Folder Title:	United States Government Agencies - Varvaressos - Correspondence - Volume 2
Folder ID:	1071227
Series:	Liaison with external organizations, individuals, and United States government
Dates:	07/13/1948 - 12/15/1954
Fonds:	Central Files
ISAD Reference Code:	WB IBRD/IDA ADMCF-08
Digitized:	11/12/2021

VARVARESSOS - CORRES.

United States Government Agencies - Varvaressos - Correspondence - Volume 2

Varvaressos

Mr. John H. Adler

December 15, 1954

K. Varvaressos

"Direction of International Trade"

The suggested addition in Direction of International Trade of a column showing percentage changes in trade would not be of any particular value to us.

We make extensive use of the publication in the course of our work and consider it very valuable. The main inconvenience we find in the present form of compilation is that for a great number of countries there is no way of knowing in which monthly issue the annual or semi-annual figures, which are the ones we need most, are to be found, with the result that one has to look up several issues before obtaining the data desired. I realize, however, that it would not be easy to correct this inconvenience so long as the publication of trade statistics in several countries continues to be slow and irregular.

K.V.

cc: Messrs. Rist and Goor

K. Varvaressos/vch

Varvaressos
Mr. [illegible]
RG

July 1, 1954

TO: Mr. Robert L. Garner

FROM: K. Varvaressos

Attached herewith is a short summary of recent developments in the British economy which you may be interested to read.

It is an informal paper which will be sent to only a few people in the Bank to whom it may be useful. I handed copies to Mr. Black and Mr. Rist this morning.

K.V.

Attachment-1

cc: Mr. Iliff
Mr. Rist
Mr. Sommers
Mr. Mendels
Mr. Graves
Mr. Demuth
Mr. Gregh
Mr. Knapp
Mr. Cope
Mr. Rosen
Mr. Kamarck

Secret

December 1, 1948

Dear Mr. McCloy:

On several occasions you have expressed your concern about the present position of the Bank in the face of the uncertainties of the world situation. You also told me you would welcome my views and suggestions on the matter.

In the attached note I have tried to state frankly how I feel about the problems of the Bank. Your readiness to undertake responsibilities and the knowledge that the only consideration that counts with you is the interest of the Bank have encouraged me to make proposals which, by ordinary standards, might be considered too bold to be committed to paper.

Yours sincerely,

K. Varvaressos

December 1, 1948

Dear Mr. Garner:

Attached herewith you will find a note on some of the problems facing the Bank together with a copy of the covering letter to Mr. McCloy. This is a confidential communication made only to the President and yourself.

I hope some of the ideas contained in it may be found useful for the work of the Bank.

Yours sincerely,

K. Varvaressos

SOME SUGGESTIONS ON THE PRESENT PROBLEMS OF THE BANK

By: K. Varvaressos

During the last three years the uncertainties of the international situation forced the Bank to follow a cautious and tentative policy in developing its activities and determining the scale of its participation in the solution of post-war problems. Many of the assumptions on which the establishment of the Bank had been based failed to materialize and post-war difficulties proved far more intractable than had been anticipated when the Bank was entrusted with the task of contributing actively to post-war reconstruction and development. Some clarification of the international situation was necessary before final decisions could be made on the scope of the Bank's activities and the role the Bank could expect to play in the light of post-war realities.

With the enactment of ERP and the greater understanding of the difficulties which three years' experience has given us, many of the prevailing uncertainties are slowly being removed and a clearer picture of the nature of our post-war problems is gradually emerging. It may even be said that the situation has by now been stabilized to such an extent that no spectacular changes or unexpected developments are likely to take place in the next five or six years. For the Bank, this means that the period of waiting is coming to an end, and that important decisions will soon have to be made on the scope of the Bank's activities during the next decade.

In the last three years the Bank has laid solid foundations for its future work and has done all that could be expected from it under prevailing circumstances: (a) It has set up an organization capable of handling competently the tasks entrusted to it and has made good progress in familiarizing itself with the problems of its prospective borrowers. (b) It has arrived at agreed decisions on basic questions of policy. (c) It has made two successful sales of bonds on the American market. (d) It has granted loans to European countries which have filled a serious gap in existing financial facilities and have prevented a deterioration in the position of these countries. (e) It has made a good beginning in the granting of loans for development purposes.

Now, however, the organizational stage is over and the funds at hand are insufficient for further substantial loan commitments. At the same time the background of conditions against which the Bank will have to operate has become clearer and the needs that the Bank will be called upon to meet have by now become fairly well known.

Finally, there is no likelihood of a further marked improvement in the world situation during the next few years that would by itself remove the difficulties at present facing the Bank.

This means that if the Bank is to continue justifying its existence, it can no longer wait for more favorable outside developments but must determine the scope and scale of its activities in the light of existing conditions. These activities must bear some relation to the size of the world's requirements for reconstruction and development, for while it is true that the Bank was created to meet a long-term need rather than an emergency, it is also true that the needs of the emergency are at present being adequately taken care of and consequently the Bank's failure to act on a substantial scale during the coming years could not be justified on the ground that the existing needs were outside the field of competence of the Bank, even less on the ground that world conditions were not yet propitious enough for the Bank's activities.

Technical assistance, studies, missions, small projects, are all highly useful and important, but unless countries are able to receive financial assistance which will make a difference to their position they will in the end tire of merely discussing their problems with the Bank's staff and listening to criticisms and exhortations. Wisdom lies in anticipating events and making sure that one will not be caught unprepared by developments that could have been foreseen. If the Bank wishes to retain its importance as an agency which has a substantial contribution to make to the solution of post-war problems, it must see to it that its lending activities during the coming years are of sufficient size to justify its present setup and uphold its authority towards member countries.

1. <u>The Scale of the Bank's Operations During the Coming Years</u>.

The world's needs for both reconstruction and development are great. To what extent can they be met by the Bank?

In the case of European reconstruction, the following considerations should be taken into account:

(a) ECA is today meeting Europe's current needs for food and raw materials, and is in addition supplying equipment for the improvement of European productive capacity. The hope is that in three to four years' time this dependence on American aid will have been eliminated and European self-sufficiency restored. An examination of the economic position of the major European countries shows that this aim can be achieved only if a great expansion of production over present levels takes place during the next three to four years. Since the available resources of manpower and industrial capacity are at present fully utilized in most countries, the further expansion in production will depend principally on the size of new investment during the coming years. This is recognized in all European recovery programs which call for very large additions to existing productive capacity. Comparing these objectives with the present scale of investment one is bound to conclude that the latter falls considerably short of what is necessary for the restoration of European self-sufficiency. This means that while ECA assistance is today meeting the bulk of Europe's current needs, it is not large enough to ensure that the necessary increases in productive capacity will be made during the coming years or that imports of equipment from the United States will be as large as the modernization and reequipment of European industry require. Thus, there is scope for productive loans by the Bank that will fill this gap in the financing of European recovery. The ECA Congressional documents specifically mention the Bank as an important source of additional financial resources for European reconstruction.

(b) While Europe's investment needs are great, the Bank can undertake to finance only those projects which may be expected to make a direct contribution to the solution of Europe's balance of payments difficulties, either by increasing the ability to export or by reducing the need for imports, especially to or from the dollar area. Lending for less specific purposes might improve the general economic situation of the country concerned, but it would not create the margin out of which the loans could be serviced and repaid. The European dollar shortage is a phenomenon that will be with us as far as we can see in the future. This means that dollar loans, especially under the terms granted by the Bank, must be made with caution if they are not to involve unduly large risks.

(c) Even if these financial difficulties did not exist, the supply situation is unlikely to have permitted more than a partial satisfaction of Europe's needs in machinery and equipment. This factor would in itself have limited the scope of the Bank's activities in Europe, since productive projects of the type suitable for financing by the Bank require primarily the use or installation of new equipment and machinery.

The preceding considerations suggest that, while the Bank can and must contribute to European reconstruction, its participation will necessarily have to be confined to only certain types of productive projects within the limits set by the availability of equipment and the capacity of the countries to service and repay the loans. It is true that in theory there is no difference between financing imports of equipment and financing imports of other goods that would release resources for the production of equipment in the borrowing country itself. In both cases, an increase in productive capacity would take place. Thus, a loan to Britain that would enable her to keep at home machinery previously used to pay for imports of food would not differ from a loan that would finance machinery imports to Britain. In practice, the size of the loans that the Bank can safely make to Europe is too limited for such a method of financing, while the close scrutiny of the utilization of the proceeds which must be exercised by the Bank requires that the goods purchased with Bank funds be directly related to the execution of the productive project that is being financed. Thus, the Bank's contribution to European reconstruction is closely connected with the availability of American capital equipment for export. This does not mean that purchases of equipment could not be made in Europe as well, but Europe as a whole has a net deficiency of capital equipment and European demand is overwhelmingly concentrated on American equipment. The amounts that are likely to be obtainable in Europe probably represent a very small proportion of the needs that the Bank would be called upon to finance.

It is not possible to estimate the size of the lending activities that could be profitably undertaken by the Bank before making a detailed study of European investment plans and of the supply position for capital equipment in the United States and elsewhere. My personal impression is that the opportunities for Bank lending in Europe during the next four or five years are probably in the neighborhood of $200 million per annum.

Loans on such a scale would be within the possibilities of Europe to service and repay, and at the same time they would be substantial enough to make a decisive contribution to the solution of Europe's economic problem.

Assuming that the European investment plans take four years to be completed, the Bank's total contribution for European reconstruction would be less than $1 billion and would add less than $100 million per annum to Europe's debt service. This is a burden which Europe, in spite of its foreign exchange stringency, will be in a position to bear1/ especially since it is certain that obligations towards the Bank will have a higher priority in the allocation of foreign exchange than many other current needs, including the servicing of Governmental loans which could, in an emergency, be suspended. Nor can the earnest of European Governments to fulfil their obligations towards the Bank be seriously questioned. If anything, many of these Governments show an exaggerated caution in considering borrowing from the Bank. It cannot, therefore, be said that loans to Europe on such a scale would involve undue risks for the Bank. The only major risks are the risks of war or of a failure of Europe to recover, even partially. These, however, are risks which the Bank would be not merely justified but also required to undertake because it is precisely that type of risk that the Governmental guarantees (i.e. the bulk of the Bank's capital) were intended to meet.

On the other hand, financing on such a scale, although it would meet only part of Europe's need, would enable European countries to carry out some highly productive projects which would otherwise have had to be postponed or abandoned.

1/ The Paris Report has estimated total European exports to the Western Hemisphere at $4,000 million in 1951 and total imports at $7,200 million. Compared with these sums, the problem of servicing Bank loans would be manageable.

When compared to the billions of dollars required to support Europe, a sum of $200 million may at first sight appear too small to make much difference to European recovery. But one must bear in mind that these billions are spent primarily on current needs, which means that they only serve to buy time until Europe has made the necessary adjustments in her economy, including the expansion in her production, that will restore her self-sufficiency. It is my impression that ECA assistance for the purchase of machinery and equipment is unlikely to exceed $500 million per annum during the coming years. Present plans envisage larger expenditures on such items, but experience shows that the needs for food and raw materials are always underestimated in official plans and always end by absorbing a larger share of expenditures than was originally intended. If this is so, the addition of another $200 million worth of equipment from Bank sources would represent a very considerable contribution to the European reconstruction effort. At the same time the careful selection and supervision which both the Bank and the European Governments are certain to exercise over projects to be financed with Bank loans might result in increases in output exceptionally large in relation to the sums spent.

Without attaching too great importance to the figure of $200 million itself, I believe that as an order of magnitude it probably represents what the Bank could safely invest in Europe during the coming years.

As regards the needs of other regions, the following considerations should be taken into account:

(a) The most important of these regions is Latin America with its underdeveloped resources and its keen desire for economic betterment. The significance and driving force of that desire should not be underestimated. It arises from a complexity of factors such as the proximity of the United States, the wealth of natural resources in the region, and so on. The most important factor, however, is, in my view, the growing discontent of the masses with the conditions of degrading poverty to which they are condemned to live and their determination to achieve an improvement, if necessary at the expense of the more privileged classes. Faced with such an explosive situation, the latter see in expanded production and higher productivity, achieved with outside assistance, the only answer that would raise the standard of living of the masses without depriving the wealthy of their privileges. This explains why the clamor for foreign help to develop the resources of these regions comes principally from those classes which at first sight seem to have least to gain from it.

There can be no question that there are great opportunities for economic development in these regions. Nor should it be forgotten that progress during the last decade has been real and in some cases spectacular. There is no stagnation or lethargy in Latin America. In earlier years the development of the region's resources was principally the work of private foreign investors. It is estimated that in 1938 foreign investments in Latin America exceeded $10 billion and represented some 20 per cent of the world's foreign investments (including investments in colonies). The contribution of foreign capital to the opening up of the region cannot be exaggerated, but at the same time it must be recognized that the development of the region's resources by foreign capitalists was haphazard and one-sided, and was often costly and wasteful, as a result of which it has left a legacy of hostility and antagonism to foreign capital that is today proving one of the main factors impeding the inflow of foreign capital in that region. During the 1930's, when foreign investments fell sharply, the Governments began taking an active part in the promotion of development schemes and some important projects were carried out with local resources. Since, however, savings could not be attracted in such investments and taxes on those who could bear them were inadequate, the result of

Government spending on development schemes was to intensify inflationary pressures which are endemic in Latin American countries. Thus, efforts of development intended to raise the standard of living of the population in practice ended in more social inequality and greater economic instability than before. During the war the great demand for Latin American exports and the shortage of imports resulted in great accumulations of foreign exchange resources, a large part of which were expected to be used for the financing of development schemes. In fact, only a small proportion of these foreign exchange resources was used for investment purposes; the bulk went to purchase goods for current consumption for which there is a virtually insatiable demand in these inflation-ridden countries.

Meanwhile, new and more ambitious development plans have been formulated, and Governments which have pledged themselves to carry them out are faced with a difficult situation: they dare not aggravate internal conditions by resorting to inflationary spending and their foreign exchange resources have by now been exhausted. This is why they look to foreign assistance as the only way out.

I believe it would be dangerous to underestimate the existing dissatisfaction or the extent to which Governments have committed themselves to bring about an improvement in their countries' economic conditions. Foreign assistance to these countries is an urgent need. I also think that there is great scope for the investment of foreign funds in Latin America, because the region has vast resources which await to be rationally exploited. The region is particularly suited for Bank loans, since its primary need is to develop basic facilities such as transportation, power, agriculture, for which private financing is not available.

On the other hand, it is certain that development cannot take place at the pace which these countries envisage. Their plans, which run into billions of dollars, bear little relation to what these countries are in fact capable of doing in this field. Large increases in production and productivity cannot be achieved merely by importing foreign capital and equipment. Efficient and honest administration, education, technical and organizational skill and financial stability are equally, if not more, important than the availability of equipment. There is no example of a country having raised its standard of living merely through foreign borrowing. On the contrary, all the existing evidence shows that the greatest material progress has been made by countries which have relied primarily on their own resources and their own work.

My conclusion is that, while the Bank must respond without too much delay to Latin American requests for financial assistance, the scale of its operations in that region must be limited to what can be usefully absorbed with good prospects of repayment. This, in my view, means that only a fraction of the projects at present contemplated are suitable for Bank financing. As in the case of Europe, only after a detailed study and investigation of the region's needs and possibilities would it be possible to determine the scale of lending that could be undertaken by the Bank in the region, but here again I shall venture a guess and suggest that $300 million per annum probably represents the upper limit of what the region can absorb, at least in the near future. Such a figure would probably shock Latin Americans who are thinking in terms of billions, but in my view, loans of that size flowing regularly to the region and financing the importation of machinery and equipment should be able to make a very important contribution to the development of the region's resources.

(b) Asia, including the Far East, is another region where the need for foreign investment is great and urgent, both for reconstruction and for development purposes. Here again the Bank can meet only part of the need, not only because the absorptive capacity of the region is still smaller than in the case of Latin America, but also because the political uncertainties are much greater than in Latin America. In certain parts the political and social situation is such that there can be no question of any Bank lending.

(c) Eastern Europe presents a different problem. It is probably one of the regions of the world where Bank funds would be most effectively used and would serve not only the region itself but the whole European economy. For the time being political considerations do not allow any substantial Bank lending to the region, but the Bank should keep in mind that the present political tensions, which are engineered in Moscow, may suddenly ease if Moscow decides that it is time to be more sensible. In that case, the Bank would have no justification in refusing to grant the loans so eagerly awaited by Eastern European countries. This means that in considering the world requirements for Bank financing during the coming years the eventual needs of Eastern Europe must also be taken into account.

Allowing another $100 million for Asia, Eastern Europe and the remaining regions of the world, we reach the conclusion that the scale of operations which the Bank should have aimed at if its financial resources were unconditionally available to it would have been of the order of $500-$600 million per annum. This, I think, is probably the maximum that could have been invested with good results and good prospects of repayment. More optimistic estimates made earlier in the Bank's career which assumed that Bank financing would exceed one billion dollars per annum disregarded both the seriousness and permanence of the world's dollar shortage and the obligation imposed by the Articles of Agreement on the Bank to grant loans only when the prospects of servicing and repayment were reasonably good.

It is clear, however, that even the lower figure of $500 million per annum estimated here greatly exceeds the present possibilities of the Bank. With less than $500 million of liquid funds at hand, the Bank can hardly enter into any large commitment for foreign loans unless it is able to raise additional capital in the market.

Thus, the extent to which the Bank can meet the world's needs for reconstruction and development depends primarily on the prospect of obtaining funds in the American market. The question that arises is: should the Bank wait until conditions for new sales of bonds are favorable or should it seek to make sure that it will be able to get the funds it needs whatever the conditions of the market. In the first case, there can be no question of planning the Bank's scale of operations for the coming years. These will depend on the reactions of the market to the Bank's bonds, which cannot be foreseen. Lending by the Bank may continue to be negligible for several years if developments in the market prove unfavorable or it may become substantial if market conditions improve. In the second case the Bank will be able to determine itself the scale of its operations and ensure that they are commensurate with its character as an international institution entrusted with a major responsibility in the field of international investment.

There can be little doubt, in my view, that the second course is the only one that will preserve the prestige and authority of the Bank. The question is, how can the Bank secure the collaboration of the market in planning its future activities.

2. <u>The Raising of Funds on the American Market</u>.

It is necessary to keep in mind that those who took the initiative in establishing the Bank had a quite different situation in mind from that which has arisen since the Bank began its operations. It was never envisaged that the Bank would have any difficulty with the problem of raising funds. It was universally believed (even by the market itself, which showed considerable apprehension on that score at the time) that the 100 per cent guarantee would confer on the Bank's bonds an exceptional attractiveness which would make the raising of funds a quasi-automatic process. It was also thought that the Bank would be able to obtain money at the lowest rates prevailing on the market and certainly not higher than those on U.S.A. Government bonds. It was precisely because very low interest rates were expected that the idea of making an additional charge as guarantee occurred. I remember that in all the discussions on the matter the argument was recurring that Bank loans would be so cheap that countries who would be taking advantage of such favorable conditions of lending could well afford to make a contribution that would help to reduce the burden which member Governments were undertaking in granting their guarantee. The object of giving to the capital of the Bank the form of a Government guarantee rather than of Government-contributed funds was to avoid the immobilization of large funds in the Bank and at the same time to offer an opportunity for good investment to the saving public. There was never the slightest doubt that the Bank's money was public money or that the institution was anything but an inter-governmental institution entrusted with the carrying out of the policies of member Governments in the field of foreign investment. I am sure that the idea that the Bank's operations would in any way depend on the opinion of the market about the soundness or otherwise of the Bank's lending activities never crossed the minds of those who proposed the establishment of the Bank. It was precisely because it was recognized at an early date that the private investor would be unwilling to risk his money on loans to foreign Governments which would be struggling with post-war difficulties that the establishment of an International Bank was considered necessary to assist post-war reconstruction. (Incidentally, the emphasis was originally on reconstruction. Development was added later as an afterthought.)

Unfortunately, the course of events has been entirely different from what had been expected. The market took the view that the Bank's bonds, in spite of the guarantee, were far from riskless and were certainly inferior to U.S.A. Government securities. The Bank itself at the beginning of its existence thought that it would gain the confidence of the market if it stressed the soundness of its policies rather than the importance of its guarantee. This was an ambitious conception which assumed that the Bank could hold its own without the need for Government support, and it has certainly proved overoptimistic in the light of our post-war realities. Although subsequently abandoned, this initial effort to establish the Bank as an ordinary lending institution in the consciousness of the market has not been without effect on the market's attitude towards the Bank's bonds. The result of these developments has been that the Bank has had only limited success in raising funds in the market and would probably have met with considerable difficulties if it had approached the market for further sales.

This reluctance to lend to the Bank is not absolute, but is only relative to the rate of interest offered by the Bank. I have no doubt that at higher rates of interest the Bank's bonds would have been attractive enough to find buyers. In practice, however, the Bank has gone to the limit of what could be offered without making its loans prohibitive to borrowing countries. Thus, this relative reluctance to buy Bank bonds is for practical purposes an absolute reluctance which only changes in market conditions or in the attitude of investors can overcome.

I am not familiar enough with the conditions of the American market to be able to appraise the present trends and the chances of new bond sales by the Bank in the near future. It is, however, my impression that, as matters stand, even if market conditions ease sufficiently during the coming months to make a new issue of bonds possible, the sums that will be obtained will be relatively small and there will be no assurance that the Bank will be able to make the regular sales of bonds which will be necessary if it is to develop a substantial program of operations during the coming years. I think, therefore, that merely to wait for more favorable market conditions may postpone indefinitely the time when the Bank will be able to play a role in the world economy commensurate with its responsibilities.

Is there an alternative to waiting? I think there is.

The Bank's dependence on the attitude of the investment channels is a fact which may be deplored but cannot be changed. That attitude in turn cannot be expected to change radically so long as the present tensions and uncertainties exist in the world and high levels of economic activity are maintained in the United States. Even though a rate of investment of $500 million per annum represents, in my opinion, what the world can fruitfully absorb with reasonable prospects of servicing and repayment of the loans, it would be illusory for the Bank to expect that it could obtain in the market the funds necessary for such a scale of activities. The first thing which the Bank must therefore do is to recognize that for many years to come it will be able to satisfy only part of the needs which it was created to meet.

If, however, there is an upper limit to the Bank's activities determined by the world's capacity to borrow dollars, there is also a lower limit below which the Bank's scale of operations should not be allowed to fall if the Bank is to retain the respect and consideration of its members. I believe that operations of $200 to $300 million per annum, although they would fall far short of what the Bank could have done if it had not depended on the market, would be large enough to contribute substantially to world reconstruction and development and at the same time safeguard the Bank's prestige and justify its present setup. Anything less, however, would, in my view, seriously harm the Bank and deprive it of its importance and influence in the world, because anything less than this minimum sum would not even touch the fringe of the world's needs. It is even doubtful that prospective borrowers will in the end be willing to go through the long and tedious process of negotiation and supervision for what will necessarily be very small and inconsequential loans. In that case there is the danger that the Bank would end by becoming just another over-staffed agency whose existence is barely tolerated by member Governments.

I think, therefore, that the Bank must in the near future decide on a limited but useful program that will take care of the world's most urgent needs for international loans. Having made such a decision, it will then have to secure the collaboration of the market for the raising of the necessary funds.

Until now, the Bank's approach to the investment channels has been made in general terms. The Bank has stressed its determination to make sound and productive loans and has declared itself eager to maintain close cooperation with the market. It has avoided, however, and quite rightly, to make any more specific commitments to the market. So long as the expectation could be entertained that market conditions would improve in the near future, the Bank would not have been justified in making commitments that would have restricted its freedom of action. Now, however, the paramount consideration must be to raise funds, and commitments which appeared unjustified last year may prove the only way of securing the proper functioning of the Bank in the coming years. I have in mind a new and more concrete approach to the market which might succeed in allaying the latter's fears and ensuring a more active cooperation on its part. The Bank should start by stating that in the world of today the scope of its activities is necessarily limited and that, having recognized this, it will not in the next five to ten years aim at a scale of operations exceeding, say, \$200-\$300 million per annum. It should further stress that within this limit it will seek to finance the most productive among the projects submitted to it and those for which the prospects of repayment are best. It should point out that, however short of dollars, the world can well afford to service loans of such moderate size. Finally, it should point out that such a policy of restricted activities would in fact fully concede the request heard last year in the market, that the Bank's borrowing capacity be limited to the size of the United States guarantee: under such a program it will be more than ten years before the United States guarantee is reached.

A commitment of this kind may decisively affect the attitude of the market towards the Bank's bonds. One of the chief causes for the distrust shown by the market during the last two years is that the American guarantee, the only one which under present conditions the market is prepared to consider seriously, covers only 40 per cent of the Bank's borrowing capacity. This means that, were the Bank some day to succeed in by-passing the investment channels and borrow in excess of the American guarantee, it would thereby be impairing the security of all its bonds, including those sold before the American guarantee was reached. The conclusion was that, so long as the Bank's borrowing capacity exceeds the American guarantee, the value of the Bank's over-all guarantee should be viewed with caution, if not suspicion. Last year it was still too early to concede this request for what amounts to a reduction in the Bank's capital. Next year such a concession may be no more than a recognition of hard realities.

It is almost unthinkable that the market would refuse to cooperate even on such a limited program. It is the duty of the Bank to point out that such a refusal would be against the best interests not only of the American nation in general but also of the private investors themselves. The United States occupies today a unique position in the world. Its huge productive capacity, which nearly doubled during the war, exceeds in many important lines the normal peace-time requirements of the nation. Exports of equipment financed by loans will in the long run be essential to maintain stability in the American economy. The only alternative, barring a depression which the American people do not seem in a mood to tolerate, is more Government spending on public works, involving increased Government intervention in the economy and increased Government ownership of means of production. This is a prospect which can hardly appeal to the capital market. The International Bank offers the best, if not the only hope, that the genuine export surplus of the United States will be canalized where it can best be used from the point of view of both borrower and investor. By undertaking the risks inherent in foreign investment it promises good returns with security. By promoting productive projects it promises to create important outlets for the American heavy industry which is certain to find itself over-expanded when internal demand and ECA spending taper off and when European production revives. By concentrating on the improvement of basic facilities in underdeveloped countries the Bank will help to render attractive many opportunities for direct investments which today appear unprofitable due to the lack of such facilities. (The exploitation of Brazil's rich iron ore deposits which is held up by lack of transportation and port facilities is an illustration.) Finally, being established on an international basis, the Bank has the unique advantage that it is able to rely on the cooperation of the borrowers and develop their sense of responsibility. This greatly minimizes the risk of wasteful utilization of the Bank's funds and of wilful defaulting. As things now stand, an uncooperative attitude on the part of the American market would make the Bank's failure inevitable. It would be folly for the market to destroy an instrument which is certain to serve well the interests of the American investor. But it would also be an act of irresponsibility from the point of view of the more general American interests. Post-war events have thrown on the United States the heavy responsibility of international leadership in a world which is rent by violence and conflict. Communism is on the move. It finds its allies in the teeming millions who for centuries had accepted hunger and privation as acts of God, but who today are determined to improve their lot, if necessary by force. The improvement can be made without violence or upheavals if these countries are assisted to increase their technical knowledge and develop their resources. For such assistance they look primarily to the United States. I am not among those who believe that the United States should spend indiscriminately millions of dollars on countries threatened by Communism. On the contrary, I feel that too much may already have been spent in such a way with too little effect. But I do think that by assisting these regions to develop their productive resources and raise the appallingly low living standards, the United States can effectively meet the challenge of Communism where political and social conditions have not deteriorated beyond repair. I also think that the International Bank is the best instrument through which that assistance can in the long run be provided, because the Bank will be able to canalize what is really a surplus available for investment to the regions which promise to take best advantage of it and will be able to do so in a sustained and continuous way, without being subjected to political blackmail or having to take into account considerations of short-term expediency.

It seems reasonable to assume that the market will respond favorably to such an approach by the Bank. It is true that from the point of view of the Bank itself the decision to undertake such a commitment towards the market would be a momentous one and should be carefully weighed before it is finally made.

Many will argue: Why make such a commitment? Is it not better to wait rather than restrict the Bank's future freedom of action? What will be the position of the Bank if in, say, three or four years' time market conditions improve beyond present expectations or if the Bank is by then able to by-pass the investment channels and address itself to the general public? Would not the commitments made prove galling and would it not be said that the decision to make them was unwise?

My answer to this argument is that time is running short for the Bank and that something will have to be done soon. There is a strong case for not entering into commitments towards the market if the Bank can reasonably expect that by next spring or early summer at the latest it will be able to raise some \$200-\$300 million on the market. In that case the Bank could develop a substantial program during the coming year and assume that it will be able to continue raising funds on the same scale in the following years. If, however, the market proves unreceptive to new bond sales, the position of the Bank may become impossible by the middle of next year. Impatience is already evident. One dreads to think of another Annual Meeting where the long-term character of the Bank is stressed amid an embarrassed silence. Some might say that the present funds at the disposal of the Bank would be sufficient to begin substantial operations and wait until next year for more favorable market conditions. I think this would be a most unwise thing to do. These funds represent the necessary degree of liquidity for the Bank. Without them the Bank's position in the market would deteriorate still further and its chances of raising money would become very remote indeed.

I think that in the next few months it should be possible for the Bank to ascertain market prospects for the coming year. If they are found to be unfavorable, the only alternative to an approach along the lines suggested here would be to reconcile oneself to the fact that the Bank will have to be kept in a dormant state until market conditions improve. Many would say that there is nothing so terrible about this. One day conditions in the market will change and there will always be eager clients for the Bank's loans; no harm will be done to the Bank by waiting. I cannot agree with this view. International institutions, like living organisms, must function if they are to grow and retain their health. They cannot, like merchandise, be kept in cold storage and be brought out again when market conditions are favorable. A period of protracted inactivity is certain, in my view, to prove fatal to the Bank.

Another difficulty that may have to be faced if a decision along the lines suggested here is made, is the reaction of prospective borrowers to such a restricted plan of activities. The countries which have been relying on the Bank to finance large projects are certain to be shocked by the limited scope of operations envisaged by the Bank for the coming years. I think, however, that it would not be difficult to persuade these countries that the object of the Bank in proposing such a plan is to serve and not to disregard their interests. I doubt that the Governments of these countries would undertake the responsibility to oppose the plan when they realize that the only alternative to getting so little might be getting nothing for many more years.

Assuming that the scale of operations of the Bank is decided upon on some such lines, the next step for the Bank would be to determine how the funds which will be expected to be available should be spent. The Bank will have to approach this question on many fronts.

(a) The first thing is to inform prospective borrowers, both those who have submitted applications and those who intend to do so in the future, that the scale of operations contemplated by the Bank for the coming years will allow only limited help to individual countries and will require the postponement of all save the most urgent and productive among the projects envisaged. Countries should therefore be asked to concentrate their attention on such projects, speed up the technical studies required and be ready to negotiate with the Bank on the terms under which Bank financing will be granted. It should at the same time be pointed out to them that the Bank plans a sustained level of activities for the coming years and that consequently, they must think in terms of a series of small loans spread over a number of years rather than of a sizeable loan granted at the outset. At the same time there is no reason why the Bank should not commit itself to the financing of larger projects over a period of years, subject to the qualification that the utilization of the Bank's funds is satisfactory and the conditions agreed to are kept.

(b) The Bank should not wait for a revision of loan applications before it maps out its plan of activities during the coming years. On the basis of the existing loan applications and of the studies made of the various regions' problems and requirements it should be possible to formulate a general program and decide which among the existing and prospective projects are likely to make the greatest contribution to the world economy as a whole. This work, which should be undertaken soon and completed in as short a period of time as possible, would provide the background against which to judge the significance of projects proposed by the various countries.

(c) Furthermore, if the activities of the Bank are to add up to a coherent whole and not to consist of a series of isolated small loans, it will no longer be sufficient to examine loan applications on their own merits alone. It will also be necessary to compare the projects to each other and determine their relative importance and urgency. Many projects, which would have qualified for Bank financing if the funds at the disposal of the Bank had been larger, are certain to fail to meet this test of relative importance. Such projects would have to be rejected not because they would not be sound in themselves, but because other projects would be more important. A project, for instance, for the improvement of passenger transportation in a Latin American city, however worthwhile in itself, would have no place in a program of Bank activities aiming to make the best use of loanable funds not exceeding, say, \$200-\$300 million per annum.

This is the conception of strategic lending already outlined by the President of the Bank, but its practical application will require some radical changes in the approach of the Bank's staff to the study of loan projects.

Finally, a considerable speeding up of the processing of loans will be necessary if the scale of operations envisaged here is to be achieved.

(d) In terms of goods a program of the type envisaged here is certain to involve almost exclusively equipment and machinery. The Bank would be greatly assisted in planning its operations if it had a clearer picture of the present and prospective availabilities of such goods. If an investigation into the supply position is possible it should, in my view, be undertaken by the Bank. Such an investigation would enable the Bank to relate its program to physical availabilities and prevent delays and frustrations in the execution of Bank-financed projects. Such an investigation would automatically disqualify from Bank financing those projects for which the necessary equipment is likely to be unobtainable. If, moreover, it reveals the existence of a very tight supply situation in items which are essential to the carrying out of productive projects, it would strengthen the Bank's case for a limited program of operations in the coming years, since it is the duty of the Bank to abstain from creating additional demand for scarce items whose only effect will be to push prices up. Personally, I doubt that the supply situation will be found to be a limiting factor in operations of the scale envisaged here, but it would be useful to know what the exact position is.

Acting along such lines, the Bank should, by next spring, be able to present its members with a modest but valuable program of operations which will demonstrate to them the Bank's desire to do its utmost to help them and its determination to make itself useful now and not merely in the more distant future.

There are some further problems which must receive the attention of the Bank in the coming months.

The financing of European reconstruction projects must play a predominant part in the activities of the Bank during the coming years, since the restoration of equilibrium in the European economy is an essential prerequisite for the restoration of equilibrium in the whole world economy. It is, however, conceivable that European countries may show themselves reluctant to borrow from the Bank in order to finance specific productive projects. Such a reluctance may arise from the following causes: (a) In spite of ambitious investment plans, European countries fear the inflationary consequences of devoting too large a share of their resources to reconstruction. They may, therefore, decide to postpone many of the schemes to which, on paper, they have committed themselves. Bank loans which would finance only the foreign exchange expenditure of such projects may be found of little help in this matter because they would have to be matched by substantial internal expenditures. (b) So long as the hope exists that ECA aid will meet more or less adequately European needs, there may be no hurry to incur debts towards the Bank. The fact that the ECA program is due for reexamination by what is hoped will prove a more generous Congress may add to the inclination to wait before deciding on borrowing from the Bank. (c) European countries are genuinely concerned about the terms of the Bank's loans and may feel that the burdens involved will be beyond their capacity to bear.

What should the Bank do if, as a result of such considerations, there is no response from Europe to the invitation to submit specific projects for Bank financing. I think that the Bank should keep in close touch with ECA and try to demonstrate to European countries that it is in their interest to avail themselves of the facilities placed at their disposal by the Bank, since it is obviously unrealistic to expect that ECA assistance can take care of all their needs. ECA should also point out to them that investment plans must be carried out if recovery is to be achieved by 1952.

It is clear, however, that there can be no question of exercising any pressure on European countries to borrow from the Bank. If their reluctance to borrow from the Bank is found to be based not merely on exaggerated hopes of cheaper assistance but on a real fear of future inability to service and repay the loans, the Bank should recognize that the conditions for assisting European reconstruction do not exist and should concentrate its efforts on meeting the needs of underdeveloped countries which are too eager to improve their economic position to have any inhibitions about future difficulties of repayment. (This does not mean of course that the Bank should lend to them indiscriminately. The existence of ability to repay is an essential condition for all Bank loans.)

In this connection, however, it must be pointed out that the charges made by the Bank on its loans are unquestionably excessive in relation to the world's ability to borrow dollar capital. When the Bank was established, it was hoped that the rate of interest on Bank bonds would be extremely low. As already stated, the idea of an additional charge as guarantee occurred precisely because it was expected that there would be a margin for levying such a charge. Nor had the intensity of the world's dollar shortage been fully anticipated. In the light of developments during the last three years I think that there is a strong case for reconsidering our attitude towards the guarantee. As matters stand today, the guarantee adds considerably to the burden of the borrower without in the least strengthening the position of the Bank. Nor is it reasonable to think that the levying of this charge is a factor which increases the confidence of the market in the Bank's securities. The market people are too intelligent and practical to believe that additional obligations on weak borrowers improve the standing of the lender. As already stated, the main justification for introducing the concept of the guarantee was to reduce the burden on Governments of eventual defaults by Bank borrowers. I think that the limited activities of the Bank and the size of the burdens undertaken since the end of the war by the main guarantor country, namely the United States, raise the question of whether it would be wise under present conditions to maintain an arrangement which frightens the most responsible of prospective borrowers and may prove a serious handicap to the Bank when its program of operations gets under way.

A last question to which some attention should be given in the coming months is the extent to which the Bank could contribute to promote a larger flow of direct investments to the underdeveloped regions of the world.

The private investor is at a great disadvantage when he considers investing his money in a foreign country and this is true not only of individuals but also of companies. Even the largest of companies may sometimes be inadequately informed on the general situation prevailing in a foreign country and may not have access to all the facts necessary to appraise future developments that may affect its investments. Nor can it always have the advantage of expert and unbiased opinion on questions that bear directly on its field of activity. This is one of the causes why investment in foreign countries is today considered such a risky and unrewarding enterprise.

The Bank could, in agreement with the investment channels and the interested countries themselves, undertake to provide objective and well-documented information and to contribute its own unprejudiced appraisal of the prospects of the foreign country's economy and even of the investment project itself. If the Bank undertakes this activity in a systematic way and makes a competent job of it, it might become a clearing house for information needed by private investors and a center for consultation and advice.

The Bank can further take the initiative in suggesting to both investors and foreign countries principles of behavior that would ensure the fair treatment of the legitimate interests of both parties, and lead to the establishment of a new sense of responsibility in both creditors and debtors.

Finally, the Bank could aim at eventually taking a more active part in the operations of private companies in foreign countries by supplementing their financial resources whenever these are found inadequate for the carrying out of useful projects. The Bank could do this through purchases of bonds of these companies that would be guaranteed by the Government of the country or other similar arrangements. Such a financial contribution by the Bank to private undertakings might in some cases prove the most effective way of assisting a foreign country's development because it would help to combine the advantages of private initiative and efficiency with the safeguards to the public interest afforded by Government participation in and supervision of the project.

If the response of investors and borrowers to such an initiative by the Bank is favorable it will in the long run be necessary for the Bank to establish a separate department for the handling of all the problems connected with this field of activity.

I think that the Bank can effectively contribute to the removal of obstacles impeding the flow of private capital to underdeveloped countries because it combines two characteristics which seldom go together: as an international institution established by Governments it is concerned with the general interest and not with particular interests; as an independent lending agency which must see to it that its loans are repaid, it must conduct its operations on a strictly business basis and must remain uninfluenced by political and other considerations. It can, therefore, bring to bear on the problem of foreign private investment the objectivity of a disinterested party together with the resources of a large lending institution and might, if it is successful, contribute to break the vicious circle of high returns involving high risks and high risks calling for high returns which has bedevilled the relations between investors and borrowers during the last hundred years.

I have assumed until now that the Bank will be able to raise in the market the funds necessary to develop a program of substantial operations during the next few years. It is, however, conceivable that the market might for some more time show itself reluctant to absorb new issues of Bank bonds, in spite of any commitments that the Bank may be ready to make to it. Should the Bank in that case abandon the hope of playing a more active role in the immediate future?

I think that rather than passively admitting what would amount to a failure to fulfil its role, the Bank should make a further attempt to obtain the means necessary to carry out the tasks entrusted to it.

I believe that it would be the duty of the Bank to approach the United States Government and draw its attention to the situation which has been created as a result of the impossibility of raising funds in the market. If the United States Government feels that temporary difficulties should not be allowed to prevent the Bank from fulfilling its task, it has all the means to make funds available to the Bank. An additional and more clear-cut guarantee, temporary financial accommodation through some Government agency or similar measures would place the Bank in a position to begin operations until market conditions become more favorable. Such arrangements would not constitute a change in the character of the Bank; they would merely mean that the temporary inability of the Bank to raise funds in the market would not be allowed to paralyze the Bank's activities.

The final decision will, of course, rest with the American Government.

Personally, I consider it very unlikely that the American Government will not do its utmost to assist the Bank in carrying out its task. The United States took the initiative in the establishment of the Bank. More than any other agency, the Bank embodies American conceptions on international economic cooperation. A prolonged period of inactivity would be widely interpreted as an American failure and would raise serious doubts on the effectiveness of American conceptions of economic cooperation. The American Government knows from experience how difficult it is to make so many nations agree on a common program and how many difficult compromises must be made before an international agency is established. I feel sure that it would not want to see one of the most important among them lose its prestige and authority through merely temporary difficulties.

These are the conclusions I have reached after careful consideration of the problems facing the Bank. My main thesis is that the Bank cannot wait much longer to begin playing a more active role in the world if it is to retain its standing and fulfil the purposes for which it was established. This is the basic issue on which a decision must be made. If my contention is correct, then it follows that more active steps will soon have to be taken to get the Bank going.

I realize that many will find my approach too dogmatic and will maintain that the Bank can afford to wait for another year or two before determining the scope of its activities.

I repeat that in my opinion further delay is bound to prove harmful to the Bank. But I also want to warn against another view which has been expressed in some quarters, that the time for the Bank to act on a large scale will come with the American recession or depression, which these circles consider inevitable and which, according to them, is bound to release large financial and real resources for foreign investment. So long as the American economy is fully employed, these circles say, there will be very little scope for the Bank. I think this is a very erroneous interpretation of the Bank's position in the world. In the first place, the Bank was given a much more important task than merely to serve as a means of exporting American surpluses in times of depression. In the second place, there is no justification to expect a serious American depression. The American people have demonstrated beyond doubt that they are forward-looking enough not to repeat old errors. Oje! In the third place, it is by no means certain that an American depression would prove such a boon to foreign investment. If past experience is any guide, a depression in the United States, which would inevitably throw into confusion and disequilibrium the whole world economy, increases the distrust of investors and makes them less willing than ever to undertake the risks of lending to foreign countries, especially as these will be struggling with the difficulties created by the American depression itself. Finally, the present American international commitments and the rearmament program make it very probable that high levels of economic activity will be maintained for several more years.

Another consideration which must be taken into account is the effect of prolonged inactivity on the staff of the Bank. In my view, a lowering of morale is inevitable when an organization is satisfied merely to exist and loses its sense of purpose and mission. I think that this is one of the most serious dangers involved in a policy of waiting.

There is a last remark I should like to make. The effects of prolonged inactivity on the standing and prestige of the Bank will only gradually be felt and will not be clearly recognizable until it may be too late to retrieve the situation. Only by anticipating events will it be possible to prevent such a process of slow deterioration.

Washington, D. C. December 1, 1948

June 28, 1954

SUMMARY OF RECENT DEVELOPMENTS IN THE BRITISH ECONOMY

Internal Developments During 1953

The main characteristic of this period is an expansion in industrial production stimulated by larger expenditures on consumption, investment and defense.

The Economic Survey for 1954 estimates that personal incomes rose by 6 per cent during this period as a result of higher wage rates, larger employment, higher social benefits and higher dividends.1/ Disposable income rose by more, i.e. by 7 per cent due to income tax concessions. Since retail prices rose by about 3 per cent, real disposable income increased by some 4 per cent and was accompanied by a corresponding increase in personal consumption. The increase in consumption was greatest in the case of household goods and motoring:

£ Million
Consumer Expenditures

	At Current Prices		At 1948 Prices			
	1952	1953	1952	1953	Increase	
Food	3,236	3,549	2,377	2,484	107	4 %
Drink and tobacco	1,671	1,709	1,573	1,605	32	2 %
Rent, etc.	1,171	1,258	1,024	1,042	18	1.7%
Household goods	715	780	575	651	76	13 %
Clothing	1,017	1,026	837	858	21	2 %
Private motoring and travel)	2,593	2,707	564	622	58	10 %
Other)			1,584	1,609	25	1.5%
Total	10,403	11,029	8,534	8,871	337	3.9%

This was the first increase in consumption in three years. In both 1951 and 1952 consumption had been below the levels reached in 1950:

	Million £ at 1948 Prices
1949	8,535
1950	8,712
1951	8,645
1952	8,534
1953	8,871

1/ As follows:

	Million £			
	1952	1953	Increase	Per Cent Increase
Wages and salaries	8,155	8,630	+ 475	5.8
Other employee income	748	812	+ 64	8.5
Income of self employed	1,553	1,606	+ 53	3.3
Rent, dividend and interest	1,406	1,489	+ 83	6
Social benefits	910	1,000	+ 90	10
Total	12,772	13,537	+ 765	6
Less taxation, social security contributions, etc.	1,587	1,583	- 4	
Disposable income	11,185	11,954	+ 769	6.9

The Survey estimates that fixed investment increased by 10 per cent in 1953, with house building accounting for two-thirds of the increase:

	Million £ at 1952 Prices		
	1952	1953	Increase
Vehicles, ships and aircraft	267	315	48
Plant and machinery	790	800	10
New housing	485	620	135
Other building and works	518	540	22
	2,060	2,275	215

Again, this was the first increase since 1950. In the previous two years fixed investment was below the 1950 levels:

	Million £ at 1952 Prices
1949	1,977
1950	2,073
1951	2,050
1952	2,060
1953	2,275

The Economic Survey for 1953 had estimated that in 1952 there had been a decline in the volume of stocks of the order of £100 million compared with an increase of £465 million in 1951. The 1954 Survey states that revised estimates for 1952 suggest that no decline in stocks took place in 1952. In 1953, on the other hand, the volume of stocks is estimated to have increased by £170 million (at 1952 prices). Most of the increase is attributed to retail trade and especially to textiles.

Finally, Government spending, expressed in 1952 prices, increased by £110 million, mostly for defense. This was a much smaller increase than in the previous two years when Government spending had increased as follows:

	Million £		Per Cent Increase
	At Current Prices	At 1952 Prices	From Previous Year
1950	2,066	2,400	-
1951	2,442	2,585	7.5
1952	2,895	2,895	12
1953	3,098	3,005	3.7

Summing up these developments, we find that total real expenditure in 1953 increased by 5.5 per cent over the 1952 levels, with consumption and investment accounting for most of the increase:

National Expenditures

	Million £			
		1953		
	1952	At Current Prices	At 1952 Prices	Increase At 1952 Prices
Consumption	10,403	11,029	10,753	350
Fixed investment	2,060	2,312	2,275	215
Stocks	-	170	170	170
Government current spending	2,895	3,098	3,005	110
Total	15,358	16,609	16,203	845

These increases in real domestic expenditures were made possible (a) by an increase in domestic output estimated at £500 million (1952 prices), (b) by larger imports of goods and services estimated at £285 million (1952 prices), and (c) by smaller exports of goods and services estimated at £60 million (1952 prices).

The increases in the output of goods which took place during this period are illustrated in the following table:

	Per Cent Change Between 1952 and 1953
Manufacturing	6.9
Metals, engineering, vehicles	2.5
Chemicals	13.6
Textiles	15
Leather	10.4
Food	8
Drink and tobacco	0
Paper and printing	13
China and earthenware	- 1
Glass	6.6
Bricks, cement, etc.	5
Other	8.3
Mining and quarrying	0
Building and contracting	5.8
Gas, electricity, water	3.9

Agriculture 1/

	Per Cent Change	
	Between July 1951-June 1952 And July 1952-June 1953	Between July 1952-June 1953 And July 1953-June 1954 (Provisional)
Total (net)	+ 2.0	+ 2.6
Bread grains	0	15.6
Other grains	10.7	4.2
Potatoes	- 6.0	5.2
Sugar beet	- 6.6	24.3
Milk	2	4.8
Eggs	2	6.3
Beef and veal	- 5.5	3.9
Mutton and lamb	16.0	8.6
Pig meat	23.6	3.9

The Economic Survey of 1954 attributes the "bumper crops of wheat, barley, oats, potatoes and sugar beet" in 1953 "in part to exceptionally good weather".

During the same period the volume of imports as recorded in trade accounts increased by nearly 9 per cent and as shown in balance of payments estimates by 10 per cent. At 1952 prices this increase in imports would have required an additional expenditure of £302 million, as follows:

	1952	1953
Value of imports as shown in balance of payments estimates at current prices (Million £)	2,943	2,872
Change in average import prices	100	88
Value of imports at 1952 prices (Million £)	2,943	3,245
Change in volume	100	110
Increase in imports of goods at 1952 prices (Million £)		302

1/ Based on Table 28 of Economic Survey for 1954, p. 54.

On the other hand, the use of foreign shipping expressed in 1952 prices declined by some £20 million in 1953, thus reducing the net increase in imports of goods and services to £285 million.

The trade accounts show that between 1952 and 1953 the volume of exports increased by 3 per cent. The £60 million decrease in exports of goods and services mentioned above as one of the factors making possible the increased domestic expenditures of 1953 is an estimate based on balance of payments data which show the following picture:

	1952	1953
Exports as recorded in trade accounts (Million £)	2,582	2,582
Change in average export prices	100	97
Exports at 1952 prices (Million £)	2,582	2,660
Reexports as recorded in trade accounts at current prices (Million £)	144	105
Exports and reexports at current prices as recorded in trade accounts (Million £)	2,726	2,687
Exports and reexports as shown in balance of payments estimates at current prices (Million £)	2,826	2,675
Difference from trade accounts due to coverage and timing (Million £)	+ 100	- 12
Exports and reexports as shown in balance of payments estimates at 1952 prices (Million £)	2,826	2,756
Decrease in exports of goods at 1952 prices (Million £)		70

Since the Economic Survey estimates the decrease in exports of goods and services at £60 million, it may be assumed that exports of services increased by some £10 million in 1953.

These estimates show that imports in 1953, although 10 per cent larger than in 1952, cost £71 million less. Since at 1952 prices they would have cost £302 million more than in 1952, it may be estimated that the 12 per cent decline in import prices during 1953 released £373 million of British resources which would otherwise have had to be devoted to the payment of imports. The fact, however, that export prices declined by 3 per cent in 1953 has meant that Britain obtained £81 million less from its exports than it could have obtained if prices had remained unchanged. Thus, the net gain of the British economy from the change in the terms of trade may be estimated at £292 million.1/

The increase in supplies resulting from increased production, larger imports and smaller exports appears to have been sufficient to absorb the increased expenditures shown above without any serious pressure on prices. As already stated, retail prices rose by 3 per cent in 1953, but the increase was almost wholly due to adjustments in food prices, rents, public utility rates, which would have had to take place under any circumstances, rather than to inflationary conditions in the economy. This is shown by three facts: (a) Prices of goods other than food declined during that period; (b) wholesale prices remained stable; and (c) export prices declined by 3 per cent:

1/ The Economic Survey for 1954 estimates the gain from the change in the terms of trade at somewhat less, i.e. at £ 200 to £250 million. Small differences in calculations are sufficient to produce the difference between our estimate and the Survey estimate.

	1951	1952	1953	Per Cent Change Between 1952 and 1953
		1950 = 100		
Retail prices	109.7	119.3	122.8	+ 2.9
Cost of living	109.4	118.9	122.6	+ 3.2
Wholesale prices	121.7	124.2	125	+ 0.6
Export prices	117	124	120	- 3.2
Import prices	133	129	114	-12.4
Wage rates	108.6	117.3	123.1	+ 4.9

Major Components of Cost of Living Index

	Per Cent Change Between 1952 and 1953
Food	+ 5.6
Rent and rates	+ 5.5
Fuel, etc.	+ 5.0
Services (travel, etc.)	+ 4.0
Alcoholic drink	+ 0.5
Tobacco	+ 0.3
Clothing	- 2.2
Household goods	- 2.5
Miscellaneous goods	- 1.0

The decline in retail prices of clothing and household goods and in export prices may be interpreted as evidence that prices of manufactured articles in general declined slightly during that period. This decline is explained first, by the fall in the prices of imported materials, second, by the higher output per man achieved as a result of fuller utilization of available productive capacity, third, by lower unit profits due to the easing of supplies and smaller pressure of demand and fourth by reductions in purchase tax. These factors apparently more than offset the 5 per cent increase in wage rates which occurred in that period, thereby leading to a decline in retail and export prices.

The significance of these developments for the future course of British prices may be assessed as follows:

It may be estimated that in 1953 British import prices had increased 20 per cent more compared with pre-war than British export prices. In view of the fact that the pre-war decade was a period of exceptionally low prices for primary products resulting from low levels of economic activity in the world, a return to the pre-war price relationship between industrial goods and primary products may be expected only under conditions of reduced economic activity in the industrial countries. Since a return to such conditions is unlikely, it is also unlikely that British import prices will be lower than in 1953 in the coming years. The Economic Survey for 1954 goes further and suggests that the country "cannot count in the long run on the terms of trade remaining as favorable as at present". Thus, the first factor accounting for the slight decline in the prices of British manufactures during 1953 may not continue to operate in the coming years. With regard to the other two factors, i.e. increased output per man and lower unit profits, their contribution to continued price stability will depend on whether they are substantial enough to offset the increases in wage rates which are bound to take place under the conditions of full employment under which the British economy will probably continue to operate in the coming years. A comparison between levels of employment and levels of production suggests that in 1953 output per man in manufacturing increased by 5 per cent over the previous year. This, however, represented a return to the relationship between employment and production obtaining in 1951 rather than an advance towards higher levels of productivity.1/ Thus, the maintenance of price stability through substantial increases in productivity is by no means assured.

Finally, the adjustments in food prices, rents and public utility rates which have been taking place in the last few years have not yet been completed. There are still the food subsidies to be eliminated and it remains to be seen whether de-rationing and decontrol of food can be carried out without any price increases. Rents are still at approximately pre-war levels in spite of a three-fold increase in all other prices and will eventually be adjusted upwards. Food and rent are the two major components in the cost of living and their upward movement will necessarily mean an upward movement in wage rates over and above what will be needed to ensure an improvement in real wages which workers are bound to seek in the coming years. The latest UN World Economic Report shows that in the last three years real wages have increased less in the U.K. than in most other countries:

1/ The following table compares levels of employment and production in the major sectors of industry since 1950 and suggests that there has been no significant increase in output per man in manufacturing but, as was to be expected, a substantial increase in gas, electricity, etc.:

	June			December		
	1951	1952	1953	1951	1952	1953
Manufacturing	(June 1950 = 100)			(December 1950 = 100)		
Employment	102.8	101.5	103.0	102.7	101.4	104.2
Production	105.0	93.3	100	100.5	98.7	107.5
Implied change in output per man	+2%	-8%	-3%	-2.5%	-2.7%	+3%
Mining						
Employment	100.4	102.7	102.8	101.4	104.1	102.9
Production	104.4	102.5	101.5	104.8	100	103.8
Implied change in output per man	+4%	-0.1%	-1.3%	+3.3%	-4%	+0.9%
Building						
Employment	101	100	100			
Production	98	105.5	103.5			
Implied change in output per man	-3%	+5.5%	+3.5%			
Gas, electricity, etc.						
Employment	102.5	105.4	105.4			
Production	108.0	108.0	116.0			
Implied change in output per man	+5.3%	+2.5%	+10%			

It may be assumed that average working hours were the same in 1951 and 1953. They are known to have been lower in 1952.

Real Wage Rates in 1953
(1950 = 100)

W. Germany	119
France	119
Sweden	119
Canada	113
Italy	111
U.S.A.	109
Denmark	107
Belgium	105
Australia	103
Norway	102
U.K.	101
Netherlands	99

Our conclusion is that British prices are still rising and are likely to continue their upward movement unless there is a severe deflation, which, however, appears highly improbable.

The fact, however, that the overall price increase in 1953 was one of the smallest annual increases since the end of the war in spite of wholesale abolition of controls over production and consumption,[1] and that it was due almost entirely to needed price adjustments shows that in spite of increased domestic demand for goods there was little inflationary pressure in the economy. This may be ascribed in part to the credit and fiscal policies followed during that period, but, in our view, it was primarily due to the fact that the inflationary psychology which had dominated the economy until 1952 and was checked in that year did not return in 1953 even after domestic demand revived considerably. This in turn may be attributed to the fact that, as a result of the expansion of production and the checking of inflation which took place in most countries following the excesses of the 1951 boom, the fear of shortages and of rising prices had disappeared all over the world. Thus, the decline in bank lending in 1953 may be considered as much the result of reduced demand on the part of a more conservative public as of a tightening up of credit. This is shown by the fact that interest rates, which had risen considerably in the previous year, remained unchanged in 1953, while credit control was, if anything, relaxed:

1/ The Economic Survey for 1954 summarizes as follows the measures taken in 1953 to restore greater freedom to the domestic economy:

"... The general steel allocation scheme was brought to an end in May, licensing of softwood consumption was abolished in November, and restrictions on the use of nickel and molybdenum were removed during the year. The rationing of sweets and sugar was ended in 1953, eggs came off allocation, cereals and animal feedingstuffs were de-controlled, and restrictions on the flour extraction rate were removed. Food rationing will be abolished completely this summer. Controls over prices of raw materials and manufactured goods have been almost entirely eliminated. In the building industry the licensing limits were raised in January 1953 without ill effects, and further de-control was possible at the beginning of 1954. There is no longer a complete ban on any type of building. Work on industrial and agricultural building to the value of £25,000 a year on each property may now be carried out without a licence; and even where licences for these kinds of building are still required, applications are refused only if there is a shortage of labour in the area."

Yields on Securities

	1950	1951	1952	1953	March 1954
British Government Securities					
Short-dated	2.03	1.85	2.98	3.03	2.87
Medium dated	2.99	3.59	4.25	3.95	3.77
$3\frac{1}{2}$% War Loan	3.77	3.98	4.55	4.30	4.11
Ordinary Shares	5.27	5.78	6.46	6.06	5.73

The following table shows the changes in the credit picture during 1953:

Bank Advances

	Million £			
	1951	1952	1953	Change Between 1952 and 1953
Total	1,920.6	1,930.6	1,815.8	-114.8
Agriculture	190.4	198.9	200.3	+ 1.4
Chemical industries	26.3	35.1	25.9	- 9.2
Iron and steel industries	17.3	30.9	55.0	+ 25.9
Engineering	109.5	150.0	153.6	- 3.6
Textile industries	99.4	94.8	81.3	- 13.5
Food, drink, tobacco industries	142.7	158.1	132.5	- 25.6
Building and contracting	88.6	86.6	78.0	- 8.6
Transport	16.9	20.0	17.6	- 2.4
Other public utilities	74.8	96.4	86.6	- 9.8
Shipping and shipbuilding	15.8	11.7	16.0	- 4.3
Retail trade	207.1	189.4	169.6	- 19.8
Miscellaneous industries and trade	121.2	125.2	107.9	- 17.3
Financial	206.6	183.0	185.5	+ 2.5
Personal and professional	434.3	402.2	366.7	- 35.5

Similarly, while the overall budget deficit was reduced from £436 million to £297 million, i.e. by £139 million, part of the reduction (£19 million) was due to a shift of borrowings by local authorities from the central Government to the capital market as well as to larger repayments by the Raw Cotton Commission (£20 million), i.e. to changes which did not involve any real reduction in national expenditures.

The following table compares the budgetary position of 1953-54 with that of 1952-53:

	Fiscal 1952-53	Fiscal 1953-54	Change
Ordinary Revenue			
Direct taxes	2,451	2,340	-111
Customs and excise	1,764	1,764	0
Other	224	264	+ 40
Total	4,439	4,368	- 71
Ordinary Expenditures			
Interest	576	580	+ 4
Defense	1,404	1,365	- 39
Other	2,371	2,329	- 42
Total	4,351	4,274	- 77
Ordinary Surplus	+ 88	+ 94	+ 6
Capital Account			
Revenue Total	68	95	+ 27
Raw Cotton Commission Repayments	22	42	+ 20
Payments			
Loans to local authorities	412	299	-113
Loans to new town development	24	30	+ 6
Working capital, etc.	41	41	-
War damage	58	72	+ 14
Post-war credits	16	17	+ 1
Colonial development	7	5	- 2
Other	34	22	- 12
Total	592	486	-106
Deficit	- 524	- 391	-133
Overall Deficit	- 436	- 297	-139

It will be noted that defense expenditure is shown here to have decreased in 1953 while the estimates of the Economic Survey previously summarized indicated an increase of £110 million. The discrepancy is probably due in part to the fact that the periods covered are not the same (the Economic Survey compares the calendar year 1953 with calendar year 1952 while the budget figures refer to the fiscal year, i.e. to the period April 1953-March 1954 and April 1952-March 1953, respectively and it is stated in the Survey that the rise in defense expenditure levelled off early in 1953) and in part to the fact that some items which are included under defense expenditure in the budget are probably included under investment in the national income estimates given in the Economic Survey.

The end of the inflationary psychology is also illustrated by the growth of personal saving during this period. A recent analysis of national income statistics suggests that personal saving increased from £158 million in 1951 to over

£900 million in 1953.1/ At that level it represented nearly 8 per cent of disposable personal income, i.e. a rate somewhat higher than that obtaining in the United States. Although estimates of personal saving, being the difference between two approximations, i.e. estimates of personal incomes and personal expenditures, are particularly liable to error, it is probable that the above figures reflect correct orders of magnitude since there is no reason to suppose that the degree and direction of error has changed between 1951 and 1953.

We conclude that three factors account for most of the success achieved during 1953 in combining a substantial increase in domestic expenditures with the maintenance of financial stability in the economy: (a) lower import prices, (b) disappearance of the inflationary psychology, and (c) the steady course of Government policy which this time avoided the temptation to relax unduly the fiscal and monetary policies adopted in the earlier period of crisis.

External Developments During 1953

The outstanding achievement of 1953 was that internal expansion did not, as in the past, lead to a weakening of the external position. On the contrary, while in 1952 the gold and dollar reserve had declined by £175 million, in 1953 there was an increase in the reserve of £240 million. Similarly, the stronger external position did not, as in the past, result from a tightening up of controls and restrictions on foreign transactions, but, on the contrary, was achieved in spite of a considerable relaxation of such restrictions.

The available data, which, it should be noted, are still provisional, indicate that there was no significant change in the overall current account position between 1952 and 1953: the current surplus which had been £134 million in 1952 declined somewhat and amounted to £123 million in 1953. In spite of this apparent lack of further improvement in the current account, the position was more favorable than in 1952 on two counts:

(a) Although, as already stated, imports cost £71 million less, their volume was 10 per cent higher than in the previous year due to lower import prices. Thus, with a smaller expenditure than in 1952 the U.K. was able to obtain the larger

---

1/ See The Economist, June 19, 1954, p. 1003-1004 quoting from a recent article by F. W. Paish, which is not yet available in the Bank.

The Economic Survey for 1954 estimates the difference between disposable income and expenditures as follows, but it considers personal saving as one of the factors accounting for the difference, presumably implying that the balance represents errors and omissions:

Million £

	1951	1952	1953
Total disposable income	10,220	11,179	11,957
Consumers' expenditure	9,935	10,403	11,029
Balance, including personal saving	285	776	928

It should also be noted that the Survey describes these last figures as "extremely uncertain".

quantities of food and raw materials required by the higher level of economic activity attained in 1953.

(b) While the overall picture remained unchanged, there was a shift in the regional pattern which made for a more balanced external position. Thus, the large surplus with the sterling area and the large deficits with other areas, and especially with the dollar area, which had characterized the earlier periods were sharply reduced in 1953. This resulted mainly from a shift in the pattern of trade, i.e. from an increase in the volume of imports from the sterling area and no change in the volume of imports from other areas combined with a decrease in the volume of exports to the sterling area and no change in the volume of exports to other areas.1/ These developments are shown in the following table:

Current Balance
(Million £)

		1952	1953
Sterling Area			
Exports		1,323	1,210
Imports		1,242	1,314
Net invisibles		417	392
Government (net)		- 131	- 109
	Balance	+ 367	+ 179
Other Countries			
Exports		1,503	1,465
Imports		1,701	1,558
Net invisibles		7	82
Government (net)		- 42	- 45
	Balance	- 233	- 56
Total Current Balance		+ 134	+ 123

Regional Distribution of Trade

	Per Cent of Total	
	1952	1953
Sterling Area		
Exports	47.0	45.0
Imports	43.0	46.0
Other Areas		
Exports	53.0	55.0
Imports	57.0	54.0

The strengthening of the gold and dollar reserves in 1953 was due in part to the decrease in the dollar deficit of the U.K., in part to the decrease in the dollar deficit of the rest of the sterling area and in part to the sharp improvement of the British position in EPU. These developments are summarized in the following table:

1/ Exports and imports in 1953 estimated at 1952 prices.

Dollar Accounts of U.K. and Rest of Sterling Area
(Million £)

	1952	1953
United Kingdom		
1--Ordinary current account		
Exports	+410	+428
Imports	-596	-516
Trade balance	-186	- 88
Net invisibles	-145	- 91
Total	-331	-179
2--Capital or exceptional items		
Offshore sales to U.S.	+ 1	+ 18
U.S. military spending in U.K.	+ 45	+ 55
Capital items, including repayment of loans	+ 26	- 4
Defense aid, excluding U.S. Government loans	+121	+102
Total	+193	+171
Overall dollar account	-138	- 8
Independent Sterling Area		
Exports (excluding South Africa)	+277	+246
Imports (excluding South Africa)	-417	-252
Trade Balance	-140	- 6
Invisibles and capital items	+ 62	- 9
Gold contributions	+ 72	+ 79
Overall dollar account	- 6	+ 64
Colonies		
Exports	+184	+152
Imports	- 69	- 60
Trade Balance	+115	+ 92
Gold and Dollar Payments to Third Countries		
EPU	-172	+ 18
Other	+ 30	+ 46
Total	-142	+ 64
Overall dollar account of whole sterling area	-171	+212
Increase (+) or decrease (-) in sterling liabilities to dollar area	- 4	+ 28
Change in gold and dollar reserves	-175	+240

It will be seen that four factors, i.e. U.S. defense aid, exceptional U.S. expenditures in the U.K., a dollar surplus with EPU and with other countries and increased sterling liabilities to the dollar area accounted for the whole of the increase in the gold and dollar reserves during that period. Since none of these factors can be considered as a dependable source of dollars for the sterling area, it seems reasonable to conclude that the increase in reserves during this period was the result of temporary influences rather than evidence of a genuine surplus position vis-a-vis the dollar area.

A glance at the overall capital account of the U.K. will also show that the substantial increase in British capital exports in 1953[1] was more than offset by an increase in sterling liabilities:[2]

	Million £	
	1952	1953
Current Balance	+134	+123
Capital Account		
Defense aid	+121	+102
Exports of capital	- 84	-207
Debt to EPU	+ 53	- 21
Sterling liabilities	-373	+213
Holdings of non-dollar currencies	- 26	+ 30
Gold and dollar reserve (+ decrease, - increase)	+175	-240

This brief analysis of the British external position in 1953 suggests that in the absence of exceptional U.S. expenditures and increased sterling holdings by the sterling area the U.K. would not have been able, without serious pressure on domestic resources, to finance the increase in reserves and the exports of capital which took place during that period. Similarly, without the fall in import prices, the increased volume of goods imported in 1953 would have required much larger expenditures in foreign exchange than were made in 1953 and hence would have resulted in a much weaker external position. Thus, the combination of internal expansion and exceptional external strength which characterizes the year 1953 was possible only because exceptional factors have been operating in Britain's favor during that period.

In recent months two new factors, gold sales by the Soviet Union and speculative movements of funds, have added to the strength of sterling. In May 1954 the gold and dollar reserves stood at $2,985 million, i.e. have increased by $467 million since the beginning of the year. This strength is all the more remarkable as it occurred at a time of declining American economic activity, to which the sterling area has been held to be particularly susceptible. The British Chancellor

---

1/ The Economic Survey for 1954 describes this item as follows:

"Most of the outflow of capital from the United Kingdom is for investment in the rest of the sterling area. Some of this takes the form of loans raised in the London market and of other borrowing which requires official sanction; £100 million was sanctioned in this way during 1953, though it was not necessarily all spent in this period. (The figure excludes grants to the Colonies.) Important individual transactions were loans of £23 million raised by the Colonies and £10 million by Southern Rhodesia in the London market; the Murupara loan of £10 million for the construction of a pulp and paper mill in New Zealand; and a credit of £10 million extended to Pakistan through the Export Credits Guarantee Department. In addition, there was much private investment by United Kingdom firms in the rest of the sterling area; an example is the large expenditure by the oil companies on refinery construction in Aden, Australia and India. There was also a moderate outflow of private capital from the United Kingdom for investment outside the sterling area. In particular, the Government has been ready to permit firms in this country to undertake direct productive investment in Canada on an increasing scale."

2/ Sterling liabilities changed as follows during this period:

	Dec. 31, 1952	Dec. 31, 1953	Change
	(Million £)		
Non-sterling countries	755	773	+ 18
Independent sterling area	1,606	1,774	+168
Colonies	1,076	1,161	+ 85
Total	3,437	3,708	+271
Non-territorial organizations	567	509	- 58

of the Exchequer has summed up the general feeling about these developments as follows:

> "Between July 1953 and April 1954 U.S. industrial production fell 10 per cent. Between the same dates sterling area gold and dollar reserves rose 19 per cent. If anyone in the middle of last year had forecast this combination of percentages he would have been written off as an optimist or an ignoramus--possibly both. Yet there is is."

While this strength of sterling should not be minimized, the words of caution voiced in the latest London and Cambridge Economic Bulletin[1] are undoubtedly in order:

> "A combination of good fortune and increasing resilience has made it possible for the sterling area to ride the early months of the American recession more successfully than could reasonably have been expected. This success has helped breed further success, in the form of the speculative strength of sterling reflected in the high sterling-dollar exchange rate and a continued inflow of short-term money. The present international confidence in sterling could probably survive small seasonal gold losses in the summer (which still appear quite possible), but if the recession should continue, it must certainly have adverse effects. If these effects come, a consequent reversal of speculation might easily lead to a direct gold loss of some $300 million within a period of two or three months. For the United Kingdom's own position, the worsening of the terms of trade in April, though not of great importance in itself, may be a herald of a more permanent deterioration."

By the same token, this is not the time for such a far-reaching and non-reversible step as an undertaking to make sterling freely convertible into dollars. In a recent speech, the British Chancellor of the Exchequer seems to have taken this view: "We want to make sure that in the long-term, as well as in the short-term, conditions look right for convertibility, and that it is not only a practical move when we make it, but a secure policy which can be sustained in the future." The reason why a move towards convertibility would be premature at this stage is that none of the three conditions listed by the Chancellor, i.e. sound finance within the sterling area, adequate reserves and American trade liberalization, seems to have been fully achieved. As already shown, British prices are still rising (see also Chancellor's statement: "We are probably entering a period when it will be more difficult to keep prices from rising"), inflation is still a threat in the rest of the sterling area, the reserves, at about $3 billion, cannot be considered adequate to support the experiment and American trade policy shows no signs of becoming more liberal.

In the light of these uncertainties the gradual approach seems to be the wisest. During the last year Britain has taken impressive steps towards freeing her external transactions of controls and restrictions. These are summarized as follows in the Economic Survey for 1954:

> "The strengthening of the reserves enabled the United Kingdom to take a number of important steps during 1953 in the direction of freer trade and payments. In March there was a slight easing of the

---

1/ New Series No. 10, p. viii, published in The Times Review of Industry, June 1954.

severe restrictions imposed in 1951 and 1952 on imports from other O.E.E.C. countries, and in November 1953 the process of liberalisation was further extended to cover over 75 per cent. of the goods imported from these countries on private account (calculated on the basis of imports in 1948). This has since risen to about 80 per cent.

"These relaxations were accompanied by further progress in the return of import trading to private hands and in the re-opening of commodity markets in this country. During the year private trading was resumed in copper, zinc, aluminium, wheat, coarse grains, dried fruit and a number of other commodities, while private trading in raw cotton was permitted on a limited basis. The operations of the London Metal Exchange, where dealings had previously been confined to tin and lead, were extended to cover copper and zinc; and the re-export of these metals to most countries was permitted without restriction. Traders in non-ferrous metals and cereals were given freedom to buy supplies wherever they could get them cheapest, and restrictions on dollar imports of various other materials were removed or relaxed. All these relaxations were aimed at increasing industrial efficiency and making the economy more flexible.

"As a result of these and other measures about half the United Kingdom's imports both from the dollar area and from other non-sterling countries were free of restriction by the end of the year. ..."

Since the preparation of the Economic Survey, two important new steps towards freer external transactions were taken by the British authorities: the first was the reestablishment of a gold market in London, the second was the extension of the transferable account system to virtually all non-sterling non-dollar countries and the elimination of all restrictions on the use of transferable account sterling. Neither step involves an additional element of convertibility since gold can be purchased in London only against dollars and since the widened transferability for sterling does not permit it to pass from a non-American to an American account. Both steps, however, and especially the second, "promote the international usage of sterling and its maximum convertibility into non-dollar currencies".1/

The next logical step would be to relax quantitative restrictions and discrimination on imports of dollar goods by the U.K. and the rest of the sterling area. If, after a period of time, these measures of decontrol and liberalization show no signs of weakening sterling, convertibility will have become a practical proposition. Even then, it will be necessary, before embarking on such a far-reaching undertaking, to consider whether American military outlays abroad, which account for a large part of the recent improvement in the world dollar position, can be safely made the basis of a permanent system of international economic relations.

1/ The Economist, March 27, 1954, p. 965.

K. Varvaressos
R. Zafiriou

FORM NO. 59
(3-49)

CROSS REFERENCE SHEET

COMMUNICATION: Memo

DATED: June 21,1954

TO: F.D. Gregh

FROM: J.C. de Wilde

SUMMARY:

Proposal for a Synthesis of Bank Mission Surveys

FILED UNDER: Reports: General

CROSS REFERENCE: Varvaressos - Correspondence

FILE COPY

Mr. Robert L. Garner May 17, 1954

K. Varvaressos

In a recently published little book, Britain in the World Economy, Sir Dennis Robertson makes the following comments on the International Bank which I thought might interest you:

"In these respects of comprehensiveness of outlook and elasticity of approach the pioneering work which has been done, under American leadership, by the International Bank for Reconstruction and Development seems to me deserving of the highest praise. But of course the rate of some $200 million a year at which it is at present able, consistently with its rules and standards, to disburse its own funds and those which it gathers from the market is not high compared with the $3½ billion at which the current surplus of the United States, reckoned on the narrowest basis, stood in 1951, still less as compared with the fantastic annual figure of $10 billion at which the so-called experts of the United Nations have assessed the needs of the so-called undeveloped countries of the earth for foreign capital--'those undeveloped countries from whose bourn no capital returns', as Shakespeare has so eloquently put it. The problem of working out the scope and the technique of a programme of foreign investment which is not too large to be acceptable to the investors and tax-payers of the lending countries or assimilable by the borrowing countries, and is at the same time large enough to make a real hole in the problem of dollar shortage, remains most formidable." (p 69-70)

Here are some additional quotations from the book:

On foreign investment:
"... It is worth remembering, as Professor Nurkse of Columbia University has recently reminded us, that when British overseas investments were at their zenith in 1914, only a quarter of them in nominal capital value (though admittedly this was the most lucrative section in annual income) consisted of mines, plantations and the like; the remaining three-quarters, even in those so-called laissez-faire days, consisted of railways and other public utilities and of loans to Governments which were themselves operating schemes of basic development--roads, harbours, irrigation-works and so forth. It would seem that somehow or other a balanced policy of overseas investment by the world's greatest creditor nation must, under political conditions admittedly more difficult than those of the nineteenth century, be so fashioned as to include provision for these things, and for the slow processes of agricultural improvement, and not be confined to the sucking of petroleum and the tearing of metals out of the bowels of the earth." (p 68-69)

On British Colonial development:
"... An official enquiry held last summer seems to have established that over the next two or three years it is not shortage of finance but partly of steel and partly of skilled labour and local organisation that stands in the way of more rapid progress. That is exactly what the International Bank found in its larger sphere. All experience seems to show that enthusiasts easily overrate the speed at which primitive societies can suck in large doses of imported capital without suffering grave attacks of economic and social indigestion." (p 50-51)

"It sometimes nowadays needs saying that the West in general does not owe a living to societies which are unable to give themselves good government, to cultivate the simple virtue of thrift, and to cope with, or even to admit the existence of, their own overriding problem of excessive population growth. But it sometimes also needs saying in my country, especially perhaps in Lancashire, that if any section of the depressed populations of the world can find powerful friends who will help it and to whose prosperity it can contribute in return, such a section does not owe a living in perpetuity to that branch of the western world under whose political tutelage it happens to find itself. ..." (p 51-52)

On the dollar shortage:
"The richer the country the more easily it can afford, without doing serious harm to its own standard of life, to be tender to the vested interests which are resisting readjustment. By displaying such tenderness it increases the severity of the readjustment demanded of the poorer country, causing it, once more, to reflect whether the attainment of any kind of balance with the rich neighbour is not a hopeless quest—whether, to turn from the general to the particular, the cure for dollar shortage is not to be sought, not in trying to earn dollars but in training oneself resolutely to do without them.

"Have I said enough to persuade you that when one of the partners to its operation is a country of multifarious resources and towering strength, the law of comparative advantage, for all its inexorable truth, needs a string of footnotes? That a quarrel and a baby are not the only things which it takes two to make, but that dollar shortage also falls within that interesting category? If so, we can go on to ask calmly what more America, who has poured forth a stream of generous gifts to help to set the world on its feet, can fairly be expected to do about it." (p 61-62)

On American economic fluctuations:
"... I find it hard to see how an economy like that of the United States is ever going to render itself immune from little hiccoughs of stock-taking and indecision like those of 1938 and 1949. I will go further and say that I am not at all sure that it is desirable that it should. For here too, as in the rest of the world, the social and political forces making for perpetual inflation are tremendously strong; and it may be that it is only through minor recessions of this kind that, even here, the reputation of money as a measure and store of value can be prevented from being irretrievably undermined. Nevertheless, as I have said, they have their inconveniences, to put it mildly, for the rest of us." (p 60)

On inflation as a cause of the dollar shortage
"... It is five and a half years since, speaking as President of the Economic Section of the British Association for the Advancement of Science, I reminded my audience that "what are politely called 'balance of payment difficulties' do not necessarily drop like a murrain from heaven, but that any nation which gives its mind to it can create them for itself in half an hour with the aid of the printing press and a strong trade union movement". It has always seemed to me that until this simple truth was fully grasped and acted upon by the countries of Western Europe and the Sterling Area, it was much too early to frame permanent policies on the assumption that dollar shortage was an ineluctable condition of the world's affairs." (p 56)

K.V.

KV/vch

Mr. W. A. B. Iliff

April 28, 1953

K. Varvaressos

Attached herewith is a brief note on the question of sterling lending to the colonies by the Bank about which you talked with me a few days ago on the telephone.

Attachment-1

K.V.

April 28, 1953

Is lending by the Bank to the British colonies of sterling made available by Britain as part of her 18 per cent contribution equivalent to internal lending?

Note by: K. Varvaressos

From the point of view of Bank operations this question would arise if it were determined that borrowing by a country of its own subscription to the Bank is not within the purposes of the Articles of Agreement. In that case, if it were established that the colonies are part of the British economy, lending to them of funds made available by Britain, either as part of her 18 per cent contribution or by Bank borrowing in the British capital market, would be internal lending and would not, therefore, be within the purposes of the Articles of Agreement. If, on the other hand, it were determined that borrowing by a country of its own subscription to the Bank is within the purposes of the Articles of Agreement, the question whether the colonies are part of the British economy or not would be immaterial since under such a determination even Britain herself could borrow sterling made available to the Bank as part of her contribution or by the raising by the Bank of capital in the British market.

There is a provision in the Articles of Agreement which seems to preclude explicitly such a form of borrowing from the Bank:

<u>Section 3 (a)</u>
"The Bank shall furnish the borrower with such currencies of members, <u>other than the member in whose territories the project is located,</u> as are needed by the borrower for expenditures to be made in the territories of such other members to carry out the purposes of the loan."

It is true that in Section 3 (b) it is stated that "the Bank may, <u>in exceptional circumstances when local currency required for the purposes of the loan cannot be raised by the borrower on reasonable terms,</u> provide the borrower as part of the loan with an appropriate amount of that currency."

I have argued in an earlier memorandum that this provision "is too vague and too loosely formulated to be useful as a guide to policy without a considerable amount of interpretation and amplification by the Bank".1/ In the case of Britain, however, it is clear that the condition for making local currency available under this provision, namely that the local currency cannot be raised by the borrower on reasonable terms, is not applicable. This means that if lending of British funds to the colonies is considered internal lending it would seem to be precluded by the Articles of Agreement. This conclusion is strengthened if the purpose for which the Bank was created is kept in mind. The Bank was established to promote international investment, i.e., the movement of funds between countries. By borrowing their own subscriptions, countries could deprive the Bank of the means of carrying out its purpose.

If this interpretation of the Articles of Agreement is accepted, the question of whether the Bank can lend to the British colonies sterling made available by Britain as part of her 18 per cent contribution depends on whether the colonies can be considered as separate economic entities or are held to be part of the British territory.

There are three considerations which might raise some doubts about the validity of such lending by the Bank:

(a) The Articles of Agreement provide that "the resources and the facilities of the Bank shall be used exclusively for the benefit of members".

(b) The colonies are not members of the Bank and can borrow from the Bank only with the guarantee of the British Government. This would at first sight seem to indicate that, as far as the Bank is concerned, the colonies are part of the British territory.

(c) As already stated, the Articles of Agreement provide that "the Bank shall

---

1/ Criticisms against the Bank, April 11, 1950, p. 68.

furnish the borrower with such currencies of members, other than the member in whose territories the project is located, as are needed by the borrower for expenditures to be made in the territories of such other members". Since the colonies are not members it might be held that under the Articles of Agreement the "member in whose territories the project is located" is Britain and in that case it might be argued that the currencies which the Bank may furnish for the financing of the project must be currencies other than sterling, which is the currency of the member.

Apart, however, from this question of interpretation of the Articles of Agreement, it is clear that from a political and economic point of view the colonies are not a part of Britain. One might even say that if they were not separate entities they would not be colonies, since a colony is almost by definition an area which is run by and usually in the interests of a Colonial Power but is not incorporated in the territory of that Power.

In the case of British colonies, the view that they are distinct economic and political units is supported by the following considerations:

(a) Each colony has its own Government and administration which may be controlled from the center but is distinct from the British Government and the British administration. Similarly, each colony has its own legislation which is applicable only in the territory of the colony.

(b) Each colony has its own budget with revenues raised locally on the basis of local legislation and expenditures made exclusively for local administrative and other needs.

(c) Each colony has its own currency which may be based on sterling but is a separate monetary system administered locally.

(d) Economic conditions and living standards vary widely not only between Britain and the colonies but also between the colonies themselves, being determined in each case by the resources available to the colony, the structure of its economy and the stage of development in which it finds itself. It is true that Britain and the colonies complement each other in the sense that the colonies produce primary products needed by Britain while Britain supplies the colonies with the industrial goods which they themselves cannot produce. This complementarity is typical of the economic relationships between primary producing areas and industrial areas but, contrary to communist propaganda, it is not synonymous with colonialism. British commercial relations with the independent countries of the sterling area, with Canada and with all other major exporters of primary products, including the United States, are based on essentially the same pattern.

(e) Historically, colonial territories tend to evolve into independent nations. Viewed in perspective, the colonial status appears as a phase in an area's political development rather than as a permanent condition. Only a century ago most of the independent countries of the British Commonwealth were colonies. India, Burma, Ceylon, have only recently acquired their independence. There is no reason to believe that the process will not continue.

(f) British investment in the colonies has always been considered by the British public as foreign, not domestic investment. All computations of British foreign investments include colonial investments.

(g) Britain's recent decision to release her Bank subscription for lending to sterling area countries, including colonies, provides a clue to the nature of British investment in the colonies. It is clear that there is no problem as far as borrowing in Britain by the colonial Governments is concerned, since these Governments traditionally enjoy a good credit standing in the British capital market. On the other hand, by supplying sterling capital through the Bank rather than directly Britain gives up the advantage of receiving interest and amortization payments to the benefit of the Bank and she also foregoes the opportunity of having a say on the way in which the funds will be used.

I believe that one consideration which may have prompted Britain to take this action may have been the following: During the post-war period Britain has made available to the sterling area, including the colonies, large amounts of capital in the form of grants, loans or direct investments. However, compared with the amounts spent, the results have been disappointing. This has been true not only of the sums made available to independent countries where no control could be exercised over the use of the funds, but also of the very considerable sums spent in the colonies, often under direct British supervision and with the principal object of developing resources needed by Britain herself. This lack of success may have led British officials to the conclusion that, among other things, the technical resources of the British and colonial Governments were not sufficient to ensure the formulation and execution of sound projects, while the obvious success with which the Bank has tackled similar problems elsewhere seemed to indicate that if the carrying out of colonial projects were placed under the auspices of the Bank better results might be attained. If this has been a principal factor in the British decision to release her Bank subscription as far as the colonies are concerned, it would mean that Britain has reached the conclusion that the problems and difficulties of economic development in the colonial territories are far too different from those facing her own economy and that, consequently, their solution cannot be based on British technical resources and experience alone.

It is true that another consideration which may have been a factor in Britain's decision to release her Bank subscription is that since such a release was an obligation which she would sooner or later have to meet, and since the financing of economic development in the sterling area was also an obligation which Britain had undertaken towards the sterling area, an action, such as the release of her Bank subscription for the financing of sterling area projects, which enabled her to combine these two sets of obligations would help reduce the burden on her resources which these obligations represented. This consideration, however, would not have applied to the colonies if these had been held to be a part of the British economy, in the same way that it does not apply to Scotland. The fact that Britain presumably contemplates the utilization by the Bank of part of her subscription for lending to the colonies clearly indicates that from the point of view of investment no distinction is made between colonies and independent sterling area countries.

If this appraisal of the relationship between Britain and her colonies is correct, it suggests that the above-quoted provisions of the Articles of Agreement should be interpreted in a manner that would make possible the lending of sterling to the colonies. The reason why the colonies could not become members of the Bank is a legal one, namely that they lack the attribute of sovereignty which is essential for undertaking international obligations, but this does not in itself make the colonies a part of Britain. It seems to me that if lending of sterling by the Bank to the colonies is economically justified, and I think it is, provided the colonies do not absorb too high a proportion of the British subscription, the Articles of Agreement should not be interpreted as excluding such lending.

Varvaressos

December 18, 1952

Mr. W. A. B. Iliff
International Bank for Reconstruction
and Development
Washington 25, D. C.

Dear Mr. Iliff:

Thank you for sending me Mr. Beckhart's paper on convertibility which I read with great interest and am returning to you herewith. I have recently had the opportunity to deal with the same problem and I find that we agree with Mr. Beckhart that the causes of the present lack of convertibility are inflation in the non-dollar world and protectionism in the United States. Unlike Mr. Beckhart, however, I believe that the removal of these causes can be accomplished only gradually and consequently that convertibility remains a long-term objective rather than the answer to present difficulties. I also disagree with Mr. Beckhart on the following points:

(1) What he calls "workable convertibility" i.e. convertibility limited to current transactions and to new non-resident claims, is not the type of convertibility that will do all the things claimed on pages 6 and 7. Under such a type of convertibility there would still have to be exchange controls, holders of one currency would still be unable to convert it into another currency except for specified purposes and discriminatory import restrictions will presumably be maintained. Under such a type of convertibility the British pound would not be a very different currency from what it is today. The only difference is that the monetary authorities of other countries, not individual citizens in other countries, holding certain types of sterling would be entitled to exchange them for dollars. This means that while Britain would be restricting its purchases of American goods to the bare minimum in order to achieve a surplus or at least a balance in its dollar accounts, it might have to pay dollars for less essential goods imported from other regions. This would obviously be a very poor arrangement from the British point of view although it would no doubt be highly welcome to countries like Belgium. Finally such convertibility, unless introduced simultaneously by the major countries, is likely to repeat the experience of 1947 when countries holding sterling were refraining from using it in order to present it for conversion into dollars, thereby making the failure of the experiment inevitable.

(2) Unlike Mr. Beckhart, I do not believe in free or floating exchange rates. I think that exchange stability is an essential condition for orderly international transactions. What the proposals for free or floating rates amount to is letting each country change its rate of exchange at will, i.e., relieving it of the obligation undertaken under the Fund Agreement to consult with other countries on exchange policy. I see grave dangers in such a unilateral approach to a problem which by definition requires international cooperation.

(3) There is a great deal of oversimplification and loose thinking in Mr. Beckhart's arguments. Thus he says that "unless sterling convertibility, even of this limited character, is achieved, the sterling area will cease to exist". This ignores the fact that what holds the sterling area together at present is, more than anything else, the dollar shortage and the need to discriminate against American goods. Similarly, when he says that "sterling convertibility is a prerequisite to the integration of the economies of the free world" he is putting the cart before the horse. It is the integration of the economies of the free world which is the prerequisite of convertibility as Mr. Beckhart himself shows in his chapter on America's responsibility.

Then there is the statement that "the French problem is one of monetary confidence" since otherwise "the economy of the country is sound and well-balanced". This ignores the working class discontent and the other social tensions which dominate French economic life and produce the inflationary conditions that cause the distrust in the currency. I don't think that an economy in which such tensions exist can be called either sound or well-balanced.

Finally, I find statements like the following rather meaningless - "If renascent protectionism is to be checked, it is imperative that the United States now take vigorous action to lower trade barriers". It seems to me that this statement would make more sense if it were reversed - "If vigorous action to lower trade barriers is to be taken it is imperative that renascent protectionism be checked".

On the other hand, I agree with Mr. Beckhart that the inadequacy of reserves is not a serious obstacle to convertibility if such convertibility were possible otherwise.

These are some off-hand comments on the paper. I shall be glad to have a talk with you on the questions raised in the paper at any time you suggest.

Yours sincerely,

K. Varvaressos

KV/al

FORM No. 75
(7-48)

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

ROUTING SLIP

Date____________

TO-	Name	Room No.
1	Mr ~~Cope~~	
2	~~Leyeune~~	
3		
4		

FOR-

	Action		Initialing
	Approval		Preparing Reply
	Comment		Previous Papers
	Filing		Noting and Returning
	Full Report		Recommendation
	Information		Signature

REMARKS

Interesting.

FROM- G. Gondicas

COPY

May 22, 1952 *Files* ✓

THE CREDITWORTHINESS OF THE STERLING AREA

COMMENTS ON THE MEMORANDUM OF THE ECONOMIC DEPARTMENT

By: K. Varvaressos

The first point I should like to make is that it is not accurate to speak of the creditworthiness of the sterling area as a group. The sterling area (with the exception of the colonies) is an association of sovereign nations who cooperate closely in the field of international economic policy but who otherwise manage their economic affairs in an entirely independent manner. From the point of view of a lending agency like the International Bank there can be no question of lending to the sterling area; loans can be made only to the individual countries of the area. Thus, from the point of view of the Bank the relevant question is not the creditworthiness of the sterling area as a group but whether membership in the sterling area affects the creditworthiness of a country, favorably or unfavorably. In order to answer that question, it is essential to have a clear understanding of the nature of the sterling area and of the manner in which it functions. Since the Bank is interested primarily in the ability of sterling area countries to undertake dollar obligations, the crucial question to be answered is whether, in determining the ability of a sterling area country to undertake dollar obligations, the Bank should base itself on the dollar position of the individual country or on the combined dollar position of the whole group. The need for elucidating this point arises from the fact that since the war the sterling area countries adopted the practice of paying their dollar earnings into the central dollar reserve managed by the United Kingdom in exchange for sterling and withdrawing dollars from the reserve when having to settle dollar obligations. If this practice means that a country's ability to draw on the pool is determined by some criterion of need, as it undoubtedly was during the war, and not by its own contribution in dollars, then the Bank, in order to appraise the dollar creditworthiness of an individual sterling area country, should examine the overall dollar position and prospects of the sterling area and not the dollar position of the individual country. Under such an interpretation of the dollar pool, the fact that a country has a surplus in its transactions with the dollar area does not necessarily mean that it can undertake substantial dollar obligations if the sterling group as a whole has a substantial dollar deficit. And inversely, the fact that a country has a deficit with the dollar area does not mean that it cannot undertake dollar obligations if the dollar position of the group as a whole is one of equilibrium. If, however, this interpretation is not correct and if the present practice is merely a matter of convenience which could be discontinued without leading to a break-up of the system and which in no case implies the possibility for a country to obtain from the pool year in year out more dollars than it contributes to it, then it is clear that in appraising the dollar creditworthiness of a sterling area country the Bank must look at the dollar position of the applicant and not of the whole group.

Thus, the basic question to be answered before deciding on the significance of sterling area membership from the point of view of the Bank's operations is what are the rights and obligations involved in that membership with regard to the dollars earned by the members of the group. The Memorandum of the Economic Department does not give a clear answer to that question.

The whole argument of the Memorandum seems to assume that the present sterling area practices involve a real pooling of dollar resources and also that this arrangement is a basic characteristic of the system. This leads the authors of the Memorandum to exclude from the sterling area South Africa, i.e. a country which is an important member of the group both legally and in fact, on the ground that South Africa administers its dollar resources independently.

On the other hand, however, when considering lending by the Bank to the independent members of the sterling area, i.e. to the countries in the group with which the Bank is mainly concerned, the Memorandum concludes that such loans should be made "only if it is judged that these countries could balance their dollar accounts bilaterally should the occasion arise". This departure from the assumption that the sterling area pools its dollar resources is justified in the Memorandum on the ground that the position of the sterling area dollar balance is precarious, which means that it would not be wise for the independent countries of the area "to count on a large annual net contribution from the dollar pool to cover dollar deficits".

It seems to me that if one accepts the assumption of the Memorandum that there is a real pooling of dollar reserves in the sterling area, then the fact that the overall dollar position of the sterling area is precarious should lead to the conclusion that it would not be safe for the Bank to make substantial loans to individual member countries, even in those cases in which the individual dollar position of the country is favorable, since that country as a member of the group has the obligation to contribute its dollar earnings to the pool. And inversely, if the overall dollar position of the sterling area ceases to be precarious, the Bank should be willing to make large dollar loans to countries whose own dollar position is weak on the basis that these countries can draw on the pool to finance their dollar needs.

The conclusion that the Bank's decisions in lending to the independent members of the sterling area should be based on the dollar borrowing capacity of individual countries is justified only if one accepts the interpretation that present sterling area arrangements with regard to the pooling of dollars do not mean that membership in the sterling area gives to a country access to dollars earned by others. In that case, however, the precariousness of the dollar position of the United Kingdom, which is what is usually meant by "dollar position of the sterling area", is not as decisive a consideration as the Memorandum suggests, since even if the dollar position of the United Kingdom turns out to be more favorable than assumed in the Memorandum, it does not necessarily follow that the improvement would be devoted to the dollar needs of the rest of the sterling area rather than to the dollar needs of the United Kingdom itself. Thus, if British exports to the dollar area turn out to be larger than the \$1.1 - \$1.2 billion assumed in the Memorandum, say \$1.4 billion, it does not necessarily follow that the \$200 to \$300 million difference would be available to support larger dollar borrowing by the rest of the sterling area, since it is more than probable that Britain will expand correspondingly its dollar imports, which, at the level of \$1.5 to \$1.7 billion per annum assumed in the Memorandum, would be considerably below their prewar volume. The reason why so much importance is attached to the dollar position of the United Kingdom when discussing the dollar prospects of sterling area countries is that it is implicitly assumed that normally the United Kingdom should be a source of dollars for the rest of the sterling area and that a situation in which these countries have to balance their dollar accounts constitutes an anomaly. Thus, in discussing the prospects of the independent members of the sterling area, the Memorandum states that "the most that can be expected of them is that they will keep their drawings on the pool within reasonable limits and, indeed, balance their dollar accounts <u>if circumstances should require</u>". Again when discussing dollar loans by the Bank to these countries, the Memorandum states that large loans should be made to them only "if it is judged that these countries could balance their dollar accounts bilaterally <u>should the occasion demand</u>". This view that the United Kingdom is a natural supplier of dollars to the independent members of the sterling area is based on Britain's prewar position in the area and on postwar experience. Before the war the convertibility of sterling meant that a sterling area country did not have to be concerned with its individual dollar position since it could always acquire dollars against sterling. Since the end of the war the fact that the United Kingdom has supplied over \$2 billion to the independent members of the sterling area has created the impression that it was natural for these members to supplement their dollar resources in this way. Neither consideration, however, is relevant in determining the dollar prospects of the independent members of the sterling area in the coming years, since the conditions for a restoration of sterling convertibility do not exist and since the ability of the United Kingdom to supply dollars to these countries in the postwar period was due to the availability of large American aid. I think it would not be safe for the Bank to assume either that sterling will become convertible in the foreseeable future or that American aid to Britain will be continued on the scale of recent years. In that case, however, there is no justification for discussing the dollar borrowing capacity of independent sterling area countries in terms of prospective developments in the dollar position of the United Kingdom. On the contrary, I think that the discussion should be primarily in terms of the conditions and prospects of the borrowing countries themselves.

The second point I should like to make in connection with the discussion contained in the Memorandum concerns the criterion suggested for determining the amount of dollar debt that the "sterling area" can be expected to be able to service. The Memorandum states that "under present conditions a reasonable solution would be for the Bank not to make loans to the sterling area which would result in a substantial net increase in the dollar debt owed or guaranteed by the United Kingdom. Amortization payments on such debt amount to about $70 million in 1952 and rise gradually thereafter."

I confess I am unable to see the economic significance of this criterion.

In the first place, it is not clear whether the sum suggested includes dollar borrowing by the whole of the sterling area or only by the United Kingdom and the colonies. The wording of the statement seems to indicate that this is an overall figure applying to the whole of the area. The fact, however, that two paragraphs later a different criterion is suggested for the independent countries of the area would seem to indicate that these countries are not included in the above estimate. I think that a clarification on this point is necessary.

In the second place, the fact that the dollar debt owed or guaranteed by the United Kingdom consists largely of intra-Governmental loans granted under special terms means that amortization payments on such loans are not a very significant criterion for determining the amount of new dollar debt that the United Kingdom could undertake. A loan at 4 percent repayable in 25 years involves a burden twice as heavy as a loan at 2 percent repayable in 50 years.

On the other hand, loans which contribute to the strengthening of the dollar position of a country either by increasing its ability to earn dollars or by making possible savings of dollars (provided, of course, that the savings expected are genuine savings and not paper ones as is often the case) are, by definition, self-liquidating as far as the problem of transfer is concerned. In the case of such loans, therefore, a decision on whether they should be granted or not should be based not on the dollar position of the country at the time the loan is made, but on the expected improvement from the loan. This means that in the case of these loans the criterion suggested in the Memorandum is too restrictive.

<u>The third point</u> I should like to make refers to the role of the United Kingdom as a provider of capital for the other members of the sterling area. The Memorandum considers that one of the main attractions of sterling area membership consists in the fact that participation in the system gives a country free access to the British capital market. Not only this, but it also contends that unless Britain is in a position to lend substantial sums to the other sterling area countries it cannot hope to keep these countries within the system. Thus, the Memorandum concludes, the restoration of Britain's ability to export capital is one of the two essential conditions for the long-run viability of the

sterling area, the other being overall balance in the area's dollar accounts.

On this I should like to make the following remarks:

The term "export of capital" has been loosely used in the postwar period to describe both the repayment of debt and the genuine export of capital. There is, however, a very great difference between repayment of debt, which is an obligation and a necessary burden on a country, and export of capital as a feature of a country's international economic position which indicates that that country has funds to spare for investment abroad and a balance of payments position which makes possible the transfer of these funds.

With regard to the releases of sterling balances, there is no indication that participation in the sterling area ensures to a country more favorable conditions of release. The fact that British sterling liabilities to non-sterling countries have declined more than sterling liabilities to sterling area countries seems to suggest that the opposite has been the case. Thus, it is not likely that the prospect of obtaining more favorable releases of sterling balances is keeping in the sterling area countries that would otherwise have decided to secede.

With regard to borrowing on the British market, the Memorandum itself points out that already during the interwar period the United Kingdom had ceased to be a net exporter of capital and that during the prewar decade was probably liquidating some of its former investments. This happened during a period when the British external position was infinitely stronger than it is today or is likely to become in the coming years. Hence, the Memorandum rightly concludes that a return to Britain's traditional role as chief provider of capital for the sterling area will require very considerable sacrifices and austerity on the part of the British people. The question is: Is it really necessary for Britain to make these sacrifices and is it true that unless the sacrifices are made the sterling area would break up? I do not believe that this is so.

In the first place not all countries in the sterling area need to borrow sterling. Many of them have large sterling balances on which they can draw for their capital needs.

In the second place an effort to export capital, by weakening the British economic position and hence the value of sterling, reduces the attractiveness of sterling area membership to countries whose continued participation in the sterling area may be more important for the preservation of the system than that of the borrowers. Thus, British capital exports in the face of a weak British economic position are a two-edged proposition and may on balance do more harm than good to the sterling area system.

In the third place the fact that a very large, I should say excessive, export of capital over and above the releases of sterling balances, has taken place in the postwar period is no indication that the British economy will be able to stand such a strain in the coming years. During the postwar years there was American aid and the liquidation of investments to draw on which are non-recurring resources, there was austerity at home which is not likely to be tolerated indefinitely, and there was inflation which will have to be stopped if sterling is to regain its position as a world currency.

The fact, however, that Britain is not really in a position to become an important exporter of capital does not mean that there is no future in the sterling area. What keeps the sterling area countries together and will continue to do so in the future, barring any further serious weakening in the British position, is the complementary nature of their economies which is reflected in their close commercial ties and the fact that participation in the system in its present form enables them to meet the consequences of the world shortage of dollars in a more satisfactory manner than if they had had to face these consequences as isolated countries.

The fourth point I should like to make refers to the other aspects of membership in the sterling area besides the problem of the dollar balance which are of importance in determining the influence of sterling area membership on a country's creditworthiness. In a paper which I prepared last September on the subject I pointed out that ability to repay loans is a relative, not an absolute, concept in which human attitudes play a decisive role. My contention was that participation in the sterling area, where the credit standards set by the United Kingdom and the other important members are very high, is bound to have an important influence on a country's willingness to meet its contractual obligations. At the same time I pointed out that in determining a country's creditworthiness one should not confine oneself to an examination of its balance of payments prospects but should also make sure that the internal policies of the country do not become a threat to its external balance. In this respect too, membership in the sterling area increases the probability that a country will manage responsibly its financial affairs. Thus, in both respects, membership in the sterling area is a factor which should be taken into account by the Bank when considering the creditworthiness of a prospective borrower. It is a factor which may not be susceptible of quantitative measurement like the usual projections of dollar earnings and dollar requirements, but which may in some cases prove of greater significance than these dollar calculations.

dm. files
2

Mr. W. A. B. Iliff May 20, 1952

K. Varvaressos

Comments on the address on "Monetary Illusions Put To The Test" by Roger Auboin.

I have read with great interest Mr. Auboin's address on "Monetary Illusions". I agree completely with his criticisms of postwar economic policies and especially with the two points he makes, first, that war-time financial management is not appropriate to peace-time conditions and, second, that the obsession with the danger of depression was in large part responsible for the failure to recognize that the real threat in the postwar period was inflation, not deflation. I also share entirely Mr. Auboin's view that sound money is an indispensable condition for economic health and progress. This was the main theme of my recent report to the Greek Government.

I think, however, that in several respects Mr. Auboin has overstated his case and oversimplified the issues:

(1) It is true that there is a close connection between internal monetary conditions and the balance of payments. This is no new discovery. Every competent economist is familiar with this relationship. It is also true that the postwar practice of foreign exchange "budgeting" and import "programming" has often ignored this relationship. But it does not necessarily follow that present balance of payments difficulties are due solely to internal factors and would disappear if inflationary pressures were removed. This was true during the 19th century when the gold standard automatically adjusted the internal monetary conditions of the various countries to their external position and vice versa, and when sterling, the currency of a great importing nation, was the major world currency. It is not true today not only because currencies are inconvertible, but also because even the countries whose currencies are convertible have abandoned the gold standard in favor of national management of the currency and because the dollar, which is a structurally scarce currency, has replaced sterling as the major world currency. The fact that the United States is not prepared to expand its credit structure when it experiences an inflow of gold means that the whole burden of adjustment must fall on the country experiencing the outflow of gold. If that country attempts to bring about the adjustment by means not of exchange and import restrictions but of internal monetary contraction it will have to go to lengths that would paralyse its economy. The fact that the United States is still reluctant to see any serious decline in its exports and any serious invasion of its market by foreign goods means that a sharp contraction abroad that would result in cutting down foreign demand for American goods and increasing the competitive position of foreign goods in the American market would be more likely to lead to increased subsidization of American exports and to the raising of American tariffs than to the restoration of balance in the world dollar position. These facts explain why exchange control and import restrictions are likely to be needed outside the United States even after the internal monetary situation has been stabilized.

My contention is that conditions today are vastly different from what they were in the 19th century and that, consequently, the remedies will also have to be different. The dollar shortage arises in part from the lax monetary policies followed in Europe and elsewhere, but it is also in large part a symptom of the anomalous position of the United States in the world economy which is created by the American unwillingness to open the American market to foreign goods. The problem existed during the interwar period, but at that time Britain and, to a smaller extent, the Netherlands realized substantial dollar earnings from past investments in the United States, from the sale of colonial products in the American market and from gold production to meet not only their own dollar needs but also those of most of Europe and other areas as well. Today most of these earnings are gone and a dollar balance, if it is to be achieved at tolerable levels of trade that would make possible a restoration of convertibility and an abandonment of restrictions, will require a very considerable expansion in the exports of Britain and the other European countries to the United States. Thus we come back to this fundamental problem of the American attitude towards imports and to the resulting structural character of the present dollar scarcity.

That this is so is also shown by the fact that even the countries which Mr. Aubоin praises for their sound financial policies, namely Belgium, Italy, Western Germany have sizeable dollar deficits. The fact that these countries have surpluses in Europe is due not so much to the soundness of their internal policies in itself as to the inflationary policies of the other European countries. Experience to date shows that every time inflationary pressures are reduced in these other countries the Belgian and Italian surpluses tend to disappear (incidentally, this is likely to happen again in the coming months).

(2) I do not share Mr. Auboin's nostalgia for the interwar years. What is wrong with postwar policies is not that they have departed from prewar practice but that they have gone too far in the opposite direction. I think that the interwar policies were neither wise nor successful, as suggested by Mr. Auboin. The obsession with the danger of inflation under conditions of widespread unemployment and idle capacity was as unjustified then as is today the obsession with the danger of deflation under conditions of full employment and shortage of capacity.

(3) I do not agree with Mr. Auboin about the superiority of League of Nations loans over Marshall aid. It is true that the methods followed in granting Marshall aid have often been too rigid and that the excessive concentration on import requirements of particular commodities has often tended to divert attention from the overall economic problem of a recipient country and especially from the fact that import needs were often swollen by inflationary conditions inside the country. On the other hand, the idea behind most League of Nations loans, namely that increasing the reserves of a country would enable it to restore the convertibility of its currency, was still more unsound. I think that the importance of reserves for the restoration of monetary stability is being greatly exaggerated in certain circles. If a country's economy is in equilibrium a lack of adequate reserves may cause inconvenience but nothing more; in no case can it be a cause of instability. If, on the other hand, a country's external position is unbalanced (as was the position of all the recipients of Marshall aid), the provision of reserves will do no more than create an illusion of stability while the reserves last to be soon followed by a rude awakening when the reserves have been exhausted. This is what happened with the short-lived convertibility of the British pound in 1947. Nor should it be forgotten that most of the stabilization loans made during the late 1920's evaporated in a few years in capital flight. In this respect I find Mr. Auboin's reference to the Rumanian experience very unconvincing. It is true that Rumania attempted to maintain the original par value of the lev after the devaluation of sterling and did not devalue until 1935, but it is also true that the

external value of the lev had become wholly artificial and that Rumanian exchange controls and manipulations had become a nightmare for those who had to deal with that country.

(4) I think that a practical test for determining the nature of a country's balance of payments difficulties is whether the difficulties are confined to the dollar area or extend to other currency areas as well. A country which is unable to balance its accounts not only with the dollar area but also with most other areas will, in most cases, be found to be a country experiencing internal inflation. A country whose accounts are in balance with all areas other than the dollar area is likely to be a country whose external difficulties are due not to internal monetary conditions but to other factors affecting directly its external position. Of course it should be kept in mind that a country which requires severe restrictions and controls to maintain external balance is not a country which has attained a genuine equilibrium in its dealings with other countries. Thus a balanced dollar position attained through severe restrictions is no evidence that a country has solved its dollar problem and can afford to restore the convertibility of its currency.

Most of the deficits(and hence the surpluses) in inter-European trade can easily be shown to have arisen as a result of the disparity in internal monetary conditions existing in the various European countries, that is, the existence of inflationary conditions in the deficit countries and of deflationary tendencies in the surplus countries. This is one of the main reasons why I have always felt that providing dollars and credits to settle such unbalances was a waste of resources which could have been used more profitably elsewhere.

I return herewith your copy of Mr. Aubein's address.

K.V.

Attachment-1

Europe; Sem

April 4, 1952

Dear Dr. Rodan:

Miss Zafiriou and myself have read with great interest your study on Europe's future creditworthiness. We find that it states in a very clear and concise form the nature of Europe's dollar problem and its main determinants and is, therefore, a very useful basis on which to assess the creditworthiness of European countries. The actual figures used are necessarily speculative in view of the many unknowns involved, but the overall picture is probably of the right order of magnitude.

With regard to the specific assumptions used in the study, we should like to make the following comments:

(a) Your conclusion that the problem of servicing the European dollar debt in 1952-53 is likely to be of manageable proportions seems reasonable in view of the availability of American aid and the probability of American military offshore procurement and spending in Europe. We are, however, inclined to think that the sums that will thus be made available may prove smaller than your estimate of $2.85 billion, but we also think that the current dollar deficit estimated by you at $3.065 billion may also be smaller, considering that in 1950 it was only $2 billion, which, even if the exceptional factors applying to that year are taken into account, seems to suggest that a contraction in European dollar expenditures below $3 billion is possible.

An alternative estimate of the European dollar position in 1952-53 might be as follows:

Dollar deficit on current account	$2.30 billion
Amortization	$0.30 "
Total	$2.60 billion
Covered by:	
U.S.A. aid	$1.30 billion
U.S.A. purchases and spending in Europe	$0.8 "
Loss of dollar reserves	$0.5 "

(b) You assume that U.S.A. capital exports by 1960 will be of the order of $3 billion per annum. This may well happen, but we personally doubt that American capital exports of that magnitude are in prospect. If our doubts are realized, your estimate of over $1 billion accruing to Europe from this source

($700 to $800 million of U.S. capital exports to "monetary" Europe and some $300 to $350 million of offshore purchases from U.S. capital exports to other regions) may be too high. Our own feeling is that the European dollar problem will require a more drastic cut in dollar imports than assumed in your study.

(c) These overall estimates are undoubtedly useful in assessing the size of the problem, but the crucial question from the point of view of the debt service is the position of individual European countries. We agree completely with your determination of the factors affecting a country's ability to service dollar debts made on page 7 and also with your assessment of the relative creditworthiness of individual European countries. We do, however, find it difficult to accept the assumption made in your study that the sterling area would be willing to spend some $250 - $300 million per annum in the form of dollars in order to maintain a deficit with continental Europe. It is sufficient to take into account (i) the very severe restrictions on dollar imports in force in the sterling area in 1950; (ii) the fact that some of the goods most urgently needed by the U.K. and the sterling area, namely food, raw materials and equipment, are obtainable under the most favorable conditions in the dollar area; and (iii) that U.K. imports from continental Europe are the least needed by the British economy in order to reach the conclusion that the U.K. is unlikely to be willing to become a regular supplier of dollars to Europe. Once, however, this assumption is rejected, the dollar prospects of the other European countries become necessarily less optimistic than in your study. This conclusion does not affect your assessment of the ability of continental European countries to service their present dollar debts: it affects your estimate of the total size of European dollar imports and of the ability of European countries to undertake further dollar obligations.

(d) Even if prospects prove to be less favorable than assumed in your study, it does not necessarily follow that the servicing of Bank loans may have to be suspended in the next decade. A large part of the present dollar debts of European countries consist of intra-Governmental debts which are of an entirely different nature from the loans obtained from the International Bank. It seems reasonable to expect that in the event of dollar difficulties a suspension or scaling down of the dollar debt service will be confined to U.S.A. Government loans and credits and will not extend to private or international lending. This is especially likely to happen if U.S. aid to Europe has been terminated, in which case the danger of unfavorable reactions in the U.S.A. will be smaller, while the knowledge that full payment will require a sharp curtailment of U.S. exports to Europe will have a sobering effect on American public opinion. Thus, we think that from the point of view of the Bank's loans to Europe it might be desirable to distinguish between intra-Governmental debts and other debts.

Yours sincerely,

K. Varvaressos

Dr. Paul N. Rosenstein-Rodan
Chief
Economic Advisory Staff
Economic Department
International Bank for
Reconstruction and Development
Washington, D. C.

Var

Mr. Leonard B. Rist January 23, 1950

K. Varvaressos

National and Internation Measures For Full Employment.
Report by a Group of Experts appointed by the Secretary-General
of the United Nations.

Considerations and Recommendations Affecting the Bank

Although the Report is primarily concerned with the problem of full employment, it attempts to include economic development in the concept of full employment. It states that: "unemployment is of three kinds. The first results from a lack of the complementary resources necessary to keep wage earners at work; the second arises from certain structural factors in the economy; and the third is engendered by the insufficiency and instability of effective demand." (It is this last type of unemployment which we are accustomed to consider when discussing the problem of full employment.)

Having thus extended the scope of the problem of full employment, the authors of the Report attempt to determine "the requirements for the establishment of the kind of over-all international economic equilibrium and stability which would enable countries successfully to maintain their economies at a stable and prosperous level."

They find that there are three major requirements for attaining this purpose:

(a) Maintenance of over-all international equilibrium.

(b) Stabilization of the flow of international investment.

(c) Stability in world trade.

The discussion and recommendations of the Report referring to the "stabilization of the flow of international investment" are of particular interest to our Bank and raise some important questions with regard to which our Bank will have to take a position.

The main arguments of the Report on this subject are the following:

The interests not only of the underdeveloped countries but of the world economy at large depend heavily on a substantial and steady flow of capital from the leading industrial countries. The problem is to stabilize the flow so as to avoid the wide fluctuations which are traditionally connected with foreign investment and to attain a structural equilibrium in world trade.

If governments are to make a rational and coordinated approach to the adjustments required for the achievement of international equilibrium or for the formulation of rational development programs, it is essential that they should be able to foresee the level of external currency disbursements of the major lending countries for a considerable period ahead and anticipate a steady flow of capital from the lending countries.

We cannot rely on private investment alone for this purpose. Private investment is not only unstable, but also unlikely to revive on any large scale.

The only practicable solution is to organize a large part of long-term foreign lending through an international organization, and the International Bank for Reconstruction and Development is soundly conceived from this point of view.

The Bank, however, in its present structure would be unable to act as the main channel of international lending and bring about a stable flow of international investment of major dimensions because the Bank has three major defects: Its resources are too small, it is too dependent on the private markets and it can finance only specific projects which are unlikely to result in a total flow of funds of the magnitude required.

The Report, therefore, proposes that the Bank, in addition to its present functions, should be empowered to obtain funds by borrowing from governments, and to lend to governments for general development purposes not only in special circumstances but also generally. The details of the proposed reorganization of the Bank are discussed on pages 92 - 94 of the Report.

Before determining the attitude of the Bank on these far-reaching proposals of the Report, it will be necessary to answer the following questions:

1.--Although the Report speaks of "lending countries", it is more realistic to assume that its recommendations are directed primarily to the United States. It is, therefore, essential to recognize that international investment means a flow of resources from the United States to the rest of the world. If this is so, and in view of the fact that the Report provides for government lending on a large scale, the question arises whether the United States Government would be willing and authorized to commit the American people to a policy of lending substantial amounts of capital to foreign countries for a "considerable period ahead".

2.--The United States has attained a great degree of economic independence from the rest of the world. American imports represent a small percentage of American national income, while American products are eagerly sought by foreign countries and Americans themselves are only too anxious to sell in foreign markets. Is there not a danger that a large volume of foreign lending by the United States would, at the end of the period of the program, result in the piling up of huge dollar liabilities which the borrowers will find themselves unable to discharge? Can large dollar lending be sound lending without a drastic change in the structure of the American economy which would result in a great increase in American imports?

3.--Is it true that under the present structure of the American economy foreign (American) investment, if used productively, will be self-liquidating and can never be excessive?

4.--Those who established the International Bank assumed that lending on a specific-project-basis was the best way to ensure that a country would not undertake excessive debt burdens, that it would mobilize to the limit its own resources, and that it would exercise the utmost care in the utilization of the funds borrowed. They believed that the authorization given to the Bank to deviate from that basis, when special circumstances justify such deviation, allows for considerable flexibility in the Bank's operations and eliminates the danger of rigidity. Was this conception correct at the time of the establishment of the Bank, and did anything happen since then to justify a radical change of ideas in this respect?

5.--When the authors of the Report contend that a stable flow of international investment of major dimensions is required in order to enable countries successfully to maintain their economies at a stable and prosperous level, do they have in mind genuine loans in which the prospects of servicing and repayment are a decisive consideration, or do they appear to endorse the widely shared opinion that if American investments can make a decisive contribution to world progress, the problem of their servicing and repayment becomes a secondary consideration?

6.--Assuming that the United States Government, under the pressure of events, modifies its present attitude and makes the policy of direct government lending to foreign countries a permanent American policy, is it likely that it would decide to channel the funds it will make available through an international institution like our Bank or would it prefer to lend these funds directly?

7.--If the United States Government were willing to lend through the International Bank, would it be in the interest of the Bank to serve as an intermediary between the United States and the borrowing countries? It may be argued in favor of such a solution that the Bank would have large funds at its disposal and the flow of these funds would be steady and would not depend on the state of the market. This would enable the Bank to expand the scope of its operations in underdeveloped countries while continuing to exercize its present functions. It might also be said that from the point of view of the borrowing countries such a solution would ensure greater objectivity of treatment and less political interference .

On the other hand, it may be contended:

(a) That the Bank would be acting in a dual capacity and with dual criteria in its operations. One department of the Bank would be handling funds largely obtained on the market and would be guided primarily by considerations of soundness of the loans to be granted. Another department would be handling public funds and would be concerned mainly in granting general loans and keeping the world well supplied with dollars. Is there not a danger in such an arrangement that the Bank would gradually loose its present character as an organic link between the investing public and the countries in need of capital?

(b) That if the United States is induced by events to become almost permanently involved in foreign lending activities, political considerations will play a major part in that decision. Is it not likely that such political considerations will also prevail in the administration of the funds which will be made available, and in such a case, is it not to be feared that the utilization of the International Bank as an intermediary would affect its international character and weaken its prestige and authority?

Oc. ber 31, 1949 Europe : Gen

A Few Remarks on Mr. Rist's Statement at the Bank's Information Meeting on October 14, 1949

Mr. Rist's argument is that the pattern of European recovery has been markedly different this time from what it was after the First World War, that the differences are due to differences in circumstances and that the time is now approaching to return to the type of economy prevalent after the First World War. I agree with the general thesis, but I have a few observations to make.

It seems to me that neither the emergence of Russia as a great world power nor the new importance of the Middle East, two factors stressed by Mr. Rist, are facts which, whatever their other significance, have affected to any considerable extent the pattern of European recovery. Similarly, I wonder whether the fact that American aid reached the "enormous total of $25 billion" in 1946-48 can be considered as an explanation of why European countries have preferred to resort to controls and planning rather than let the price mechanism attend to the job of recovery. I should have thought that the availability of aid would have made it easier to relax controls, and that in the absence of aid, controls would have had to be even more severe than they were. Finally, I doubt that the more limited scope of emigration has been a very important factor impeding the return to normal conditions, considering that in most European countries man-power has been extremely short during the last four years and any reduction in the labor force would have affected the level of output. My general feeling is that the factors stressed by Mr. Rist explain some of the changes which have taken place in Europe's position, but they do not necessarily explain why the pattern of recovery has been different from what it was after the First World War. In my view, the main reason for the difference is the changed social structure of Europe and the much stronger position of labor, which have increased the claims of the most numerous section of the population on the community's resources at a time when these resources, even when supplemented by outside aid, were already inadequate to take care of the requirements of reconstruction and adjustment to the post-war economy.

I agree that the recent devaluations, if they prove effective, are an important step towards the liberalization of the European economy. I also agree that with the major tasks of reconstruction completed there is great scope for relaxation of controls and a return to more normal economic processes. In my view, however, it is unrealistic to think that Europe has only to return to the price mechanism and freer trade to solve her problems. The case of France illustrates clearly the complexities of the present European situation. France has returned to a liberal economy, but it is an economy of the most vulnerable kind, depending on the workers' acceptance of a standard of living which falls dangerously short of what they consider their due share of the national income. I think that if Britain relaxed to any considerable extent her present controls, the labor situation there would have been even more critical and troublesome than in France.

In my view, the basic European problem is that of productivity, and as such, it is a problem that will take years to solve. I also think that the question of attaining independence from American exceptional aid should not be confused with this long-term problem. Europe could, by making the necessary adjustments in its economy, earn sufficient dollars to buy her essentials from the Western Hemisphere. This would absorb only a small fraction of her resources, and would not affect substantially present living standards. It is a question of <u>flexibility</u> rather than <u>availability</u> of resources, but it is also, if not primarily, a question of recognizing that American aid cannot continue indefinitely.

Mr. Leonard B. Rist April 20, 1949

K. Varvaressos

Mr. Harrod's Proposal for an International Economic Conference.

Mr. Harrod's argument is that the Bank and Fund were created to provide an international solution to economic depressions, that we are now entering into the phase of depression and that the Fund and Bank, having failed to meet the world's needs under inflation, are not likely to be able to do so under depression.

I do not agree that we are entering into a period of depression unless we have become so greatly acclimatized to inflation that we consider the disappearance of inflation as a deflationary phenomenon. In my view, the United States is not going to have a depression and if it does it will act to prevent it from becoming serious. Europe has no right to allow itself to go into a depression while it receives billions of outside aid on the ground that its resources are inadequate to meet its needs. (The definition of depression is that available resources are left unemployed because of lack of purchasing power. A depressed economy needs an export surplus, not an import surplus in order to be stimulated.) The appearance of widespread unemployment in Europe before the balance of payments deficit is closed will be evidence of failure to produce the kind of goods that the region and the world needs and not of inadequacy of over-all purchasing power. Inappropriate exchange rates can very well check exports to the extent of producing serious unemployment, while generous unemployment benefits can very well maintain the demand for imports at its present levels and thus widen the gap in a country's external payments. This, however, would not be a cyclical phenomenon of the pre-war type; it would be a structural maladjustment which would require a completely different type of solution from that envisaged in the case of the typical depression. I think it would be not only incorrect, but also outright dangerous to start talking of a depression in Europe when, in fact, what would be happening would be that the end of the sellers' market would be revealing the weaknesses of the European economic structure. To do this would be a sure means of postponing indefinitely Europe's return to solvency, because it would allow European countries to start anti-cyclical spending on the basis of their present maladjusted economic structure instead of taking measures to correct the maladjustment. If this happens, Europe will never become independent of American aid.

I have great sympathy with Mr. Harrod's view on the work of the Fund, and I also agree with his diagnosis, that Governments have not really worked through the Fund but have looked for legal loopholes in the Agreement enabling them to go on doing what they wanted as if the Fund did not exist.

This, however, being so, I cannot see what Mr. Harrod expects of a new conference. If the cause of the present return to nationalistic policies is the failure of the most important Governments to support real international economic cooperation, a new conference and the new arrangements that it would make would have exactly the same fate as the older ones. So long as Governments continue to place expediency above principle and refuse to accept any limitations to their sovereignty, nationalistic policies will be the order of the day and no machinery for international collaboration and consultation, however ingenious, will be able to alter this fact.

K.V.

Europe: Gen

COPY

23 Wall Street
New York 8

R. C. Leffingwell

March 24, 1949

Dear Jack:

Homework and office work have fallen so heavily upon me that I haven't gotten around to acknowledging your very interesting and thoughtful letter of February 21st, or the accompanying letter of February 10th to you from Mr. Varvaressos (which I return herewith), or Mr. Varvaressos's and Mr. Zafiriou's essay on The Problem of Intra-European Trade and Payments and its Significance to European Recovery dated December 31, 1948.

Having in my previous letters expressed my own views and drawn your fire and that of Mr. Varvaressos, I don't think I ought to burden you with rejoinders and surrejoinders. The facts are I suppose pretty well known to all three of us. We have I think sufficiently expounded our differences of opinion, which are probably constitutional and incurable.

I am in fullest agreement with the main thesis of Mr. Varvaressos's essay on intra-European trade. I think he has done a great service in exposing the fallacy of the New Federalists or Western Unionists. As I wrote Bob Lovett nearly a year ago:

"I am a free trader; but the problem is to find solvent buyers, outside Western Europe, for European manufactures, in order to enable Europe to pay for necessary imports of food and raw material from the world outside. European nations cannot achieve recovery by taking in each other's washing, by exchanging manufactured products with each other. There would still remain the problem of paying for the food and raw materials they must buy in the Americas and elsewhere."

Western Europe is highly industrialized and densely populated. Even before the war it was living to a considerable extent on the foreign and colonial wealth accumulated in better times. Now the foreign and colonial wealth is lost or impaired, and foreign debts have, particularly in the case of England, taken its place. Europe's monopoly of the manufacturing business of the world, which was pretty complete in the early days of the industrial revolution, has disappeared, and pretty much every nation to a greater or less extent has gone into the manufacturing business.

Europe has been able to do very well, with immense American aid, in the early post-war period, when world shortages and the elimination of Germany and Japan from the manufacturing business gave her a special opportunity. As the shortages disappear and the pipelines are filled up, her problem is going to be to find markets for her exports while she pursues a restrictionist policy in regard to her imports. It seems to me there is the gravest possible problem for Western Europe to solve, the problem of selling her manufactures to the western world for food and raw materials, and the less time and labor and material she devotes to intra-European trade the more she will have to devote to exports to the Americas and other suppliers of food and raw materials. I take it that is Mr. Varvaressos's main thesis, and with it I am in most complete agreement.

Yours ever,

/s/ R. C. LEFFINGWELL

Hon. John J. McCloy
President, International Bank for
Reconstruction and Development
Washington 6, D. C.

Enclosure

February 10, 1949

Dear Mr. McCloy:

I have read with great interest Mr. Leffingwell's letter of January 19th which you kindly transmitted to me. Mr. Leffingwell's appreciative words on our Memoranda are a great encouragement to us and we value highly his stimulating comments on the problems we have discussed.

I should like to comment myself on some of the points raised by Mr. Leffingwell:

1. - The explanation of the fact mentioned in our Memorandum that during the first half of 1948 the French money supply remained stable while bank credit expanded is that there was a surplus on Government account which offset the expansion in money supply resulting from the expansion in bank credit.

The changes in money supply and its origins between February and June 1948 were as follows:

1 9 4 8
(Billion Francs)

Money Supply	End January	End May
Currency in circulation	922	791
Blocked notes	-	57
Demand deposits in banks	635	728
Deposits at Bank of France	69	64
Postal deposits	86	109
Total	1,712	1,749

Sources of Money Supply	End January	End May
Public accounts	1,084	1,015
Private credits	522	635
Miscellaneous	41	34
Total	1,712	1,749

The 50 per cent expansion in bank credit mentioned in our Memorandum refers to the period January-July when private credits increased from 490 billion francs to 737 billion. We quoted this expansion rather than the 25 per cent expansion during the months February-June shown in the preceding table because we thought it was important to indicate how great was the increase in bank credits in 1948 at a time when the Government was trying to apply a deflationary policy. We omitted to explain that the 2 per cent increase in money supply corresponded to a 25 per cent increase in bank credit and the 50 per cent increase in bank credit to a 12 per cent increase in money supply.1/ This, however, does not alter the fact which we wanted to bring out in our memorandum, that Government financing during that period was deflationary and that it helped maintain monetary stability in the face of a great expansion in bank credit.

2. - Mr. Leffingwell's comment on our suggestions for social reforms in France are the result of a misunderstanding, which is probably due to lack of clarity on our part resulting from an effort to condense what we had to say on France in 9 pages. It was never our intention to suggest that social reforms were an alternative to a balanced budget and credit restriction. In all our memoranda we have stressed that one of the most important tasks facing European countries is to achieve monetary and financial stability and restore confidence in their currencies. The point we wanted to make about France is that so long as the present inequitable system of taxation and administrative incompetence remained, the mere balancing of the budget could not restore equilibrium to the French economy because it would necessarily be accomplished through indirect taxes, which are

---

1/ As follows:

1948
(Billion Francs)

Money Supply	End December	End July
Currency in circulation	921	849
Blocked notes	-	23
Demand deposits in banks	608	817
Deposits at Bank of France	55	64
Postal deposits	85	119
Total	1,669	1,872

Sources of Money Supply	End December	End July
Public accounts	1,088	1,072
Private credits	490	737
Miscellaneous	26	-2
Total	1,669	1,872

paid largely by the masses, and which raise prices, lead to new demands for wage increases and set in motion the vicious spiral of inflation instead of checking it. That a budget which is balanced overwhelmingly through indirect taxes does not remain balanced very long in a country where labor is politically strong has been strikingly demonstrated in France during the last few years, and it is our impression that the latest version of budget balancing adopted in France will not prove more successful than the earlier ones. It is sufficient to compare the incidence of American and French taxes in order to realize how iniquitous the French tax system is and how greatly it contributes to the social tensions and class conflicts which paralyse France. In 1947 direct taxes represented 70 per cent of total taxes in the U.S.A. and only 26.4 in France, and of this percentage, one-third consisted of taxes on wages and salaries. It is this need for reforming the tax system in accordance with the requirements of our modern society and not public charity that we had in mind when we spoke of social reforms in France. We entirely agree with Mr. Leffingwell that inflation is the greatest of social injustices and hits the workers more than any other section of the population. Our point was that inflation cannot be stopped in France by raising indirect taxes. This is why we said that by merely asking for a balanced budget, without indicating who must bear the burdens of increased taxation, ECA encourages the French Government to continue seeking in indirect taxation the solution of the problem and at the same time alienates the French masses, who are exasperated by the iniquity of continuous increases in the prices of essentials.

3. - While I agree entirely with Mr. Leffingwell's plea for "honest money" and for realistic exchange rates, I cannot agree with his view that ensuring the convertibility of European currencies with the help of American dollars would be the best way of restoring monetary stability in Europe. You know my views on this matter, but I would like to make a few additional remarks.

An essential prerequisite of convertibility is that the supply of a currency in world markets should not exceed its demand. This in turn depends on the existence of equilibrium between the goods and services which a country wishes to buy from abroad and those which foreign countries wish to buy from her. This condition obviously does not obtain in present-day Europe, and that is why convertibility of European currencies, if it were to be attempted, would have to be supported with American dollars. The amount of dollars that would be required would depend on the gap between the supply and demand of European currencies. Any dollar fund, however large, would melt away in a few months given the present volume of money supply in Europe. It is sufficient to recall that the British attempt at convertibility cost nearly a billion dollars in a few months in order to realize what the cost would have been if the experiment had been generalized for the whole of Europe. The only way to prevent the wholesale dissipation of dollars would have been to carry out a drastic monetary reform and rigidly control the volume of money supply, i.e., to take the very measures which the Europeans have been unable to take and which, if taken, would have restored the value of their currencies without the need for dollar support. Thus, convertibility of European currencies under present conditions would have required either an unlimited amount of dollars or full American control of European finances. Since neither course is feasible, the only alternative would have been to rely on undertakings by European countries that they will set their financial houses in order. But we know from experience that such undertakings, however solemn and specific, are seldom effective when there is no real pressure to do the things promised and, in my view, of all conceivable arrangements, dollar-supported convertibility would have been the least calculated to provide a stimulant for financial retrenchment and drastic monetary measures. Thus, while I agree with Mr. Leffingwell that a return to convertibility and multilateral trade is essential for the creation of a prosperous and well-integrated world economy, I feel that such a return cannot be ensured through the use of American dollars, (unless Americans are prepared to give away much larger sums than they are doing now), but will be possible only after economic and social equilibrium has been reestablished in Europe. Such equilibrium in turn depends, in my view, on greater production and on the realization that American help will not continue indefinitely.

4. - Here again, I find myself unable to agree with Mr. Leffingwell's view that Europe needs a restricted investment program and a longer period of American aid than the European Recovery Program contemplates. Mr. Leffingwell points to the inflationary effects of investment and at the same time doubts the possibility of Europe becoming independent of American aid in four years. There can be no question that investment is inflationary because it creates incomes without providing the goods on which these incomes will seek to be spent. Without substantial new investments, however, European production cannot expand above its present levels, since both equipment and manpower are at present fully utilized in Europe. This means that if new investments are on a restricted scale, Europe's productive capacity in 1952 will not be much greater than it is at present nor will Europe's ability to pay for its essential imports be much greater. In other words, the purpose of the Marshall Plan, which is to make Europe self-supporting at a tolerable standard of living, will not have been fulfilled, and it will be necessary either to reduce sharply European living standards or continue American assistance beyond the original period. The first course would have the same disadvantages then that it had last year when the United States decided that it was in the American interest to come to Europe's help. It would involve the same social pressures and the same danger of Communist domination that faced Europe last year, and would create the same dislocation in the world economy and the same strangulation of world trade that threatened to overtake the world in 1947. In other words, it would mean that American aid to Europe during the preceding four years has been largely wasted.

As regards the second course, which is also the course recommended by Mr. Leffingwell, I feel that there are serious dangers in prolonging a relationship between Europe and the United States which can be justified only as an emergency arrangement. You yourself have drawn attention to these dangers, and I shall not, therefore, repeat the arguments against a prolongation of Government-financed assistance to Europe. But I would like to state here that, in my view, the ten-year period of aid proposed by Mr. Leffingwell, when added to the four year period which has already elapsed, is definitely too long and is more likely to produce a pattern of permanent dependence and insolvency in Europe than spur European countries to take the measures that will restore health in their economic and social life. I would even go so far as to say that the shorter the period within which the drastic adjustments needed in Europe will have to be made, the greater will be the sense of urgency and, therefore, the greater the chances that the necessary effort will be forthcoming.

5. - I was very interested in Mr. Leffingwell's suggestion that it might be preferable to confine Marshall Plan aid to Europe to food, fuel and some essential raw materials. I myself have been thinking along these lines for some time, and I am beginning to wonder whether this might not be a more effective means of notifying Europe that it should not depend on the United States for everything and possibly inducing a greater sense of urgency in some European countries. Such an arrangement would also relieve ECA of responsibilities which it is not well equipped to handle. Is there any reason why, once ECA takes care of current needs for food and raw material imports, European countries should not be able to carry out their reconstruction projects themselves, especially since they can be assisted by the International Bank which they themselves entrusted with the task of helping European reconstruction? But I cannot agree with Mr. Leffingwell that Europe does not need American equipment. On the contrary, I feel that the more American equipment they install the better the prospects for expanded production. Europe may itself be an important producer of heavy industrial goods, but it is far behind the United States in technological progress, and is unable to produce many of the types of machinery which ensure to American industry its incomparable efficiency.

6. - There is another point on which I am again more optimistic than Mr. Leffingwell. Mr. Leffingwell wonders what will happen "when every nation has got itself provided with modern plant and equipment to make exports of manufactures". Who will import their exports? When all are equipped to be sellers, who, he asks, will the buyers be?

I agree that present European plans, unless they are better coordinated and adjusted to take properly into account the structure of world demand, may lead to the creation of excessive capacity in many lines and the production of unsaleable goods. But I do not agree that an expansion and modernization in European production is not necessary. It is necessary first, in order to provide goods that are at present supplied free by the United States, second, in order to enable Europeans to pay for overseas supplies which before the war were paid for with investment income receipts and, third, in order to provide the larger volume of goods required in Europe itself as a result of the increase in population and the demand of the working classes for a better standard of living. A reduction in European imports and an expansion in European exports is part of the process of adjustment which will make Europe self-supporting. Sound money is essential for European recovery, but sound money alone will not produce the additional goods that are necessary if Europe is to maintain its present living standards when American aid is discontinued.

7. - In conclusion, I find that we agree with Mr. Leffingwell on the aims of economic policy, but our views differ on how best these aims can be achieved. Mr. Leffingwell feels that sound money is so essential to European recovery that it would justify using American resources to restore the value of European currencies. My view is that it is not possible to get really good currencies, that is convertible currencies, in present-day Europe unless the social tensions and class conflicts which weaken the European economy are solved and unless European productivity is sufficiently increased to provide the volume of goods necessary to maintain economic and social stability. In other words, Mr. Leffingwell feels that the

European monetary problem can be attacked from the purely monetary angle, while I think that its solution is inextricably bound up with the solution of Europe's basic difficulties.

Yours sincerely,

K. Varvaressos

Mr. John J. McCloy
President
International Bank for
Reconstruction and Development
1818 H Street, N.W.
Washington 25, D. C.

Varvaresso

February 3, 1949

Dear Mr. Rist:

I have read Mr. Baruch's letter to Secretary Snyder and have the following comments to make:

The suggestion that the readiness of the United States to buy all non-perishable raw materials would help raise production and living standards in the world is based on the consideration that an assured market for these commodities would be the most effective way of inducing private enterprise to expand the production of these commodities and of encouraging a flow of American capital to the underdeveloped regions of the world where most of these commodities are being produced. The economic justification for such a procedure is that (a) most raw materials are today in short supply; (b) the United States is a large consumer of a great number of these materials and is interested in seeing their supply increased, (c) increased production of these commodities will mean increased productive capacity in the underdeveloped countries, larger foreign exchange earnings and greater ability to import and consume commodities; (d) the expansion in the production of these commodities will require substantial new investment which will largely be American investment. The assurance of an unlimited demand in the United States will make this new investment self-liquidating and practically riskless, and will thus stimulate the flow of American capital to the underdeveloped regions without the need for Government guarantees or other such arrangements.

I think that these are very solid advantages which suggest that Mr. Baruch's plan must be given very serious consideration. It is, however, my impression that the plan underestimates both the difficulties of the proposed solution and its limitations as a means of raising production and living standards in the world.

The first difficulty is the question of prices. Current prices of metals, textile fibers, petroleum, timber, etc. are excessive exactly because demand exceeds supply. In other words, they are scarcity prices and cannot be the basis of long-term purchases by the United States. If this is so, the United States would have to fix the prices at which it would be prepared to purchase the raw materials on some other basis than current market prices. This is easier said than done, and would call for a very detailed investigation of costs of production, profit margins, location, etc.

The second difficulty refers to the quantitative aspect of the plan. Mr. Baruch proposes that the U.S.A. should stand ready to buy all non-perishable raw materials produced anywhere in the world which cannot find a commercial market. I doubt that such unlimited American purchases can be considered as a practical proposition. In the first place, not all of the raw materials are in the same degree of scarcity and not all raw material production can be expanded with the same facility. The result of unlimited purchases by the U.S.A. would be to stimulate the production of those raw materials which are in shortest supply or even in short supply at all. Thus, we may see large stocks of commodities piling up for which there would be no demand, while other commodities and especially foodstuffs remain in short supply. This would constitute a very uneconomic utilization of the world's resources because it would mean producing goods which are not wanted instead of needed goods. Mr. Baruch says that "by creating such an assured market we will not only bring to this country useable materials in exchange for our dollars, but we will lessen the strains on government financing." I think there is very little difference between straight subsidies by the American Government to foreign countries and purchase of materials that are not needed. In fact, I think that the second method is considerably more wasteful (a) because the purchase, storing, insurance and disposal of raw materials will be costly in itself; (b) because scarce resources will have been utilized and production facilities will have been created to provide goods that are not needed; and (c) because painful adjustments in the structure of world production will be necessary at the end of the period of application of the plan.

It may be argued that the waste that would be involved in such an arrangement would not be great because raw materials are in such short supply that it is unlikely that the expansion in their supply can lead to overproduction in the next five to ten years. I think that the total supply of raw materials may not expand unduly under such a plan, although it might, but that the supply of individual commodities may expand very greatly and may absorb considerable resources which would have been more efficiently used in the production of other goods.

My conclusion is that the scheme, if it is to work, will have to be more limited in scope. A blanket declaration that the United States will purchase <u>all</u> raw materials in unlimited amounts is too general and vague to provide the basis for a sound and economic expansion in world production. In practice, it will be necessary to state the commodities coming under the plan and the quantities of each commodity that the United States would be willing to purchase under the plan. In order to do this, very extensive studies would have to be made of future needs and supply possibilities and, in my view, a much more elaborate machinery for the administration of the scheme would be needed than Mr. Baruch seems to contemplate.

Finally, I have the feeling that a market guarantee of five to ten years is not long enough to induce private enterprise to carry out a substantial expansion in production. The expansion itself might take five years for such products as metals, petroleum, timber, and assured sales for another few years may not be sufficiently tempting to stimulate investment. As already stated, the result of such a scheme might well be to favor those goods whose production can be most easily expanded at the expense of goods which may be in the shortest supply. On the other hand, a longer period of, say, ten to fifteen years, increases the danger that the United States will have committed itself to purchase goods in quantities that exceed the world's real requirements. Such difficulties can be solved only by dealing with each commodity on an individual basis and making different arrangements for the different commodities. This again indicates that the administration of the scheme would be far more complex than Mr. Baruch's proposals suggest. In fact, I think that the competent handling of the operations involved would require the establishment of a sizeable, if not very large, government agency.

Subject to these qualifications, assured American purchases of foreign raw materials can contribute considerably to develop world production, stimulate international investment and alleviate the dollar shortage. But I think it would not be correct to say that such a plan would be a perfect substitute for all other forms of American financial assistance to the rest of the world. It would not take care of the need to expand food production, which is at least as great as the need to expand raw material production. It would only partly (and incidentally) take care of the development of basic facilities such as power and transportation, which is one of the most urgent needs of underdeveloped regions. It would make no contribution to the industrialization of these regions on which the rise in their living standards partly depends.

It may be argued that by ensuring a larger flow of dollars to these regions the scheme would give them the means to carry out their development plans without the need for additional foreign capital. I think that this is only partly true. Expanded production means expanded money incomes, increased demand for goods and consequently larger imports. It is doubtful that much development could be carried out on the basis of larger current earnings alone. The experience of the last five years in Latin America shows that larger exports mean also larger income and consequently larger demand for imports. It must also be kept in mind that expanded production of materials which are today in short supply will bring down prices from their present unprecedented heights and therefore offset a large part of the gain to underdeveloped countries resulting from the expansion in production. This does not mean, of course, that the world economy would not profit greatly from larger production of commodities which are today in short supply, but it does mean that a considerable part of the benefit would accrue to the consumers (i.e., the industrial countries) rather than to the producers who are today taking advantage of the conditions of scarcity. Thus, one should not expect that expanded production of raw materials can solve all the problems of underdeveloped countries, and one should not rely on such an expansion alone to take care of the development needs of those countries.

I shall be glad to discuss with you any other points of the proposal.

Yours sincerely,

K. Varvaressos

C O P Y

Mr. Leonard Rist January 31, 1949

Mr. John J. McCloy

Here is a letter from Barney Baruch which he sent to Secretary Snyder. I would like to have your judgment as to what effect this might have on both the U. S. and the world economy.

J. J. McC.

C O P Y   January 28, 1949.

My dear John:

A great deal of good can come out of the President's idea of stimulating the production and living standards in the far reaches of the world.

A simple and dramatic way of accomplishing this would be for the President to announce that the United States stands ready to buy all non-perishable raw materials produced anywhere in the world, which cannot find a commercial market, for the next five to ten years — seven years would be a good medium.

No complicated government machinery would have to be set up. The Congress could simply authorize some one of the existing procurement or lending agencies, perhaps the RFC, perhaps the one already buying critical materials, to make these purchases. Only the surplus which the regular commerce of the world could not consume would come to us. While the net purchases might not be very great, the stimulating effect of such an announcement by the President would be tremendous.

A guaranteed market would be provided for anyone wanting to work, to tap new sources of supply, open new mines, discover new ore bodies. All over the world enterprise would be underwritten. Capital would be encouraged out of hoarding and into productive investment. A sound basis would be provided for the securities of such institutions as the World Bank as well as private investors.

So that the United States will not be accused of trying to monopolize or exploit the world, we should offer to let any other nation share in the purchasing under the same terms and risks that we take.

By creating such an assured market we will not only bring to this country useable materials in exchange for our dollars, but we will lessen the strains on government financing. If the program is attempted through government loans etc., it increases the tax burdens. Instead of the government borrowing from its citizens to lend to other countries, let us arrange it so that American citizens can lend directly abroad.

This plan will stimulate private enterprise abroad, as the President wishes, instead of channeling everything through government cartels.

I am sending a copy of this letter to Messrs. McCloy and Hoffman.

Sincerely yours,

Hon. John Snyder,
Secretary of the Treasury,
Washington, D. C.

V.

December 1, 1948

Dear Mr. McCloy:

On several occasions you have expressed your concern about the present position of the Bank in the face of the uncertainties of the world situation. You also told me you would welcome my views and suggestions on the matter.

In the attached note I have tried to state frankly how I feel about the problems of the Bank. Your readiness to undertake responsibilities and the knowledge that the only consideration that counts with you is the interest of the Bank have encouraged me to make proposals which, by ordinary standards, might be considered too bold to be committed to paper.

Yours sincerely,

K. Varvaressos

SOME SUGGESTIONS ON THE PRESENT PROBLEMS OF THE BANK

By: K. Varvaressos

During the last three years the uncertainties of the international situation forced the Bank to follow a cautious and tentative policy in developing its activities and determining the scale of its participation in the solution of post-war problems. Many of the assumptions on which the establishment of the Bank had been based failed to materialize and post-war difficulties proved far more intractable than had been anticipated when the Bank was entrusted with the task of contributing actively to post-war reconstruction and development. Some clarification of the international situation was necessary before final decisions could be made on the scope of the Bank's activities and the role the Bank could expect to play in the light of post-war realities.

With the enactment of ERP and the greater understanding of the difficulties which three years' experience has given us, many of the prevailing uncertainties are slowly being removed and a clearer picture of the nature of our post-war problems is gradually emerging. It may even be said that the situation has by now been stabilized to such an extent that no spectacular changes or unexpected developments are likely to take place in the next five or six years. For the Bank, this means that the period of waiting is coming to an end, and that important decisions will soon have to be made on the scope of the Bank's activities during the next decade.

In the last three years the Bank has laid solid foundations for its future work and has done all that could be expected from it under prevailing circumstances: (a) It has set up an organization capable of handling competently the tasks entrusted to it and has made good progress in familiarizing itself with the problems of its prospective borrowers. (b) It has arrived at agreed decisions on basic questions of policy. (c) It has made two successful sales of bonds on the American market. (d) It has granted loans to European countries which have filled a serious gap in existing financial facilities and have prevented a deterioration in the position of these countries. (e) It has made a good beginning in the granting of loans for development purposes.

Now, however, the organizational stage is over and the funds at hand are insufficient for further substantial loan commitments. At the same time the background of conditions against which the Bank will have to operate has become clearer and the needs that the Bank will be called upon to meet have by now become fairly well known.

Finally, there is no likelihood of a further marked improvement in the world situation during the next few years that would by itself remove the difficulties at present facing the Bank.

This means that if the Bank is to continue justifying its existence, it can no longer wait for more favorable outside developments but must determine the scope and scale of its activities in the light of existing conditions. These activities must bear some relation to the size of the world's requirements for reconstruction and development, for while it is true that the Bank was created to meet a long-term need rather than an emergency, it is also true that the needs of the emergency are at present being adequately taken care of and consequently the Bank's failure to act on a substantial scale during the coming years could not be justified on the ground that the existing needs were outside the field of competence of the Bank, even less on the ground that world conditions were not yet propitious enough for the Bank's activities.

Technical assistance, studies, missions, small projects, are all highly useful and important, but unless countries are able to receive financial assistance which will make a difference to their position they will in the end tire of merely discussing their problems with the Bank's staff and listening to criticisms and exhortations. Wisdom lies in anticipating events and making sure that one will not be caught unprepared by developments that could have been foreseen. If the Bank wishes to retain its importance as an agency which has a substantial contribution to make to the solution of post-war problems, it must see to it that its lending activities during the coming years are of sufficient size to justify its present setup and uphold its authority towards member countries.

1. The Scale of the Bank's Operations During the Coming Years.

The world's needs for both reconstruction and development are great. To what extent can they be met by the Bank?

In the case of European reconstruction, the following considerations should be taken into account:

(a) ECA is today meeting Europe's current needs for food and raw materials, and is in addition supplying equipment for the improvement of European productive capacity. The hope is that in three to four years' time this dependence on American aid will have been eliminated and European self-sufficiency restored. An examination of the economic position of the major European countries shows that this aim can be achieved only if a great expansion of production over present levels takes place during the next three to four years. Since the available resources of manpower and industrial capacity are at present fully utilized in most countries, the further expansion in production will depend principally on the size of new investment during the coming years. This is recognized in all European recovery programs which call for very large additions to existing productive capacity. Comparing these objectives with the present scale of investment one is bound to conclude that the latter falls considerably short of what is necessary for the restoration of European self-sufficiency. This means that while ECA assistance is today meeting the bulk of Europe's current needs, it is not large enough to ensure that the necessary increases in productive capacity will be made during the coming years or that imports of equipment from the United States will be as large as the modernization and reequipment of European industry require. Thus, there is scope for productive loans by the Bank that will fill this gap in the financing of European recovery. The ECA Congressional documents specifically mention the Bank as an important source of additional financial resources for European reconstruction.

(b) While Europe's investment needs are great, the Bank can undertake to finance only those projects which may be expected to make a direct contribution to the solution of Europe's balance of payments difficulties, either by increasing the ability to export or by reducing the need for imports, especially to or from the dollar area. Lending for less specific purposes might improve the general economic situation of the country concerned, but it would not create the margin out of which the loans could be serviced and repaid. The European dollar shortage is a phenomenon that will be with us as far as we can see in the future. This means that dollar loans, especially under the terms granted by the Bank, must be made with caution if they are not to involve unduly large risks.

(c) Even if these financial difficulties did not exist, the supply situation is unlikely to have permitted more than a partial satisfaction of Europe's needs in machinery and equipment. This factor would in itself have limited the scope of the Bank's activities in Europe, since productive projects of the type suitable for financing by the Bank require primarily the use or installation of new equipment and machinery.

The preceding considerations suggest that, while the Bank can and must contribute to European reconstruction, its participation will necessarily have to be confined to only certain types of productive projects within the limits set by the availability of equipment and the capacity of the countries to service and repay the loans. It is true that in theory there is no difference between financing imports of equipment and financing imports of other goods that would release resources for the production of equipment in the borrowing country itself. In both cases, an increase in productive capacity would take place. Thus, a loan to Britain that would enable her to keep at home machinery previously used to pay for imports of food would not differ from a loan that would finance machinery imports to Britain. In practice, the size of the loans that the Bank can safely make to Europe is too limited for such a method of financing, while the close scrutiny of the utilization of the proceeds which must be exercised by the Bank requires that the goods purchased with Bank funds be directly related to the execution of the productive project that is being financed. Thus, the Bank's contribution to European reconstruction is closely connected with the availability of American capital equipment for export. This does not mean that purchases of equipment could not be made in Europe as well, but Europe as a whole has a net deficiency of capital equipment and European demand is overwhelmingly concentrated on American equipment. The amounts that are likely to be obtainable in Europe probably represent a very small proportion of the needs that the Bank would be called upon to finance.

It is not possible to estimate the size of the lending activities that could be profitably undertaken by the Bank before making a detailed study of European investment plans and of the supply position for capital equipment in the United States and elsewhere. My personal impression is that the opportunities for Bank lending in Europe during the next four or five years are probably in the neighborhood of $200 million per annum.

Loans on such a scale would be within the possibilities of Europe to service and repay, and at the same time they would be substantial enough to make a decisive contribution to the solution of Europe's economic problem.

Assuming that the European investment plans take four years to be completed, the Bank's total contribution for European reconstruction would be less than $1 billion and would add less than $100 million per annum to Europe's debt service. This is a burden which Europe, in spite of its foreign exchange stringency, will be in a position to bear[1] especially since it is certain that obligations towards the Bank will have a higher priority in the allocation of foreign exchange than many other current needs, including the servicing of Governmental loans which could, in an emergency, be suspended. Nor can the earnest of European Governments to fulfil their obligations towards the Bank be seriously questioned. If anything, many of these Governments show an exaggerated caution in considering borrowing from the Bank. It cannot, therefore, be said that loans to Europe on such a scale would involve undue risks for the Bank. The only major risks are the risks of war or of a failure of Europe to recover, even partially. These, however, are risks which the Bank would be not merely justified but also required to undertake because it is precisely that type of risk that the Governmental guarantees (i.e. the bulk of the Bank's capital) were intended to meet.

On the other hand, financing on such a scale, although it would meet only part of Europe's need, would enable European countries to carry out some highly productive projects which would otherwise have had to be postponed or abandoned.

1/ The Paris Report has estimated total European exports to the Western Hemisphere at $4,000 million in 1951 and total imports at $7,200 million. Compared with these sums, the problem of servicing Bank loans would be manageable.

When compared to the billions of dollars required to support Europe, a sum of $200 million may at first sight appear too small to make much difference to European recovery. But one must bear in mind that these billions are spent primarily on current needs, which means that they only serve to buy time until Europe has made the necessary adjustments in her economy, including the expansion in her production, that will restore her self-sufficiency. It is my impression that ECA assistance for the purchase of machinery and equipment is unlikely to exceed $500 million per annum during the coming years. Present plans envisage larger expenditures on such items, but experience shows that the needs for food and raw materials are always underestimated in official plans and always end by absorbing a larger share of expenditures than was originally intended. If this is so, the addition of another $200 million worth of equipment from Bank sources would represent a very considerable contribution to the European reconstruction effort. At the same time the careful selection and supervision which both the Bank and the European Governments are certain to exercise over projects to be financed with Bank loans might result in increases in output exceptionally large in relation to the sums spent.

Without attaching too great importance to the figure of $200 million itself, I believe that as an order of magnitude it probably represents what the Bank could safely invest in Europe during the coming years.

As regards the needs of other regions, the following considerations should be taken into account:

(a) The most important of these regions is Latin America with its underdeveloped resources and its keen desire for economic betterment. The significance and driving force of that desire should not be underestimated. It arises from a complexity of factors such as the proximity of the United States, the wealth of natural resources in the region, and so on. The most important factor, however, is, in my view, the growing discontent of the masses with the conditions of degrading poverty to which they are condemned to live and their determination to achieve an improvement, if necessary at the expense of the more privileged classes. Faced with such an explosive situation, the latter see in expanded production and higher productivity, achieved with outside assistance, the only answer that would raise the standard of living of the masses without depriving the wealthy of their privileges. This explains why the clamor for foreign help to develop the resources of these regions comes principally from those classes which at first sight seem to have least to gain from it.

There can be no question that there are great opportunities for economic development in these regions. Nor should it be forgotten that progress during the last decade has been real and in some cases spectacular. There is no stagnation or lethargy in Latin America. In earlier years the development of the region's resources was principally the work of private foreign investors. It is estimated that in 1938 foreign investments in Latin America exceeded $10 billion and represented some 20 per cent of the world's foreign investments (including investments in colonies). The contribution of foreign capital to the opening up of the region cannot be exaggerated, but at the same time it must be recognized that the development of the region's resources by foreign capitalists was haphazard and one-sided, and was often costly and wasteful, as a result of which it has left a legacy of hostility and antagonism to foreign capital that is today proving one of the main factors impeding the inflow of foreign capital in that region. During the 1930's, when foreign investments fell sharply, the Governments began taking an active part in the promotion of development schemes and some important projects were carried out with local resources. Since, however, savings could not be attracted in such investments and taxes on those who could bear them were inadequate, the result of

Government spending on development schemes was to intensify inflationary pressures which are endemic in Latin American countries. Thus, efforts of development intended to raise the standard of living of the population in practice ended in more social inequality and greater economic instability than before. During the war the great demand for Latin American exports and the shortage of imports resulted in great accumulations of foreign exchange resources, a large part of which were expected to be used for the financing of development schemes. In fact, only a small proportion of these foreign exchange resources was used for investment purposes; the bulk went to purchase goods for current consumption for which there is a virtually insatiable demand in these inflation-ridden countries.

Meanwhile, new and more ambitious development plans have been formulated, and Governments which have pledged themselves to carry them out are faced with a difficult situation: they dare not aggravate internal conditions by resorting to inflationary spending and their foreign exchange resources have by now been exhausted. This is why they look to foreign assistance as the only way out.

I believe it would be dangerous to underestimate the existing dissatisfaction or the extent to which Governments have committed themselves to bring about an improvement in their countries' economic conditions. Foreign assistance to these countries is an urgent need. I also think that there is great scope for the investment of foreign funds in Latin America, because the region has vast resources which await to be rationally exploited. The region is particularly suited for Bank loans, since its primary need is to develop basic facilities such as transportation, power, agriculture, for which private financing is not available.

On the other hand, it is certain that development cannot take place at the pace which these countries envisage. Their plans, which run into billions of dollars, bear little relation to what these countries are in fact capable of doing in this field. Large increases in production and productivity cannot be achieved merely by importing foreign capital and equipment. Efficient and honest administration, education, technical and organizational skill and financial stability are equally, if not more, important than the availability of equipment. There is no example of a country having raised its standard of living merely through foreign borrowing. On the contrary, all the existing evidence shows that the greatest material progress has been made by countries which have relied primarily on their own resources and their own work.

My conclusion is that, while the Bank must respond without too much delay to Latin American requests for financial assistance, the scale of its operations in that region must be limited to what can be usefully absorbed with good prospects of repayment. This, in my view, means that only a fraction of the projects at present contemplated are suitable for Bank financing. As in the case of Europe, only after a detailed study and investigation of the region's needs and possibilities would it be possible to determine the scale of lending that could be undertaken by the Bank in the region, but here again I shall venture a guess and suggest that $300 million per annum probably represents the upper limit of what the region can absorb, at least in the near future. Such a figure would probably shock Latin Americans who are thinking in terms of billions, but in my view, loans of that size flowing regularly to the region and financing the importation of machinery and equipment should be able to make a very important contribution to the development of the region's resources.

(b) Asia, including the Far East, is another region where the need for foreign investment is great and urgent, both for reconstruction and for development purposes. Here again the Bank can meet only part of the need, not only because the absorptive capacity of the region is still smaller than in the case of Latin America, but also because the political uncertainties are much greater than in Latin America. In certain parts the political and social situation is such that there can be no question of any Bank lending.

(c) Eastern Europe presents a different problem. It is probably one of the regions of the world where Bank funds would be most effectively used and would serve not only the region itself but the whole European economy. For the time being political considerations do not allow any substantial Bank lending to the region, but the Bank should keep in mind that the present political tensions, which are engineered in Moscow, may suddenly ease if Moscow decides that it is time to be more sensible. In that case, the Bank would have no justification in refusing to grant the loans so eagerly awaited by Eastern European countries. This means that in considering the world requirements for Bank financing during the coming years the eventual needs of Eastern Europe must also be taken into account.

Allowing another $100 million for Asia, Eastern Europe and the remaining regions of the world, we reach the conclusion that the scale of operations which the Bank should have aimed at if its financial resources were unconditionally available to it would have been of the order of $500-$600 million per annum. This, I think, is probably the maximum that could have been invested with good results and good prospects of repayment. More optimistic estimates made earlier in the Bank's career which assumed that Bank financing would exceed one billion dollars per annum disregarded both the seriousness and permanence of the world's dollar shortage and the obligation imposed by the Articles of Agreement on the Bank to grant loans only when the prospects of servicing and repayment were reasonably good.

It is clear, however, that even the lower figure of $500 million per annum estimated here greatly exceeds the present possibilities of the Bank. With less than $500 million of liquid funds at hand, the Bank can hardly enter into any large commitment for foreign loans unless it is able to raise additional capital in the market.

Thus, the extent to which the Bank can meet the world's needs for reconstruction and development depends primarily on the prospect of obtaining funds in the American market. The question that arises is: should the Bank wait until conditions for new sales of bonds are favorable or should it seek to make sure that it will be able to get the funds it needs whatever the conditions of the market. In the first case, there can be no question of planning the Bank's scale of operations for the coming years. These will depend on the reactions of the market to the Bank's bonds, which cannot be foreseen. Lending by the Bank may continue to be negligible for several years if developments in the market prove unfavorable or it may become substantial if market conditions improve. In the second case the Bank will be able to determine itself the scale of its operations and ensure that they are commensurate with its character as an international institution entrusted with a major responsibility in the field of international investment.

There can be little doubt, in my view, that the second course is the only one that will preserve the prestige and authority of the Bank. The question is, how can the Bank secure the collaboration of the market in planning its future activities.

2. The Raising of Funds on the American Market.

It is necessary to keep in mind that those who took the initiative in establishing the Bank had a quite different situation in mind from that which has arisen since the Bank began its operations. It was never envisaged that the Bank would have any difficulty with the problem of raising funds. It was universally believed (even by the market itself, which showed considerable apprehension on that score at the time) that the 100 per cent guarantee would confer on the Bank's bonds an exceptional attractiveness which would make the raising of funds a quasi-automatic process. It was also thought that the Bank would be able to obtain money at the lowest rates prevailing on the market and certainly not higher than those on U.S.A. Government bonds. It was precisely because very low interest rates were expected that the idea of making an additional charge as guarantee occurred. I remember that in all the discussions on the matter the argument was recurring that Bank loans would be so cheap that countries who would be taking advantage of such favorable conditions of lending could well afford to make a contribution that would help to reduce the burden which member Governments were undertaking in granting their guarantee. The object of giving to the capital of the Bank the form of a Government guarantee rather than of Government-contributed funds was to avoid the immobilization of large funds in the Bank and at the same time to offer an opportunity for good investment to the saving public. There was never the slightest doubt that the Bank's money was public money or that the institution was anything but an inter-governmental institution entrusted with the carrying out of the policies of member Governments in the field of foreign investment. I am sure that the idea that the Bank's operations would in any way depend on the opinion of the market about the soundness or otherwise of the Bank's lending activities never crossed the minds of those who proposed the establishment of the Bank. It was precisely because it was recognized at an early date that the private investor would be unwilling to risk his money on loans to foreign Governments which would be struggling with post-war difficulties that the establishment of an International Bank was considered necessary to assist post-war reconstruction. (Incidentally, the emphasis was originally on reconstruction. Development was added later as an afterthought.)

Unfortunately, the course of events has been entirely different from what had been expected. The market took the view that the Bank's bonds, in spite of the guarantee, were far from riskless and were certainly inferior to U.S.A. Government securities. The Bank itself at the beginning of its existence thought that it would gain the confidence of the market if it stressed the soundness of its policies rather than the importance of its guarantee. This was an ambitious conception which assumed that the Bank could hold its own without the need for Government support, and it has certainly proved overoptimistic in the light of our post-war realities. Although subsequently abandoned, this initial effort to establish the Bank as an ordinary lending institution in the consciousness of the market has not been without effect on the market's attitude towards the Bank's bonds. The result of these developments has been that the Bank has had only limited success in raising funds in the market and would probably have met with considerable difficulties if it had approached the market for further sales.

This reluctance to lend to the Bank is not absolute, but is only relative to the rate of interest offered by the Bank. I have no doubt that at higher rates of interest the Bank's bonds would have been attractive enough to find buyers. In practice, however, the Bank has gone to the limit of what could be offered without making its loans prohibitive to borrowing countries. Thus, this relative reluctance to buy Bank bonds is for practical purposes an absolute reluctance which only changes in market conditions or in the attitude of investors can overcome.

I am not familiar enough with the conditions of the American market to be able to appraise the present trends and the chances of new bond sales by the Bank in the near future. It is, however, my impression that, as matters stand, even if market conditions ease sufficiently during the coming months to make a new issue of bonds possible, the sums that will be obtained will be relatively small and there will be no assurance that the Bank will be able to make the regular sales of bonds which will be necessary if it is to develop a substantial program of operations during the coming years. I think, therefore, that merely to wait for more favorable market conditions may postpone indefinitely the time when the Bank will be able to play a role in the world economy commensurate with its responsibilities.

Is there an alternative to waiting? I think there is.

The Bank's dependence on the attitude of the investment channels is a fact which may be deplored but cannot be changed. That attitude in turn cannot be expected to change radically so long as the present tensions and uncertainties exist in the world and high levels of economic activity are maintained in the United States. Even though a rate of investment of $500 million per annum represents, in my opinion, what the world can fruitfully absorb with reasonable prospects of servicing and repayment of the loans, it would be illusory for the Bank to expect that it could obtain in the market the funds necessary for such a scale of activities. The first thing which the Bank must therefore do is to recognize that for many years to come it will be able to satisfy only part of the needs which it was created to meet.

If, however, there is an upper limit to the Bank's activities determined by the world's capacity to borrow dollars, there is also a lower limit below which the Bank's scale of operations should not be allowed to fall if the Bank is to retain the respect and consideration of its members. I believe that operations of $200 to $300 million per annum, although they would fall far short of what the Bank could have done if it had not depended on the market, would be large enough to contribute substantially to world reconstruction and development and at the same time safeguard the Bank's prestige and justify its present setup. Anything less, however, would, in my view, seriously harm the Bank and deprive it of its importance and influence in the world, because anything less than this minimum sum would not even touch the fringe of the world's needs. It is even doubtful that prospective borrowers will in the end be willing to go through the long and tedious process of negotiation and supervision for what will necessarily be very small and inconsequential loans. In that case there is the danger that the Bank would end by becoming just another over-staffed agency whose existence is barely tolerated by member Governments.

I think, therefore, that the Bank must in the near future decide on a limited but useful program that will take care of the world's most urgent needs for international loans. Having made such a decision, it will then have to secure the collaboration of the market for the raising of the necessary funds.

Until now, the Bank's approach to the investment channels has been made in general terms. The Bank has stressed its determination to make sound and productive loans and has declared itself eager to maintain close cooperation with the market. It has avoided, however, and quite rightly, to make any more specific commitments to the market. So long as the expectation could be entertained that market conditions would improve in the near future, the Bank would not have been justified in making commitments that would have restricted its freedom of action. Now, however, the paramount consideration must be to raise funds, and commitments which appeared unjustified last year may prove the only way of securing the proper functioning of the Bank in the coming years. I have in mind a new and more concrete approach to the market which might succeed in allaying the latter's fears and ensuring a more active cooperation on its part. The Bank should start by stating that in the world of today the scope of its activities is necessarily limited and that, having recognized this, it will not in the next five to ten years aim at a scale of operations exceeding, say, \$200-\$300 million per annum. It should further stress that within this limit it will seek to finance the most productive among the projects submitted to it and those for which the prospects of repayment are best. It should point out that, however short of dollars, the world can well afford to service loans of such moderate size. Finally, it should point out that such a policy of restricted activities would in fact fully concede the request heard last year in the market, that the Bank's borrowing capacity be limited to the size of the United States guarantee: under such a program it will be more than ten years before the United States guarantee is reached.

A commitment of this kind may decisively affect the attitude of the market towards the Bank's bonds. One of the chief causes for the distrust shown by the market during the last two years is that the American guarantee, the only one which under present conditions the market is prepared to consider seriously, covers only 40 per cent of the Bank's borrowing capacity. This means that, were the Bank some day to succeed in by-passing the investment channels and borrow in excess of the American guarantee, it would thereby be impairing the security of all its bonds, including those sold before the American guarantee was reached. The conclusion was that, so long as the Bank's borrowing capacity exceeds the American guarantee, the value of the Bank's over-all guarantee should be viewed with caution, if not suspicion. Last year it was still too early to concede this request for what amounts to a reduction in the Bank's capital. Next year such a concession may be no more than a recognition of hard realities.

It is almost unthinkable that the market would refuse to cooperate even on such a limited program. It is the duty of the Bank to point out that such a refusal would be against the best interests not only of the American nation in general but also of the private investors themselves. The United States occupies today a unique position in the world. Its huge productive capacity, which nearly doubled during the war, exceeds in many important lines the normal peace-time requirements of the nation. Exports of equipment financed by loans will in the long run be essential to maintain stability in the American economy. The only alternative, barring a depression which the American people do not seem in a mood to tolerate, is more Government spending on public works, involving increased Government intervention in the economy and increased Government ownership of means of production. This is a prospect which can hardly appeal to the capital market. The International Bank offers the best, if not the only hope, that the genuine export surplus of the United States will be canalized where it can best be used from the point of view of both borrower and investor. By undertaking the risks inherent in foreign investment it promises good returns with security. By promoting productive projects it promises to create important outlets for the American heavy industry which is certain to find itself over-expanded when internal demand and ECA spending taper off and when European production revives. By concentrating on the improvement of basic facilities in underdeveloped countries the Bank will help to render attractive many opportunities for direct investments which today appear unprofitable due to the lack of such facilities. (The exploitation of Brazil's rich iron ore deposits which is held up by lack of transportation and port facilities is an illustration.) Finally, being established on an international basis, the Bank has the unique advantage that it is able to rely on the cooperation of the borrowers and develop their sense of responsibility. This greatly minimizes the risk of wasteful utilization of the Bank's funds and of wilful defaulting. As things now stand, an uncooperative attitude on the part of the American market would make the Bank's failure inevitable. It would be folly for the market to destroy an instrument which is certain to serve well the interests of the American investor. But it would also be an act of irresponsibility from the point of view of the more general American interests. Post-war events have thrown on the United States the heavy responsibility of international leadership in a world which is rent by violence and conflict. Communism is on the move. It finds its allies in the teeming millions who for centuries had accepted hunger and privation as acts of God, but who today are determined to improve their lot, if necessary by force. The improvement can be made without violence or upheavals if these countries are assisted to increase their technical knowledge and develop their resources. For such assistance they look primarily to the United States. I am not among those who believe that the United States should spend indiscriminately millions of dollars on countries threatened by Communism. On the contrary, I feel that too much may already have been spent in such a way with too little effect. But I do think that by assisting these regions to develop their productive resources and raise the appallingly low living standards, the United States can effectively meet the challenge of Communism where political and social conditions have not deteriorated beyond repair. I also think that the International Bank is the best instrument through which that assistance can in the long run be provided, because the Bank will be able to canalize what is really a surplus available for investment to the regions which promise to take best advantage of it and will be able to do so in a sustained and continuous way, without being subjected to political blackmail or having to take into account considerations of short-term expediency.

It seems reasonable to assume that the market will respond favorably to such an approach by the Bank. It is true that from the point of view of the Bank itself the decision to undertake such a commitment towards the market would be a momentous one and should be carefully weighed before it is finally made.

Many will argue: Why make such a commitment? Is it not better to wait rather than restrict the Bank's future freedom of action? What will be the position of the Bank if in, say, three or four years' time market conditions improve beyond present expectations or if the Bank is by then able to by-pass the investment channels and address itself to the general public? Would not the commitments made prove galling and would it not be said that the decision to make them was unwise?

My answer to this argument is that time is running short for the Bank and that something will have to be done soon. There is a strong case for not entering into commitments towards the market if the Bank can reasonably expect that by next spring or early summer at the latest it will be able to raise some \$200-\$300 million on the market. In that case the Bank could develop a substantial program during the coming year and assume that it will be able to continue raising funds on the same scale in the following years. If, however, the market proves unreceptive to new bond sales, the position of the Bank may become impossible by the middle of next year. Impatience is already evident. One dreads to think of another Annual Meeting where the long-term character of the Bank is stressed amid an embarrassed silence. Some might say that the present funds at the disposal of the Bank would be sufficient to begin substantial operations and wait until next year for more favorable market conditions. I think this would be a most unwise thing to do. These funds represent the necessary degree of liquidity for the Bank. Without them the Bank's position in the market would deteriorate still further and its chances of raising money would become very remote indeed.

I think that in the next few months it should be possible for the Bank to ascertain market prospects for the coming year. If they are found to be unfavorable, the only alternative to an approach along the lines suggested here would be to reconcile oneself to the fact that the Bank will have to be kept in a dormant state until market conditions improve. Many would say that there is nothing so terrible about this. One day conditions in the market will change and there will always be eager clients for the Bank's loans; no harm will be done to the Bank by waiting. I cannot agree with this view. International institutions, like living organisms, must function if they are to grow and retain their health. They cannot, like merchandise, be kept in cold storage and be brought out again when market conditions are favorable. A period of protracted inactivity is certain, in my view, to prove fatal to the Bank.

Another difficulty that may have to be faced if a decision along the lines suggested here is made, is the reaction of prospective borrowers to such a restricted plan of activities. The countries which have been relying on the Bank to finance large projects are certain to be shocked by the limited scope of operations envisaged by the Bank for the coming years. I think, however, that it would not be difficult to persuade these countries that the object of the Bank in proposing such a plan is to serve and not to disregard their interests. I doubt that the Governments of these countries would undertake the responsibility to oppose the plan when they realize that the only alternative to getting so little might be getting nothing for many more years.

Assuming that the scale of operations of the Bank is decided upon on some such lines, the next step for the Bank would be to determine how the funds which will be expected to be available should be spent. The Bank will have to approach this question on many fronts.

(a) The first thing is to inform prospective borrowers, both those who have submitted applications and those who intend to do so in the future, that the scale of operations contemplated by the Bank for the coming years will allow only limited help to individual countries and will require the postponement of all save the most urgent and productive among the projects envisaged. Countries should therefore be asked to concentrate their attention on such projects, speed up the technical studies required and be ready to negotiate with the Bank on the terms under which Bank financing will be granted. It should at the same time be pointed out to them that the Bank plans a sustained level of activities for the coming years and that consequently, they must think in terms of a series of small loans spread over a number of years rather than of a sizeable loan granted at the outset. At the same time there is no reason why the Bank should not commit itself to the financing of larger projects over a period of years, subject to the qualification that the utilization of the Bank's funds is satisfactory and the conditions agreed to are kept.

(b) The Bank should not wait for a revision of loan applications before it maps out its plan of activities during the coming years. On the basis of the existing loan applications and of the studies made of the various regions' problems and requirements it should be possible to formulate a general program and decide which among the existing and prospective projects are likely to make the greatest contribution to the world economy as a whole. This work, which should be undertaken soon and completed in as short a period of time as possible, would provide the background against which to judge the significance of projects proposed by the various countries.

(c) Furthermore, if the activities of the Bank are to add up to a coherent whole and not to consist of a series of isolated small loans, it will no longer be sufficient to examine loan applications on their own merits alone. It will also be necessary to compare the projects to each other and determine their relative importance and urgency. Many projects, which would have qualified for Bank financing if the funds at the disposal of the Bank had been larger, are certain to fail to meet this test of relative importance. Such projects would have to be rejected not because they would not be sound in themselves, but because other projects would be more important. A project, for instance, for the improvement of passenger transportation in a Latin American city, however worthwhile in itself, would have no place in a program of Bank activities aiming to make the best use of loanable funds not exceeding, say, $200-$300 million per annum.

This is the conception of strategic lending already outlined by the President of the Bank, but its practical application will require some radical changes in the approach of the Bank's staff to the study of loan projects.

Finally, a considerable speeding up of the processing of loans will be necessary if the scale of operations envisaged here is to be achieved.

(d) In terms of goods a program of the type envisaged here is certain to involve almost exclusively equipment and machinery. The Bank would be greatly assisted in planning its operations if it had a clearer picture of the present and prospective availabilities of such goods. If an investigation into the supply position is possible it should, in my view, be undertaken by the Bank. Such an investigation would enable the Bank to relate its program to physical availabilities and prevent delays and frustrations in the execution of Bank-financed projects. Such an investigation would automatically disqualify from Bank financing those projects for which the necessary equipment is likely to be unobtainable. If, moreover, it reveals the existence of a very tight supply situation in items which are essential to the carrying out of productive projects, it would strengthen the Bank's case for a limited program of operations in the coming years, since it is the duty of the Bank to abstain from creating additional demand for scarce items whose only effect will be to push prices up. Personally, I doubt that the supply situation will be found to be a limiting factor in operations of the scale envisaged here, but it would be useful to know what the exact position is.

Acting along such lines, the Bank should, by next spring, be able to present its members with a modest but valuable program of operations which will demonstrate to them the Bank's desire to do its utmost to help them and its determination to make itself useful now and not merely in the more distant future.

There are some further problems which must receive the attention of the Bank in the coming months.

The financing of European reconstruction projects must play a predominant part in the activities of the Bank during the coming years, since the restoration of equilibrium in the European economy is an essential prerequisite for the restoration of equilibrium in the whole world economy. It is, however, conceivable that European countries may show themselves reluctant to borrow from the Bank in order to finance specific productive projects. Such a reluctance may arise from the following causes: (a) In spite of ambitious investment plans, European countries fear the inflationary consequences of devoting too large a share of their resources to reconstruction. They may, therefore, decide to postpone many of the schemes to which, on paper, they have committed themselves. Bank loans which would finance only the foreign exchange expenditure of such projects may be found of little help in this matter because they would have to be matched by substantial internal expenditures. (b) So long as the hope exists that ECA aid will meet more or less adequately European needs, there may be no hurry to incur debts towards the Bank. The fact that the ECA program is due for reexamination by what is hoped will prove a more generous Congress may add to the inclination to wait before deciding on borrowing from the Bank. (c) European countries are genuinely concerned about the terms of the Bank's loans and may feel that the burdens involved will be beyond their capacity to bear.

What should the Bank do if, as a result of such considerations, there is no response from Europe to the invitation to submit specific projects for Bank financing. I think that the Bank should keep in close touch with ECA and try to demonstrate to European countries that it is in their interest to avail themselves of the facilities placed at their disposal by the Bank, since it is obviously unrealistic to expect that ECA assistance can take care of all their needs. ECA should also point out to them that investment plans must be carried out if recovery is to be achieved by 1952.

It is clear, however, that there can be no question of exercising any pressure on European countries to borrow from the Bank. If their reluctance to borrow from the Bank is found to be based not merely on exaggerated hopes of cheaper assistance but on a real fear of future inability to service and repay the loans, the Bank should recognize that the conditions for assisting European reconstruction do not exist and should concentrate its efforts on meeting the needs of underdeveloped countries which are too eager to improve their economic position to have any inhibitions about future difficulties of repayment. (This does not mean of course that the Bank should lend to them indiscriminately. The existence of ability to repay is an essential condition for all Bank loans.)

In this connection, however, it must be pointed out that the charges made by the Bank on its loans are unquestionably excessive in relation to the world's ability to borrow dollar capital. When the Bank was established, it was hoped that the rate of interest on Bank bonds would be extremely low. As already stated, the idea of an additional charge as guarantee occurred precisely because it was expected that there would be a margin for levying such a charge. Nor had the intensity of the world's dollar shortage been fully anticipated. In the light of developments during the last three years I think that there is a strong case for reconsidering our attitude towards the guarantee. As matters stand today, the guarantee adds considerably to the burden of the borrower without in the least strengthening the position of the Bank. Nor is it reasonable to think that the levying of this charge is a factor which increases the confidence of the market in the Bank's securities. The market people are too intelligent and practical to believe that additional obligations on weak borrowers improve the standing of the lender. As already stated, the main justification for introducing the concept of the guarantee was to reduce the burden on Governments of eventual defaults by Bank borrowers. I think that the limited activities of the Bank and the size of the burdens undertaken since the end of the war by the main guarantor country, namely the United States, raise the question of whether it would be wise under present conditions to maintain an arrangement which frightens the most responsible of prospective borrowers and may prove a serious handicap to the Bank when its program of operations gets under way.

A last question to which some attention should be given in the coming months is the extent to which the Bank could contribute to promote a larger flow of direct investments to the underdeveloped regions of the world.

The private investor is at a great disadvantage when he considers investing his money in a foreign country and this is true not only of individuals but also of companies. Even the largest of companies may sometimes be inadequately informed on the general situation prevailing in a foreign country and may not have access to all the facts necessary to appraise future developments that may affect its investments. Nor can it always have the advantage of expert and unbiased opinion on questions that bear directly on its field of activity. This is one of the causes why investment in foreign countries is today considered such a risky and unrewarding enterprise.

The Bank could, in agreement with the investment channels and the interested countries themselves, undertake to provide objective and well-documented information and to contribute its own unprejudiced appraisal of the prospects of the foreign country's economy and even of the investment project itself. If the Bank undertakes this activity in a systematic way and makes a competent job of it, it might become a clearing house for information needed by private investors and a center for consultation and advice.

The Bank can further take the initiative in suggesting to both investors and foreign countries principles of behavior that would ensure the fair treatment of the legitimate interests of both parties, and lead to the establishment of a new sense of responsibility in both creditors and debtors.

Finally, the Bank could aim at eventually taking a more active part in the operations of private companies in foreign countries by supplementing their financial resources whenever these are found inadequate for the carrying out of useful projects. The Bank could do this through purchases of bonds of these companies that would be guaranteed by the Government of the country or other similar arrangements. Such a financial contribution by the Bank to private undertakings might in some cases prove the most effective way of assisting a foreign country's development because it would help to combine the advantages of private initiative and efficiency with the safeguards to the public interest afforded by Government participation in and supervision of the project.

If the response of investors and borrowers to such an initiative by the Bank is favorable it will in the long run be necessary for the Bank to establish a separate department for the handling of all the problems connected with this field of activity.

I think that the Bank can effectively contribute to the removal of obstacles impeding the flow of private capital to underdeveloped countries because it combines two characteristics which seldom go together: as an international institution established by Governments it is concerned with the general interest and not with particular interests; as an independent lending agency which must see to it that its loans are repaid, it must conduct its operations on a strictly business basis and must remain uninfluenced by political and other considerations. It can, therefore, bring to bear on the problem of foreign private investment the objectivity of a disinterested party together with the resources of a large lending institution and might, if it is successful, contribute to break the vicious circle of high returns involving high risks and high risks calling for high returns which has bedevilled the relations between investors and borrowers during the last hundred years.

I have assumed until now that the Bank will be able to raise in the market the funds necessary to develop a program of substantial operations during the next few years. It is, however, conceivable that the market might for some more time show itself reluctant to absorb new issues of Bank bonds, in spite of any commitments that the Bank may be ready to make to it. Should the Bank in that case abandon the hope of playing a more active role in the immediate future?

I think that rather than passively admitting what would amount to a failure to fulfil its role, the Bank should make a further attempt to obtain the means necessary to carry out the tasks entrusted to it.

I believe that it would be the duty of the Bank to approach the United States Government and draw its attention to the situation which has been created as a result of the impossibility of raising funds in the market. If the United States Government feels that temporary difficulties should not be allowed to prevent the Bank from fulfilling its task, it has all the means to make funds available to the Bank. An additional and more clear-cut guarantee, temporary financial accommodation through some Government agency or similar measures would place the Bank in a position to begin operations until market conditions become more favorable. Such arrangements would not constitute a change in the character of the Bank; they would merely mean that the temporary inability of the Bank to raise funds in the market would not be allowed to paralyze the Bank's activities.

The final decision will, of course, rest with the American Government.

Personally, I consider it very unlikely that the American Government will not do its utmost to assist the Bank in carrying out its task. The United States took the initiative in the establishment of the Bank. More than any other agency, the Bank embodies American conceptions on international economic cooperation. A prolonged period of inactivity would be widely interpreted as an American failure and would raise serious doubts on the effectiveness of American conceptions of economic cooperation. The American Government knows from experience how difficult it is to make so many nations agree on a common program and how many difficult compromises must be made before an international agency is established. I feel sure that it would not want to see one of the most important among them lose its prestige and authority through merely temporary difficulties.

These are the conclusions I have reached after careful consideration of the problems facing the Bank. My main thesis is that the Bank cannot wait much longer to begin playing a more active role in the world if it is to retain its standing and fulfil the purposes for which it was established. This is the basic issue on which a decision must be made. If my contention is correct, then it follows that more active steps will soon have to be taken to get the Bank going.

I realize that many will find my approach too dogmatic and will maintain that the Bank can afford to wait for another year or two before determining the scope of its activities.

I repeat that in my opinion further delay is bound to prove harmful to the Bank. But I also want to warn against another view which has been expressed in some quarters, that the time for the Bank to act on a large scale will come with the American recession or depression, which these circles consider inevitable and which, according to them, is bound to release large financial and real resources for foreign investment. So long as the American economy is fully employed, these circles say, there will be very little scope for the Bank. I think this is a very erroneous interpretation of the Bank's position in the world. In the first place, the Bank was given a much more important task than merely to serve as a means of exporting American surpluses in times of depression. In the second place, there is no justification to expect a serious American depression. The American people have demonstrated beyond doubt that they are forward-looking enough not to repeat old errors. In the third place, it is by no means certain that an American depression would prove such a boon to foreign investment. If past experience is any guide, a depression in the United States, which would inevitably throw into confusion and disequilibrium the whole world economy, increases the distrust of investors and makes them less willing than ever to undertake the risks of lending to foreign countries, especially as these will be struggling with the difficulties created by the American depression itself. Finally, the present American international commitments and the rearmament program make it very probable that high levels of economic activity will be maintained for several more years.

Another consideration which must be taken into account is the effect of prolonged inactivity on the staff of the Bank. In my view, a lowering of morale is inevitable when an organization is satisfied merely to exist and loses its sense of purpose and mission. I think that this is one of the most serious dangers involved in a policy of waiting.

There is a last remark I should like to make. The effects of prolonged inactivity on the standing and prestige of the Bank will only gradually be felt and will not be clearly recognizable until it may be too late to retrieve the situation. Only by anticipating events will it be possible to prevent such a process of slow deterioration.

Washington, D. C. December 1, 1948

Record Removal Notice

The World Bank Group Archives & Records Management

File Title	Barcode No.
United States Government Agencies - Varvaressos - Correspondence	1071227

Document Date	Document Type
13 July, 1948	Letter

Correspondents / Participants
To : Mr. John J. McCloy, President
From : K. Varvaressos

Subject / Title
Note on Common Problems of the Bank and ECA

Exception(s)

Additional Comments
Declassification review of this record may be initiated upon request.

The item(s) identified above has/have been removed in accordance with The World Bank Policy on Access to Information. This Policy can be found on the World Bank Access to Information website.

Withdrawn by	Date
Chandra Kumar	30-Apr-15