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THE MARSHALL PLAN AND  
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*In this, the ninth essay in the series published by the International Finance Section of the Department of Economics and Social Institutions in Princeton University, Professor Friedrich A. Lutz, whose essay on International Monetary Mechanisms inaugurated the series, returns to the list. The importance of the problem he here treats needs no emphasis.*

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# THE MARSHALL PLAN AND EUROPEAN ECONOMIC POLICY

By FRIEDRICH A. LUTZ

## I. INTRODUCTION

THE three aspects of the Marshall plan that have been most thoroughly discussed are (1) the estimates of the Paris conference on the expected deficit of the sixteen European nations with the American continent and the United States in particular, (2) the possible repercussions of the plan on the American economy, and (3) the method of administering foreign aid. A fourth aspect concerns the economic policy which the recipient countries should follow if the Marshall plan is to be a full success. Apart from a general statement that these countries should make every effort to balance their budgets and stop inflation, little has been said about this phase of the problem. In an endeavor to fill the gap the present essay deals with the principal implications of the plan for the economic policy of the recipient countries, and offers a short addendum on administration.

## II. THE PURPOSE OF THE AMERICAN FOREIGN-AID PROGRAM

If the United States could freely choose the period in which to make foreign loans it would obviously be in the interest of the American economy to start, or increase, lending in times of a domestic depression and to stop, or retard, lending in times of a domestic boom. Such a foreign loan policy would, in a depression, keep employment above the level it would attain in the absence of the loans and, in a boom, would assuage inflationary tendencies.

The United States, however, is now called upon to lend or grant aid to foreign countries in a period of domestic boom characterized by strong inflationary forces. It is quite obvious that such lending is not in the *short-run* interest of the American economy. On the contrary, it is generally agreed that a large lending program at the present time may have three unpleasant economic consequences: 1) it will create acute shortages in some of the products which both this country and Europe most urgently need (scrap iron, steel, agricultural machinery, grains); 2) it will in all probability strengthen present inflationary tendencies; 3) it may lead to the reintroduction of controls for the purpose of allocating the scarce commodities between rival domestic

and foreign users and of preventing sharp price rises in such commodities.

Present inflationary tendencies will be strengthened for two reasons. First, the foreign lending may directly increase the aggregate monetary demand for commodities in the domestic market. Such an increase in the aggregate demand is not, indeed, a *necessary* consequence of the loans. Only if the funds are newly created by the banking system, or are released from hoards, does foreign aid directly increase aggregate expenditures in the American economy. But this is likely to happen unless strong efforts are made to prevent its occurrence. Secondly, and this is perhaps more important, foreign aid will affect certain prices much more than others. The commodities in very short supply, the prices of which will be most affected, occupy a strategic position in the American economy; in particular, steel, because it enters as a cost item into many manufactured products, and grains, because their prices are likely to affect, *via* the cost of living, the wage demands of workers. It is, therefore, likely that the potential sharp rise in the price of these commodities will promote an additional application for newly-created bank funds on the part of the business community and thus indirectly increase the aggregate monetary demand in the economy.\*

If, from the standpoint of American economic interest, no advantages but only disadvantages from the plan can be expected in the short run, what are the benefits to be gained over a longer period? Some of the Government Reports, *e.g.* the report of the Economic Advisors to the President and the Harriman Report, express the fear that without such aid the European countries would be driven into ever more stringent devices of foreign trade control, and they voice the hope that the aid will enable these countries to develop their productive capacities and their exports so that, after a number of years, they will be in a position to drop foreign exchange control, at least for transactions on current account, and return to multilateral trade. Foreign aid, so far as the United States is concerned, is thus another milestone on the road the government has been traveling, a road that went from the Bretton Woods Agreement, to the American loan to Britain, to the negotiations on the International Trade Charter, and to the Geneva tariff reductions. This road, the indefatigable traveler hopes, will eventually lead to the final goal—a stable world with relatively free multilateral trade and the enormous benefits that would accrue from such trade to all who participate. Such a result, even if but partially achieved, would far outweigh the temporary, and minor, disadvantages more or less inevitably

\* It might, however, be argued that a shortage of steel will prevent some industries from expanding investment in equipment and that this would, to some extent, counteract the inflationary effect of rising steel prices.

associated with its attainment. *Complete* failure to achieve it, moreover, would be a tragedy of the first magnitude not only on economic but, still more, on political grounds.

The attentive observer, however, is bound to note that, in spite of great efforts, the traveler has so far made but little progress. This seems to be largely because his companions, much weaker than he, must be constantly pushed as well as supported by him, because they march only halfheartedly towards the same goal and because they sometimes go off in a different direction whence they have to be pulled back. This, of course, slows down the pace at which the goal can be approached since the matter is, of necessity, a *group* enterprise.

It is the main purpose of this essay to show that the return of the Western world to a system of multilateral trade, free of the more obnoxious types of control such as foreign exchange control, quotas, import licenses, and the like, depends primarily on the general economic policy of the European countries (rather than on the amount of aid that they receive), and to indicate what kind of policy is required on their part if such multilateral trade is to be reestablished. The essay will concentrate on the *economic* aspects of the foreign-aid problem. This does not mean that the writer believes that economic objectives are the really decisive factors. Political rather than economic fears, or hopes, are undoubtedly the driving force behind the whole program. More concretely, the major fear is that the economic distress of Western European countries will drive them to Bolshevism. The improvement in economic conditions which will result from American aid, whether or not such aid leads to the reestablishment of multilateral trade, may well prevent this disastrous development. It is interesting to note that this piece of materialistic interpretation of history, according to which a nation can prevent other nations from adopting an undesirable ideology by granting economic aid, has, so far as the author is aware, remained unchallenged by any of the participants in the discussion, regardless of their political or intellectual background.

### III. DOLLAR SHORTAGE

The American loan to Britain, however indispensable in furtherance of our long-term objectives, was a failure in the sense that it did not have the desired result of making the pound sterling freely convertible into dollars. The dollar shortage persisted. The proposed foreign-aid program, again, is intended to furnish European countries with current dollars in the hope that, after a few years, they will, through their exports, be able to earn the dollars required to finance their imports. Is there any guarantee, or reasonable expectation, that foreign aid will this time be more successful than has hitherto been the case?

It is somewhat disturbing, in the present discussion of the foreign-aid program, to find that it seems to be generally assumed 1) that the current dollar shortage is God-given and, over the next few years, can be alleviated only by what certain foreign countries tend, for this purpose, to regard as God's representative on earth, the United States Government, and 2) that the dollar shortage drives countries suffering from it into bilateral agreements among themselves. Neither of these propositions is at all self-evident. And, unless this is clearly realized, there is great danger that American aid to Western Europe will prove as inconclusive as the American loan to Britain.

"Dollar shortage" is not a new phenomenon of the post-war era. In the years 1934-39, Germany, for instance, suffered from a dollar shortage as well as from a shortage of every other freely convertible currency. The term may not have been widely current at that time but the thing described by the term was nevertheless present. In that period every reputable economist was convinced, and rightly so, that Germany's dollar shortage was the result of Germany's own policy. It was a matter of common consent among economists that the shortage resulted from two main policy decisions on the part of Germany: first, the decision to keep the mark, artificially, at its old gold parity, *i.e.* to stick to an exchange rate for the mark which greatly overvalued that currency, and second (inextricably linked with the first point), to devote an excessive quota of productive resources to the output of domestic commodities in the form of armaments as well as domestically consumed goods in general. Both of these factors are again responsible for the dollar shortage from which European countries now suffer. Military expenditures, of course, play a smaller rôle than in the case of Germany but the Harriman Report is quite right in pointing out that the domestic investment program of the sixteen European nations reporting to the United States is of such dimensions as, in all probability, to prevent these countries from reaching "self-sufficiency" by 1951.

Most economists would agree that a country with a free market economy internally, and a freely fluctuating exchange rate, could not suffer from a shortage of dollars, or of any other currency, no matter how poor the country in question might be. A shortage of foreign currencies can be defined only with reference to a given exchange rate. Foreign currencies are short if, *at that rate*, payments to foreign countries tend to exceed receipts from them. With freely fluctuating exchange rates a shortage of foreign exchange would, however, lead to such a rise in the value of foreign currencies as would bring payments and receipts into equilibrium regardless of the poverty of the country concerned.

Take, now, the other extreme: a centrally planned economy. Here the imports as well as the exports are decided by authoritarian action and a plan can be devised, theoretically at least, so that, at some more or less arbitrarily set exchange rate, the planned receipts from foreign countries will provide sufficient exchange to cover the planned payments to foreign countries. No general shortage of foreign currencies (or of any particular foreign currency), in any pregnant sense of the word "shortage," need then make itself felt no matter what the general economic condition of the country concerned might be. The country might, of course, want to borrow abroad in order to alleviate a scarcity of goods; but it makes no sense to say that such a country is suffering from a general shortage of foreign currencies or from a shortage of any particular foreign money. We do not speak about a "dollar shortage" in Russia but rather of a desire of Russia to borrow in the United States.\*

If the Marshall plan works out, so that, for each and all of the borrowers, the future receipts from foreign countries roughly equate, at the established exchange rates, with the future payments to foreign countries, the currency of any of the countries can be made freely convertible into any other currency, including dollars, provided the countries in question have a sufficient reserve of foreign exchange to take care of minor and temporary discrepancies between payments and receipts *and* the currencies of other countries are freely convertible among themselves. If, however, the exports of any country go partly to countries which themselves prevent free convertibility of their currencies in any other, such as the dollar, the convertibility into dollars of the original currency will, of course, require a plan which, among other things, will determine the countries to which the given country's exports go and the countries from which its imports come.

A "dollar shortage," as it expresses itself in inconvertibility of a country's currency into dollars, can thus, in principle, be overcome in a planned economy, without any foreign aid, just as it is automatically overcome in a free economy with freely fluctuating exchange rates. In other words, any shortage of foreign currencies in general, or of a particular foreign currency, is the result of faulty planning, the main fault being that the domestic production and investment program absorbs an excessive proportion of the domestic productive resources and leaves an inadequate proportion for exports. The latter are then in-

\* "Dollar shortage" seems to mean to the layman, and even to many economists, nothing more than that the country suffering from it cannot buy as many commodities in the United States as it would like to buy. In this sense every country may feel a dollar-shortage whether or not it has a free market economy and freely fluctuating exchange rates. The author, along with nearly everyone else, suffers from this type of dollar shortage. Such a use of the term deprives it of any significant meaning.

sufficient to buy the imports required for the execution of the domestic production and consumption plan.\* If, moreover, the imports can come in the main from only one country, the fault in the plan will be predominantly reflected in a shortage of that country's currency. Such a shortage might be aggravated by another fault in planning which directs into wrong channels whatever exports the country may emit, *i.e.* into countries which do not permit convertibility of their currencies into the "short" currency. If Great Britain, and Western Europe in general, could in no way obtain aid from the United States, they would be *forced* to achieve an equilibrium in the balance of payments vis-à-vis the United States and to overcome the dollar shortage, by restricting imports or expanding (and possibly redirecting) exports, whether their economies were, or were not, planned; *i.e.* they would, with central control, be forced to achieve by conscious planning what a free market economy would achieve automatically, no matter how hardly, in either case, such a policy might bear on their suffering populations. They would, in short, be compelled to live within their means.

The proposition that the general shortage of dollars in foreign countries is, in large part, the result of faulty planning cannot be seriously questioned. Such a statement does not at all mean that foreign aid should not be given to Britain and other countries. Devastation has been great and need is intense. Commodities are extremely scarce. Our aid will relieve this scarcity both immediately, by facilitating imports of consumers' goods, and in the longer run by rendering possible the improvement of productive apparatus. Western Europe urgently requires all the aid that we seem at all likely to supply and, if our aid brings to pass the sort of world in which free enterprise can freely function, it will have been clearly in our own interest to give support, but if, with the extension of aid, adjustments in the present distorted composition of European industry are not immediately set in train, we shall find, at the end of a quinquennium, that we have made no progress whatever toward the attainment of the international economic system we seek to reestablish. It is essential that we should all be aware of the true nature and causes of the dollar shortage since only then can we form a judg-

\*This does not mean that a country should under no circumstances plan for a surplus of imports. Provided the country can obtain foreign loans, or gifts, to finance such a surplus, it may be in its interest (and in the interest of the world as a whole) to draft a production and consumption plan of which an import-surplus, covered by foreign loans or gifts, is an integral part. This is the situation which the Marshall plan envisages for the next four years. But, to secure foreign loans to finance larger imports does not involve a "shortage" of dollars in the sense that the recipient country's currency becomes inconvertible into dollars. When we ascribe a "dollar shortage" to "faulty" planning, we mean that, as a result of the defective general plan, a negative balance of payments develops which was no part of the intention and for the financing of which no foreign funds have been secured.



ment as to whether, and under what conditions, our aid can lead to the eventual reestablishment of multilateral trade and free exchange markets. Once we are clear about the general causes of a dollar shortage we shall immediately realize that the possibility of an early return to multilateral trade by Great Britain, and the other countries involved, is not so much a function of the volume of aid given as of the policies adopted in the recipient countries. It would be sounder to regard our aid simply as a "grub-staking" of the countries of Europe, with consumers' and capital goods, instead of as a means of enabling them permanently to overcome the dollar shortage; and to look for the permanent solution of the latter problem in their own economic policy rather than in the amount of aid they now receive. If we treat the dollar shortage as what it actually is, a shortage of commodities which, because of faulty planning, shows itself in the form of a shortage of dollars, it becomes immediately apparent: 1) that it does not much matter whence the actual commodities may come, whether from the United States or other countries, and 2) that, no matter how much aid the European countries may receive from the United States, the dollar shortage will still be with us in 1952 if European production and investment plans remain faulty in the sense in which this term has been defined. To these two points we shall now give more detailed attention.

#### IV. BILATERAL AGREEMENTS

A country with a planned economy has the power not only to determine its total exports but also to determine the direction in which its exports will flow. A soft-currency country could, for instance, push its sales to a hard-currency country by the use of discriminatory exchange rates, or by subsidizing its exports to such a country, or by a general reduction in the exchange value of its money, and by so doing could relieve the shortage of the relevant currency. We find in fact, however, that many soft-currency countries prefer to export to other soft-currency countries with which they have concluded bilateral agreements. I say "prefer" deliberately; many economists would doubtless say that a soft-currency country is *forced* to export to other soft-currency countries in order to obtain the imports which it cannot buy from a hard-currency country because it is short of the hard currency. But, if it is true that the soft-currency country could push its sales to hard-currency countries by the methods described above, the word "prefer" is the appropriate word.

If a country may be presumed to act rationally, the explanation for bilateral agreements can be only 1) that the initiating country hopes to get better terms of trade than it could get in commerce with hard-currency countries, or 2) that the agreement is expected to induce the

partner country to lend to the initiating country in the form of an accumulation of unexpended balances in that country. In both cases the basic reason for concluding such agreements is the hope that the initiating country will acquire more commodities than it could obtain by trading with hard-currency countries. If the terms of trade in the bilateral exchange of goods were not more favorable than the terms of trade to which the initiating country would have to descend if it were to procure its imports from a hard-currency country, or if the initiating country did not expect to get a forced loan from the partner soft-currency countries, there would be no reason at all for such bilateral agreements: This only goes to show that it is commodities that the countries in question are after, and not hard currencies as such. They are quite willing to sacrifice the convertibility of their currencies on the chance of obtaining more commodities through bilateral deals.

This preference for bilateral deals is understandable when the hard-currency countries, through tariff policy, make it difficult to export to them; in other words, the terms of trade may perhaps be made quite unfavorable for the soft-currency countries by the tariff policy of the hard-currency countries. The tariff reductions negotiated in Geneva may therefore contribute substantially to the solution of the problem of the "dollar shortage."

It is obvious, however, that not all soft-currency countries can simultaneously gain in this fashion through bilateral agreements; and this is the reason why the benefits which may accrue to a stronger country in the agreement are likely to be merely temporary. The case of German trade with the South-Eastern European countries before the War has shown that the weaker partner in the agreement will eventually shift its exports to hard-currency countries in order to avoid exploitation. An analysis of the renewals of bilateral agreements either before or after the War would show that the countries which had accumulated balances in the partner country pressed for changes in the agreement which would allow them to convert their balances into hard currencies and/or remove the cause for such involuntary lending.\*

## V. ECONOMIC POLICY AND DOLLAR SHORTAGE

Faulty planning is all but inevitable under the conditions in which European governments now have to work. For this there are several reasons as follows:

\* There is even a presumption against the notion that *any* country can gain through induced bilateralism since it is unlikely that the citizens of any country will gain as much from trade when, by governmental action, they are prevented from buying and selling where they please (that is to say in what is, for them, the best market) as they would gain if they were given freedom in the matter.

a) Many governments may deem it necessary, if they are to stay in power, to engage in extensive housing programs, road construction, and other investments that absorb a large part of the productive effort of the nation and leave too little for exports. Such a policy may actually be facilitated by foreign aid since such aid temporarily relieves the pressure on the balance of payments which results from too ambitious a domestic investment program. On the Continent, in particular, where some countries are approaching a state of civil war, there is no predicting what governments will be forced to do in order to prolong their life. No rational economic policy, of course, is possible in a highly unstable political situation.

b) In the European economies there are two markets: the official market in which prices are fixed and goods rationed, and the unofficial market, the black market, in which prices are free. Leaving the black market out of consideration for the moment let us assume an economy in which only controlled markets exist. This is a type of economy to which Great Britain is perhaps the nearest, though quite far from a perfect, approximation. Firms and consumers are very liquid and the producers can without difficulty sell in the domestic market all that they can produce. How much they will produce for domestic consumption is no longer mainly determined by price, but rather by the raw materials the government allocates together with the labor force over which the firms can dispose. The price system is in fact replaced by official allocation of resources. Yet in one market, that for exports, prices still play a very significant role. It is not sufficient here to allocate raw materials for export purposes; British industry must also be able to compete with the industry of other countries. It is no longer true (if it ever was) that Great Britain can sell abroad, irrespective of price, all that it could produce for export. In many lines it has become a question of markets, and therefore of prices as well as of production. In many manufactures British industry cannot compete in price with American industry, or with the industry of other European countries, either in the American market or in such European markets as Switzerland and Belgium. Planning for export, therefore, cannot be done simply and solely by allocating more resources to production for export. So long as the exchange rate is fixed at a level which overvalues the domestic currency, exports tend to lag behind the volume they might otherwise attain; and a tendency arises to devote too large a proportion of resources to the production of domestic goods. In other words a wrong exchange rate contributes to the mal-functioning of the overall plan and to the shortage of hard currencies. A thoroughgoing review of the exchange rate structure connecting the various currencies is a necessary

requirement for overcoming the dollar shortage whether or not American dollars are now made available. It is admittedly difficult to find the right exchange rate, particularly in a country in which relative inflation is still going on so that what appears a correct exchange rate today may not be correct tomorrow. Successful planning aiming at elimination of the dollar shortage is, for this reason alone, extremely difficult to achieve.

Such planning is made still more difficult if there is a well-developed black market (as is the case on the Continent). In France, farmers get a liberal allowance of imported gasoline for running their tractors; but many of them are said to prefer to sell it on the black market to owners of automobiles who get a meager allowance from the government and are willing to pay exorbitant prices for the fuel. Under such circumstances a government might devise a perfect plan, allocating resources in exactly the right proportions, and yet the plan would go agley, because the resources were not in fact used where they were supposed to be employed. The black market is the result of price control, scarcity of goods, and excess liquidity (arising from inflation and price controls) in the hands of consumers as well as business firms. So long as prices continue to be controlled, and goods to be rationed, and so long as excess liquidity exists or inflation proceeds, there is little hope that plans can be devised and successfully carried out which, to use a vague newspaper phrase, "will put the country on its feet," and bring the shortage of hard currency to an end.

c) A government can make plans, allocate resources, control prices, etc., but it cannot make people work except, perhaps, when it has dictatorial power and is willing to use it ruthlessly; and this is another reason why plans can, and do, go wrong. This brings up the whole question of incentives which, as is now recognized in Great Britain, are of paramount importance. If people can buy all their rations with a certain fraction of their income, and cannot buy unrationed goods, there is little or no economic incentive to work harder, particularly if the larger part of any additional income is taxed away, saving is made unattractive by a policy which keeps interest rates below 3 per cent, and a very liberal social-security program is on the books. To create adequate economic incentives to work harder in countries like Great Britain will probably require a thorough departure from established policies involving a change in the tax system, a change in food prices through the removal of food subsidies, somewhat less complete security of employment, and, possibly, a change in the interest rate. This is a vast program—easy to propose but difficult to carry out.

We may summarize by saying that, if convertibility of European

currencies into dollars is to be achieved by the end of 1951, the economic policies of European countries must be directed towards the following aims:

1) Cessation of new issues of money and, if economic planning is to continue, the removal of the conditions responsible for the existence of black markets. The stopping of further inflation though a necessary is not a sufficient condition for the disappearance of black markets. Even if inflation were stopped, price controls and rationing, together with excess liquidity, would still present inducements for trading in the black market. Monetary reform to remove the excess liquidity would also have to be undertaken, or prices must be allowed to rise until they absorb the present relative redundancy of monetary means of payment.

2) Adjustment of foreign exchange rates—a vast and difficult task for the Monetary Fund. We should never forget that the exchange rate is a price, with all the functions of equilibrating supply and demand that any free-market price performs, and that rates must be adjusted in such a way as at least roughly to express the current purchasing power parity of the respective currencies.

3) The creation of economic incentives to work harder.

Unless these conditions are fulfilled the best intentions and most carefully worked out production-plan is likely, in execution, to go awry, and the countries concerned may find, after foreign aid is exhausted, that they have made not the slightest progress toward the goal of general convertibility of their currencies.

If now we reflect a moment on the conditions just listed we shall find that they are exactly those which, if fulfilled, would make it easy for the countries concerned to restore a free-market economy. The best though not the sole guarantee for the ultimate success of the foreign-aid program (in terms of a return of the world to relatively free multilateral trade and free exchange markets) would be the gradual but complete restoration of the price mechanism in the internal economy of the countries concerned.

This conclusion is not surprising. Free exchange markets, multilateral trade, the abolition of import licensing, etc., are nothing but the application of the free-market principle to international commerce, and it is all but impossible to run the international sector of the economy on the free-market principle while the domestic sector is run on the principle of central planning.

In support of the preceding argument it is worth-while to call attention to the case of Sweden which is an ideal illustration of a country

which, by faulty planning, has maneuvered itself out of the position of a hard-currency country into the position of a soft-currency country.

A memorandum from the Board of Directors of Sweden's Central Bank, dated September 30, 1947, gives as the main reason for the deterioration in Sweden's foreign exchange position a large increase in imports. This resulted from too large an expansion of domestic investment (in the form of buildings, equipment, and inventories) made possible by the inadequacy of import regulations. The reason for this inadequacy, according to the memorandum, is, in the first place, that it has been necessary, by means of rather liberal transitional regulations, to further the fulfilment of contracts already undertaken. A second reason is that consideration had to be given to the provisions of previously concluded bilateral trade agreements. Thirdly, an effort has been made to maintain some of the more necessary imports on the free list. Finally, the application of the transitional regulations has successively, and to a significant degree, been relaxed, and the possibilities of importing "free list commodities" have been utilized to an unexpected extent. The result, so says the memorandum, has been an essentially larger volume of imports than one could earlier have had any reason to expect. It is a safe guess that the appreciation in the exchange value of the Swedish crown had something to do with the "unexpected extent" to which free list commodities have been imported. The outcome was a loss of 2,200 million Swedish crowns' worth of foreign exchange in the fourteen months' period between July 15, 1946 and September 15, 1947.

The elements to which I have ascribed the dollar shortage—a wrong production plan and a wrong foreign exchange rate—are here quite clearly responsible for the dollar shortage which now faces Sweden.

## VI. MULTILATERAL TRADE

One interpretation of the term multilateral trade seems to identify it with a system of foreign commerce characterized by the condition that every importer may buy any desired amount of any commodity *from* any country while every exporter may sell any desired amount of any commodity *to* any country. In this sense multilateral trade is identical with a system in which tariffs constitute the sole interference (if there is any interference at all) with the free flow of goods. Quotas, import licensing, and foreign exchange control are incompatible with multilateral trade so defined, and a country with a centrally-planned economy (which always controls, in one way or another, imports as well as exports) could then never participate in a multilateral trading system.

The term should, however, preferably be interpreted in a narrower

sense. This narrower definition derives from the contrast with bilateral trade and (closely connected with this) from the idea of general convertibility of a country's currency into all other currencies. Under this definition a country engages in multilateral trade whenever foreign traders who sell goods to its citizens can convert their receipts into any currency they please. It is characteristic of bilateral trade agreements that this can not be done. The receipts for a country's exports to another country with which the first has concluded a bilateral trade agreement can, in the normal case, be used only for the purchase of commodities in the importing country. A definition of multilateral trade based on the general convertibility of a country's currency therefore excludes, as it ought, bilateral trade-agreements.

If this narrower definition be adopted, a country with a centrally-planned economy can, at least theoretically, participate in a system of multilateral trade. Despite the fact that the total volume of imports of each commodity is planned and controlled by import licensing, the decision on the sources of supply, provided overall equilibrium in the balance of payments has been achieved, can be left to the importers. If it is cheaper for citizens of country X (with a planned economy) to buy wheat in Canada than in Argentina there is no inherent reason why their wheat should not be bought in Canada. Canada could have an active balance of trade with the centrally-planned economy and Argentina a passive balance of trade. And Canada could change its surplus receipts of X's currency into pesos (or any other currency) in order to buy in Argentina (or any other country). Since the sum of the deficits, in the trade of the controlled economy with "surplus" countries, is equal to the sum of the surpluses in the trade with "deficit" countries (so long as the overall balance of payments is in equilibrium and all other currencies are convertible into each other), the currency of the controlled economy can be made freely convertible into any other, *i.e.* multilateral trade is possible.

To distinguish between these two different meanings of multilateral trade the term "uncontrolled multilateral trade" will be used whenever the reference is to the broader definition and the term "controlled multilateral trade" whenever the reference is to the narrower definition.

The policy of the United States aims in principle at uncontrolled multilateral trade. To be sure, each new draft of the International Trade Charter allows for more and more exceptions to the rule of uncontrolled multilateral trade and it looks as if little of the rule will be left when the final Charter is adopted. Nevertheless, the goal of United States policy remains a multilateral trade completely freed from exchange control, import licensing, and quotas. Internal central planning of an economy

is, as already noted, incompatible with this "uncontrolled" multilateral trade. The controlled type of multilateral trade is, on the other hand as has been shown, quite possible for a centrally-planned economy. The American loan to Britain was intended to enable Britain to adopt such a policy. The lack of success of the loan suggests, however, that, in practice, it may be difficult for a controlled economy to achieve even the narrower multilateralism.

Whereas it was implicitly assumed above that a centrally-planned economy is surrounded by free economies with currencies all freely convertible, let us now go to the other extreme and assume that all economies are centrally planned. Controlled multilateral trade is then still possible, provided the national plans of the countries match, *i.e.* that there is a world plan for exports and imports. Such a world plan could allow for triangular, quadrilateral, or more complex, exchange of commodities between countries. Argentina, for instance, could be "granted" an export surplus of a given amount to Great Britain and the acquired pounds sterling could be used by Argentina to finance an import surplus from Canada provided Great Britain is "granted" a corresponding export surplus to that country; theoretically many more countries could be involved in this kind of trade, which would be truly multilateral. Free convertibility of currencies, in the sense that a foreign currency acquired by a country could be spent wherever it "liked," could then, however, not exist. The currency would have to be spent in accordance with the world plan.

Such a system, although theoretically conceivable, is not within the realm of practical possibilities and we need, therefore, be at no pains to give it a distinctive name. If all countries had controlled economies, the result in practice would be a preponderance of bilateral agreements with perhaps some attempts at triangular agreements. It is practically certain that multilateral trade and freely convertible currencies would disappear.

At present the world is divided into free economies and controlled economies. If one country alone has a controlled economy it need not enter into bilateral trade agreements. If *all* economies are centrally planned, bilateral agreements are a practical necessity. It is, however, an interesting question whether bilateral agreements and inconvertibility of currencies are in practice necessary when part of the world has controlled economies and the rest uncontrolled economies. This problem requires a much more detailed analysis than it can here receive. The summary answer, it seems to the writer, is "no." So long as an economically important area of the world has a free market economy in which prices determine the quantities bought, and so long as the exchange rates between the free economies and the controlled economies



are flexible, the discrepancies in the import and export plans of the various controlled economies can be ironed out through the medium of the free market in the uncontrolled economies, which will then fulfill the function of a safety valve. If, for instance, the imports of the controlled economy A from the controlled economy B are greater than A's exports to B, there is no reason why the surplus receipts of B could not be made convertible into the currency of the uncontrolled economy C, provided A restricts its imports from C or, through price reductions via subsidies or the lowering of its exchange rate vis-à-vis C, can push its sales to C sufficiently to attain a balance. Since exchange rates under the Bretton Woods scheme are relatively inflexible, and plans cannot be quickly changed, it is very likely that controlled economies will experience periodic shortages of specific currencies. But there is no inherent reason for *chronic* shortages. It is always possible to overcome such shortages by an appropriate domestic economic and monetary policy or the choice of an appropriate exchange rate. And, if foreign exchange reserves are large enough, it will not be necessary, even temporarily, to drop convertibility.

All this is said in re-emphasis of the assertion that neither bilateral trade nor dollar shortage are economic necessities in the modern world, "planned" or not. Yet one needs more of faith in authoritarianism than the author can muster if he is to believe that bilateral trade will disappear, and controlled multilateral trade take its place, so long as a large part of the world has adopted and persists in central economic planning. Planners do not like to alter their plans; they prefer "reliable" sources of foreign supplies and "reliable" foreign markets. It is, therefore, natural that they favor bilateral agreements and it is, no doubt, a faint hope that multilateral trade will replace bilateral trade so long as the European countries retain anything like fully controlled economies.

## VII. SUPERVISION OF THE PROGRAM

Two considerations, one economic, the other political, should be carefully weighed each against the other before any decision is reached as to whether or what strings should be attached to our foreign-aid program.

Since the ultimate goal of the United States is uncontrolled multilateral trade it seems natural that the United States Government should make foreign aid dependent on a domestic economic policy in the recipient countries which will create the necessary conditions for the attainment of that end. We have seen what these conditions are. Their realization requires a thoroughgoing change in the domestic economic policy of the recipient countries, a definite move away from price con-

trols and allocation of materials toward the reestablishment of a free market. From the economic point of view everything argues for a policy which uses our offer of aid to achieve this result.

Political considerations, however, seem to require a more clement tactic. Any interference with the domestic affairs of the European nations will be resented. Less powerful nations are always resentful toward the more powerful, the more so the more they are dependent on the latter. Any attempt by the United States to impose its will on a European country, by refusing aid unless the recipient country follows the "suggestions" of the United States, will certainly be considered an infringement of jealously guarded sovereignty.

Political factors, therefore, suggest a procedure which is in all but direct contrast with that which economic considerations, *in vacuo*, might postulate. Nobody can seriously advocate that American interference should go to the extreme of seeking to dictate to the recipient countries the kind of economic system we think they ought to have. Yet we must keep in mind the fact that there is little chance that the goal of multi-lateral trade will be reached unless the indicated shift in the economic policies of the recipient countries takes place. On the whole, it seems wise to express our views but to attach as few strings as possible to the program of aid. This conclusion conforms with the attitude of the Secretary of State in his testimony before the Senate Foreign Relations Committee, on January 8, when he said: "We have stated in many ways that American aid will not be used to interfere with the sovereign rights of these nations and their own responsibility to work out their own salvation. I cannot emphasize too much my profound conviction that the aid we furnish must not be tied to conditions which would, in effect, destroy the whole moral justification for our cooperative assistance toward European partnership. . . . We cannot expect any democratic government to take upon itself obligations or accept conditions which run counter to the basic national sentiment of its people. . . ."

Three methods have been suggested for more or less gently influencing the domestic economic policies of the recipient countries. These are:

(a) A request for pledges from the recipient countries to follow defined policies during the period of aid. This method was proposed in the eighth Herter Report which states that ". . . the following points, in our opinion, must be taken into account in formulating and administering any program of aid." The six points mentioned would require the recipient countries to

1) make every effort to increase local production of food and needed materials,

- 2) facilitate the economic interchange of goods and services among themselves,
- 3) draw, if possible, supplies not only from the United States but also from other countries,
- 4) encourage private initiative,
- 5) balance their budgets, stabilize exchange rates, and restore confidence in their currencies,
- 6) give full publicity regarding the aid furnished to them.

The President's Message to Congress, December 19, 1947, is more definite. It asks for agreements between the United States and the recipient countries in which these countries will give pledges to take action along the lines indicated by points 1, 2, 5, and 6 above. It adds some further points, one of which will be discussed below.

There can be no objection to the assertion that the recipient countries should take action along the proposed lines. But, even if we assume that the European countries promise to "make every effort" in this direction, there is no guarantee that they will actually live up to their promises. Breaking international undertakings, to say nothing of merely deviating from them, is not without precedent, and the circumstances may be such that the governments are practically forced to waver on their pledges. It is therefore doubtful whether formal commitments should be asked of them. Such pledges, to be sure, would put moral pressure on the recipient countries to do their best to fulfill their obligations. If, on the other hand, internal political and economic instability practically compels them to go back on their pledges, the breaking of the pledges will poison the international atmosphere and have political repercussions in the United States which will be highly undesirable. European governments will acquire the reputation—if they do not have it already—of being unresponsive to their promises, and this will accentuate the feeling among the American public that Europe should be "written off."

(b) The United States could press indirectly for the fulfilment of such conditions as are laid down in the six points by providing for so flexible an administration of the foreign-aid program as to permit withdrawal of aid to any country in which things do not develop in what the United States considers a favorable direction. The fact that the President, in his message to Congress on the State of the Union, asked merely for an initial amount of 6.8 billion dollars to cover the first 15 months of the projected period of aid indicates that the program is to be reconsidered periodically in the light of previous experience. Since one of the main purposes of the program is to prevent the recipient nations

from becoming communist, there would clearly be no sense in continuing aid to such of them as actually did go that way. It would seem wise, however, not to use this method to enforce a definite economic policy on the recipient countries in general. Aid should cease to such countries only as join the communist camp.

(c) The third suggested method for influencing the economic policy of European countries follows the line advanced in the eighth Herter Report under which the United States would acquire the potentiality of direct interference in the economic policy of the recipient countries. I refer to what may be called the "local currency proposal" (favored in the President's message of December 19) according to which the recipient countries would pledge themselves "to deposit in a special account the local currency equivalent of aid furnished in the form of grants."

The ninth Herter Report, supplementing the eighth, suggests

- 1) that capital equipment required by the European countries be financed by the International Bank,
- 2) that raw materials other than fuel and fertilizers be financed by the Export-Import Bank, and
- 3) that food, fuel, and fertilizers (the three F's) be financed by the United States Government which would receive local currency in exchange for them.

The method of administration (outlined in the eighth Herter Report) is as follows:

A corporation is to be set up in the United States known as the "Emergency Foreign Reconstruction Authority" ("Economic Cooperation Administration" in the President's message of December 19). This corporation will sell the three F's to the governments of the European countries against "tax money." (It is assumed that the European governments will actually succeed in achieving a sufficient surplus in their budgets to permit them to inaugurate and maintain the buying of the three F's with the excess of revenues over other expenditures.) This money is then to be turned over to the American corporation or to its representatives on the spot. The foreign governments, on selling the three F's in the domestic market, reimburse themselves for the funds thus spent.

The local currency held by the corporation should, according to the Herter Report, primarily be used to help the recovery of the recipient country "under safeguards to prevent inflationary effects." The American corporation which owns the local currency would be able to in-

fluence both the investment programs of the recipient countries and their monetary policies. If the American authorities think, for instance, that inflation is present in, or is threatening, a recipient country, that capital expenditures are too heavy and are likely to upset the international balance of payments, they might force a mildly deflationary policy on the country by simply hoarding the money; and they could act in the converse fashion if a noxious deflation were imminent. The Treasury, or Central Bank, of the country concerned could of course, in the event of a disagreement with the American authorities, seek to counteract the deflationary pressure exercised by the hoarding of local currency by the American authorities. It remains true, nevertheless, that the local currency proposal would give the United States very substantial power in the internal economic affairs of each of the recipient countries.

Since the American corporation owns its deposits it has the right to do with them what it pleases (except to change them into foreign currencies). But, since the monetary authorities of the recipient countries (the Treasury and Central Bank) might, in the event of disagreement, sabotage the monetary policy followed by the American corporation, the funds should clearly be administered in cooperation with those authorities. It is logical, therefore, that the President's message of December 19 suggests that the local currency deposits be used "only in a manner mutually agreed between the two governments." In daily contact, between the representatives of the American corporation and the representatives of the Treasury and Central Bank of the recipient country, a cooperation may readily develop in which the American authorities will, with a minimum of friction, have an opportunity to influence the monetary policy of the recipient country. Though this gives no firm guarantee of the eventual return of those countries to a system of uncontrolled multilateral trade it could at least be used to create the necessary monetary conditions for the consummation of that devoutly to be desired end.

#### VIII. SUMMARY

The argument of this paper can be summarized in a few propositions:

- a) The ultimate return of the European countries to multilateral trade free from foreign exchange controls, import licensing, and the like, depends on their own economic policies rather than on the volume of aid they may receive. The amount of that aid is measured by their need for goods and will not, *per se*, evoke the shift in policy toward a freely trading world.
- b) The conditions for their return to a liberal trading policy are

- 1) that inflation be stopped,
  - 2) that excess liquidity be mopped up,
  - 3) that foreign exchange rates be adjusted to the current purchasing powers of the respective currencies,
  - 4) that the countries return to the essentials of a free-market economy within their own borders.
- c) Aid should, nevertheless, be given without detailed prescription of the economic policy that the recipient countries must follow. Only through the administration of the local currency deposits paid in for the provision of the three F's should an attempt be made, in cooperation with the local monetary authorities, to influence the policy of the recipients.
- d) The program should be kept flexible in the sense that no indefeasible commitments for so long a period as four or five years should be undertaken by the United States.

*Feb. 1, 1948.*

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