IMPLICATIONS FOR DEFENSE OF WESTERN EUROPEAN ECONOMIC UNION

5 May 1949

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IMPLICATIONS FOR DEFENSE OF
WESTERN EUROPEAN ECONOMIC UNION

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MR. BUTTS: General Holman and guests: This morning I assure you we are going to have a treat.

It is my pleasure to introduce to you Mr. Allan Evans, Director of the Office of Intelligence Research of the State Department. Mr. Evans has chosen for his topic this morning, "Implications for Defense of Western European Economic Union."

Mr Evans.

MR. EVANS: Before starting, I want to make one footnote, partly to clear my own conscience. This paper that I am presenting to you is the product of our Intelligence organization (as, indeed, any good intelligence paper should be) and I come here as the mouthpiece of many minds. Numerous colleagues of mine have contributed ideas, and a small group took the lion's share in putting together the material. So, in my talk, when I say "I," I hope you will spell it "we."

INTRODUCTION

Economic union in western Europe is much more a potential than an actual fact. It has seemed to us best, therefore, to discuss the matter in general terms, with illustrations drawn from the few existing samples of action, so that you may in your thinking and in your planning have pointers to assist in evaluating current and future proposals. I shall discuss, first, the objectives of economic union; secondly, practical obstacles; thirdly, the major proposed approaches to such union; and, finally, the relation of this matter to our own interests.

I shall leave to you the precise determination of what constitutes the defense potential of a nation. I shall assume here, so that we may proceed with the business at hand, that the ability of western Europe to defend itself requires, first, the will on the part of Europeans to defend themselves; secondly, the ability to mobilize all western Europe in case of attack; thirdly, an improvement in European industrial efficiency; and, fourthly, a rising standard of living in Europe. Naturally, these factors, are all inter-related. The problem is to determine whether or not the integration of western Europe into an economic union can contribute to the defense of Europe by assisting in the attainment of these four conditions.

The question as defined, it seems to me, is but the rump of a very much larger animal. We are beginning the discussion in a very academic way, with the assumption that economic union is an evolutionary possibility in Europe. Does it not appear at first glance that we are wishing away more than 2,000 years of history during which, to some exten constructive statesmanship and common interests, but also to a considerab extent wars, revolution, and economic competition, shaped the present nations of Europe? We are really here questioning the usefulness of boundary lines and the concepts of nationality and sovereignty. Is it possible to assume that enlightened self-interest can wipe out suspicion among national societies, deny everyday habits, and change the patterns of thinking within a relatively short period of time? Economic union can be achieved by evolution only if it is the logical continuation of forces already in existence.

And so, we should begin this discussion by studying the history of Europe, the evolution of the ideas which Europeans hold about themselves and about their neighbors, and the development of similarities in the institutions of the different countries. To do this would, however, make this speech book-length. It will be sufficient if we remember that we are attempting to make predictions about a complex society by starting somewhere in the middle of a problem.

DEFINITION OF ECONOMIC UNION

What precisely is the economic union which we are discussing? Economic union in the abstract is not difficult to define. The United States of America represents an economic union and can serve as a model. Except for some health and motor-truck rules, there are no impediments to trade among the several states of the Union. There are no import or export tariffs, and no quotas to govern what may be imported into or exported from any of our states. A single tariff and a single commercial policy apply to all the trade coming into our Union. Persons, goods, and capital move across state boundaries without hindrance. We have one currency and one central bank. The states have their own tax system, but Federal levies have increased to such an extent that 80 percent of all taxes are now imposed by the Federal Government. Even the state social security systems are related to each other by Federal statute. We are also, of course, unified by one Supreme Court which establishes a common commercial law.

This is what we have in America, and what many people advocate for Europe. Of course, we in America have much more than economic union We have a political union as well, a common history, a common social heritage, and a common language. But what we are considering here for Europe is economic union only, putting aside the possibility, the expectation, or the hope--as the case may be--that economic union would develop into the kind of union which we have.

What about the geographic extent of a western European economic union? An economic union should be defensible as a unit, and some candidate nations might, from the military point of view, better be left out. Since we should like some permanence in this economic union, we could perhaps leave out one or two nations that would be difficult to assimilate. Then there is the question of the inclusion of certain colonies and dominions of European powers. These are questions which require solutions, but at this time, and for our present purposes, we shall assume that we are talking about an economic union of all the European nations west of the Iron Curtain, including their overseas dependencies.

What can we expect from such a union in Europe? It has been said by both Europeans and Americans that America's predominant position in the world today arises from a simple circumstance. The strength and wealth of America, they say, derive from the fact that we are one nation, while the weakness and poverty of Europe result from its multiplicity of national units.

We know that this is an oversimplification. America has a relatively sparser population than Europe but is endowed with vastly greater natural resources. The larger amount of natural resources readily available to American enterprise gives our worker an advantage over his European counterpart. This profusion of material endowment and the very process of rapid settlement of a virgin continent have combined to favor investment and to speed up the development of industrial techniques. We cannot omit mention of temperment and tradition. Without going into the interplay of our material circumstances and the "American character", we can say that current American attitudes are very much a fact, and one that must be considered in any analysis of our progress. One salient point is, however, beyond discussion; it is true that the size of the American market has in itself been a powerful factor in the development of American mass-production methods and industrial proficiency. We may, therefore, pose the question: In what specific ways would economic union enable Europe to approximate more closely our own happy circumstances?

Carried to its logical conclusion, economic union in western Europe would result first in a relocation of its agricultural and industrial production. Crops would be grown on the most favorable European and colonial soils; preferably, Europe would depend on the tropics for the bulk of its fat supply, while importing much of its grain from the land-rich and fertile countries of the New World. The intelligent and educated populace of Europe would turn their talents to manufacturing even more than they do now, so that appreciable increases in productivity could occur. The nations would no longer be driven to work their own raw-material deposits, regardless of quality, but would rather exploit first the highest-grade and most accessible resources available in any part of the area, just as we do in this country. Those industries which process indigenous European raw materials would be located close to their new sources of supply, and they would thus avoid many of the expensive transportation costs which they now incur.

Not only would geographic specialization occur in this way, but manufacturing firms would specialize to a much greater extent than they now do. The removal of trade barriers in western Europe, which is what economic union implies, would immediately open up to each firm a larger market than heretofore, free of present tariffs and other restrictions. Thus, each firm would sell to a larger potential market even though the total effective purchasing power remained the same.

With a larger market, each firm could sell more of the one or two products which it manufactures most efficiently, instead of attempting to make 20 or 30 different adaptations of its basic product to suit the separate needs and desires of the small potential market previously served A Belgian textile plant, for instance, instead of producing a large number of designs for women's dresses in Belgium, could produce one design and sell it all over Europe. If this manufacturer had attempted to sell one or two designs only in Belgium, he would have soon exhausted his market because, unlike soldiers, women do not like to wear the same clothes as their neighbors.

What applies to designs for clothes also applies to other consume goods, such as furniture, and also to producers' goods, such as lathes and drills, as these, too, have to be designed differently for different uses. In short, each plant could have longer manufacturing runs, which would instantly permit a saving of labor. The advantages of standardization and of building plants closer to the optimum economic size would soon be recognized. After some years, during which existing plants could be amortized and new plants built, the plants of Europe would each specialize in a few products produced in long runs and made in factories specifically adapted to optimum production.

Furthermore, the difficulties of dealing with many different currencies would be abolished. The uncertainty of passing goods through customs offices, seeking licenses to import and to export, would be things of the past. Raw materials, so far as they were available in the economic union, would be assured to all who could pay for them. The risk that Britain would cut off coal from Holland, because England required the coal itself, or that Sweden would decrease the export of wood, because it could increase its exchange by concentrating on pulp, or that France would limit the convertibility of francs paid to Belgian workmen in French factories, would be eliminated. With far greater certainty, with much less fear of losses, production in Europe could be rationally organized.

The European Continent would be no longer fragmented into tiny entities, each one incapable of leading a truly independent existence. At present the economic sovereigns of the smaller European countries are not their legislators, but the impersonal world markets against whose vagaries these small countries are largely powerless. An economic union of all

western Europe would change this and build in Europe a finely meshed economic system whose economic destiny would to a much greater extent remain in its own hands. With the whole of western Europe an economic unit, measures could be taken to prevent unemployment, or if unemployment developed to undertake prompt and effective action to eliminate it.

Our catalogue of the theoretical advantages of an economic union scarcely ends here, for indeed we may extend the list until we have remade Europe in the image of the United States. Continent-wide advertising could aid in centralizing production in huge plants where the latest mass-production methods would be employed. These plants could be built with funds raised in a Europe-wide money market, instead of depending upon the smaller volume of funds available in each of the present countries. The larger enterprises which would then exist could foster research and develop and maintain the highest productivity.

An improvement in the productivity of Europe would tend to raise not only its standard of living but also its rate of investment. For the past 30 years, the capital resources of Europe have increased very slowly. If its business were more efficient, a larger part of its product could be devoted to increasing productivity, and its capital might grow at a rate approaching that of the United States. An increase in the rate of growth would encourage the heavy industries--steel, chemical, engineering, coal, and power--which are, incidentally, essential for war. Such growth would be important because, besides stimulating the basic industries, it would enable Europe to keep up with the Soviet bloc. For Europe's defense problem is by no means static, but involves consideration of a continuously developing economy beyond the iron curtain.

These changes which could be brought about by economic union would without question increase the defense potential of western Europe. More efficient plants and methods would increase Europe's over-all capacity to produce weapons and war supplies. Moreover, unified European industrial, monetary and credit systems could be mobilized for war much more efficiently and quickly than at present. As confidence in Europe's ability to withstand foreign invasion grows among the people, its will to resist Soviet pressure will toughen. Furthermore, an economic union commits each country to a defense of the union as a whole, for economic interdependence deprives the individual nations of military independence. Finally, the increase of productivity resulting from specialization would maintain a rising standard of living and thus produce an atmosphere of individual security in which at least the sharply economic appeals of Communist propaganda would fade and the force of Soviet "fifth columns" be diminished.

PROBLEMS IN ACHIEVING UNION

At this point we leave the realm of possibility and enter the domain of practicability. The descent to reality is precipitous, but it should not be disillusioning. Although the most roseate hopes may not be

fulfilled by economic union, some part of the program will be attained, if economic union can overcome its first crises. There are, however, reasons to believe that economic union in western Europe will not have clear sailing.

First, western Europe could not begin to face up to the problem of reallocating basic industries unless military security was assured. To the extent that military security depends upon economic union, then, we have a vicious circle. Ideally, of course, as in the model economic union we have been examing hitherto, mining, agriculture, and basic industries would become concentrated in the locations where production would be the least costly. Now surely no individual nation will consent to close its mines, depopulate its farms, or deprive itself of industries basic to war unless it relies for its defense on the union as a whole.

In negotiations on the projected Franco-Italian economic union, agreement has already been reached on a division of vegetable seed production, but no agreement has been reached to date on the reallocation of steel production. It is safe to say that no nation, however small, will allow war industries within its national boundaries to dwindle until military union is assured.

Economic union is not only dependent on military union; it is also dependent on a large measure of political unification. If the countr of western Europe were to deprive themselves, under a treaty, of the right to control trade and restrict the flow of currency abroad, and the right to pursure separate fiscal and financial policies, they would lose much of their power to solve their own economic and social problems. Even a country as large and wealthy as the United States employs tariff restricti and subsidies to support various sectors of its economy. Its fiscal polic is adjusted from time to time to assure economic stability and full employ ment.

If the European nations had economic union, but not political union, the economic problems of any one nation would have to be negotiated by diplomats, instead of settled by constitutional procedures, as in this country. Diplomatic negotiation for relief of a member in economic distress would be far too slow and uncertain. As soon as the lack of control created economic dislocations within any country, irresistible political pressures would develop to break away from the union. Consequently, in the process of developing economic union, segments of sovereignty would have to be transferred by each nation to a supranational agency. There would arise the need for one central bank for western Europe, one authorit for regulating commerce between the member countries, one central social security agency, and so on. Europe would begin to grasp the notion that it could not have the fruits of economic union without the sacrifice of sovereignty. There would have to be a central economic administration and

a legislative authority with powers in the large and growing field of economic policy. It is not difficult to see, therefore, that an economic union, to be effective, must have many of the attributes of a political union.

I am sure you will at once see the danger of the step we have taken here. We are on the borderline between the bright calm of objective economics and the dark, confused area of political passion. There are forces aplenty which will draw on political passion to obscure the economic facts, for not everyone would gain and many would lose from economic union. Relocation means dislocation, and all those sectors of the economy--including powerful business and labor groups--which would be adversely affected could raise a hue and cry that politicans could not ignore. Willing hands would ring the changes on the historic loyalties and equally historic antipathies which affect Europeans.

Yet another difficulty stands in the way of realizing the hopes of remaking Europe's economy along American lines. Europe's psychological and social impulses differ in certain respects from those that drive this country relentlessly toward technical efficiency. Economic union can, if agreed to on paper, create the opportunity for more efficient operation, but the will to adopt novel modes of operation must somehow arise in the minds of European statesmen and businessmen. Unfortunately, from our point of view, European businessmen have developed techniques of maintaining the status quo; they lean to security rather than adventure, and prefer the relatively controllable profits from limited production of high-cost articles to the fractional gain per unit of mass production. Cartels, monopolies, but more especially an understanding not to compete too vigorously, have been developed to protect shrinking markets. Of course, some cartels have acted to eliminate inefficient plants and to increase efficiency. But by and large the purpose of cartelization is to safeguard profit by restrictionism. The vigorous competition of America has been avoided.

Not only have employers cartelized, but labor has also cartelized into labor unions, which strive not so much to raise wages as to maintain job security. Restrictionism and featherbedding are more widespread in Europe, and have been so for a longer time, than they have in this country. The work rules of labor unions are an important inhibiting influence on the rationalization of European production. Nor can the agricultural interests be forgotten in considering the forces that strive for protection.

European economic union would put both business and labor to a test. If the present mixed economic systems of Europe, which try to combine the incentives of private enterprise with the social benefits of social democracy, should prove incapable of assuring economic stability, a more drastic plan of Socialism will recommend itself as an alternative and the trend toward nationalization will be strengthened.

Now, in the face of all these problems, must we conclude that the possibility of economic union in western Europe is remote? By no means. We must, however, be careful not to look to action in the economic field alone. In the last analysis, the achievement of economic union is dependent on the strengthening of the political, cultural and military bonds between the countries of Europe. This suggests a step by step process in which each advance in economic unification is matched by a step forward in political and military union.

APPROACHES TO AN ECONOMIC UNION

In theory, two major approaches are possible in progressing toward economic union--the all-at-once approach and the bit-by-bit approach.

The all-at-once approach is the way we started in this country. We wrote a constitution which unified the 13 separate colonies at one time. The all-at-once approach may appeal to us on emotional grounds, but it is altogether impossible for Europe. I would like to show you why it is impossible in a moment.

The bit-by-bit approach, on the other hand, might start the process of developing an economic union by substituting one tariff duty around the union for the several internal tariffs, one commodity at a time. When all the internal tariff duties are eliminated, and a single tariff around the union is established, the cooperating nations can move to the next phase which might consist in unifying bank laws, money laws, and so on. Alternatively, a beginning could be made by initiating a monetary union, as has recently been proposed by some members of ECA, and going on from that point to develop a uniform tax system, eliminate tariffs, and so on. In 10 to 50 years, the complete economic union would be achieved in this gradual way.

Let us examine briefly the all-at-once approach before analyzing customs unions and monetary unions in detail.

Imagine a situation in this country in which all trade barriers were let down, all subsidies removed, all taxes altered, and the dollar revalued, all within a week. What consternation would ensue! How differen was the situation at the end of the eighteenth century when the American union was formed. The colonies traded little with one another, news crept from colony to colony at a snail's pace, and labor competition between colonies was limited to itinerant tradesmen who wandered up and down the coast. If discontent arose, cheap land drained off the discontented. Luckily, the colonists had the good fortune to possess a common hard currency--gold and silver--which served as a standard of value if not as a medium of exchange. The history of that day reports no serious economic repercussions of economic union, and this is not surprising since the area of contact between the colonies was so small.

But if Europe formed a complete economic union all at once, without providing for a gradual transition, unemployment and inflation would arise simultaneously in different parts of the union. In contrast to earlier days, the European nations are in constant contact with one another in a thousand different ways, but constrained by all manner of commercial laws, regulations, and traditions.

To illustrate the effect of union-all-at-once, let us assume that the European nations would, at the moment of becoming a union, agree to convert all the separate currencies into a new common currency, and assume further that the rate of exchange between the French franc and the pound was 1,500 francs to one pound. At this rate of exchange, French steel could be unloaded at the Liverpool docks, forcing steel mills in Birmingham to shut down and unemployment to arise. In France, however, French steelmakers would bid up the price of labor and material in their anxiety to meet the new demand. If the franc/pound rate was adjusted so steel production would be undisturbed, then textile, pottery, chemical or motor vehicle production would be disrupted.

The adverse repercussions--unemployment in the high cost areas and inflation in the low cost areas--would occur because, as a result of a multitude of protective devices, the cost structure of each country has developed independently. Such forces as tariffs, quotas, taxes, subsidies, monopolies, health regulations, price controls, and the restriction of migration have determined, to a very large extent, the location of industries and the cost of production. Wipe those away suddenly, let in the cold wind of competition--and the patient will probably succumb before he gets better. The chances are that if Europe tried the all-at-once approach, events would force a halt.

The most likely way in which economic union may develop is by the step-by-step approach. The method most frequently attempted to date is the method of first achieving a customs union. The other is to start with the unification of monetary systems. But we should realize that neither a customs union nor a monetary union is synonymous with full economic union.

A customs union in western Europe would be a milestone on the road to economic union, but a customs union alone would at best be only a halfway mark. By removing tariff and quota restrictions on intra-European trade, a customs union would, as I have shown previously, increase productive efficiency as a result of geographic and product specialization. But a customs union alone would not achieve the optimum allocation of resources. This result will be attained only through the removal of all man-made differences in the cost of producing goods, such as differences in taxes, social services, and credit conditions. Indeed, even when all restrictions on the movement of persons and goods are removed, and a common monetary

unit, common economic policies, and common social services are established, the achievement of the optimum pattern of production is often retarded by the reluctance of people to move to new areas or to new jobs, the lack of adaptability of workers and businessmen, and the like.

But even the first steps toward customs union raise great difficulties. In the first place, there are now differences between countries in the average level of their costs. If all trade restrictions were removed between a country whose industries carry a high fiscal and wage burden, and one whose manufacturers pay low wages and few taxes, the markets of the former would soon be swamped with the products of the latter To prevent this, the high-wage country would probably try to protect itself by quantitative import restrictions, by import taxes, or by export subsidies; similarly, the low-wage country might try to protect itself from the excessive drain by imposing export restrictions.

Secondly, even if the average level of costs were equalized, the structure of costs between the two countries might be different. In each country only the more efficient industries would be able to market their goods, while other industries would be left at a disadvantage in competition with imports from more favored producers in the other country. The result would be a depression in some sectors of the economy of each country and high-pressure demand in other sectors. Unemployment and bankruptcies would occur side by side with inflation.

Clearly a gradual approach is called for which eases the painful process of adjustment during the period in which geographic and product specialization develops. The process itself will raise a host of economic and social problems. Each industry would wish to be the last to go through the wringer, and we would hear the anguished exclamations of industrialist trade unions, and farm groups that national interests are being sacrificed by misguided diplomats.

The progress, or lack of it, which some of the present-day customs unions have made may illustrate some of the problems we have been talking about. The Benelux customs union, for instance, went into effect in January 1948. The situation in which these countries found themselves was very favorable to the establishment of a customs union. Tariffs between Belgium, Luxembourg, and the Netherlands were relatively low. None of the three countries relied heavily on protectionist policies since all three, then and now, depend on the import of raw materials which they process for export, and use the earnings to purchase food and other consumer goods abroad.

For these reasons it was relatively easy to eliminate mutual tariffs and to make external tariffs uniform. It soon appeared, however, that very little was gained by this step. Since the end of World War II,

the Netherlands had been pursuing economic policies which were quite different from those of its neighbors to the South. The Netherlands has been, and still is, operating a controlled economy, with large-scale planned investments financed out of forced savings, while Belgium has removed most economic controls and has been content with a relatively low rate of savings and investment. As a result, a suppressed inflation prevails in the Netherlands, while deflationary conditions exist in Belgium; and a relatively overvalued, "soft" Dutch guilder is confronted with a relatively undervalued, "hard" Belgian franc. To protect its controlled economy, the Netherlands has found it necessary to continue the rationing of Belgian francs to its importers and also rations its exports, so that trade is moving no more freely than had been the case before the duties were removed.

The projected French-Italian customs union must overcome much greater difficulties than those found among the Benelux nations. The two economies are competitive rather than complementary and tariffs are a major obstruction to mutual trade. By 1950, France and Italy plan to announce the abolition of tariffs between themselves. Since, however, the repercussions of removing tariffs would be too severe, the customs union draft provides for the levying of taxes which will compensate in part for the tariffs which are to be removed. Consequently, the adoption of the French-Italian Customs Union Treaty will not result in the immediate freeing of trade. The elimination of trade barriers will have to await the gradual removal of the cushioning taxes, following detailed negotiation.

The experience of the Benelux customs union and the problems faced by the projected French-Italian unions indicate the magnitude of the difficulties which will be encountered. Because of the complexities involved in the problem of freeing trade, it is probable that customs unions between pairs or among small groups of countries may be established before steps are taken toward an over-all European customs union. Such an approach has certain advantages. In the first place, groups of small nations, such as the Low Countries or the Scandinavian countries, may find a customs union of more immediate benefit than the larger and more diversified countries.

By forming customs unions, the small countries increase their bargaining power in the negotiation of trade treaties, since they can offer larger quantities and a greater variety of products. Furthermore, the problems of internal adjustment are also simplified by dealing with two or three countries at a time. But this piecemeal approach is not an unmixed blessing. After painfully adjusting to one union, countries would, at a later date, be required to go through a new process of adjustment, perhaps in an entirely different direction, when the regional customs unions were integrated. The sounder process would be to attempt to achieve an over-all European customs union in one series of coordinated steps.

Fortunately, the western European countries are not concentrating solely on the piecemeal approach to customs union. In 1947, a Study Group for a European customs union met in Brussels and analyzed the probable benefits and the difficulties which would be encountered in such a union. All the western European countries except Spain were represented at this meeting. The Study Group recognized that a customs union could be accomplished only gradually in a series of steps. It was also pointed out that if these steps were taken without a clear idea of the dislocations which would ensue, the countries suffering from these dislocations would be forced to impose quantitative controls on trade which would be more restrictive than ordinary tariff barriers. The Group is, therefore, attempting to obtain all possible information on the importance of tariffs in protecting the economic structure of potential member countries. It is hoped that in this way undesirable dislocations can be foreseen and guarded against.

While a planned transition to a Europe-wide customs union is to be preferred, it will be extremely difficult to foresee all its effects; it will be even more difficult to persuade those adversely affected by it to adapt themselves in advance. The most efficient way of dealing with the problem would be to empower a central union administration to continue tariffs and other restrictions temporarily wherever justified, and to refuse such authorization in other instances. But the delegation of such powers to an international body would obviously constitute a transfer of important elements of national sovereignty. Whether, in the ensuing months the nations of Europe can summon up enough courage to take this step remains to be seen.

Some statesmen, discouraged by the prospects of reducing hundreds of different tariff duties, have swung around to the view that perhaps the best first step in achieving an economic union is the formation of a monetary union. Unlike the principle of customs union, which permits a variety of approaches and requires tedious, detailed negotiations, monetary union boldly highlights the necessity for a supranational agency with real powers. Plans for monetary union which fall short of this will soon prove to be impracticable.

One proposal for attaining the equivalent of a common currency which pretends not to require any surrender of national sovereignty is that the European nations simply abolish all monetary restrictions and let the free market adjust the flow of trade according to its own automatic laws. On the surface this suggestion sounds plausible, since it is a proposal that we return to the older, and presumably better, days of what is popular known as the "gold standard." The world has, in the past, had systems of freely convertible currencies and has sometimes flourished under them. There is, however, a difficulty--in times of stress, the automatic adjustments of the market are not pleasant. In addition, these adjustments take too long

to work themselves out. To the nations most severely affected by difficulties in balance-of-payments, it appears that allowing the market to adjust itself is something like letting a forest fire burn itself out. In a hundred years, if the observer lived that long, he might see a regrown forest no worse than the original.

To be sure, these fears are often exaggerated. The economic forces of the market, if given free play, would probably not require a hundred years to work themselves out. But how would a sudden transition to free convertibility affect the Europe of today? If the western nations made their currencies freely convertible today without drastically reducing their exchange rates, foreign exporters would begin to flood them with goods. However, instead of using the proceeds for the purchase of European goods, which are too expensive at the present overvalued exchange rates, they would present them for conversion into dollars or other hard currencies. Foreign holders of hitherto inconvertible soft currency funds would also try to convert these into hard currencies. The magnitude of the disturbances thus created may be gauged from the disastrous results of the British experiment in free convertibility in July 1947, when Britain's holdings of dollars were reduced by about 730 million dollars within six weeks.

It is often said that once the European nations "put their houses in order" by removing most internal economic controls and adjusting their internal price level and their foreign exchange rates to the world market, most of these difficulties would not arise. These are sound principles if applied to a stable and prosperous economy, and if European recovery proceeds according to schedule, the time may be approaching when they can gradually be put into effect. But the difficulties of transition to a free economy should not be underestimated.

The removal of trade barriers, as we have seen, may create unemployment in many industries which formerly exported under barter agreements and other special arrangements, and which would now suddenly find themselves unable to compete in foreign markets. Furthermore, import quotas and tariffs are often imposed with a view to correcting an undesirable distribution of income and in order to prevent excessive imports of luxury goods. The lifting of such restrictions may, therefore, result in increased social tension.

The removal of exchange controls raises equally serious problems of adjustment. In theory, three types of adjustment are possible. First, there is the classical prescription of a general downward adjustment of internal prices and wages to competitive levels. The deflationary approach is no longer considered practicable, however, because of its adverse effects on employment and social stability. Another possible remedy, a drastic additional restriction of imports through quotas, tariffs or taxes, must be rules out because it would tend to reduce employment and the national income. Furthermore, additional import restrictions, like the dumping

of subsidized exports, would invite retaliation. The third possibility, which is now much talked about, is the devaluation of currencies.

If the rationing of foreign exchange is abandoned and European exchange rates are permitted to seek their natural levels, some European currencies may depreciate at first by as much as one-third. The consequent increase in the internal price of imported goods would have repercussions on prices and wages generally. Workers, farmers, and employers will tend to resist reductions in their real income and unless severe measures are taken to stabilize the economy, an inflationary spiral might be set in motion, leading to further devaluation and further price rises.

One of the desired effects of devaluation is to make export industries more profitable. At the same time, imports will tend to be reduced because they are more expensive. If the country's export goods are such that a small reduction in prices will greatly stimulate sales abroad, the probable result will be an immediate improvement in its balance of payments (This is an oversimplification of the problem. The effect of devaluation on the balance of payments depends also on the elasticity of demand for its imports and the elasticity of supply for both its imports and exports.) But in this way the country will be deprived of goods needed for consumption and reconstruction; this will add to the inflationary pressure in the short run, or affect the country's long run viability. If, on the other hand, the demand for its exports is inelastic, the country may actually find its receipts of foreign exchange falling as it tries to sell more, thus aggravating its balance-of-payments deficit. Experience has shown that, at least in the short run, the international demand for many European export goods is rather inelastic.

There is also the ever-present danger of capital flight. Few among even the most orthodox economists propose to lift all controls on international capital movements, since this could only result in a resumption of the prewar tendency, induced by the fear of war, taxation and confiscation, to export European funds to the safe havens of Switzerland and in the Western Hemisphere. But unfortunately there are many ways of transferring capital under the guise of legitimate exports or imports, and the lifting of restrictions on current transactions would make it more difficult to prevent such manipulations.

The immediate obstacles in the way of a return to the general convertibility of currencies are formidable, and it seems to be almost as difficult to restore the convertibility of European currencies among themselves as to make them all convertible with the dollar.

But even if the postwar problems of adjustment could be successfully solved, the basic problem remains. What assurance do the European nations

have that there will not be another war, or another depression? Would the different national governments be free to pursue their individual policies of stabilization of prices or employment, and at the same time maintain free convertibility and abide by the rules of fair play in international trade? One might wish that these objectives were reconcilable; unfortunately we must recognize the possibility, and indeed the probability, of conflicts between national stabilization policies and international economic stability. This problem was not very important in the nineteenth century, when governments interfered little in domestic economic affairs and most countries were less dependent on international trade and therefore less vulnerable to external economic disturbances. But since that time, and particularly since the "Great Depression" of the early 1930's, practically all countries have come to regard the power to take measures of economic policy to combat inflation or unemployment as an essential element of their sovereignty. By agreeing to free convertibility and fair trade rules, a country, therefore, does surrender a part of its sovereignty. That this is a surrender of sovereignty not to a supranational agency, but to the vagaries of the world market, makes it no more acceptable. Most nations, if they have the means to permit it, will not allow the world market to be the arbiter of their destinies.

Generally speaking, however, large nations are less dependent on foreign trade and are, therefore, less vulnerable to economic disturbances originating abroad than are small nations. As a result they can more easily afford to open their doors to free foreign trade and payments. It is thus clear that the way to restore freedom of trade and payments is to create economic units which are sufficiently large and sufficiently balanced to be able to reconcile the principles of free convertibility of currencies and free trade with a measure of independence in shaping their internal economic policies.

There is one neat and plausible proposal of which mention should be made, both because it is much talked about and because in the end it points to the same basic problem. It is proposed that the western European nations agree to maintain consistent fixed rates of exchange for a substantial time period between every pair of currencies. This would be substantially the same as inventing a new currency, let us say the unita, in each country, all unitas to be equal but each to have an appropriate fixed rating in terms of the present national currency. The French unita would equal so many francs, the English unita so many pounds, and the two unitas would be equal and freely exchangeable.

This has psychological value, perhaps, but in the end any nation could violate this agreement by changing its internal price structure. If France, for instance, retained the power to creat money, it could, by means of inflation, attract within its boundaries more goods than it exported.

If this occurred, other countries would probably retaliate by setting up export controls. Conversely, no one would want to receive French unitas in payment for merchandise, since it would be unprofitable to buy the overpriced French goods. That would hardly be the freeing of trade. We come back to the inescapable conclusion that an agreement on exchange rates without an agreement on the internal price level is meaningless.

A monetary union, to be effective, really requires that one agency control the creation of money. This is an obvious proposition, but there are many people who wish the form without the substance and prefer to stop short of a single money-issuing authority for all Europe. Reducing this problem to fundamentals, it means that one central bank must be created with supervision over the banks in each nation. But the creation of a central European bank requires that each nation give up a basic sovereign right. The existence of one central bank implies that the power of each nation to run a budget deficit is severely limited. No nation could fight a depression by deficit financing without receiving permission from the central bank. Similarly, the power to create credit would be taken out of the hands of individual countries. A substatial part of national sovereig would thus be transferred to a supranational agency.

A monetary union in this last sense--the issuance of money by one central bank--would automatically eliminate exchange controls. Trade restrictions such as tariffs could still be maintained temporarily to ease the difficulties of particular industries which suddenly become unprofitab because of foreign competition. But monetary union would make people inevitably think in terms of unity on questions of economic policy, nation budgets, taxes, social security, and defense. They would have to think in European terms since, with the control of currency by a central agency would severely limit the freedom of action of any one nation. The advanta of having uniform taxes, social services, defense, etc., would then be mor obvious. Consequently, the establishment of a single currency, centrally controlled, would probably prove to be a decisive step toward economic union.

IMPLICATIONS FOR AMERICAN SECURITY

What are the implications for American security of this ferment to reach economic union in western Europe?

I hope I have established in the preceding discussion that econom union, if it could be achieved, would have great advantages for Europe. I believe that for this reason alone economic union deserves encouragement. But by encouraging economic union in western Europe we are, at the same ti pursuing our self-interest. In the last analysis, a western European unic supported by the economic and military might of the United States, would prove to be an essential factor in any effort to contain Soviet expansioni

If western Europe is considered as a whole, the factors which are commonly regarded as the basis of its economic potential for war add up to an impressive total. In terms of population, ERP Europe is the equal of the Soviet bloc (exclusive of China). Its national income is twice that of the Soviet bloc its steel production is 80 percent greater, and its coal production 50 percent greater. But at the present time, as is well known, this superior economic capacity cannot be translated into military capacity. The economic resources of western Europe will have to be integrated and subjected to a common plan for economic mobilization before they become effective for defense. From the point of view of economic striking power, the atomized Europe of today is no match for the economically inferior but well organized and integrated Soviet sphere. Any real progress toward economic union will tend to strengthen western Europe's ability to resist Soviet aggression.

The need for European integration becomes even more imperative if we look beyond the immediate future. The economic capacity of the Soviet Union and its satellites, despite the serious setback as a result of the war, is growing rapidly. Most of the wartime destruction has now been repaired and industrial production has recovered to the prewar level. If the present rate of growth continues, industrial production will triple within the next 20 years.

Even under favorable circumstances, western Europe will be unable to equal the rapid rate of development of the Soviet bloc. It has been estimated, on the basis of the rate of growth in the 25 years preceding World War II, that, at best, the industrial capacity of western Europe will increase by about 70 percent within the next two decades. In other words, even without any further territorial expansion, the Soviet bloc will have caught up with western Europe by 1970. It is all the more important that we remove all artificial obstacles to economic growth in the West and assure a degree of unity and organizational efficiency at least equal to, and if possible superior to, that attained in the Soviet bloc.

It is often pointed out, of course, that when economic union has been achieved, we will then be dealing with a new third great force. Do we have any guarantees that this new colossus will be on our side? Might it not find itself economically complementary to the Soviet bloc and competitive to the United States? Is it not possible that we will help in building up a third great power only to see it join forces with our opponent?

This possibility cannot be dismissed simply by pointing to the close bonds that exist at present between the nations which constitute the "Atlantic Community." To be sure, these bonds are still strong; they dominate our entire cultural, political and economic life. Even before the war, four-fifths of western Europe's external trade was directed toward overseas areas and only one-fifth was directed toward the area now included

in the Soviet bloc. Currently, western Europe's dependence on the West is even greater, and its economic ties with the East are even less importan than before the war. But even now, as before the war, there are some countries along the eastern margin of western Europe which would find it advantageous to increase their trade with the East, such as Sweden, Germany Austria, and Italy. Any step forward in the direction of western European economic union will strengthen the ties of these countries with the West and reduce the temptation to negotiate separately with the countries to the East. I do not have to stress to you the importance of assuring wester European solidarity in prohibiting the export to the USSR of materials and equipment which would make a significant contribution to the Soviet war potential. This policy is not inconsistent, however, with the encouragement of exports to the East of nonstrategic items which can be exchanged for coal, timber, potash, grain and other foods, and raw materials.

In the long run, however, we cannot rely wholly on the automatic influence of trade relations. We ourselves shall have great responsibility for adjusting our policy, for taking initiatives to strengthen or weaken our ties with western Europe. If our present expectations materialize, the need for direct economic aid to Europe may disappear or at least greatly diminish after 1952. But the overpopulated countries of western Europe, which are so poor in natural resources, will never be able to support an acceptable standard of living unless they are permitted to develop their specialized industries and to expand their markets in the underdeveloped areas of Africa, Asia, and South America. In these markets, and also in the American market, European suppliers will enter into competition with American manufacturers. We must accept this fact. This will call for a foreign economic policy of continued self-restraint, generosity, and wisdom, and an internal economic policy designed to maintai stability, prosperity, and progress in the Western World. It will also call for continued military vigilance.

COLONEL McCULLOCH: Sir, it seems highly inconsistent that anyone can talk about the establishment of an economic union and neglect considering the establishment of a single type of currency, or at least an arbitra rate of exchange of currency.

Isn't it quite vital that positive controls be obtained over fiscal policies before we can begin talking about the actual formation, step by step, of an economic union, as such?

MR. EVANS: An economic union cannot be divorced from control ove fiscal policy. The point I was trying to make was that the approach through monetary union is inescapably tied up with the necessity for agree ment on fiscal policy. The establishment of a single currency obviously involves such central financial powers as would lead automatically to what you are referring to.

COLONEL McCULLOCH: Belgium furnishes an excellent example. After the war was over, Belgium immediately adjusted its currency situation. And even in the case of the USSR--of course, that nation can do it more effectively than we can--the Russians found it necessary to adjust their currency.

So it seems to me that, in any event, a certain number of countries have to go through the wringer. The question is whether it is more desirable to go through slowly and painfully or to make a quick job of it.

MR. EVANS: Yes. Of course, in countries where there is no such thing as civil resistance, you can do just what they are doing in the USSR. There is a happier example, perhaps, in what we accomplished in Germany. But when we talk about an economic union, we have to consider politics. I think that is the consideration on which this scheme would fail in immediate operation.

QUESTION: Will the North Atlantic Treaty accelerate or decelerate the tendency to secure a European economic union?

MR. EVANS: That is a pretty straight, prognostic intelligence question.

The treaty may make economic union a little more difficult to the extent that military aid is associated with the Atlantic Pact, which will disturb the fluidity of labor and absorb some of the economy in war production. The extent of that disturbance, of course, is anybody's guess. We have not as yet analyzed this situation. One might as well wait to see how the figures finally come out. I think, in addition, that the Treaty undoubtedly will contribute in the sense that it stimulates the will, the spirit, and the temper; thinking in terms of union will make a very great contribution, indeed. There is a mixed blessing--in terms of disturbing the budget, it is bad; in suggesting a common interest, it is good.

QUESTION: Mr. Evans, I would like to have you give your opinion as to why Russia has now realized it cannot continue with the Berlin blockade. In other words, what is the reason behind Russia's "getting soft" on the Berlin blockade?

MR. EVANS: You have to tie this thought into our subject with one word--economic. I think, to some extent, that is the answer. There were undoubtedly difficulties developing in the Soviet zone and the Russians were feeling the pressure.

It is a very nice question, whether or not the USSR has retreated in order to find a better place from which to jump, and if so, just where

the Russians are going to jump. I am not prepared at the present time to say what their motives are. However, a settlement would liquidate a situation which was not providing good propaganda value--a "deterioration of face," so to speak.

QUESTION: Mr. Evans, would you comment on the feasibility of an economic union of the British Commonwealth and the United States? It seems to me it would be a more natural union than joining the hodgepodge of western Europe.

MR. EVANS: That is a possibility. It is a very nice question: Which way should the British Commonwealth go--toward the Continent or across the Atlantic?

Taking the general view, the great issue at the present time, of course, is to achieve an improvement in western Europe as a whole. As compared with the desirability of accomplishing that, I would not think so much would be gained. Even if we were joined--and, of course, we are pretty close--for strategic purposes to the Commonwealth, it would still be a net loss if conditions in Europe did not improve enough so as to diminish the danger of its collapsing. We consider it would be preferable to insure the increasing prosperity and security of western Europe at the present time.

QUESTION: I had a little difficulty separating your discussion of a theoretical situation from one that has actually been existing. If I understood you correctly, there has been economic union of the Benelux nations; also, there is a treaty between Franch and Italy which substitutes internal taxes for tariffs. Is that correct?

MR. EVANS: Correct.

QUESTION: Is that all that has been accomplished, in fact?

MR. EVANS: Just about. That is why you had difficulty in distinguishing.

There is another possibility that should be mentioned. The Marshall Plan, from its inception, included provision for the rationalization of the European economy as a whole--the location of industry, power, and so on--with a view to an over-all European plan. Up to the present time it has been a hand-to-mouth operation. Those particular aspects of the plan have not come into effect. But we still have some years to go and it is assumed that with the spadework having now been completed it will be possible to go on to the happier refinements of the original plan. So we may expect that the OEEC planning and the action of the ERP will, in the next few years, be more effective in arriving at the rationalization of the general European economy than it has been to date.

QUESTION: I gather that the bit-by-bit plan seems more prominent. In view of the experience we have had in the last few years in these bit-by-bit problems within Europe and in the South American countries, do you think that that past experience will lead us to believe there will be a better chance for putting across these agreements between a larger group of countries, provided there is no greater fear of Russia than now exists?

MR. EVANS: First, for a brief moment, I would like to step down from my role as an economic oracle (which is not by best role perhaps) to that of historian. I would certainly say that unification has, in an incredibly high percentage of cases, taken place as a result of antagonism and fear rather than from the more positive and constructive aspects of human psychology.

I agree at once that fear exists. The danger, I think, will be the halfway point. When there is sufficient ground to diminish the fear, as conditions improve, you have less and less impulse and effectiveness in the drive for unification.

QUESTION: Do you mean by that, if we went half way, we would be in perhaps a worse situation than we are at present?

MR. EVANS: The result would not be very effective. But I think one has to watch. There is a danger and one has to keep his eye on that danger. After all, the last steps are always the hardest in these things. As soon as you get greater security and greater contentment among the people of Europe, you will have less urgency to change anything that now exists.

QUESTION: I would like to ask whether or not you consider political union a prerequisite for economic union?

MR. EVANS: They have to go hand in hand; otherwise, as I pointed out, you cannot have economic union. It is automatic. Economic union means the giving up of segments of national sovereignty.

QUESTION: I want to ask whether complete political union is necessary if you expect to have complete economic union?

MR. EVANS: Assuming that a federal union counts as complete union?

QUESTIONER: What I have in mind is a situation similar to that in the United States. In other words, we have one government for all the states.

MR. EVANS: I think it is inescapable; yes.

COLONEL KEELER: We read in the papers about the economic plan of the Council of Europe. You said, I believe, that consisted of words and not deeds. In other words, very little has actually been accomplished. I also am led to believe that came out of the planning that started back in 1947, within the present structure.

MR. EVANS: Yes. That is embryonic as yet. It had to be determin what kinds of people should actually participate--foreign secretaries, representatives, or who they should be. There was a question of whether to have actual representatives of nations in legislative capacities or merely to conduct diplomatic negotiations. Those are rather basic question to determine.

COLONEL KEELER: I gather also from what you said that the possibility of economic union in Europe is probably in inverse proportion to the success which we achieve in the Recovery Program. In other words, as conditions get better, the chances for economic union worsen.

MR. EVANS: That is why it is so important to have the two things go together. As has been recognized, this is the moment to get the hard part of the initial work done. From then on it becomes more a matter of having, so to speak, a sound information program and keeping up the will to unite.

MR. BUTTS: Mr. Evans, on behalf of the College I extend our deep gratitude and thanks to you for coming here this morning.

In addition to that, I have one other obligation to fulfill on behalf of the College. Mr. Evans has been personally responsible for furnishing at least 80 percent of the consultants who have been coming to our seminars. We are more than delighted to acknowledge gratitude to you, Mr. Evans.

MR. EVANS: I am glad to know I have been of assistance.

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