drawn from the Fund because there is a shortage of dollars, not because the Fund plan fails to take account of the fact that the dollar is a "key" currency.

2. Perhaps Professor Williams really means that the main difficulty is that there will be a shortage of dollars due to the fact that foreign countries will want to accumulate dollars because it is a "key" currency. In that case the important question is whether the Fund will tend to reduce or intensify the desire to accumulate dollars. Professor Williams seems to think the Fund plan would lead to dollar hoarding and in this connection says: "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.** But there is no reason why the existence of this gap should lead to dollar hoarding around the world. The Fund is essentially an international loan fund. Even if there were no gap there would still be a limit to the amount of dollars that any single country or all countries

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* Page 46.
** Page 50.

together could obtain from the Fund. In the past dollar loans have been available from private individuals and from public institutions and the fact that there was a limit to the amount that could be borrowed was not responsible for any hoarding of dollars that has taken place.*

Foreign countries have accumulated dollar balances in the past either because they anticipated an adverse balance with the United States or because they could always obtain other currencies with dollars since other countries had or anticipated adverse balances with the United States. To the extent that the Fund succeeds in promoting a better balance in international transactions the desire to hold dollars or any other currencies will be less. The fact that other currencies can be obtained from the Fund when needed will also tend to diminish the holding of dollars.

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* Professor Williams thinks the Keynes plan avoided the mechanical difficulty of the Fund plan because enough dollars would be available to meet the maximum quota demands for dollars. As mentioned above this means that when dollars run out the quotas have also run out. Professor Williams' difficulties of key currencies, the fact that the United States might pay for her imports outside the Clearing Union, possible hoarding of dollars, etc. would be as important, or unimportant, in the Keynes plan as in the Fund plan.

Another reference to the Keynes plan says the quotas were much larger because Keynes intended the Union to be used for relief and reconstruction purposes and for the settlement of war balances. But Keynes simply said that additional bancor credits might be given for these purposes.

There are also references (pp. 43, 50) to the gold standard which imply that somehow we would be better off under the gold standard without the Fund plan. This seems inconsistent with Professor Williams' earlier position that both the Keynes and White plans were essentially gold standard plans. The references appear to be misleading since under the Fund plan gold could be used as freely as ever for the settlement of international balances and countries not only would continue to accept gold without question but may be required by the Fund to supply their currencies in exchange for gold. Furthermore, under the gold standard loans have always been made from one country to another. The Fund would perhaps increase the total amount of international lending, and would certainly see that loans were forthcoming to those in need at reasonable rates. But the gold standard mechanism of gold flows would continue to operate and whatever tendency there is in the mechanism toward an even balance position would not be substantially interfered with by short-term loans of the type the Fund is designed to make.

3. Even if we assume that the desire to hold dollars is not diminished under the Fund plan, there is little reason to expect that foreign countries will be able to accumulate dollars in large amounts for some time to come. To go back to our hypothetical example, the Latin American countries will not be able to accumulate dollars year after year unless they not only have a favorable balance with the United States but with the world as a whole (or unless they convert gold or other foreign exchange reserves into dollars). They can not accumulate dollars as a result of trade with the United States and continue to finance deficits with other countries through the Fund. First of all half of any increase in their dollar balances would have to be used to repay their borrowings from the Fund, or at the outset, for most countries, to bring their gold and dollar contributions up to 25 per cent of their quotas even if they have not been borrowing from the Fund. More important, the Fund can not be used to finance a large or sustained outflow of capital, and any country accumulating large foreign balances and borrowing from the Fund at the same time would be doing just that. In substance, then, the fear that a large demand for dollars arising from a desire to hoard dollars will exhaust the dollars in the Fund is based on an unstated assumption that several countries with large favorable balances with the United States also have large favorable balances with the world as a whole. This is not a very realistic assumption. Most people believe that there is more possibility of a shortage of dollars coming about as a result of huge foreign demands for goods and equipment. Even if relief and reconstruction needs are financed on a permanent or long run basis and loans are forthcoming for industrial development programs it is very doubtful if many countries will have large favorable balances with the world as a whole for some time to come.

II. The Functions of the Fund

I shall not comment at length on some of the other criticisms of the Fund plan in Professor Williams' article because they are restatements of positions already widely discussed. A few comments on specific points follow.

1. Professor Williams says that it has now been recognized that the Fund can not finance relief and reconstruction needs, or assist in liquidating war balances. Also it is provided that members can maintain controls in the transition period. Professor Williams wonders then what the functions of the Fund in the transition period are. The answer, I think, is quite clear. 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 payment difficulties are bound to arise in the course of adjustments to wartime shifts in production and transportation and markets. For this reason

there is need immediately after the war, not only for an international agreement to stabilize exchange rates and looking toward the removal of exchange controls, but for a fund of credits to meet temporary difficulties.

2. Professor Williams thinks that the present Fund plan provides for adequate exchange flexibility which he felt that neither of the earlier plans did. But Professor Williams says even if the actual Fund provisions are reasonable he doubts that they can be administered properly because of the fundamental difference in attitude which he says exists as between British and American authorities and proponents of the plan. I wonder if these differences are not much more important from a political point of view than in a real sense. As Professor Williams says, sterling is a key currency and Britain operates as an important banking and exchange center for the world as a whole. Although the British fear the absolute power of an international body to refuse a change in the sterling rate should England again be in the position similar to that in the early 'thirties, nevertheless 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 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. Another main criticism of Professor Williams which he reiterates in the October article is that there is no general need for foreign exchange in view of the fact that many countries have large gold or dollar balances. It is true as Professor Williams says that many countries have much larger reserves of gold and dollar balances in terms of post-1934 dollars than they have ever had before. But these reserves continue to be unevenly distributed. According to confidential estimates of gold and dollar balances as of the end of March 1944 there are many countries whose reserves are inadequate from the point of view of being able to meet a probable deficit in their balances of payments. Of the 44 original members of the Fund, 5 countries 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 approximately 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 are in a position to meet probable deficits by exporting gold without fear of the effect on their total reserve position. This is all the more clear if account is taken of the fact that most countries have a large percentage of their reserves tied up in meeting internal reserve requirements.

If a country facing the development of a deficit in its balance of payments is unwilling to use its reserves and takes steps to eliminate the deficit there may be domestic deflationary consequences or restrictions on international trade which may in the long run turn out to be unnecessary should the deficit prove to be only temporary. This is precisely