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THE DOMESTIC CURRENCY EQUIVALENT OF U.S. FOREIGN AID

Robert A. Rennie

In the Paris report of the Committee of European Cooperation, the member countries pledged themselves to work for internal financial and monetary stability. If the European Recovery Program is approved by Congress, these commitments will be formalized in bilateral treaties between the United States and each of the participants. The proposed legislation defines in general terms the substance of these agreements. To help restrain inflationary pressures, the country receiving goods or services on a grant basis shall deposit domestic currency in a special account in amounts commensurate to the aid received. These deposits shall be immobilized or used only for such purposes as may be agreed to by the country receiving the aid and the Administrator of the Recovery Program acting in consultation with the National Advisory Council.

In scope, these deposits will have widely varying significance within the individual countries. In approximate terms, the ratio of domestic currency deposits to total public expenditures, and to money supply in Austria, Denmark, France, and the Netherlands probably will vary between 25 and 30 per cent in the first case and 12 and 18 per cent in the latter. The monetary instability in Greece and Italy, however, will distort the ratios for these countries perceptibly. The proportions in the remaining countries are relatively small or negligible. It is obvious that if the domestic currency equivalent were to be sterilized in several of these countries, the deflationary impact upon their economies would be felt immediately. Whatever policy is adopted, the United States will assume very great, though indirect, responsibilities in European fiscal and monetary management under the European Recovery Program.

Local Currency Measures Prior to ERP

To understand all the implications of the domestic currency proposal, it is necessary to analyze not only the details of the ERP legislation, but also the local currency measures that accompanied previous foreign aid programs.

At the first session of the UNRRA Council it was decided that if a country could not pay for relief or rehabilitation supplies in suitable foreign exchange, it would make available to UNRRA, in whole or in part, the local currency proceeds derived from the sale of the supplies.1/ The local currency could be used for relief and rehabilitation work within the country and for such other purposes as might be agreed upon with the member government involved.2/ However, the conclusion was soon reached that it would be more practicable for the funds to remain under the control of the receiving governments rather than of the Administration, with the restriction that the expenditure of funds should be for purposes acceptable to UNRRA. This decision was adopted partly as a practical measure to provide several of the countries in financial difficulties with operating revenue and partly as a matter of principle to recognize the sovereignty of the recipient countries and to permit them to administer this important factor in their economies. Furthermore, it would have been impossible for UNRRA to collect and administer such large amounts of local currency unless it increased its missions in these countries beyond desirable limits.3/

In dealing with the local currency question, UNRRA neglected problems of internal monetary and financial stability. Its policy papers on this subject were primarily concerned with the purposes for which these funds were spent and the compliance of the individual countries with their bilateral agreements. There was nothing in these agreements which would tend to reduce purchasing power in the hands of consumers; in fact, they

1/ In should be noted that while UNRRA dealt with the local currency proceeds derived from the sale of supplies, the domestic currency deposits under the ERP program will equal the dollar equivalent of the landed cost of goods received on a grant basis at the ports of the recipient countries. This change, first introduced in the Interim Aid Act, was designed to correct a serious defect in the administration of foreign aid.

2/ First Session of the Council of the United Nations Relief and Rehabilitation Administration, November 10 - December 1, 1943, Selected Documents, Resolutions on Policy, Resolution No. 14, Section 19, pp. 47-48.

3/ A few variations were introduced in particular countries because of the special conditions which prevailed. For example, in Italy, and later in China, proceeds were placed in a joint account which was drawn on only with the joint concurrence of both parties. Final Report of the Director General on the Proceeds of Sale of UNRRA Supplies, CC(48)2, January 15, 1948, pp. 1-2.

stressed the desirability of prompt re-spending of the proceeds. The relevant text of the Czechoslovakian pact, a typical basic agreement, emphasizes this difficulty:

> "It will be the policy of the Government to use for relief and rehabilitation purposes, within a reasonable time after the commencement of the Administration's operations in the country, funds equivalent in amount to the sums recorded as net proceeds ..." 1/

Moreover, to the extent that the proceeds were treated as current budget receipts and were used for relief or rehabilitation work which should have been a charge against the normal government budget, the deficit was reduced. Thus, although the receipt of funds from relief sales and their subsequent disbursement did not necessarily increase inflationary pressures, in practice under the UNRRA program, they probably delayed the introduction of fiscal measures necessary to promote greater internal financial stability.

The foreign aid programs of the United States Government enacted during 1947 also included provisions for the segregation of the domestic currency proceeds. They have been supplemented by agreements with the recipient countries providing that the funds will not be spent except with the approval of the United States. The provisions of the laws in this matter are as follows:

1/ Addendum to Final Report on Proceeds of Sale, CC(48)8, January 26, 1948, p. 2. As an anti-inflationary measure, Austria took independent action to block the proceeds of relief sales during the period of UNRRA operations.

Post-UNRRA Relief[1]	Interim Aid[2]
Sec. 6. To the extent that relief supplies procured with funds authorized under this joint resolution are not furnished on terms of repayment in dollars, they shall be furnished only upon condition that the government of the receiving country agree that when it sells such relief supplies for local currency (a) the amounts of such local currency will be deposited by it in a special account; (b) such account will be used within such country, as a revolving fund, until June 30, 1948, only upon the approval of the duly authorized representative of the United States, for relief and work relief purposes, including local currency expenses of the United States incident of the furnishing of relief; and (c) any unencumbered balance remaining in such account on June 30, 1948, will be disposed of within such country for such purposes as the United States Government, pursuant to Act or joint resolution of the Congress, may determine.	Sec. 5. Before any commodities are made available to any recipient country under the authority of this Act, an agreement shall be entered into, subject to the limitations and provisions of this Act, between such country and the United States containing an undertaking by such country-- ..... (b) to make, when any commodity which is not furnished on terms of repayment in dollars is made available under this Act, a commensurate deposit in the currency of such country in a special account under such general terms and conditions as may, in said agreement, be agreed to between such country and the Government of the United States, and to hold or use such special account for, and only for, such purposes as may be agreed to between such country and the Government of the United States, and under agreement by the government of the receiving country that any unencumbered balance remaining in such account on June 30, 1948, will be disposed of within such country for such purposes as may, subject to approval by Act or joint resolution of the Congress, be agreed between such country and the Government of the United States;
1/ Public Law 84--80th Congress, H.J.Res. 152, Joint Resolution providing for relief assistance to the people of countries devastated by war. Approved May 31, 1947, p. 4.	2/ Public Law 389--80th Congress, Foreign Aid Act of 1947. Approved December 17, 1947, p. 2.

The testimony of Mr. Herbert Hoover at the hearings on the post-UNRRA relief bill raised an issue which has dominated all subsequent consideration of the local currency question. He suggested that the funds be placed in a special depository to the credit of the United States Government. Although this proposal was rejected as impractical in both the post-UNRRA and the Interim Aid statutes, it has reappeared with renewed vigor in the Herter bill.1/ This measure provides for the creation of local reconstruction funds from the proceeds of the foreign aid. Title to these funds will be held by the corporation created to administer the aid program. This bill is also much more explicit than the Vandenberg bill concerning the criteria that should govern the disposition of the local currency equivalent. The funds may be used, subject to arrangements concluded between the corporation and the recipient country, for the purchase of securities, for investment in productive industries of the recipient country, for the purchase of strategic materials, and for the development of new sources of wealth in the country.

The Committee on Foreign Relations of the Senate rejected the proposal that the United States should take title to the local currency deposits arising from the operation of the European Recovery Program. In view of the probable size of the deposits in certain countries, it felt that ownership of these funds would require the United States to assume a responsibility for financial policies which it was in no position to discharge. The Committee did insist, however, that while this country should not take title to the deposits, neither should the Administrator alone wield veto power for the United States under the requirement that the deposits be utilized in agreement with this country. It amended the section to provide that use of these funds shall be subject to the approval of the Administrator <u>in consultation with the National Advisory Council</u>.

<u>Some Problems in Administering Local Currency Funds</u>

Although bilateral agreements have been signed with European nations covering the general use of domestic currencies under both the Post-UNRRA and the Interim Aid Programs, it has not been possible to arrive at a mutually satisfactory arrangement on specific questions of policy. From the viewpoint of the United States, the most efficient use of the local currency equivalent in certain countries suffering from an inflated money supply would be its partial withdrawal from the economy. France, in particular, has never accepted this position. In this case, the U.S. draft agreement provided that the proceeds could be used "only" for specified purposes such as retirement of the national debt or currency stabilization. The French Government objected to such restrictive limitations upon its use of the currency, and it was agreed to eliminate the objectionable word "only" from the agreement, but the fundamental divergence in viewpoints still persists. The French Government desires to place the local currency equivalent in two funds, one to be used for reconstruction, the other for a program of industrial and agricultural re-equipment. However, under the proposed legislation, the French reconstruction and re-equipment appropriations will not be limited to the amount of currency in the funds. In view of the ERP objective of internal financial stability, it is unfortunate

1/ Entitled "Emergency Foreign Reconstruction Act, 1948" (EFRA), H.R. 4579.

that the French capital expenditures and the deficit in the government budget cannot be covered by non-inflationary means of financing. The National Assembly has recently appropriated reconstruction credits of 80 billion francs for the current fiscal year and indicated that the local currency deposits would be used to cover them.1/ It is unlikely that the local currency equivalent of ERP aid will be adequate to meet the needs of government finance if further appropriations are made.

In countries with multiple exchange rates or with extensive subsidy programs, it will be difficult to determine the appropriate rate of exchange at which local currency deposits will be made. None of the basic legislative texts indicates clearly the rate of exchange to be used. The Interim Aid law stipulates that the deposits shall be made "under such general terms and conditions as may ... be agreed to between such country and the Government of the United States ..." The phrasing of the present Vandenberg bill is substantially the same. The Herter bill is somewhat more explicit: "The exchange value of any foreign currency received shall be fixed in the arrangements concluded, but if agreement cannot be reached in this respect then the exchange value shall be that currently fixed by the International Monetary Fund."

The Italian Interim Aid bilateral agreement is slightly confusing, for it provides that the amount deposited in Italian currency will be computed at the most favorable rate of exchange in terms of U.S. dollars, <u>authorized under the Articles of Agreement of the International Monetary Fund</u>, applicable to imports. Since the Fund authorizes no exchange rates for Italy, the agreement is not directly applicable to present circumstances. This is true also of the French Interim Aid agreement, which provides that the deposit shall be made at the par value authorized by the Fund. The introduction of multiple exchange rates on January 26, 1948, raised the question of which one of the exchange rates would be used in making local currency deposits.

The administration of local currency funds may encounter difficulties in countries such as the United Kingdom which have large subsidy programs. In that country, many essential commodities are distributed at prices much lower than the cost equivalent in dollars. In other words, there may be a significant difference between the local currency proceeds derived from the sale of supplies and the special deposit made by the government under the terms of the ERP agreement. If the government should make up the difference in the account by borrowing from the Central Bank, there may be unfavorable psychological effects. Furthermore, if the special account should then be used to finance government expenditures, it would have a definite inflationary impact. However, monetary stability could be maintained in this case by making up the difference from current tax revenues or by sterilizing this portion of the special currency account.

Despite the numerous problems which will arise, the local currency deposits can become the instrument through which the participating countries and the United States can work out mutually agreeable programs for currency stability and for the reconstruction and stimulation of their industries. There is complete agreement on the ultimate objectives of the European Recovery Program and, consequently, solutions can undoubtedly be found for all the problems involved in the local currency equivalent provisions.

1/ New York Times, January 3, 1948, p. 1, February 27, 1948, p. 4, and March 5, 1948, p. 7. New York Herald Tribune, January 3, 1948, p. 5. Approximately 8 billion francs had been earmarked in the special domestic currency account from Interim Aid on March 4, 1948.

ESTABLISHMENT OF A BANK OF GERMAN STATES J. Herbert Furth

Identical ordinances of the Military Governors of the U.S. and U.K. zones of Germany which were promulgated on February 15, 1948, and went into effect on March 1, have established a Bank of German States for the area of the combined U.S.-U.K. zones.

These ordinances conclude the current reform of the administration of the combined zones, which was inaugurated with the establishment of a reorganized Bizonal Economic Administration and a Bizonal Supreme Court on February 9, 1948. At the same time, the ordinances implement and amend the laws creating central banks in the individual states of the combined zones. These State Central Banks have been operating in the U.S. zone since January 1, 1947, but were only recently (January 27, 1948) established in the U.K. zone.

The new banking organization shows far less decentralization than did the preliminary plans.1/ Originally, the individual State Central Banks were merely to be coordinated by an Advisory Council the functions of which were confined to making recommendations on uniform discount rates, reserve requirements, and open market policies. Now this body has been replaced by a full-fledged bank, with important powers of regulations restricting the autonomy of the State Central Banks. The policies of the new bank still will depend to a large extent upon the decisions of the State Central Banks, the Presidents of which constitute a majority of the Board of Directors. The new bank, however, will achieve a certain degree of autonomy since the powerful Chairman of the Board, although appointed by the representatives of the State Central Banks, will be independent of any outside influence for the duration of his tenure.

The new bank will deal exclusively with the State Central Banks, the central banks of other areas, and the Bizonal Economic Administration (Section 2).2/ It thus will be something like a central bank for central banks, resembling in that respect the Bank of International Settlements or the Bretton Woods institutions. The bank will not be subject to any other German agency, although the state governments which appoint the Presidents of the State Central Banks will be able, through this appointive power, to influence the election of the officers of the new bank. On the other hand, the bank will be expressly subject to directions issued by the Allied Bank Commission, a newly established bipartite agency.3/ This Commission will have to approve all by-laws and regulations issued by the bank and may require the submission of any report or information (Sections 3, 6, 7, and 34). In contrast to the State Central Banks, the new bank is not even in a limited way a successor to the German Reichsbank. Its organization is such, however, that with the consent of the other occupation powers it could easily be developed into an institution covering all of Germany.

1/ See this Review, February 11, 1947, p. 1.

2/ The quotations refer to the text of Military Government Law No. 60, which will be published in the Federal Reserve Bulletin for March 1948.

3/ In recent official usage, "bizonal" denotes German, and "bipartite" Allied institutions.

The new bank is to become the exclusive bank of issue "on the direction of the appropriate Allied authorities" (Section 8). These "appropriate Allied authorities" are not defined, and the reference may be to quadripartite, tripartite, or bipartite action. Obviously, the definition will await the outcome of the present quadripartite talks aimed at a common currency reform for all of Germany, and these talks failing, the outcome of the tripartite meeting aimed at integrating the French zone (excluding the Saar) into the combined U.S.-U.K. zones.

In addition to its function as a bank of issue, the new bank has to "promote the solvency and liquidity" of the State Central Banks; establish common policies with respect to banking and insure "as far as possible the maximum uniformity in banking policies" within the states; and regulate credit policies and especially interest and discount rates and open market operations of the State Central Banks as well as reserve requirements for individual banks within the states. The new bank also will effect the settlement of bank balances between the states, taking over an agency recently established for that purpose by the State Central Banks (Sections 9-12).

In addition, the bank may, in transactions with central banks, trade in foreign exchange and precious metals; accept deposits; rediscount bills of exchange; grant loans against bills of exchange, against bills and securities issued by the Bizonal Economic Administration or any state government, and against other bonds purchased by State Central Banks; and provide facilities for the safekeeping of securities (Section 13). The bank may serve as fiscal agent for the Bizonal Economic Administration and the Joint Export-Import Agency, grant short-term advances to the Bizonal Economic Administration, and trade in the open market in bills and bonds issued by the Bizonal Economic Administration (Sections 14-16). Finally, the bank may regulate foreign exchange transactions, fix interest and discount rates for its transactions with the State Central Banks and the Bizonal Economic Administration, set minimum reserve requirements (not to exceed 30 per cent of deposits) for the State Central Banks, establish principles for auditing the State Central Banks, and issue regulations to the State Central Banks (Sections 19, 31, and 34).

The powers of the new bank apparently supersede those of the State Central Banks with respect to the regulation of the currency circulation, the settlement of inter-state transfers, foreign exchange transactions, and the regulation of discount and interest rates, open market operations, and reserve requirements. Since the new bank will be the exclusive bank of issue and the exclusive rediscounting agency for the State Central Banks, it will have as much power over the State Central Banks as in other countries a central bank has over other credit institutions. By the same token, its powers will be somewhat larger than those of the Board of Governors in respect to the Federal Reserve Banks; its officers, however, will have no hand in the selection of the officers of the State Central Banks, but, on the contrary, will be selected by them.

In its own sphere of transactions with central banks and the Bizonal Economic Administration, the new bank has powers virtually identical with those of the State Central Banks in their spheres of transactions with other credit institutions and the governments of their respective states. The only deviation (the reason for which is not clear) is the lack of power of the new bank to make loans against gold and to rediscount Treasury bills.

The bank has a Board of Directors and a Board of Managers. The Board of Directors consists of the Presidents of the State Central Banks (four each in the U.S. and the U.K. zones), the President of the Board of Managers, and the Chairman of the Board of Directors. The latter two are elected by a majority of the Presidents of the State Central Banks. The Chairman is elected for a period of three years and during his term of office must not be connected with any State Central Bank.

The Board of Directors determines the policies of the bank. The Chairman may act for the entire Board if immediate action is necessary in the opinion of the President of the Board of Managers; the Board of Directors may also delegate any of its functions to the Chairman, or to a committee. Since the Presidents of the State Central Banks certainly will not be able to assemble sufficiently often to determine the policies of the new bank in every important detail, the Chairman may be expected to exert broad powers in deciding these policies himself, subject to periodic ratification by the Board.

The President of the Board of Managers, assisted by a deputy and a number of members, is responsible for the execution of the policies as determined by the Board of Directors. The independence of the Board of Managers will be guaranteed by fixed term of office although the Board of Directors retains the power of discharging any member of the Board of Managers for important reasons.

The capital of the new bank, fixed at 100 million reichsmarks or twice the capital of the largest State Central Bank (Bavaria), is subscribed by the State Central Banks. The bank's profits will accrue to a legal reserve fund and, when this fund exceeds the bank's capital, to the State Central Banks. The bank will publish detailed statements of its financial position four times a month and consolidated statements of the financial positions of the State Central Banks once a month.

Despite the strengthening of the powers of the new bank as compared with the original plans, the organization of central banking in the combined zones still is highly decentralized. Eight central banks and one super-bank for an area with a population of 40 million will pose serious problems. German experts already have pointed out the shortcomings of such a complicated system. Whether or not it will function in a satisfactory manner, rests with the Presidents of the State Central Banks. If the Presidents pursue a narrow-minded policy aimed at preserving as many functions as possible for their individual institutions, they may cripple the new bank just as the state governments crippled the bizonal economic institutions before the recent reorganization. If the Presidents, however, recognize the need for a uniform currency and credit policy as a prerequisite for the financial and economic revival of Western Germany, they can permit the new bank to play an important role without curtailing decisively the functions of the State Central Banks. The new bank is not permitted to have branches, and so the State Central Banks remain indispensable for operations within their territories. Moreover, the officers of the State Central Banks remain independent of the new bank, and for this reason alone there is no danger that they might become completely subservient to the coordinating body. On the contrary, there is some danger that the lack of administrative controls will result in insufficient execution of uniform policies. The more the State Central Banks try to preserve their autonomy, the greater will be the threat of inefficiency and disorder, and the greater therefore the need for amending the ordinances in the direction of still greater centralization. If the Presidents of the State Central Banks wish to preserve the present legal status of their banks, they will be well-advised to cooperate in making the new bank an effective concern.

U.S. IMPORTS FROM THE E.R.P. COUNTRIES DURING 1947 G.H.F.

Since the end of the war the European Recovery Program countries have been striving to increase their exports to hard currency areas. General increases over 1946 were registered in the total exports of most of these countries, the gains ranging from a 4 per cent increase for Turkey to 133 per cent for the Netherlands. Portugal alone showed a decrease, a decline of 15 per cent from the previous year. However, U.S. imports from the 16 E.R.P. countries and Germany increased very slightly from $679 million in 1946 to $697 million in 1947. Sweden, Norway, the United Kingdom, Germany, and the Netherlands expanded their export trade with the United States during 1947. Only the first four of these nations, however, increased exports to the United States at a higher rate than they increased their general exports. The actual amount involved in German exports to the United States was negligible.

According to a survey of U.S. imports for January-November 1947, compared with corresponding 1946 totals, Sweden increased exports of paper base stocks and iron ore; Norway increased exports of fish oil, paper, ferroalloys, and nickel; the United Kingdom raised exports of brass and bronze, chemicals, and beverages; and the Netherlands exported more textiles, greenhouse stocks, spices, and cocoa, although shipments of diamonds, cut but not set, declined from the 1946 level. Most of these increases were in raw materials, for which there is a ready market in the United States.

All of the participating countries, except Portugal, showed marked increases in their general exports during 1947 over 1946 levels. In the cases of eight of the 16 participating countries, however, 1947 exports to the United States actually were well under 1946 levels. The drop in diamond shipments and textiles adversely affected Belgian and Luxembourg exports to the United States; France shipped less brandy and wine, although textile exports increased in value; Switzerland's exports of clocks and textiles were lower; Portugal exported less brandy, wine, sardines, and anchovies; Italy shipped less silk, furs, artworks, and musical instruments; Greece shipped less unstemmed cigarette leaf; and Turkey exported less tobacco, furs, nuts, copper, and ferroalloys. Most of these products are luxury items, and in most cases, total U.S. imports of these commodities have declined from 1946 levels. Thus it does not appear that alternative sources of supply have replaced the European countries.

In the following table, data for total exports of the various countries are not strictly comparable with the figures for exports to the United States since the latter are actually U.S. import figures. The two series accordingly cover slightly different time periods and (although U.S. imports are valued f.o.b. foreign ports) doubtless reflect numerous differences in valuations.

Exports of the European Recovery Program Countries

Country	Total Exports 1/			Exports to the U.S. 2/		
	1946	1947	% increase (+) or decrease(-) from 1946	1946	1947	% increase (+) or decrease(-) from 1946
	(In millions of dollars)			(In millions of dollars)		
Sweden	657	895	+ 36.2	47.1	92.6	+ 96.6
Norway	249	388	+ 55.8	13.3	22.1	+ 66.2
United Kingdom	3,889	4,821	+ 24.0	156.4	204.9	+ 31.0
Netherlands	308	718	+133.1	22.9	26.5	+ 15.7
Belgium and Luxembourg	675	1,401	+107.6	77.3	58.5	- 24.3
France	850	1,792	+110.8	62.8	47.2	- 24.8
Switzerland	623	760	+ 22.0	98.5	83.4	- 15.3
Portugal	184	157 3/	- 14.7	23.3	21.1	- 9.5
Italy	360 (e)	742 4/	+106.1	68.6	44.2	- 35.6
Greece	40 5/	63 6/	+ 57.5	23.6	16.6	- 29.7
Turkey	216	224 4/	+ 3.7	68.2	57.4	- 15.8
Other ERP countries	560	744 3/	+ 32.9	14.0	15.6	+ 11.4
Bizonal Germany	156 7/	222 8/	+ 42.3	2.9	6.5	+124.1
Total 16 ERP countries and Germany	8,767	12,927	+ 47.5	678.9	696.6	+ 2.6

(e) - estimated.

1/ Source: International Financial Statistics, International Monetary Fund, February 1948, p. 21.

2/ Source: U.S. General Imports, Department of Commerce, Bureau of the Census, FT-950.

3/ Annual rate based on 11 months' data.

4/ Annual rate based on 10 months' data.

5/ Consular Report #340, November 26, 1947.

6/ Consular Report #381, January 20, 1948. Annual rate based on 9 months' data, converted at 5,000 drachmas to the dollar.

7/ Control Commission - British Element.

8/ New York Times, January 27, 1948.