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A-A - Mr. Armour

A-T - Mr. Thorp

A-H - General Hilldring

EUR - Mr. Matthews

Attached is the draft of a paper prepared in the Policy Planning Staff on the subject of the United States and European Reconstruction.

It is proposed that this paper be submitted by the Policy Planning Staff to the Under Secretary, with the recommendation that it be made available, as a staff study and without commitment on the part of the Secretary, to interested committees of Congress and to the committees set up by the President to study the impact of possible aid to Europe on our domestic economy. It has been prepared with the thought that it might eventually be found desirable to make it public, either in toto or in part.

While not asking you to share responsibility for the report, I would appreciate any comments you may care to make and any suggestions for improvement.

As it now stands, the document has been reviewed only by Professor Ed Mason, who has approved it.

Since the report must go forward to the Under Secretary before the end of the present week, I would appreciate the favor of an early comment.

O. F. Kennan

FOREWORD

The attached report has been prepared in the Policy Planning Staff of the Department of State.

It would be erroneous, however, to present it as exclusively the work of that Staff. It is in large part based upon the studies, recommendations and suggestions of a wide cross-section of the operating and research units of the Department. The role of the Staff has consisted chiefly in organizing and digesting this material and developing a unified set of conclusions.

The Staff wishes to express its appreciation for the loyal and enthusiastic support which it has received from the several operating and research units of the Department and for the excellence of the contributions which they have made.

THE UNITED STATES AND EUROPEAN RECONSTRUCTION

This Government will soon be called upon to discuss with European governments the problem of European recovery and to determine the part which the United States should take in its solution.

The purpose of this report is to examine the elements of the problem in their relation to the interests of the United States and to suggest some of the considerations by which this Government might usefully be guided in determining its attitude in the questions at issue.

I. THE SOURCE OF U.S. INTEREST

The factors which have impeded the general recovery of European economy since V-E day need no elaborate description. They have been widely analyzed and discussed in the United States. For purposes of this report, it is sufficient to note that they include, in addition to certain long-term trends of European development, the following factors arising directly from the recent war:

- (a) The physical and psychic exhaustion of people everywhere;
- (b) the feelings of disillusionment, insecurity and apathy occasioned by the developments of the post-hostilities period and particularly by the tendency toward division of the continent between east and west;
- (c) the destruction and depreciation of physical plant and equipment;
- (d) the depletion of financial reserves, particularly in foreign exchange;
- (e) social and economic dislocation, including the breakdown of the machinery of economic intercourse;
- (f) the prolonged prostration of German productive power.

In consequence of these factors, and of other lesser ones, we face a situation today in which important industrial and population centers of the continent are unable to recover by dint of their own efforts the living standards which their peoples enjoyed prior to the war. In many instances, they are not even in a position to prevent, unaided, a further deterioration of the conditions under which their peoples are obliged to live.

Further deterioration might be disastrous to Europe. It might well bring such hardship, such bewilderment, such desperate struggle for control over inadequate resources as to lead to widespread repudiation of the principles on which modern European civilization has been founded and for which, in the minds of many, two world wars have been fought. The principles of law, of justice, and of restraint in the exercise of political power, already widely impugned and attacked, might then be finally swept away,—and with them the vital recognition that the integrity of society as a whole must rest on respect for the dignity of the individual citizen. The implications of such a loss would far surpass the common apprehensions over the possibility of "communist control". There is involved in the continuation of the present chaotic conditions in Europe, nothing less than the possibility of a renunciation by Europeans of the values of individual responsibility and political restraint which has become traditional to their continent. This would undo the work of centuries and would cause such damage as could only be overcome by the effort of further centuries.

United States interests could not fail to be profoundly affected by such a trend of events. The traditional concept of US security has been predicated on the sort of Europe now in jeopardy. The broad pattern of our

recent foreign policy, including the confidence we have placed in the United States Nations, has assured the continuation in Europe of a considerable number of free states subservient to no great power, and recognizing this common heritage of civil liberties and personal responsibility and determined to maintain this heritage. If this promise were to be invalidated, there would have to be a basic revision of the whole concept of our international position-- a revision which might logically demand of us material sacrifices and restraints far exceeding the maximum implications of a program of aid to European reconstruction. But in addition, the United States, in common with most of the rest of the world, would suffer a cultural and spiritual loss incalculable in its long-term effects.

It is on the recognition of these realities that U.S. interest in European recovery is founded. And it is from this recognition that any assessment of the proper role of the United States in a European recovery program must proceed.

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II. NATURE OF THE PROBLEM FROM THE U.S. STANDPOINT

As indicated above, it is important industrial and population centers of the continent which are most in need of outside aid. It is these areas which lack above all the agricultural resources and raw materials necessary to their own support. They can make up these deficiencies only by imports. Their dependence upon imports has, for a variety of causes, actually increased, at least temporarily, over what it was before the war. Thus they cannot make themselves financially self-supporting until their production and their export possibilities, through which they would normally pay for these imports, have not only been restored to, but have surpassed, pre-war levels.

So far, the peoples of these areas have not nearly attained this goal. On the contrary, their productive effort in a number of cases has not been even sufficient to enable them to pay for the imports necessary to sustain minimum consumption standards. To satisfy even these irreducible requirements, they have found it necessary to turn to the Western Hemisphere, as the only part of the world which, generally speaking, had sizeable surpluses of production in the commodities they most needed. In so doing, they have drawn heavily on their own gold and dollar resources and on the readiness of

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the people of this country, and others in this Hemisphere, to furnish aid by grant and loan.

The assistance already granted to Europe by the United States in the form of loans or grants since the termination of hostilities has been very considerable. It has totalled almost ten billion dollars. Many Americans wonder why it has not achieved greater results and why, in particular, it has not served to eliminate the dependence of the Europeans on abnormal financing of their import requirements.

There have been two main reasons for this.

The first is that in many instances our aid has simply not been enough. Either there has been an under-estimation, for which we ourselves share responsibility, of the extent of war-time damage and of the cost of reconstruction; or unpredictable events, such as the severity of the past winter, have rendered calculations unreal.

The second reason is that there did not exist, for the most part, comprehensive, well thought out and effective programs of recovery, national or international, to which U.S. aid could be geared. This is not stated by way of reproach. The unrealistic post-hostilities period was not favorable to this sort of planning, nor was

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the need for it readily apparent. The immediate needs were too urgent, the uncertainties too great. In general, the American people have nothing to regret in the aid which they extended so promptly and so generously to European peoples as the continent emerged from the terrible restraints of the war. Without this aid, conditions in Europe would today be incomparably worse than they are.

But the fact remains that the dependence of the main European trading nations on abnormal means of financing, and to some extent on abnormal sources, for the satisfaction of their import requirements has not yet been remedied. It plainly cannot be remedied by a mere continuation of the approaches, both here and in Europe, which have prevailed in the past. Yet this dependence must now be removed, if these European peoples are not to be permanently pauperized and if the United States is to be relieved of a burden which no nation could be expected to bear for long.

A new approach is therefore required, and it must rest on a new assessment of the resources needed and of the conditions under which they should be made available and utilized.

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This is essentially the problem. And in facing it, we should bear in mind that from our standpoint it is predominantly a problem of overcoming urgent shortages of dollar exchange. While investigation may show that there are certain individual items in which the present heavy outflow of goods to Europe is straining our economy or our resources, in general it is not the scale of the exports themselves which is unusual. A high level of exports is consistent with our traditions and with the character of our economy. What is abnormal is the fact that the greater part of these current exports cannot be paid for by imports and therefore represent a heavy and steady unrequited drain on our economy and resources.

For this reason, if for no other, our concern would naturally be with those highly industrialized and heavily populated areas which have not only the greatest need for imports, and hence for foreign exchange, but also the greatest possibility for expanding their production and exports.

This does not mean that we need interpret narrowly the scope or function of our assistance. The problems of these key countries involve in many respects the

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recovery of the European area as a whole; and our readiness to aid must be addressed to that recovery itself and to all those who are prepared to take a loyal part in achieving it. We still hope that this circle will eventually come to include all the nations of the continent. But since the total demands upon us, even in Europe alone, plainly exceed in many instances our capacity to produce and export, we shall be obliged to make choices and to husband carefully the resources and facilities which we can spare for this purpose. It is here that we must bear in mind that our immediate possibilities for helpfulness relate primarily to the alleviation of the difficulties of the highly industrialized, heavily-populated trading nations which have the greatest need of imports and which cannot at this time acquire the requisite amounts of foreign exchange with the produce of their own economies. If the back of this problem can be broken there is no objective reason why all European nations and the world at large should not eventually share in the resulting benefits.

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III. THE ELEMENTS OF EUROPEAN RECOVERY

The recovery of European economy involves three main elements. These are:

A. Production.

There must be restored to full productivity, or created, sufficient productive capacity to enable the countries concerned to reduce their abnormal dependence on imports, particularly from the dollar area, and to cover their normal import requirements by the proceeds of exports.

This constitutes the indispensable axis of any adequate and realistic program. Unless a program holds out solid promise of substantially accomplishing this end, it can be considered at best only a partial and uncertain answer to the problem, and at the worst only another inadequate palliative.

While some of the capital goods for this purpose must come from abroad, the greater part can and should be provided from European sources. The emphasis in U. S. aid in this field must be laid on assisting the Europeans to overcome the principal bottlenecks in the restoration of production.

B. Interim Consumption Deficits.

Only gradually, as productive capacity is restored or added, can the individual countries be expected to satisfy more of their own consumption needs and to produce the export surpluses necessary to pay for the remainder. Meanwhile, merely to maintain existing rates of production, let alone to increase these rates, they will require imports of staple commodities, particularly food and raw materials, beyond those which they can finance out of their own resources. As European production increases, these margins of abnormally financed imports should decline; and if a program for European recovery is to be a complete one, they should be substantially eliminated by the time the program comes to an end. The goal of the program should be a state of affairs in which essential imports and the servicing of foreign indebtedness could be

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covered by exports or services from the importing state or by normal forms of finance. Thus U. S. aid with respect to consumption goods should start at substantially the level of present requirements and decline to zero at some stage of the recovery program.

The importance of this type of aid in European recovery must not be underestimated. Only if the European governments concerned can have the assurance that these abnormal needs will be met in reasonable measure over a definite and prolonged period will they be able to apply their energies and resources effectively to ^{the} increase of production on which their future ability to support themselves must rest. It is in this field that U. S. aid will be most needed and can be most effective.

G. Intra-European Exchange Facilities.

Any European recovery program which relies extensively on U. S. aid will bear with it the danger of encouraging an unhealthy unilateral orientation of the economies of the participating countries on U. S. economy, and possibly vice versa. This is particularly true in present circumstances. Many of the arrangements for intra-European commercial exchange have been disrupted by war; there is a wide shortage of the only generally-acceptable medium of exchange--namely convertible currencies or gold; and there is a general lack of export surpluses in Europe itself. This has already led to a state of affairs in which best advantage is not being taken of Europe's own resources. Examples of this are the failure of European countries to utilize the full fish production capacity of the Scandinavian countries and the United Kingdom for lack of suitable exchange arrangements and the lack of markets for Italian, Dutch, and Greek vegetables. It may be argued that fish and vegetables are theoretically an economic luxury for countries where food is in short supply; but they represent European productive capacity and surpluses which are not being fully utilized; and a certain degree of temporary autarchy may be an unavoidable

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corrective in an area which is now importing annually, from this country alone, goods to the value of some \$5,390,000,000 more than it can pay for.

The following possible remedies for this situation deserve mention:

1. Multilateral Clearing.

One of the most commonly suggested answers to this problem for the short term is some form of multilateral clearing, designed to widen the area of currency convertibility pending the time when general arrangements envisaged in the Monetary Fund agreement can become fully effective. At present, intra-European trade is conducted almost exclusively through an intricate network of bilateral agreements. This system is inflexible and essentially arbitrary in its economic effects. In many respects it tends to limit, rather than to encourage, intra-European exchanges. Consisting as it does of a patchwork of short-term agreements, it gives no assurance of permanency in the channels of trade which it creates.

Presumably these deficiencies could be substantially remedied by the establishment of a multilateral clearing system, assuming that currency revaluations and other corrective measures, if they prove necessary, are made a part of the arrangements. In the initial period, while export surpluses are still few and meagre, such a system would not attain full importance. As production recovers, the part which it could play in general European rehabilitation should become greater. Eventually, it should come to carry a good part of the weight of a healthy and self-sustaining European economy. But even at the outset, it should be beneficial in facilitating more effective use of the limited existing resources.

If these clearing arrangements should not involve outside support, their exact nature would be primarily a matter for negotiation among the European nations themselves. It is possible, however, that a European clearing center

ould be found to require a working fund in the form of dollar exchange or some other acceptable medium. In this case, this Government would have to give careful scrutiny to the character and general soundness of the proposed arrangements.

The possible use of sterling, instead of dollar exchange as a medium of European clearing, should be explored.

2. Improvement in Exchange Rates and Domestic Price Levels.

The European price system is seriously unbalanced. To the inevitable war-time distortions there has been added, in many countries, post-war inflation in varying degrees. Exchange rates as a consequence do not necessarily bear any close relationship to comparative purchasing power.

It is essential that steps be taken to restore internal currency stability within European countries. Again, this is largely a matter for the Europeans themselves. A most glaring example of the need for such reforms, however, is Germany. Here the responsibility of the United States is direct, and this Government should take the initiative in promoting a program of currency and price reform in as wide as possible an area of Germany which would place that area in a better position to contribute to European recovery.

3. Customs Barriers.

Tariffs are not now an important limiting factor with respect to intr-European trade. Quotas, as set forth in the bilateral agreements, in most cases control both the volume and direction of trade. Price inflation has reduced the incidence of duties.

However, with increasing recovery of production and restoration of price stability tariffs may again become a significant impediment. The eventual formation of a European customs union should be held in view as a long-term objective.