L.5.2 RFD 311

Board of Governors of the Federal Reserve System

Division of International Finance

REVIEW OF FOREIGN DEVELOPMENTS

November 4, 1958

Currency Problems of an Integrated Europe 11 pages

Ralph C. Wood

NOT FOR PUBLICATION

November 4, 1958

Currency Problems of an Integrated Europe*

Ralph C. Wood

In order to provide a framework for our discussion of the broad subject we are to consider, I have organized my remarks under two major headings: the international payments system, on the one hand, and currency and payments problems, on the other. Under the first of these two headings, I shall discuss the payments arrangements implied by the Treaty of Rome, and the payments arrangements that might be expected under the proposed Free Trade Area. While the Free Trade Area plan may not constitute "integration" in the sense in which that term is currently used, at least in some quarters, the plan certainly has an important bearing on our subject. We must therefore take account of it, as well as of the Common Market.

Under the second heading (that of currency and payments problems), I shall examine first the implications of the integration plans for internal financial stability in the member countries. After that, I shall say something about the problem of balance-of-payments equilibrium.

We can now move to the first topic, the system of international payments; and I shall begin with the Common Market.

I. The System of International Payments

A. The Common Market

1. A common currency

In order to understand the currency arrangements likely to exist under the Treaty of Rome, we shall want to look presently at the essential implications of the Treaty in such matters. However, it has frequently been suggested that a common currency should be established for the six countries of the Common Market. Such an arrangement could not flow from the existing provisions of the Treaty, some of which would in fact have to be changed if a common currency were established. We may as well take up the common-currency question immediately.

---

* Talk given in New York on October 23, 1958, at a seminar of the American Management Association, International Management Division, on "Capitalizing on the European Common Market." The views expressed are those of the author, and are not necessarily those of the Board of Governors of the Federal Reserve System.

NOT FOR PUBLICATION

This question is one of those complex problems that have either to be discussed at some length, or disposed of in rather few words; and in view of the amount of other ground we have to cover, I shall deal with it in rather summary fashion. I shall make only two comments, the first being that while there is much to be said for the view that a common currency for the six countries of the Common Market is desirable, the fact is that whether desirable or not, the ultimate establishment of such a currency is I think practically inevitable if and when the basic underlying aim of the Common Market, which is nothing less than the political unification of Europe, is someday realized. On the other hand--and this is my second comment--I strongly doubt that it will be possible to establish a common currency until political unification is realized or at least until it is imminent. This is admittedly a personal judgment, based on what seem to me to be the present realities of the situation.

Arguing from the extraordinary speed of events from Messina in June 1955 to Rome in March 1957, some people urge that it is a mistake to underestimate the possibility either of a fairly rapid move to the ultimate goal of political unification, or at least the adoption of a common currency well in advance of political unification. This is a matter of opinion, of course. We may be in for surprises in the speed of further evolution of the Common Market; and we certainly need to keep in mind the fact that some very able men are involved in the drive toward such evolution. Nevertheless I believe we should view the common-currency idea as one that is not a "starter" right now, and one that may not be for very many years to come.

With that thought in mind we can move on to consider the payments aspects of the Common Market in the absence of a common currency. In passing, however, it should be noted that even if there were a common currency for the six countries of the Common Market, there would still be problems of payments relations between the Six and the rest of Europe, as well as between Europe and the rest of the world. While a common currency for the Six might narrow the number and scope of European payments problems, it could not, of itself, be expected to eliminate them altogether. This follows from the fact that there can be payments imbalances between any integrated currency area--the United States, for example--and the rest of the world.

2. Payments arrangements in the Common Market in the absence of a common currency

Turning to the question of the payments arrangements which would be desirable for the Common Market in the absence of a common currency among the Six, in one respect the answer is very simple. Under a system of complete free trade--which is essentially what is aimed at inside the Common Market--there has to be a multilateral payments system, because no member country will be in exact balance in its commercial and financial relations with each other member. Indeed, a multilateral payments system is essential even under trading arrangements which are far from being completely free. This is clearly illustrated in the fact that trade liberalization in OEEC --which has never pretended to be a system of entirely free trade--had to be paralleled by a multilateral payments system, namely the European Payments Union. The Common Market, which contemplates eventually complete freedom of trade among its member countries, obviously requires a payments system that will enable each member country to offset its deficits with some members against its surpluses with others.

However, we can go further than this. Just as no member country can expect to have an exactly balanced position in its commercial and financial relations with each other member, neither can it expect that its position with all the other members together will necessarily be in continuous balance; it would be curious, in fact, if such a balance existed. To take an example, there is no reason in logic for Italian exports of goods, services, and capital to the other member countries of the Common Market to equal, continuously, her imports of goods, services, and capital from those same countries. This means that Italy will normally be either in net deficit or in net surplus inside the Common Market. Assuming the position will be one of net deficit, Italy will naturally want to be able to settle that recurrent deficit out of her surplus with other areas.

One of the virtues of the EPU is that although it is only a regional payments system, it does permit member countries to offset deficits incurred almost anywhere in Western Europe against surpluses earned almost anywhere in Western Europe. (In fact, the scope of EPU extends beyond Western Europe itself. There are several reasons for this, chief of which is the fact that transactions between a metropolitan EPU country and countries in the monetary areas of other EPU countries are reflected in the accounts.) What I am suggesting is that the Common Market countries will want a payments system which provides at least as many possibilities for offsetting deficits as exist at present under EPU. Because EPU is already in existence, what this means in effect is that the Common Market countries will want EPU itself to continue until something better comes along. This would assure Italy--to refer back to my example--that she would be able to go on offsetting deficits against surpluses without difficulty on at least a Western European-wide basis.

The point I have been making may seem a very obvious one. The reason I have elaborated it in some detail is that it was suggested to me that American business firms with established interests and connections in Western Europe have become familiar with EPU, and accustomed to doing business under its influence; and I understand that some of these firms have raised questions as to what will become of EPU as the Common Market develops. What I have been trying to show is that purely from the standpoint of logical payments arrangements, the Common Market need not constitute a threat to the continued existence of EPU. Whether it constitutes a threat to EPU for other reasons will emerge when we move on to discuss the Free Trade Area.

<u>Convertibility and the EPU.</u> My suggestion was that the Common Market countries will want EPU to continue "until something better comes along." I was alluding, of course, to the prospects for formal convertibility (in the sense of current usage, meaning convertibility of other currencies into dollars, and not a legal right to conversion of currency into gold). Current hopes that the establishment of formal convertibility may come in the not-too-distant future are evident in--for example-- some of the comments made at the recent annual meetings of the International Monetary Fund, the World Bank, and the International Finance Corporation, in New Delhi.

Let me stress my use of the term "<u>formal</u> convertibility." The fact is, of course, that Europe already <u>has</u> a considerable measure of the <u>substance</u> of convertibility. By the substance of convertibility-- and here I am thinking of convertibility on current account, which is the essential goal, although freedom for capital movements is also important, and Europe has likewise made considerable progress in this sphere--I mean freedom to import desired goods and services from practically any source, including the dollar area. Although some European countries still have a considerable distance to go in the removal of quantitative restrictions on imports from the dollar area, others have already made much progress in this direction, and more is promised. As a result, the establishment of formal convertibility, if and when it comes, will probably not make startling differences in the conduct of most day-to-day business.

Progress toward convertibility has been reflected in the EPU system itself. Over the years since 1950, when EPU was founded, there has been substantial growth in freedom from restrictions on trade and payments within Europe; and in addition, there has been substantial "hardening" of monthly EPU settlements, which now normally require that three-fourths of the net amounts owed by or to member countries be paid in gold or dollars. There has also been what might be termed "concealed hardening," in the form of occasional consolidation and gradual amortization of old outstanding debt in EPU. Therefore, although EPU is still a great convenience, and has the advantages which stem from the fact that it is, after all, the "going" system, it no longer has the importance it once did. This is true with respect to each of the three essential parts of its original construction: credit, clearing, and discriminatory trade liberalization. (Although OEEC trade liberalization does not take place under the rules of EPU as such, it is correct to say that such liberalization is a vital part of the EPU "system.") It is a tribute to the EPU system, however, that while its importance is declining, this is the result of its success, not of its failure. The decline in its importance is a result of the extent of general progress toward convertibility which was always the ultimate goal of the founders of EPU.

Since I am now digressing away from the Common Market and into EPU and convertibility--although I think it is not really a digression if it illuminates our understanding of the international payments arrangements likely to exist in an integrated Europe--I might say something about the specific arrangements which are expected to replace EPU in the event of a move to formal convertibility: if, indeed, they do not do so before that event. Some of you are probably familiar with these arrangements, which are covered by what is known as the European Monetary Agreement.

The European Monetary Agreement (EMA), which was drafted and signed in Paris in the summer of 1955, was the result, on the one hand, of the desire of the United Kingdom for an EPU "escape clause" which would facilitate the termination of EPU on relatively short notice in the event of a move by some member countries to convertibility; it was also the result, on the other hand, of the desire of the Continental countries at that time that an organized multilateral settlement and credit institution continue to exist after such a move. The original U.K. view was that no such institution would be needed. As might be expected, the plan established on a "stand-by" basis in 1955 under the EMA was a compromise between these two views. For our purposes today, I think I need mention only two or three main facts about the Agreement.

In the first place, the EMA deals mainly with two things: credit, and multilateral settlements. (Somewhat as in EPU, trade liberalization is also assumed; but also as in EPU, the arrangements for it do not form part of the EMA itself.) In principle, there would be <u>no</u> automatic credits under EMA, of the type available under quotas in EPU; credit would be essentially <u>ad hoc</u> rather than automatic, and would be made available, under certain conditions, and for a maximum period of two years, by something to be known as the European Fund. The Fund would have a capital of $600 million, made up of the residual assets of EPU plus subscriptions by member countries of EMA.

Second, the multilateral settlements mechanism would be similar in certain respects to that of EPU. Settlements would take place monthly; central banks would provide each other with "interim finance" during the month; and the system would be operated by an agent on behalf of OEEC. In some important respects, however, the EMA multilateral settlement system would differ from that of EPU. For one thing, the monthly settlements would be entirely in U.S. dollars, instead of partly in dollars (or gold) and partly in credit. For another, the amount of "interim finance" available would be limited to a much smaller amount than under EPU. In addition, the system has built-in incentives for central banks to settle outstanding balances through the market, rather than through the formal monthly clearing.

Finally, the Agreement requires each member country to establish margins, which are to be valid "until further notice," beyond which it will not allow the value of its currency to fluctuate. Taken in conjunction with the arrangements relating to monthly settlements, this provision means that central banks of member countries would have an implicit exchange-rate guarantee for any of their holdings of the currencies of other member countries. Such a guarantee also exists in EPU; there is a difference, however, in that the guarantee implied by EMA would be at the lower limit of fluctuation in the value of such currencies in effect prior to a change in their margins, whereas the EPU guarantee is at the "parity" rate.

I have summarized these main points about the EMA in order to make clear the fact that it is a coherent plan, constituting an evolutionary step forward from EPU, and better adapted than EPU to the conditions of a convertible world. If that is so, industrial and commercial concerns with interests in Western Europe should welcome it, just as they will presumably welcome the arrival of formal convertibility itself.

B. The Free Trade Area

Thus far we have considered international payments arrangements under the Common Market; and I have tried to show how that subject led us back to EPU, and to the system into which EPU seems likely to evolve. I shall now turn, much more briefly, to the proposed Free Trade Area. As of this moment, of course, we do not know its ultimate form and character. However, there is nothing in its basic concept that would lead to a conclusion different from the one we have already reached in the case of the Common Market, on the question whether the countries concerned will want to have EPU continue, and to evolve into EMA when the moment for that event arrives. So far as movements of goods and services inside the area covered by the system are concerned, those visualized for the Free Trade Area are very similar in principle to those planned for the Common Market. It is true that the Free Trade Area may not achieve (or even seek) the degree of freedom for some kinds of movements--for example, of persons, or of capital--which is aimed at in the Common Market. There is also the possibility of special limits on free movement, in connection with the well-known "distortions of trade" question. Such differences, however, will constitute differences merely in degrees of freedom between the two systems. So far as one can now judge, the Free Trade Area will be one in which there will be a very large amount of free or relatively free movement; and for the "non-Six" countries of the Free Trade Area there will be just as much incentive as for the Six to have the widest possible system of multilateral settlements within Europe. Moreover, one basic aspect of the Free Trade Area plan is that the Common Market would be <u>inside</u> the Free Trade Area, with ultimately free trade (in principle) throughout the combined area of the two groupings. This clearly reinforces the need for a single payments system in Europe, and does nothing to detract from the idea that that system should be EPU or (later) the EMA.

It seems clear, therefore, that there will be a general desire in the Free Trade Area countries as well as in the Common Market countries (and also in the central bodies of both institutions) to continue EPU until the move to EMA. In saying this, however, I am assuming that a Free Trade Area <u>will</u> come into existence. Whether it will be possible to continue EPU if the Free Trade Area negotiations fail is not at all clear. The prospects for an FTA may be clarified through the meetings in Paris which begin today,[1] although it is probably advisable to keep in mind that in the past there have already been agreements "in principle" that there would be a Free Trade . ea, and it has not yet been possible to transpose these agreements into something concrete.

In the event of failure of the negotiations, it can be argued that after the dust had settled, EPU would still be intact, because all parties would be anxious to continue a system that is both convenient and familiar. On the other hand, in addition to uncertainty as to what might be done in anger and in spite, there is a substantive problem involved in the close connection between EPU and trade liberalization. In the past, all members of EPU have been subject to the same rules of liberalization; but the Treaty of Rome envisages steps which go beyond those rules and beyond the goals now envisaged by OEEC. Under the circumstances there might be a strong feeling that continuation of EPU would not be possible, because unanimity (or an approximation to it) on one of the vital clauses of the "contract" no longer existed. In terms of its merely technical arrangements, EPU would be just as workable as ever; the breakdown, if it came, would be caused by a belief among some of the member countries that there was no longer a sufficient degree of reciprocity in trade liberalization, one of the underlying bases of EPU.

There is a real possibility, therefore, that EPU would be brought to an end; and it is not easy to see what would take its place. It is tempting to consider that such a situation might precipitate the move to formal convertibility; and whatever the merits of either EPU or EMA, institutional arrangements of this kind are not essential in a convertible world. However, in view of the great uncertainty which would exist as to the future rules of trade between the Six and the non-Six, I strongly doubt that collapse of the FTA negotiations would precipitate a move to formal convertibility.

Fortunately, we do not have to dot the last "i" and cross the last "t" on what would happen in this purely hypothetical situation. I suggest we proceed on the assumption that a modus vivendi will be achieved under which it will be possible for a rational multilateral payments system to continue in Europe, on a European-wide basis.

II. Currency and Payments Problems Under the Integration Plans

It is time now to move along to the second of my two topics. I said earlier, you will recall, that I would deal first with international payments arrangements, and then with the question of currency and payments problems. I added that under this second heading I would discuss two points:

1/ October 23, 1958. As of November 4 the prospects are still not very clear.

first, the implications of the integration plans for internal financial stability in member countries; and second, the problem of balance-of-payments equilibrium. The two are so closely related that discussion of one leads right into a discussion of the other.

The question which the first point raises can be stated as follows: Is there anything about the integration arrangements--those in existence or those proposed--that can be expected to exorcise problems of internal financial stability in Europe once and for all?

On this question, I am tempted to modernize an old saying by suggesting that nothing is certain but death, taxes, and crises in some country's balance of payments.

It is a central fact that under the Common Market, each member country retains its own national currency and its own ultimate control of it. It is also a central fact that the institutions of the Common Market have no police power (in the sense of armed force) to enforce their decisions. The bald implication of these two facts is that if a member country were to decide firmly on a highly inflationary course of action (or in what might be the more likely case, to refuse to implement measures necessary to halt a serious inflation already under way), and if, as a result, it had to suspend trade liberalization during a prolonged period of time, there is little that the other Common Market countries could do, save to retaliate; and in such an event, the Common Market could of course fall apart.

But it would be misleading to stop with the facts I have cited. In signing and ratifying the Treaty of Rome, the member countries have undertaken serious commitments. Among these commitments is that of Article 104:

> Each Member State shall pursue the economic policy necessary to ensure the equilibrium of its overall balance of payments and to maintain confidence in its currency, while ensuring a high level of employment and the stability of the level of prices.

In addition to this, in Article 105 the member countries have agreed that "in order to facilitate the attainment of the objectives stated in Article 104, Member States shall coordinate their economic policies." In Article 103 they have agreed that "Member States shall consider their policy relating to economic trends as a matter of common interest." And in connection with all of this, they have established a Monetary Committee which, it is true, has only "consultative status" (in the language of the Treaty), but which is almost certain to play a very influential role.

It is not without significance that the Treaty article establishing the Monetary Committee is found in the chapter on the balance of payments. In other words, monetary questions of mutual interest to all parties under the Treaty are viewed as being of such interest because of the connection between internal monetary matters and the balance of payments. It seems to me that this view is correct for purposes of the Treaty. If a country's internal financial policy and problems had no potential impact whatever on other members of the Common Market, it could be contended, with considerable justice, that the internal monetary affairs of member countries were of no concern to other member countries or the central institutions of the Community. However, the monetary behavior of any member country does have an impact on the other members; and that impact is transmitted through the balance of payments.

In the first place, because of the freedom of trade which is projected for the Common Market, excessively inflationary or deflationary policies in one member country would quickly be transmitted to the others. In the second place, if any member country gets into balance of payments difficulties it may call on the Community, under the Treaty, to provide assistance in one or more forms. Several of these, including the possibility of suspension of trade liberalization, could be costly or create difficulties for other member countries in the Community. Thus, the member countries do have a legitimate interest in each other's monetary behavior.

There has been much discussion as to the proper approach to the balance-of-payments question inside the Common Market. Some people argue for techniques which they believe can prevent balance-of-payments problems from arising inside the Community, and three such techniques have been mentioned: a common currency, the "coordination" of the economic and financial policy of all member countries, and a system of floating exchange rates. Other people argue that balance of payments problems cannot be prevented from arising, and that one can hope only to eliminate or moderate their impact. The main suggestion on this is mutual assistance by all other members to the country in difficulty. Of course, these four ideas are not mutually exclusive.

I shall not attempt to discuss the four in detail. As for the proposal of a common currency, I suggested earlier than this is not a realistic possibility now or in the foreseeable future. Two of the other three ideas are incorporated in the Treaty: the coordination of policy, and the possibility of mutual assistance. As for a system of floating exchange rates, such a system is not necessarily incompatible with the Treaty. (But it is important to bear in mind that this question also involves the IMF.)

What I want to say mainly about these four ideas is that there is no magic in any of them. By this I mean that none of them eliminates the need for a high degree of internal financial stability in each of the member countries. This is essentially true even of the common-currency idea, even if a common currency does permit variable rates of economic expansion in the various segments of the area it serves. I suggested earlier, you will recall, that a common currency would not eliminate balance of payments questions as between the Six and the rest of the world; and it makes no sense to suppose that the Common Market would be concerned if one of its member countries had a balance of payments deficit, but would not be concerned if all the member countries collectively had such a deficit. If a serious deficit of this kind were to be avoided under a common-currency arrangement, a requirement of financial stability would exist implicitly for the Community as a whole.

A system of floating exchange rates would also ultimately require financial stability; for under such a system, a sustained inflationary policy in one or more member countries would ultimately be disastrous, despite the mere technical possibility that balance of payments deficits could for a time be avoided by letting exchange rates float. (By this I do not imply that I am necessarily opposed to floating exchange rates; I mean only that such a system is not a substitute for sane financial policy.) As for coordination of policy among the member countries, this is of course desirable, provided policy gets coordinated in the right direction. Finally, mutual assistance is no substitute for correct policy; it is merely a way to tide countries over until they have made necessary changes in policy, and until such changes have had the desired effect.

I have been discussing these matters solely in relation to the Common Market. However, practically everything I have said about internal financial stability and balance-of-payments questions is equally relevant to the Free Trade Area. Granted that in the last analysis every country needs internal financial stability, that need is especially acute for countries forming part of a system which aims at substantially complete freedom of trade. Although to a lesser extent than the Common Market, the proposed Free Trade Area would be such a system.

However, the need for financial stability is one thing; the prospect of achieving it under either or both institutional plans may be something quite different, although there are grounds for an optimistic view. First of all, it seems to me that from postwar experience the countries of Western Europe have gradually learned (some more slowly than others) that certain rigidities in modern economic life greatly reinforce the need for sound monetary and fiscal policy. Secondly, there are the formal commitments under the Treaty of Rome which I have already cited; I think these should not be regarded as merely verbiage. Thirdly, the very danger which will exist under the new institutions--the danger of very large balance-of-payments deficits--should make parliaments as well as governments acutely and continually conscious of the need for internal stability. A fourth hopeful sign, it seems to me, is the recent dramatic change in the French political picture. What this may mean economically in the short run is not yet clear; but in the long run it should certainly tend to eliminate what has hitherto been an important source of economic instability in Europe during the postwar period.

I would be misleading you, however, if I left you with the impression that in my view there is a strong prospect that important balance of payments problems are unlikely to arise in Europe under the new institutions. Our own domestic concern with the problem of preventing inflation under a system dedicated to the principle of high employment should be a sufficient warning of the difficulties that can still arise. In appraising the prospects for currency stability in Europe, one should bear in mind that in all probability the success achieved will only be relative.