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THE EUROPEAN PAYMENTS UNION

Albert O. Hirschman

On July 7, 1950, one week after the expiration of the second Intra-European Payments Scheme, the Council of the Organization for European Economic Cooperation reached full agreement on the establishment of a European Payments Union. This Union represents a radical innovation in the mechanism of intra-European payments and may have important repercussions on the whole system of international financial relations. The following paper does not give a systematic exposition of the EPU agreement. ^{1/} It attempts to trace the rather tormented history of that agreement and to discuss in this connection some of the more important issues that had - and in part remain - to be faced.

Background

Projects for multilateral clearing in Europe have been discussed ever since the European Recovery Program was launched. ^{2/} During the first two years of the European Recovery Program, however, the entrenched position of bilateralism in the postwar trade and payments situation in Europe and the United Kingdom's unwillingness to permit any transfers of sterling that might result in gold obligations, prevented the successful negotiation of any multilateral clearing arrangement. The intra-European payments schemes which have been operating during the past two years were essentially ad hoc arrangements providing some essential finance for intra-European trade but, among many other shortcomings, they failed to make any substantial advance toward multilateralization of payments.

In the course of 1949, it became clear that the main European problem had shifted from the area of production to that of trade and payments. The currency adjustments of September 1949 not only improved the competitive position of the devaluing countries with respect to the dollar, but also served to bring about a greater degree of balance in intra-European payments. At the same time, a number of efforts got under way to relax the most irksome restrictions on trade and payments in Europe. Mr. Hoffman's speech before the OEEC Council in Paris of October 31, 1949, in which he advocated the economic "integration" of Europe through the creation of a single market freed from restrictions, crystallized action in the two related fields of trade and payments. With respect to trade, the OEEC countries agreed (with some exceptions) to lift quantitative restrictions on 50 per cent of their imports from each other. In the field of payments, ECA drew up a blueprint for a European Currency Union (later renamed European Payments Union) which was presented to the OEEC in December 1949.

^{1/} For a good description, see the article "Mechanics of EPU" in the Economist of July 15, 1950, pp. 130-132. The agreement is embodied in a 26 page-long OEEC Document, C (50) 190 (Final) Paris, July 7, 1950. The actual convention to be approved by the OEEC Council and to be signed by the member countries is still being drafted.

^{2/} See, e.g., the paper by J. Burke Knapp on "Intra-European Financial Arrangements" in this Review of July 15, 1947; also Raymond F. Mikesell, "Regional Multilateral Payments Arrangements" Quarterly Journal of Economics Vol. LXII (August 1949), pp. 500-18 and Robert W. Bean, "European Multilateral Clearing" Journal of Political Economy, Vol. LVI (Oct. 1948) pp. 403-15.

Principal characteristics of any scheme for multilateral clearing in Europe

As was true of all similar previous plans for multilateral clearing, the EPU project consisted of two distinct parts: (1) an offsetting mechanism and (2) a settlement mechanism.

1. The offsetting mechanism is designed to break through the bilateral channels within which intra-European trade has been constricted since the beginning of the war. It aims at permitting one country to offset a deficit in one direction by a surplus in another. This is not expected to be achieved by making European currencies directly convertible into each other and into the dollar, a step considered as premature by many European countries. Rather, each country, while maintaining its present system for controlling foreign exchange transactions, will have an account with a central Payments Union, and the debits and credits accumulated by each country's central bank in its bilateral relations with the central banks of other countries will be transferred at monthly intervals to its EPU account, which will thereby be debited or credited by the combined net result of its intra-European transactions. The great advantage of this method as contrasted with bilateralism lies in the fact that a country does not have to be concerned by deficits with some countries provided that these deficits are offset by surpluses in other directions. It thus eliminates bilateral bargaining and permits an expansion of useful trade. It also means that a country that experiences a serious deficit with another country but remains in over-all balance will feel no need to resort to quantitative restrictions in order to correct this deficit.

2. The settlement mechanism. - The settlement of the net balances emerging from multilateral clearing raises a number of important issues. One hundred per cent settlement in gold or dollars would amount to the establishment of one type of full convertibility of European currencies. ^{1/} It has been generally agreed that such a step would not only be premature, but would also interfere with current efforts to liberalize intra-European trade. In a situation in which countries are faced with the obligation to pay gold for any additional import, they probably would be quite unwilling to undertake new risks by lifting existing trade barriers, even though this were done on a reciprocal basis.

On the other hand, there also was agreement that the terms of settlement of the net balances emerging from the clearing should not be too "soft". If countries knew that, as a result of large-scale credit facilities, they could run up a considerable net deficit with the other countries in the group without having to make gold payments, they might be tempted to pursue policies of monetary ease that would lead them straight back into the conditions of inflation from which they were just emerging.

These conflicting considerations led to the conclusion that the deficit countries should be granted some credit by the Union, but should make gold payments on an increasing scale as their deficit rose. Creditor countries also would finance their surplus partly by credits and would receive gold for the balance. The Payments Union would be endowed with an initial

^{1/} For a discussion of this and other varieties of convertibility, see "Types of Convertibility," below in this issue.

fund in dollars which would serve to make up any differences between gold payments by debtors and gold receipts by creditors.

Launching of the EPU project and first difficulties

In December 1949, the OEEC Council entrusted its Payments Committee to draft the outlines of a European Payments Union that would start operation on July 1, 1950. A general outline was produced and inserted into the second interim report of the OEEC, which was published in January. In the meantime, however, the project encountered many difficulties. First, there was some concern within the U. S. Government that the projected Payments Union would in some respects duplicate the functions of the International Monetary Fund; and, more important, it was feared that the arrangement, particularly in view of the inclusion of the whole sterling area, might lead to the establishment of a "high-cost soft-currency area" characterized by inflationary pressures and discriminatory restrictions against the dollar.

To counteract any tendency in this direction it was agreed that the EPU arrangement should not be of such a nature as to force countries that had already made considerable progress in the direction of convertibility to go back in the direction of soft-currency arrangements characteristic of (e.g.) the sterling area. Similarly, there was a consensus of opinion that any dollars contributed by ECA should not be provided to underwrite whatever net deficits would emerge but should only supplement the hard currency resources and mutual credits of the participants.

British opposition

The most serious trouble arose for the EPU project as the result of British opposition. While British representatives had fully collaborated in outlining the project on a technical level within the OEEC, Sir Stafford Cripps declared during the session of the OEEC Council in January that the United Kingdom would be unable to accept substitution of the proposed clearing mechanism for the bilateral agreements involving sterling. He refused to accept an EPU that would supersede the existing bilateral agreements; rather, he favored one that would be super-imposed upon these agreements as a "lender of last resort." It is easily seen that this concept of the EPU was directly opposed to the concept developed within the U. S. Government. At the same time, Sir Stafford declared that the United Kingdom could not agree to restrict its freedom of action with respect to quantitative restrictions on trade.

It should be mentioned here that ECA was trying to obtain commitments from the OEEC countries to make further progress in abolishing quantitative restrictions in intra-European trade. Moreover, once these restrictions had been removed, it was deemed important that countries should not easily and unilaterally be able to restore them. It was in this respect that the United Kingdom served notice that it would have to retain its full freedom of action.

The EPU in Congress and the dollar contribution

In spite of these difficulties, ECA went ahead with its project and made it figure prominently in the Congressional presentation of its request for funds for 1950/51. In order to make it possible to provide the Union with appropriated funds, ECA sponsored an amendment of the Economic Cooperation Act so as to permit a transfer of \$600 million in free dollars from its

appropriated funds to

"any central institution or other organization formed to further the purposes of this Act by two or more participating countries, or to any participating country or countries in connection with the operations of such institution or organization, to be used on terms and conditions specified by the Administrator and designed to promote multilateral intra-European trade, to facilitate the transferability of European currencies, and progressively to eliminate the existing systems of bilateral trade, and to liberalize trade among participating countries and between them and other countries."

The Congress accepted this amendment and even provided that unless the \$600 million were used for the purposes mentioned in the amendment, they were to be returned to the Treasury (ECA had only asked for permission to transfer funds). Through this mandatory provision, the Congress no doubt intended to exert some pressure on the United Kingdom, whose hesitations to join had in the meantime become public.

ECA's dollar contribution will serve a triple purpose: (1) to make up any difference between debtors' gold payments to EPU and creditors gold receipts from EPU that might arise in the course of EPU operations; (2) to provide funds for the redemption in certain conditions (see below, page 8) of existing European-held sterling balances; and (3) to constitute a separate fund which will permit ECA to intervene when a country experiences extraordinary and unforeseen difficulties in its intra-European payments relations.

Agreement on the special position of sterling

With favorable action by the Congress, the principal immediate task was to break the deadlock with the British. It was recognized by United States and Continental officials that sterling was indeed in a special position with respect to the EPU project. In the first place, sterling, unlike any other European currency, is widely used as a means of settlement among third countries. Secondly, many countries have traditionally held sterling as part of their monetary reserve. Thirdly, several European countries had, during or after the war, accumulated considerable holdings of sterling. These holdings posed a special dilemma for the EPU: neither Britain nor the countries holding these sterling balances would consent to any blocking of such balances; but, in the absence of such blocking, the holders of these balances could continue to settle bilaterally with the United Kingdom and would thereby infringe on the principle that all countries had to settle multilaterally through the EPU.

On their side, the British realized that they could not maintain the negative attitude exhibited by Sir Stafford Cripps in January. In March, they came forward with a proposal of their own which advocated a limited participation of sterling in the scheme. Without going into its details, one may affirm that the proposal constituted considerable progress since, for the first time, the British showed themselves ready to accept transfers

of sterling even when such transfers could involve them in losses of gold. The proposal, however, was rejected by both the American and the Continental negotiators since it did not go far enough in the direction of doing away with bilateral payments agreements.

After intensive further negotiations, in the course of which ECA, the Belgians, and the OEEC secretariat each produced tentative proposals, agreement was finally reached in May on the insertion of sterling into the EPU. The agreement provided that Britain would be a full member of the EPU: i.e., that it would establish a net balance with it for all the transactions of the sterling area with the other OEEC countries and would settle this balance through the EPU in accordance with the general procedure for settlements (part in gold and part in credits). The United Kingdom also agreed that it would reintroduce previously lifted quantitative restrictions only in the case of a serious drain on its reserves and then only on a multilateral as opposed to a discriminatory basis.

On the other hand, the "special" position of sterling was taken into account as follows:

(1) With respect to the use of sterling as a monetary reserve: it was agreed that, instead of holding EPU credits, creditors could make arrangements to hold in the form of sterling that part of their surplus which would correspond to their surplus in sterling;

(2) With respect to the existing sterling balances of the Continental members of the EPU: it was decided that these balances could be used only if the holders were in a net deficit position with respect to the EPU, but could then be used irrespective of whether the holders were in a deficit position vis-a-vis the sterling area. ECA agreed to indemnify the United Kingdom for any actual losses of gold that might result from such multilateral use of sterling balances. 1/

This solution of the vexing problem of the special position of sterling was generally found quite satisfactory. It was felt that the United Kingdom had indeed come a long way since Cripps' statement in January and that the price paid by ECA for the British concessions was a reasonable one.

Administration of the EPU and the International Monetary Fund

In the meantime, it had become clear that the issue of EPU's relationship to the International Monetary Fund, which had caused much concern at an earlier stage, would be disposed of without too much trouble. By general agreement, the EPU would be governed largely by automatic rules and would function under the supervision of the OEEC, a body that can make decisions only by unanimous vote. This arrangement did not seem likely to result in a powerful supra-national monetary board whose authority would supersede that of the Fund.

1/ For suggestions for a solution along these general lines see "The European Payments Union - A Possible Basis for Agreement," this Review, February 28, 1950.

Nevertheless, an attempt has been made to avoid the paralysis that has often been exhibited by international bodies tied to the rule of unanimity. On a number of important issues that must be deferred for decision to the OEEC Council, the final EPU agreement provides for the procedure of the "Special Restricted Committee". These Committees are to consist of "five persons chosen by lot from a list of persons nominated by each of the members for reasons of competence and standing." When the issue to be decided is a dispute involving one or several specific countries, none of the Committee members may be a national of one of the parties to the dispute. The Committee is to make a report to the OEEC Council on the issue at stake and the Council will then make a recommendation or take a decision "in the light of this report." The intention of this procedure is to invest the Committees with a moral authority which will make for unanimous acceptance of their reports within the OEEC Council.

The terms of settlement of EPU balances

One important question remained to be settled: that of the actual terms of settlement of EPU credits and debits. There was agreement that the gold payments by the debtor should increase as his deficit rose and that the creditor should extend some credit. But exactly what the ratio of gold settlement to credit settlement was to be, had been left undecided pending the solution of the sterling problem. The discussion started around a British proposal that was "soft" in the extreme: it called for a gold-free credit margin for debtors of 10 per cent of each country's total trade turnover (imports plus exports plus invisible current account items) with the other EPU members and, in addition, for another 5 per cent of credits which would go hand-in-hand with increasing gold payments. During subsequent discussions, these figures were whittled down to gold-free credit margins of 3 per cent of total turnover, with gold-assorted credits for an additional 6 per cent.

With respect to the gold-assorted credits the ratio of gold to credit settlement is to increase for debtors in equal installments from 1:4 over 2:3 and 3:2 to 4:1, whereas for net creditors the ratio is to remain fixed at 1:1 after exhaustion of the gold-free credit margin. The quota of each member country is defined as that range of its deficit within which it can command any credit from the EPU or, alternatively, as that range of its surplus within which it is committed to credit extension to EPU. This range is thus equal to 15 per cent (3 per cent gold-free credit margin plus 6 per cent credit tied to 6 per cent gold) of its total trade turnover. After exhaustion of the quota, the debtor has to settle fully in gold unless the OEEC specifically decides otherwise. On the other hand, a net creditor who exhausts his quota has no assurance that he will automatically be paid 100 per cent in gold. It is merely provided that, at this point, the OEEC shall consider what arrangements can be made to enable the creditor to remain an effective member of the EPU.

The above asymmetries in the settling of debtors' and creditors' balances are only feeble reminders of the original blueprint idea that the EPU settlement mechanism should be such as to discourage equally the accumulation of excessive debit as well as of excessive credit positions. To this purpose, it was proposed that the debtors should settle increasing portions of their debit balances in gold while creditors should

extend more and more and more credit. Naturally it proved impossible to obtain the unlimited commitments to extend credit that were implicit in this idea. Nevertheless, the mode of settlement as finally agreed goes farther than any previous international monetary mechanism in placing responsibility to maintain international balance on the creditor as well as on the debtor.

The question of "softness" of the terms of settlement

Even though the quotas and credits are established for a two-year period, it was felt in many quarters that the scheme still resulted in too large an injection of credit into the intra-European payments system. In view of the wide swings that have been characteristic of intra-European payments over the past few years, it is extremely hard to formulate a precise judgment as to the "generosity" of the credit margins provided under EPU. It seems safe to say, however, that the EPU system is, by itself, not "hard" enough to deter countries from following unduly expansionary policies. On the other hand, inflation is far too serious an affair to be started merely because of the existence of sizeable credit facilities for the settlement of intra-European deficits. This has been amply shown during the past years when countries have repeatedly failed to utilize drawing rights established for them under the Intra-European Payments Schemes.

With respect to debtor countries, the credit provisions of the EPU mean, that one of the many punishments for inflation will be mild, at least in the beginning. While this absence of punishment does not appear likely to induce countries to "commit" inflation, it does place more of a burden on their self-restraint than would have been the case with a harder system of settlement. The need for self-restraint will be even greater with the inflationary pressures that are likely to be generated by the additional military expenditures presently being planned.

Special arrangements for Belgium

With respect to the probable creditors, the possible inflationary consequences of wide credit margins are more direct than in the case of the debtors. Whereas it was feared for the latter that the existence of over-generous intra-European credit facilities might fail to check, or might even elicit, inflationary developments, the commitment of the creditors to grant large credits could result directly in an unduly large volume of "unrequited" exports and thereby start inflation in the creditor country. The country that was most concerned with this danger was Belgium. Since Belgium's foreign trade with OEEC countries is particularly high in relation to its national income, the Belgians felt that credit extension by their country according to the general formula would represent a disproportionate contribution which might result in inflation and would thereby compromise the considerable progress Belgium had made toward non-discriminatory trade arrangements and currency convertibility. These feelings led to a last minute crisis in the EPU negotiations. The Belgian Cabinet decided at first to reject the agreement but the deadlock was broken by a series of concessions to Belgium which considerably reduced its credit commitments.

One of the concessions, later generalized for all countries, provided for repayment of Belgium's outstanding credits within two years unless special agreements providing for longer terms were concluded bilaterally between Belgium and its debtors. Provided that the two-year terms are not widely superseded by such bilateral agreements, this will result in making for somewhat less "softness" in general since part of the EPU credits will then be used for the repayment of old debts rather than for the financing of current deficits.

Flexibility and prospective functions of the EPU

The debate over the desirable degree of "softness" or "hardness" in the terms of settlement of EPU balances caused very specific provisions for review to be inserted into the final EPU Agreement. In addition to regular periodic reports, a special comprehensive report is to be made as of June 30, 1951. All these reports will be devoted particularly to the question whether the credit facilities presently provided for will have proven to be excessive or inadequate.

These provisions for review underline the flexible nature of the EPU as a new international financial instrument. With multilateral clearing as its basic operating function, the ECA can indeed be adapted to play a useful role in a great variety of developments. With further progress toward freedom of trade within Europe and toward dollar solvability, the provisions for settlement could be progressively tightened. Such a process is likely to be hastened by the tapering off of ECA aid and would in the end convert EPU into a mere clearing house where income equals outgo. Even in such a situation EPU would still fulfill a useful function, since it would then represent a reliable mechanism for assuring the convertibility of European currencies. 1/

On the other hand, the EPU provides us in the present situation with an excellent instrument for giving precise financial meaning to such phrases as "European solidarity" and "equality of sacrifice". Because of the differences in the industrial and manpower resources of the various OEEC or Atlantic Pact countries, there are bound to be great differences in their individual contributions to a stronger common defense. The EPU, however, can serve as a ready instrument for equalizing these burdens by the channeling of EPU credits toward those countries shouldering the largest direct burdens and vice versa. In this way, the total volume of credit in the system need not be increased; but the available credit volume would be used and, if necessary, rearranged so as to provide the countries that devote most resources to defense with some resources of the other countries which would thus participate indirectly in the common effort.

Thus the EPU, whose original and central purpose is to make a contribution to the creation of a single European market, is well suited to play a useful

1/ See article on "Types of Convertibility," in this issue, p. 4.

role under conditions of world-wide convertibility as well as in the setting of a large defense effort. Naturally, there is no guarantee that the EPU will actually perform these useful functions. It could well develop into a brake on the progress toward convertibility if it were to refuse to introduce harder terms of settlement as such terms became possible. It could also interfere with a rational common defense effort if it permitted those countries that contribute least to the direct building up of armed strength to suck in additional resources from those countries already burdened by heavy defense expenditures.

To point out these possibilities, however, is merely to say that, like every human institution, the European Payments Union has potentialities for both good and evil. But, endowed with well-defined functions in response to pressing current problems and operating in an area ever more intimately bound together, the EPU at least promises to be that most difficult achievement: a genuinely alive international institution.

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THE EUROPEAN PAYMENTS UNION: FURTHER OBSERVATIONS

Randall Hinshaw

The purpose of the present paper is to evaluate the newly born European Payments Union in the light of American international economic objectives. These objectives have been stated so often that any restatement is likely to seem hackneyed. In general, however, post-war American policy has been directed toward the establishment of nondiscriminatory multilateral trade on the basis of general convertibility--at least for the major currencies. The designers of the new Payments Union hail it as an important step forward in the attainment of these objectives. Certain critics, on the other hand, are unfavorably impressed by the explicit provision for discrimination against outside exports, and in some quarters it is believed that the Payments Union represents a step, not toward, but away from dollar convertibility. The issues which emerge in this controversy are highly complex, involving difficult problems of judgment on which honest and intelligent persons can easily differ. The ensuing remarks are consequently presented in an undogmatic spirit, and analysis will be confined solely to economic issues in a peace-time setting. No attempt will be made to consider the important political implications of the new institution, nor will any effort be made to take into account the repercussions of the Korean crisis.

The EPU and discrimination

The European Payments Union is designed to make possible the removal of intra-European trade barriers and exchange restrictions, but it is not contemplated that European trade "liberalization" should be extended, at the present time, to the outside world. Consequently, it is clear that the Payments Union, at least for the time being, rests on a discriminatory foundation. Indeed, it is maintained in some quarters that, if the Payments Union is to be successful, import restrictions against the outside world may have to be increased in order to prevent the liberalization of intra-European trade from resulting in an unwanted increase in European imports from outside sources (via member countries, such as Belgium, which have only moderate restrictions against such imports).

In discussing this matter, it is only fair to point out at the outset that European countries have been gradually emerging from a period of extreme commercial discrimination, not only against the outside world (including, especially, the dollar area), but also against each other. At the end of the war, European trade was at a virtual standstill, and was able to revive only on a bilateral basis, which of course meant that European countries made no pretense of maintaining a policy of equal treatment in their import policies, even within Europe. A higher degree of implied discrimination in all directions could scarcely be conceived. This situation of more or less strict bilateral balancing has been modified during the past two years by the recently superseded ECA-sponsored payments arrangements, which provided for a limited degree of multilateral settlement, but these measures did not result in the removal of intra-European discrimination, nor were they designed to do so.

The European Payments Union may be regarded as a means of removing trade and payments discrimination within Western Europe. This in itself is a big step forward. It can be argued, however, that to the extent that this involves a reduction of intra-European trade barriers unaccompanied by a corresponding reduction of European trade barriers against the dollar area, the result is an increase in discrimination against the dollar area. While this may be granted, it is important to distinguish between (1) discrimination resulting from a preferential reduction in import barriers, and (2) discrimination resulting from an increase in import barriers which is not universally applied. The most serious question in the present connection is whether the Payments Union requires for its success an increase in trade and payments restrictions against the dollar area. This is a problem of sufficient complexity and interest to warrant a somewhat extended discussion at this point.

Since European import restrictions against American products are not uniformly tight, there is the likelihood that countries with the more stringent restrictions may find themselves confronted with an increase in dollar imports simply by liberalizing intra-European trade. For example, Belgium has only moderate restrictions against dollar imports, while Norwegian restrictions are very tight. If, under these conditions, Norway proceeds to remove intra-European import restrictions, it is likely to find that it is thereby undermining its restrictions against dollar imports.

Of the direct ways of dealing with this problem, none appear very desirable. There are several possibilities:

(1) Countries with the more stringent restrictions against dollar goods could be asked not to remove intra-European import restrictions. This policy avoids all problems by surrendering the objective of trade liberalization for those countries which are most in need of it.

(2) Such countries could be asked to confine intra-European trade liberalization to products which (a) are produced within Western Europe, and (b) contain no raw materials from the dollar area. This policy might be fairly easy to carry out in the case of so-called "differentiated products" (e.g., Fords, Frigidaires), but would be difficult or impossible to enforce in the case of undifferentiated goods, such as many types of food and raw materials.

(3) Countries with the less stringent restrictions against dollar goods could be asked to tighten them. This policy would of course expose ECA to the charge that EPU requires for its success an increase in European restrictions against dollar goods.

(4) Such countries could be asked (or might wish) to prohibit the exportation of goods obtained from the dollar area. This policy suffers from the same objection as (2); it would be impossible to enforce effectively in the case of undifferentiated products.

None of these policies have much to be said in favor of them. Moreover, all four policies share the basic inconsistency of attempting to secure the removal of one group of direct controls (i.e., import controls) by the substitution of a new group of direct controls. Nor is it clear that the controls listed above would be superior to the controls they were designed to replace.

There is, however, another possible approach to the problem. This is to deal with European deficit positions (regardless of how created) as they emerge through EPU. A member country presumably would be concerned solely with the over-all magnitude of its deficit with EPU, and would have no occasion to be concerned with that part of the deficit which could be attributed to dollar imports via third countries. Thus, it is hardly likely that a country with access to EPU credit would refuse to liberalize intra-European trade simply because some portion of the resulting increase in imports might, via a roundabout route, be imports from the dollar area. Of course, it is entirely possible that, because of an increase in dollar imports via third countries, a country might develop a much larger deficit with EPU than would otherwise be the case (or might develop a deficit which otherwise would not have appeared). In this event, the problem, from the standpoint of EPU, would be simply one of discouraging excessive deficit positions (positions which could not be justified on "structural" grounds).

The amount of additional dollars required by EPU to take care of the possibility of European dollar imports via third countries would depend on how successful EPU would be in preventing the emergence of excessive deficit positions. To the extent that EPU was successful in this objective, the dollar cost to EPU might be little, if any, greater than if such dollar imports were effectively prevented by direct means. Moreover, if it developed that any substantial volume of American exports to Europe were financed through EPU in this indirect way, the amount of direct ECA aid to Europe might be correspondingly reduced.

In short, the charge that EPU requires for its success an increase in restrictions against dollar goods does not appear to stand up under close analysis. It may be replied, however, that while EPU may not require an increase in restrictions against dollar goods, neither does it assist in making possible a reduction in such restrictions. This is not necessarily true. The increase in intra-European competition made possible by the removal of restrictions on intra-European trade and payments should have the effect of lowering European costs and, thus, of reducing the need for external discrimination.

In the European case, it would be an impossible counsel of perfection to insist that discrimination must be removed simultaneously with all areas or not at all. To have insisted on this would have been virtually to guarantee that no improvement whatever would take place. If, on the other hand, it is taken for granted that a step-by-step reduction

of discriminatory import policies is all that can reasonably be expected, then the most natural order of events would surely be to secure, first, the removal of intra-European discrimination and, later, the removal of European discrimination against the outside world. The first step has now been virtually achieved.

The EPU and convertibility

The European Payments Union is widely hailed by its supporters as an important step in the return to general convertibility. It is pointed out that the new system provides not only for the complete inter-convertibility of member currencies but also for automatic partial convertibility of the member currencies into dollars (as determined by the fractional gold-payment provisions). On the other hand, critics of the new institution express considerable dissatisfaction with the gold-payment provisions, which, they contend, are too "soft"; and they maintain that the achievement of transferability within Europe has been achieved by methods which delay the attainment of full dollar convertibility.

With respect to the "hardness" of the EPU gold-payment provisions, it is not easy to make a simple statement. One point, however, seems clear: A careful examination of recent intra-European payments data does not support the conclusion that gold would be unlikely to flow at an early stage. If, for example, the Payments Union had been established on October 1, 1949 (i.e., shortly after devaluation), and if the pattern of payments had been the same as has actually occurred, four member countries would have reached gold points during the first eight months—a period characterized by a marked increase in intra-European balance. The four countries are Belgium, Turkey, the United Kingdom, and Western Germany. On the basis of its May deficit alone, Turkey would have been thrust into the 80 per cent gold-payment range. During the eight months, Western Germany would have been required to pay \$34 million to EPU, while the United Kingdom and Belgium would already be entitled to receive substantial sums of gold from EPU in spite of large "initial debt positions."

This information does not, of course, prove that the gold-payment provisions are "hard," and it may be objected that if the Payments Union had been in existence during this period, the pattern of payments would have been quite different. This may be admitted, but there seems to be no reason to believe that the pattern would have revealed a higher degree of intra-European balance. On the contrary, it seems more likely that the reverse would have been the case.

In any event, much will depend on how the system is administered. In particular, the hardness of the system to a very large extent will depend on how generous ECA is in renewing "initial positions" and in coming to the rescue of member countries in difficulties.

A related but more fundamental criticism of EPU is that the achievement of intra-European transferability has increased the difficulty of the "dollar problem," and has thereby diminished the chances for an early return to dollar convertibility. The substance of the argument is this: The liberalization of intra-European trade and payments, coupled with the extension of credit by EPU, will tend to place participating debtor countries in a position to outbid the American market for European goods which would otherwise be exported to the dollar area. It has been suggested that the European demand for European products which are potential exports to the dollar area tends to be less elastic than the American demand (because of the availability of American substitutes), with the result that a rise in European prices (induced, for example, by the extension of EPU credit) would tend to result in a diversion of European sales from the American to the European market.

While this assumption with respect to elasticity may be correct, it is clear that the foregoing analysis is relevant only if the effect of EPU is to raise European costs and prices. Such a development seems possible, but hardly likely. On the contrary, it would seem reasonable to believe that the new arrangements may result in substantial and widespread price reductions throughout Western Europe. It should be remembered that post-war Western Europe until the present time has been a "sheltered high-cost area," and would have been likely to remain so permanently in the absence of determined efforts to liberalize European trade and payments. Under EPU, efforts are centered on liberalizing intra-European trade and payments, but any major success in this direction should exert downward pressure on European costs and prices in at least four ways.

(1) In the first place, even in the absence of trade liberalization, the introduction of full multilateral settlement within Western Europe should result in European price reductions by making it possible for member countries to import from the cheapest European source. Such price reductions are likely to be mainly at the expense of abnormal profits, and are not likely to result in the elimination of existing firms. Nevertheless, it should be noted that this is an immediate effect of the introduction of multilateral settlement.

(2) Any substantial liberalization of intra-European trade is likely to lead to the gradual elimination of high-cost marginal firms. While the firms may remain in business for a long period after they have ceased to be profitable, it should again be noted that the prices they charge would be immediately affected by exposure to outside competition.

(3) The removal of trade restrictions is almost certain to affect the pattern of new investment in such a way as to result in a more economical allocation of resources. In the recent European environment, which has been characterized by a high degree of bilateralism and by trade barriers which discriminate not only against the outside world but within Europe, it has been impossible to plan investment on a rational basis. Many plants which have been built may be able to remain in production only if heavily protected, while low-cost plants which might

have been highly profitable if trade had been liberalized have not been built because of inadequate markets. While this is a long-run argument, it is probably the most important argument in favor of liberalization of European trade and payments, and it is the argument which most clearly suggests the urgency of taking action without delay. Once high-cost firms become established in a sheltered environment, they become vocal vested interests, and their political influence tends to increase with age. Consequently, every month that liberalization of trade and payments is postponed makes the task politically more difficult and economically more painful. Since, at the same time, American bargaining power is diminishing as the aid program tapers off, liberalization may well be a question of now or ever.

(4) As had already been mentioned, to the extent that European restrictions against American exports vary in stringency from one country to another, countries with the more stringent restrictions may find themselves exposed to American competition simply by liberalizing intra-European trade and payments. If Norway, for example, proceeds to remove intra-European trade and exchange restrictions, it is also tending to reduce restrictions against the United States. To the extent that such liberalization occurs, the effect is clearly to create a less sheltered European environment.

These four influences clearly operate in the direction of lower European costs and prices. Whether these influences will be offset, or even outweighed, by the inflationary impact of the rather generous EPU credit provisions remains to be seen. In any case, it must not be assumed that such price reductions as may occur as a result of the liberalization of intra-European trade and payments will necessarily be sufficient to obviate the need for further changes in exchange rates (or, alternatively, further deflation).

TYPES OF CONVERTIBILITY

Albert O. Hirschman

There is hardly any economic issue on which the non-Communist world has been as divided during the postwar years as on that of currency convertibility. At one extreme the quest for convertibility was decried as the "old adoration of blind economic deities"; ^{1/}to others, convertibility represented an essential means of integrating the whole free world into a rational and progressive economic order. The following note does not enter directly into this discussion, but attempts to clarify and dissect the concept of convertibility in the hope that the discussion will thereby be brought into sharper focus, and that agreement on a common objective will be facilitated.

General vs. current account convertibility

The distinction between general and current account convertibility is well established. Fund members, for instance, are obliged in principle (i.e. subject to the provisions regarding scarce currencies and the transition period) to maintain convertibility on current account only. Restrictions on capital movements are not proscribed in any way. The experience with "hot money" movements during the inter-war period was directly responsible for this distinction and for the freedom left to Fund members to impose any restrictions whatsoever on capital movements.

The experience of the past few years, however, tends to show that the distinction meets with great practical difficulties. There have been numerous instances of large-scale capital movements that have taken place in the guise of commercial transactions. The control of capital transactions has proven to be more difficult than that of current transactions. Whereas the normal sequence of lifting exchange controls was believed to run from current to capital transactions the actual sequence has often been the reverse in the few postwar examples that are available. Thus, freedom of capital transfers was substantially reestablished among some Continental countries through the restoration of the freedom to export, import, and trade bank notes at a time when these same countries often maintained elaborate quantitative restrictions and other controls over their merchandise trade with each other.

Current account convertibility: Convertibility of foreign-owned vs. convertibility of domestically-owned balances

Within the concept of current account convertibility an important distinction must be made between convertibility of foreign-owned as opposed to the convertibility of domestically-owned balances. A country might well narrowly limit the right of its residents to use their local currency balances for the purpose of current spending on imports, tourism etc. while granting non-resident owners of such local currency balances complete freedom to convert them into third currencies, provided such conversion is required

1/ Barbara Ward in the New York Times Magazine, July 30, 1950, p. 38.

for the settlement of current account deficits incurred with these third countries. This narrower concept of convertibility is referred to in Article VIII, Section 4, of the Fund Agreement while the wider concept of general current account convertibility appears to correspond to Section 2 of the same article. ^{1/} Generally we have the narrower concept in mind when we talk of convertibility of sterling. In fact we might write down the equation:

convertibility on current account = convertibility
of foreign-owned balances for current account purposes +
absence of quantitative trade or exchange restrictions
on current transactions.

Conceptually, the distinction between the narrower (and more usual) concept of current account convertibility and the wider concept is unequivocal. To what extent, however, it is possible and desirable to divorce the one objective from the other, is quite another matter.

It is clear that the crucial step in the direction of multilateral trade and payments is the establishment of convertibility of foreign balances. All the trading partners of the country taking this step (let us call it country X) are thereby enabled to use balances earned in country X for purchases in the cheapest market. On the other hand the removal of quantitative restrictions on imports would make it possible only for the importers of country X to buy in the cheapest market and even then only to the extent that its trading partners have established currency convertibility in the narrow sense.

Nevertheless, if rigid quantitative restrictions (whether discriminatory or not) are maintained as convertibility of foreign-owned balances is established, a dangerously precarious situation might well arise. The decision to establish convertibility of foreign balances necessarily results in a brusque change; it creates an entirely new situation overnight. Quantitative restrictions, on the other hand, can be lifted one by one and retreat here is always possible without too much danger to the ultimate objective. In the case of convertibility of foreign balances, on the contrary, retreat means defeat, and one more defeat - after that of 1947 - would probably be definitive. In view of this situation, it appears desirable that a country go rather far in reestablishing freedom from quantitative restrictions on current account for its own residents before establishing convertibility of foreign balances.

The reason for this is twofold. In the first place, the maintenance of tight quantitative restrictions over a wide range of imports while convertibility of balances is restored would make any advance toward the elimination of quantitative restrictions perilous for the maintenance of convertibility. A premature restoration of convertibility of balances might therefore have the effect of freezing the existing pattern of quantitative restrictions.

^{1/} This section prohibits only restrictions on current payments on the theory that the prohibition or regulation of quantitative restrictions on trade will be assured by another international institution such as the ITO. Thus it aims at the wider concept of current account convertibility only insofar as the realization of the concept is a responsibility of the Fund.

Secondly, restoration of the convertibility of foreign-owned balances without prior relaxation of quantitative restrictions would reduce the number of alternative remedies that would be before a country experiencing balance of payments difficulties. These alternatives are:

- (1) Devaluation,
- (2) Restrictive monetary and fiscal policies,
- (3) Reintroduction or reinforcement of quantitative restrictions,
- (4) Abandonment of convertibility of foreign balances.

I do not wish to discuss here the order in which the first three measures should be adopted in different situations; but it will probably be granted that a country which has reestablished convertibility should have at its disposal the maximum number of alternatives other than the cancellation of convertibility of foreign balances since this is the decisive step that leads from a multilateral to a bilateral world. One of these alternative courses of action is resort to quantitative restrictions. But in order to be able to tighten or reintroduce quantitative restrictions a country must first have relaxed or abolished them. It is for this reason that a country ought to have abolished or substantially relaxed quantitative restrictions before taking the great jump into convertibility.

Convertibility of foreign-owned balances: Convertibility of balances held by foreign residents in general vs. convertibility of net balances held by central banks

This distinction is useful, since it brings out the fact that exchange controls - i.e. channeling of all foreign exchange operations through national central banks or ad hoc institutions - are compatible with convertibility. This is often not realized. It is possible to imagine a situation in which convertibility in the most general sense prevails with all foreign exchange freely bought from the central bank and all foreign exchange earnings sold to it against local currency. It is true, of course, that in this situation there would be no real need for the central bank's monopoly of foreign exchange. It would be sufficient for the central bank to intervene at the margin so as to make sure that the market is cleared at the going exchange rate. But in a world of nations which move toward convertibility at widely different rates, exchange controls are likely to be maintained even in countries that move fastest toward convertibility. Although such a country will grant to its trading partners the right to convert balances in its currency, the reciprocal right may not be assured. It will, therefore, be important for the country in question to make sure that no more than the net balance owned by it is converted into another currency. This assurance can only be had if the transactions are centralized and netted periodically among the central banks concerned.

Convertibility of balances held by foreign central banks: Convertibility between pairs of countries vs. convertibility through multilateral clearing

The final distinction is between the two methods of operating convertibility when it is restricted to balances held by foreign central banks. With world-wide establishment of this type of convertibility, it is possible to conceive of all central banks establishing net positions periodically with all other central banks and every central bank standing ready to convert every balance owed - directly or indirectly via a "key currency" - into whatever other currency is desired by the holder. Theoretically such a system is unexceptionable, but in practice it seems bound to give rise to bilateral argument or bargaining at any time when a country finds itself or believes to find itself in balance of payments difficulties. To avoid this it would be preferable (and only natural) to lift the whole process out of the bilateral channels where it might well be choked and to assure its automatic operation through some multilateral clearing device. If all countries were to transfer the balances held by them to an international clearing house some countries would emerge as net creditors and some others as net debtors. In the course of the offsetting process, countries would in effect convert surpluses earned in one direction into means of payments for settling deficits incurred in other directions. Under a system of full convertibility, the net debits owed to the clearing house should be payable entirely in gold or in any currency acceptable to the net creditors.

In contrast with the European Payments Union the Clearing House envisaged here is world-wide in scope and in contrast with both EPU and Keynes' International Clearing Union it makes no provision for credits or overdrafts. It is presented here merely as a type of convertibility that probably would be most efficient in a world in which exchange controls persist and which, therefore, is unable to return to a system where convertibility is assured in private exchange markets. Such a system would still do the job which convertibility is meant to do: it would permit all countries to spend their current earnings in the country and currency of their choice.

It is often said that the European Payments Union would cease to have any *raison d'être* if and when settlement will take place one hundred per cent in gold. The preceding analysis shows that this is not the case. As long as exchange controls are maintained and convertibility means the convertibility of balances held by foreign central banks, a system effecting convertibility through multilateral clearing is far more efficient and reliable than a system that relies on what might be termed "bilateral convertibility."