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TOWARD EUROPEAN CONVERTIBILITY

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DEPARTMENT OF ECONOMICS AND SOCIOLOGY
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Princeton, New Jersey

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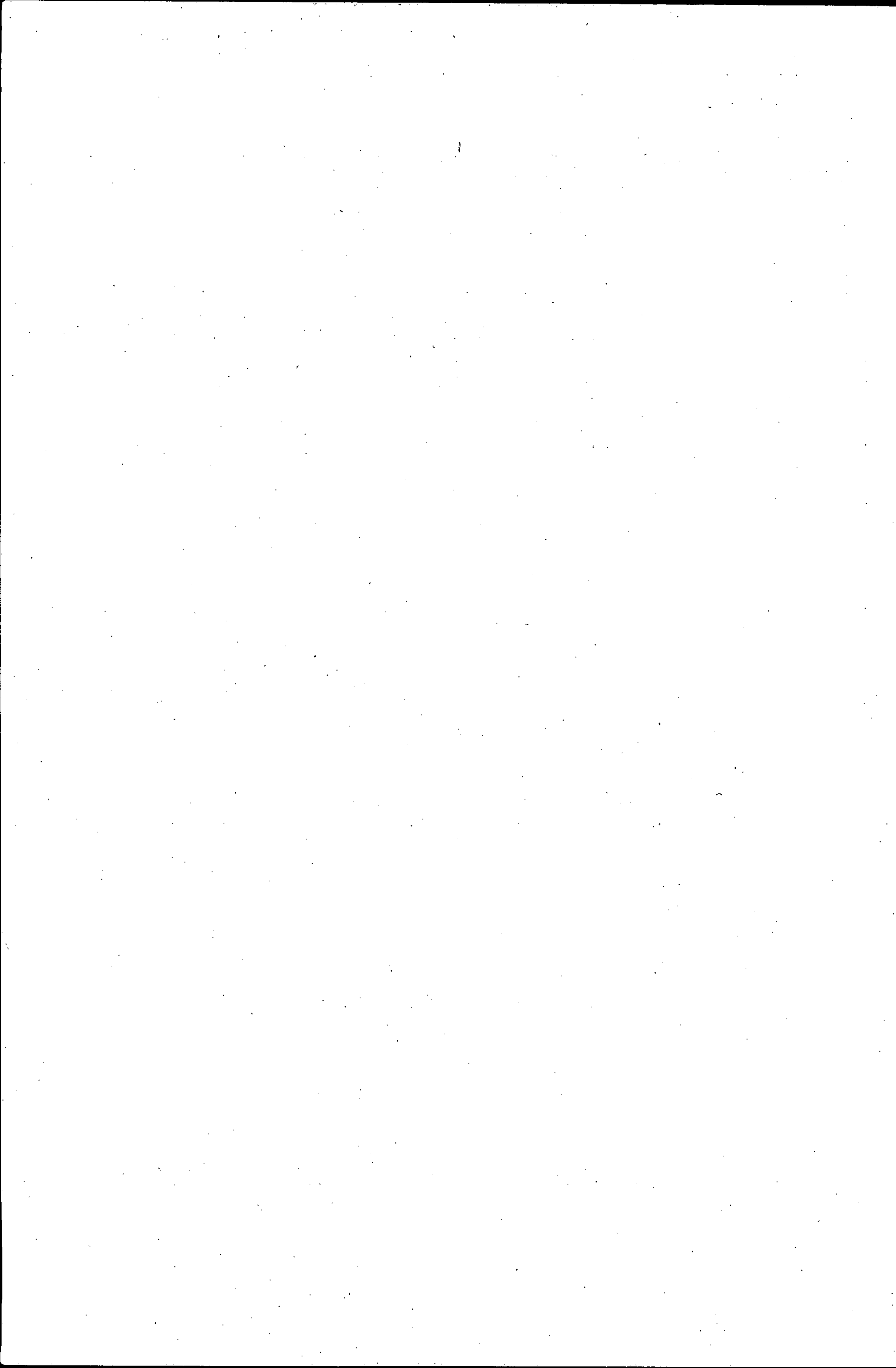

TOWARD EUROPEAN CONVERTIBILITY

THE Second World War, like the First, brought about the collapse of the international financial system. But whereas after World War I, there was an early return to the form, if not the substance, of the *status quo ante*, as embodied in the gold standard, progress since World War II toward the more modest goal of "convertibility" has been at a much slower pace. Moreover, there has been much less agreement and much less confidence with regard to the goal itself. In part, this has been due to the disillusionment stemming from the early collapse of the interwar financial system and, in part, it has been due to a disastrous experiment with convertibility in 1947. But while reconstruction of the international financial framework has been less dramatic than after the First World War, there are good reasons for believing that such progress as has been made rests on firmer foundations, and there can be little doubt that the discussion of objectives has been on a less superficial plane.

The present essay is an attempt to interpret postwar developments in international finance with a view to assessing the degree to which the damage inflicted by World War II (and, earlier, by the world depression) has been repaired. Interest in this subject has fluctuated sharply in recent years. At times, discussion has been largely confined to certain rather narrow concepts of convertibility, almost to the exclusion of commercial considerations. At other times, such as the present, attention has shifted to questions of commercial policy, as reflected in the current preoccupation with the emerging Western European Common Market and the associated proposals for a European Free Trade Area. In this essay, an effort will be made to steer a middle course, in which both financial and commercial considerations are kept in view. Discussions of commercial policy are frequently unfruitful because of failure to give adequate attention to the international financial framework, and this is even more true of discussions of convertibility which forget that international finance is, or should be, the servant of trade.

I. PREWAR BACKGROUND

Prior to the war, the world was united by a multilateral payments system. This was almost as true for the period after the collapse of the gold standard as for the period preceding. With certain exceptions, countries could use their earnings from any part of the world to make

payments to any other part of the world, because the major currencies—that is to say, the currencies in which international trade was transacted—were convertible. This statement applies pre-eminently to sterling since, with the possible exception of the dollar, sterling has always been by far the most important international currency. Before the war, sterling could be used to make payments anywhere. A holder of sterling either could sell it for dollars or other currencies in the foreign exchange market or could pay it direct, for sterling was generally acceptable as an international medium of exchange.*

Because of the convertibility of sterling and other major currencies, most countries had little financial incentive to engage in trade discrimination since, with few exceptions, they were able to use a payments surplus with one country to finance a payments deficit with another.† Under these conditions, a country could largely ignore its bilateral or regional relationships, and needed to be concerned only with its balance of payments as a whole—a situation far different from that prevailing throughout most of the postwar period.

This is not to say that all was well in the sphere of trade and payments before the war. On the contrary, because of the world depression, many countries were confronted with a sharp decline in exports, and thus had great difficulty in maintaining balance in their international accounts. Moreover, partly as a result of the depression and partly as a result of the grave international political situation preceding the war, many countries were faced with an outward flight of capital which added to their payments difficulties. While these developments did not result in a general breakdown in *non-resident* convertibility (that is to say, in the convertibility of foreign-held balances), they led to a serious reduction in what is now frequently termed "resident convertibility"—i.e., in the right of residents to make payments abroad.

In an attempt to restore a measure of over-all balance in their international accounts, a large number of countries introduced one or both of two forms of action: (1) quantitative restrictions on merchandise imports and (2) centralization and control of foreign exchange trans-

* Under the gold standard, convertibility was generally understood to imply the free exchange of currencies at fixed exchange rates (i.e., rates free to fluctuate only within the gold points). After the United Kingdom left gold in September 1931, sterling convertibility no longer implied a fixed relationship to gold or dollars, but during the later 1930's the sterling-dollar rate achieved a high degree of *de facto* stability. Between May 1935 and July 1938, the monthly average of daily rates fluctuated only between a low of $4.89 (March 1937) and a high of $5.04 (September 1936)—a range of only 3.1 per cent (i.e., only 1.5 per cent on either side of the midpoint).

† A considerable degree of tariff discrimination was resorted to by many countries, but was motivated by other considerations—notably political ties.

actions—at first mainly to prevent capital flight but later, on an increasing scale, to limit the volume of imports. Thus, financial controls—that is to say, restrictions on access to foreign exchange—were frequently used as a substitute for trade controls which achieved the same result by aiming directly at the transactions themselves. The economic effects of both forms of restriction were the same, and postwar experience has amply demonstrated the pointlessness of attacking the one without attacking the other.

The effect of these measures in the years immediately before the war was greatly to curtail the right of residents to make payments to foreign countries. Moreover, as a more or less unintended by-product, the new controls provided protection from foreign competition on such a scale as to make earlier tariff protection appear like free trade. Thus, while international financial arrangements in the prewar period were, with certain important exceptions, fully multilateral,* the advantages of a multilateral system were to a considerable extent nullified by the rapid growth of direct controls on trade and payments.

With the outbreak of the Second World War, normal international financial arrangements came to an end. In order to conserve foreign exchange—notably dollars—direct controls over trade and payments were greatly extended and, for the same reason, sterling and other currencies ceased to be convertible, except at administrative discretion, for both residents and non-residents. Within the Sterling Area, which embraced the British Commonwealth (except Canada) and a few other countries, sterling continued to be freely transferable, but it could no longer be sold for dollars. Sterling Area earnings of dollars were centralized in London, and access to the supply was carefully controlled by direct means.

II. A SECOND LOOK AT WAR-TIME PLANNING FOR CONVERTIBILITY

If ever a need was foreseen well in advance, it was the need for adequate international financial arrangements when the war was over. Long before the end of the war, a great deal of thought was devoted to this subject in official circles. It was generally recognized that recon-

* It is advisable to repeat "with certain important exceptions," since it is well known that Germany forced bilateral arrangements on several of its trading partners, and bilateral agreements emerged in certain other cases. Moreover, even sterling was not completely unaffected; in a few cases, the United Kingdom as a defensive measure curtailed the convertibility privilege for sterling flowing to countries which had placed restrictions on the servicing of debts to British creditors. Such measures were exceptional, however, and in the main sterling remained fully convertible until the war.

struction in the sphere of international trade and finance would present formidable difficulties, and it was also widely felt that the state of affairs prevailing in this field in the years immediately before the war had been far from satisfactory.*

Under the leadership of Lord Keynes, the British in 1942 put forward a proposal for an international clearing union. Whatever else may be said about this plan, it was a bold effort to deal with fundamentals. Without going into details, which have been discussed at length elsewhere, it will be recalled that the scheme had two basic objectives: (1) to provide at the end of the war a fully multilateral international payments system, in which any country could offset its bilateral surpluses against its bilateral deficits, and (2) to provide each country with a substantial cushion of international reserves in the form of drawing rights in order to encourage the rapid removal of direct restrictions on trade and payments. The first feature meant that all currencies were to be convertible for non-residents from the outset (at least at the central bank level), while the second feature was designed to promote progress toward resident convertibility as well.

The scheme provided, in effect, for an international clearinghouse, in which each country, through its central bank, would periodically clear all international transactions and thus emerge with a net surplus or net deficit with the system as a whole. Coupled with this were very generous credit features. Each country was to have a large quota of credit, the amount of which was to be based on the magnitude of its trade with other countries. This credit, labelled "bancor," could be used for the financing of net deficits with the union. Indeed, Keynes thought of bancor as a new form of international currency which would be accepted by countries in a surplus position because it could be used at any future time to finance a net deficit with any part of the world. Thus, Keynes argued that bancor would be literally as good as gold, and that if a country were developing a surplus more rapidly than it wished, it could always take measures, such as currency appreciation, to correct the situation.

For a number of reasons, however, the proposal did not obtain a welcome reception in Washington. For one thing, the Americans were already working on their own blueprints for postwar international

*Ironically, the problems anticipated by the British and by the Americans proved to be the reverse of those which actually emerged. Instead of the early postwar depression feared by the British, the war was followed by strong and persistent inflationary pressures throughout the world; and instead of the competitive exchange depreciation feared by the Americans, countries since the war have been much more likely to resist all pressure to devalue, even when their currencies have been sharply overvalued.

financial arrangements, and had acquired a certain pride of authorship in these. In the second place, there was a technical objection. American experts had the impression that United States participation in a clearing union might necessitate, if not exchange control, at least a centralization of foreign exchange transactions in order to be able to establish a periodic net position with the union. While this would not have required exchange *restrictions*, it was felt that it might involve a great deal of form-filling for individuals and a large number of desk jobs for bureaucrats that could otherwise be avoided. Since most other countries already had such an apparatus, no problem was involved for them but, for the United States, the possibility of having to centralize foreign exchange transactions appeared to be a serious technical objection to the British proposal.

Moreover, there was a more fundamental difficulty. The American authorities were afraid that, under the British plan, foreign countries would rapidly use their credit privileges to finance their urgent relief and reconstruction needs arising from the war and that, as a result, the United States would build up an enormous surplus with the union which there would be little prospect of reversing. Such a surplus, as a maximum, could reach the combined drawing rights of the rest of the world—that is to say, under the formula suggested by Keynes, a total of over $30 billion.

It can be argued that this was not a valid objection to the British proposal since, in the postwar years, the United States built up an even larger cumulative surplus in its balance of payments, and largely wrote off the surplus by outright gifts to the rest of the world. This is true, but calls for two comments. In the first place, of course, the magnitude of postwar reconstruction and defense needs was not foreseen. The more important point, however, is that under the British plan the United States would have had no control over the *direction* of its assistance. That is to say, the United States surplus would not necessarily have been accounted for by foreign countries whose needs were greatest, but rather might have been largely directed toward improvident or unfriendly countries. Under the methods of aid actually employed, the United States was able to maintain close control over the total amount of assistance, the rate of assistance, and the direction of assistance.

In any case, the British plan was rejected, and a more conservative proposal—namely, the American proposal for an International Monetary Fund—was adopted. Instead of establishing a worldwide multilateral system from the outset, as proposed in the British plan, the International Monetary Fund simply provided a pool of currency resources which was intended, broadly speaking, to assist member countries in

their efforts to return to convertibility (in both the resident and the non-resident senses) and to help them maintain convertibility once this had been achieved.

The Fund did not commence operations until the second quarter of 1947. Moreover, no timetable was set up for the attainment of convertibility; on the contrary, Fund members were authorized to retain exchange restrictions, for both current and capital transactions, for a postwar transitional period of indefinite duration.

III. EARLY POSTWAR MAKESHIFTS, 1945-1947

In the meantime, countries were left to re-establish international trade as best they could. This was no easy task. In waging the war, Western European countries had seriously depleted their reserves of gold and dollars, and were able to use their holdings of most other foreign currencies only in the country (or currency area) of origin, since these currencies were inconvertible. In addition, the devastation left by the war had cut sharply into the productive capacity of Western Europe, and at the same time had created an urgent need for commodities of many types which for the time being could be obtained only from the Dollar Area. Under such conditions, European countries were highly reluctant to dip into their meager reserves of gold and dollars to make payments to each other, since they badly needed these reserves to help finance their dollar deficit.

These conditions led almost inevitably to the attempt within Europe (as well as between Europe and other non-dollar countries) to restore international trade along bilateral lines. In fact, even before the war had ended, the countries of Western Europe began to negotiate bilateral payments agreements, and by 1950 more than two hundred had been signed. These agreements generally provided for a measure of bilateral credit but, in view of the straitened circumstances in which Europe found itself, the credit element was strictly limited. A country which exceeded the credit limit was required to pay gold, and since European countries wished to avoid payment of gold in non-dollar trade, they took pains to insure, by means of direct controls on trade and payments, that such payment was minimized. These controls were in general highly discriminatory, tending to vary with the requirements of each bilateral position.

Not only was it in the interest of European countries to avoid bilateral deficits but also to avoid bilateral surpluses, since a surplus with one country could not ordinarily be used to finance a deficit with another. The result of these conditions was to encourage a high degree of bilateral

balance. Trade within such limitations was decidedly better than no trade at all, but at the same time highly unsatisfactory, because bilateral pressures seriously impeded European recovery by preventing the return to an efficient pattern of international specialization.

Somewhat different was the situation in the early postwar years between Western Europe and the Dollar Area. Western European countries were not forced into bilateral balance with the Dollar Area, first, because the dollar was convertible and, second, because the United States poured out billions of dollars of aid, making it possible for Europe to finance a large dollar deficit. Nevertheless, European countries were compelled to pay close attention to their bilateral position with the Dollar Area since, at existing rates of exchange, the demand for American goods was far in excess of dollar earnings plus dollar aid. To limit the demand for dollars to tolerable dimensions required tight restrictions on dollar payments which provided as a by-product an exceedingly high level of protection against American competition.

Thus the system of trade and payments which emerged in the early postwar period was far from satisfactory from any point of view. In general, each country had the problem, not only of getting into over-all balance in its international accounts, but of achieving a high degree of bilateral balance as well. The major exception to bilateral settlement in the non-dollar world was the Sterling Area, within which sterling was freely transferable, but sterling arrangements with the outside world were mainly bilateral (with, however, the Sterling Area as a whole as one of the partners).

IV. CONVERTIBILITY—THE FIRST EFFORT, 1947

The first important postwar effort to provide more adequate international financial arrangements was the disastrous attempt in July and August of 1947 to make sterling convertible for non-residents. One of the conditions of the large loan made by the United States to the United Kingdom in 1946 was that sterling should become convertible not later than one year after the effective date of the loan agreement. Under the agreement, the British were entitled, if conditions warranted, to request a postponement of convertibility but, as the date approached, they decided to go ahead.*

* It is interesting to speculate how Lord Keynes would have exercised his leadership in this matter. Keynes led the loan negotiations on the British side and, while favoring sterling convertibility "in due course" as an objective, felt that the one-year target date stipulated by the United States was much too ambitious. With great reluctance, he agreed to the one-year deadline in exchange for an escape clause. He died in April 1946.

To implement convertibility, the United Kingdom made agreements with a considerable number of important non-dollar countries outside the Sterling Area establishing a system of "transferable accounts." Countries participating in these agreements could use sterling for making payments not only to any part of the Sterling Area but also to each other. In addition, during the period of sterling convertibility, they were permitted to use sterling to make payments to the Dollar Area. It should be borne in mind that sterling received by Dollar-Area countries (so-called American and Canadian Account sterling) was already convertible, since Dollar-Area creditors otherwise would have insisted upon payment in dollars.*

The convertibility experiment did not affect arrangements within the Sterling Area. Sterling within this area was already technically convertible in the formal sense that requests by central banks of the Sterling Area for making payments to the Dollar Area were automatically granted by the Bank of England, but such requests were within the framework of stringent controls on trade and payments. This situation was to continue under convertibility.†

There was no intention, of course, of making all outstanding sterling convertible—even for non-residents of the Sterling Area. Mainly as a result of British overseas expenditures during the war, sterling held by countries outside the United Kingdom had reached a total (at the rate of exchange then prevailing) of $14.9 billion at the end of 1946, of which $5.1 billion was held by countries outside the Sterling and Dollar Areas. Conversion of the latter amount would have wiped out the unspent balance of the American and Canadian loans, amounting to $2.2 billion in mid-1947, as well as the British gold and dollar reserves, which in mid-1947 amounted to $2.4 billion. Consequently, convertibility was to be limited to newly acquired sterling, and the United Kingdom, by means of formal and informal arrangements, made efforts to insure that, except for agreed amounts, outstanding sterling balances would remain inconvertible. In addition, "gentlemen's agreements" were made with various non-dollar countries in an attempt to prevent the conversion of sterling for capital transfers to the Dollar Area. To be successful in this objective, the United Kingdom of course needed the

* The flow of sterling from the Sterling Area to the Dollar Area was of course rigorously restricted by means of quantitative controls on trade and by means of financial controls on capital movements and on current invisible transactions.

† With respect to trade controls, the loan agreement contained a clause which stipulated that any quantitative import restrictions maintained by the United Kingdom after 1946 should be administered on a basis which did not discriminate against products of the United States, but the escape clauses were such as to render this provision ineffective.

close cooperation of non-British countries in the administration of their exchange controls.

Sterling convertibility formally went into effect on July 15, 1947. It proved to be a disaster of the first magnitude. Although convertibility was to be limited to newly acquired sterling, and although even the conversion of newly acquired sterling was to be restricted to current-account transactions, the United Kingdom at once began to lose dollars at an alarming rate.* The rate of loss steadily increased and in the final week of the 35-day experiment reached an annual rate of over $11 billion. In view of this situation and in view of the prospect that it might get even worse, the venture was abruptly called to a halt.

In retrospect, it is not difficult to explain why the British attempt at convertibility failed. The problem was not only that there was too much sterling in foreign hands at the beginning of the experiment but that, as a result of normal payments for goods and services, *new* sterling was flowing from the Sterling Area to the outside world (excluding the Dollar Area) at an annual rate of around $5 billion at the pre-devaluation rate of exchange. It was unsafe to assume that this flow of sterling, which under convertibility could be used by the recipients to buy goods and services from the Dollar Area, would continue to be spent in the same way as before convertibility unless it was clear that the Sterling Area, at the exchange rate then prevailing, was fully competitive with the Dollar Area. Unfortunately, there was no such assurance—rather, there was much evidence to the contrary—and it is therefore not surprising that the United Kingdom experienced such an alarming outflow of dollars that it was forced to abandon convertibility.

Other factors, notably capital flight, undoubtedly contributed to the failure of the experiment, but even if these factors had not been present, convertibility would have continued to deplete British gold and dollar resources as long as the Sterling Area remained uncompetitive with the Dollar Area. In this connection, it was unwise in the months preceding convertibility to derive comfort, as some did, from the favorable trade balances that were in evidence with various non-dollar countries, since these net positions were in part determined by the inconvertibility of sterling.† In other words, there was no assurance that net trade posi-

* The loss of dollars came out of the American and Canadian loans to the United Kingdom, and was not reflected in the official British figures for gold and dollar reserves, which did not include the dollars from these loans.

† In this respect, there appears to have been a considerable amount of excessive optimism in the period immediately before convertibility. On the basis of an analysis of trade statistics, the *London Economist,* in an article dated April 5, 1947, declared that "If the promise of convertibility costs Britain as much as £50 million in hard currencies this year, we shall have to deem ourselves very unfortunate." Actually, in

tions after convertibility would resemble those prevailing before convertibility, since convertibility made it possible to use *gross* sterling receipts for making payments to the Dollar Area.

With the breakdown of convertibility, Western Europe was forced to resume arrangements which were mainly bilateral. The United Kingdom retained its system of transferable accounts, but certain important members of the system, such as Belgium and France, withdrew and returned to a bilateral relationship with the Sterling Area. These countries had been willing to accept sterling without limit as long as it could be used to make payments to the Dollar Area, but were no longer willing to do so when the convertibility privilege was removed.

The failure of sterling convertibility confronted policy makers in the various capitals with the necessity of reconsidering their blueprints for the postwar world. On two points, there was fairly general agreement. On the one hand, the *status quo* was satisfactory to few if any countries. On the other hand, in view of the recent sterling disaster, no one in a position of responsibility was prepared to support a program aimed at early convertibility.

V. THE EUROPEAN PAYMENTS UNION— FIRST PHASE, 1950-1952

With the inception of the Marshall Plan in 1948, an important new point of view began to emerge. The Marshall Plan, in a bold new way, concentrated attention on the economic problems of Western Europe, and it at once became clear that a foremost obstacle to European recovery was the network of direct restrictions on trade and payments. At the same time, it was widely felt that European dollar difficulties were so acute that little if any progress could be made for the time being in removing restrictions against the Dollar Area. Nevertheless, it was contemplated that the large-scale reconstruction promoted by the Marshall Plan would gradually make Western Europe more competitive and thus would eventually make possible a general freeing of trade and payments. In the meantime, prospects for progress appeared to be limited to the freeing of trade and payments within Europe. This was regarded, however, not only as a highly worthwhile achievement in itself but as an important and perhaps essential stage in the transition to a fully multilateral system. It was recognized that such an approach would be discriminatory in the sense that an effort would be made to remove intra-European quantitative restrictions without a simultaneous

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the final days of convertibility, the United Kingdom lost more than this amount in one week.

effort to remove such restrictions against the outside world, but it was not contemplated that this discrimination would or should be permanent.*

After certain piecemeal and not very successful efforts to deal with the more onerous evils of bilateralism, this new point of view found expression in 1950 in the establishment of the European Payments Union, which effectively ended for member nations the intra-European bilateral regime. The European Payments Union, which is perhaps better known by its initials, embraces the countries of Western Europe, except Spain and Yugoslavia, and their associated monetary areas (including the Sterling Area) in a multilateral arrangement which borrows some of the main features of the British proposal of 1942 for an international clearing union. As under the British plan, a member country is able to offset its bilateral surpluses against its bilateral deficits anywhere within the system, and thus is free from any pressure to balance bilaterally. Consequently, the only matter which concerns a member country is its net position, whether surplus or deficit, with the system as a whole. Also, as under the British plan, each member is assigned a quota, based on the level of its trade with other members, which determines the amount of its drawing right with the Union.†

The United States Government played a leading role in the difficult negotiations leading to the creation of the Union. It supported the new institution as a means of promoting the economic integration of Western Europe and as an important step toward a wider and freer system of international trade and payments—that is to say, as a half-way house on the road from bilateralism to a fully multilateral system. To this end, the United States contributed a capital fund of $350 million.‡

* This assessment of the situation was not shared by all segments of Western European opinion. In particular, there were some in academic circles and elsewhere who were so pessimistic about European dollar difficulties that they were prepared to regard the liberalization of intra-European trade and payments, not as a transitional measure, but as a final objective; that is to say, they were resigned to a very high degree of discrimination against the Dollar Area on a permanent basis. This was never the dominant view, however, and it has become progressively less influential with the passing of time.

† With certain exceptions, a member country's quota was originally established at 15 per cent of its total visible and invisible trade with the EPU area in 1949. Initially, the combined quotas amounted to $3,950 million, of which the quota for the United Kingdom, representing the Sterling Area as a whole, accounted for $1,060 million.

‡ The United States Government maintains a continuing influence in the affairs of the Union, which is governed by a Managing Board of seven members. Meetings of the Managing Board are attended by a United States representative, who has the right to participate in discussions but not in decisions. While without a vote, the United States representative has, in effect, a power of veto on certain questions affecting the EPU capital, and the EPU Agreement provides that the renewal of the Union, which has

The mechanics of the EPU are basically very simple. Once a month, the central bank of each member country reports to the Union (actually to the Bank for International Settlements, which serves as the Union's agent) the position of its accounts with each of the other member central banks, and from this information a net position for each country is calculated.* During the first four years of the EPU, these net positions were settled on a rather "soft" basis according to a somewhat complicated set of rules which has since been greatly simplified. Under the original regulations, net positions were financed mainly with credit, the rules providing for gold settlements within the quotas averaging 40 per cent of net positions for both debtor and creditor countries.

From a technical point of view, it is interesting to note not only those aspects of the payments mechanism that were altered by the EPU Agreement but also those aspects that remained unchanged. For example, member countries as a general rule retained their bilateral payments agreements, but they were required to amend these in certain important respects. In the first place, member countries assumed an obligation to extend unlimited bilateral credit to partner member countries between the monthly settlement dates.† That is to say, they could not require any gold payments in addition to those provided for by the monthly settlements. In the second place, member countries agreed that their bilateral surpluses and deficits should be fully offset at monthly intervals and that their residual net payments positions should be settled, not according to the widely varying gold-payment provisions of their existing bilateral payments agreements, but according to the standardized gold schedules of the EPU Agreement.

Other features of the pre-EPU system continued as before. In general, all foreign exchange transactions continued to be centralized by, and channeled through, the central banks, and there was nothing in the EPU Agreement as such to require member countries to relax their exchange controls or to modify their control apparatus. On the contrary, under the original EPU system, which has since been profoundly modified, centralization of foreign exchange transactions was regarded as necessary for providing the information required to establish the monthly net payments positions.

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been effected on an annual basis since 1952, must be negotiated in consultation with the United States Government.

* Net positions are expressed in the EPU unit of account, which is equivalent to the United States dollar.

† Strictly speaking, the EPU Agreement imposed this obligation only within the limits of the quotas but, in practice, as a result of *ad hoc* decisions made by the members, creditor countries outside their quotas have always continued to extend bilateral credit without restriction between the monthly settlement dates.

Having said this, it is important to emphasize that the European Payments Union is of major significance mainly because it was combined with, and made possible, a bold program calling for the immediate removal of trade discrimination within Western Europe and for the progressive removal of quantitative restrictions on intra-European trade.* By enabling a member country to use its bilateral surpluses to finance its bilateral deficits, and by establishing rules of settlement which applied uniformly to all member countries, the EPU entirely removed the financial motivation for intra-European bilateralism and discrimination. Moreover, by providing international reserves in the form of generous credits which could be used to finance the greater part of any net deficits that might arise with the system as a whole, the EPU made possible the large-scale removal of quantitative restrictions on imports from member countries.†

The progress in the removal within Western Europe of both trade discrimination and trade restrictions was rapid and dramatic. In November 1949, a few months before the establishment of the Union, only 30 per cent of intra-European trade was free from quantitative restrictions, and much of such freedom as existed was extended on a discriminatory basis—that is, was extended to certain Western European countries but not to others. By the end of 1950, after only three months of EPU operation, 60 per cent of intra-European trade had been freed from quantitative restrictions, and all such freedom was made nondiscriminatory—i.e., was extended to all EPU members.‡ During the next six years, the over-all percentage of liberalized trade was progressively

* The trade program has been under the supervision and guidance of the OEEC Steering Board for Trade, a seven-member committee which functions at the same level as the EPU Managing Board. This committee deserves great credit for the energy and vision with which it has tackled problems of commercial policy in Western Europe. Like the Managing Board, it has a United States representative, who has the right to participate in discussions but not in decisions.

† Also of great importance in this connection was the emphasis which the OEEC and the EPU placed on consultation among member countries with a view to removing the causes of individual country imbalances. The monthly meetings of the EPU Managing Board have often been largely concerned with such consultations, and have frequently resulted in highly constructive measures of mutual cooperation. Moreover, the Managing Board periodically reviews the position of every member country, whether in trouble or not, and thus is sometimes able to nip difficulties in the bud.

‡ EPU countries confined their initial attack on trade barriers to quantitative restrictions, since in the early postwar period these were by far the most important obstacle to intra-European trade. The current shift of attention to tariffs revealed in the project for a European Common Market and in the negotiations for a European Free Trade Area is largely a reflection of the reappearance of tariffs as the major impediment to trade—that is to say, a reflection of the success achieved in removing quantitative restrictions.

raised.* By early 1957, about nine-tenths of intra-European trade was quota-free; the reintroduction of French restrictions in that year reduced this proportion to a little over four-fifths.† Several countries, such as Belgium, Germany, Italy, the Netherlands, and Switzerland, have removed almost all direct restrictions on imports from EPU countries.

This liberalization contributed to a spectacular increase in intra-European trade. With 1949 equal to 100, the volume of intra-European imports rose to 141 in 1950, to 151 in 1951, and by 1956 had climbed to 226. This increase in trade reflected not only the rapid removal of quantitative restrictions under the trade program but also a progressively more liberal treatment of imports under existing restrictions. Both of these developments were greatly facilitated by the establishment of the EPU.

VI. PROGRESS TOWARD RESIDENT CONVERTIBILITY

While its success in promoting the removal of direct restrictions on intra-European trade justified all expectations, the European Payments Union during its first two years of operation made no clearly apparent contribution to a wider system of trade and payments. The "Gold Curtain" dividing the dollar and non-dollar worlds remained as impenetrable as ever. Little if any progress was made in reducing European restrictions on imports from the Dollar Area and, since intra-European restrictions had been sharply diminished, the degree of European commercial discrimination against the Dollar Area was actually considerably increased. The gold and dollar reserves of EPU countries remained at a low level; in fact, in mid-1952 they were still somewhat lower than at the end of 1945. The machinery of exchange control remained completely intact in most EPU countries, and the

* So-called "liberalized trade"—i.e., trade free from quantitative restrictions—is carefully defined for EPU members in the OEEC Code of Liberalization. In the first place, such trade must be free both from trade controls (controls which work by prohibiting the transaction) and from financial controls (controls which work by preventing the payment). In the second place, if import licenses are required (e.g., for statistical purposes), they must be granted automatically and without delay.

† These figures, which are derived from the official percentages, have been purposely rounded, since they are at best a rough measure of liberalization. The OEEC measures intra-European liberalization on the basis of the composition of imports in a base year (for most countries 1948). For example, if a given commodity accounted for 5 per cent of a member country's imports (on private account) from EPU countries in 1948, and if the commodity is free from quantitative restriction, the country receives credit for 5 per cent liberalization. The liberalization percentage for EPU (OEEC) countries as a group is an average of the country figures, with each country weighted according to its importance in intra-European trade in the base year.

terms of the monthly EPU settlements continued on the original soft basis. Under these conditions, there appeared to be some justification for the concern expressed in certain American circles that the Union was having the effect of consolidating and perpetuating a high-cost, soft-currency area.

From about the middle of 1952, however, a number of developments began to take shape which sharply altered the situation in a more hopeful direction. In the first place, Western European gold and dollar reserves, as a delayed reaction to European recovery, commenced a remarkable rise. After falling sharply in the early postwar period (from $10.5 billion at the end of 1945 to $7.7 billion at the end of 1947), such reserves had recovered by mid-1950 to a level of around $10 billion, and remained in this neighborhood until mid-1952. Thereafter, they rose spectacularly and with little interruption, although the rate of growth diminished after 1954. From a level of $10.1 billion at the end of 1951, reserves rose to $17.7 billion at the end of 1957.* That is to say, in a period of only six years, Western European gold and dollar reserves rose by 76 per cent, and in 1958 were well over twice as large as at the end of the 1940's.

This rise in reserves, which was basically a reflection of European recovery since American aid was steadily declining, had an important impact on European trade and payments. In the first place, it made possible a sharp reduction in European restrictions on imports from the Dollar Area. At the beginning of 1953, only 11 per cent of Western European (OEEC) imports from the United States and Canada were free from quantitative restrictions. By the beginning of 1954, this figure had been raised to 32 per cent, by April 1, 1955 to 47 per cent, and by June 30, 1956 to 59 per cent. In 1957, almost two thirds of Western European imports from the United States and Canada were free from quantitative restrictions. This means that, whatever may be said with respect to non-resident convertibility, there has been a significant and steady increase in *resident* convertibility in Western Europe—that is to say, in the right of residents to make purchases in the Dollar Area.

The increase in European monetary reserves has also made possible a very considerable hardening of the EPU system. The original 40 per cent average gold-settlement ratio for monthly EPU positions was raised in 1954 to a flat 50 per cent, and in 1955 was again raised to a flat 75 per cent.† This hardening of the terms of settlement for current

* Source: *Federal Reserve Bulletin* for March 1956 and subsequent issues. Gold and dollar reserves of the independent members of the Overseas Sterling Area are not included.

† In addition, EPU debtor countries in June 1954 voluntarily entered into arrangements with EPU creditor countries providing for the contractual repayment of about

positions in the EPU has been an important factor in promoting the removal of European dollar restrictions and in reducing discrimination against the Dollar Area. On the one hand, EPU creditor countries can now use 75 per cent of an EPU surplus to finance a deficit with the Dollar Area, whereas under the original rules they were able to use less than half. On the other hand, EPU debtor countries have less incentive than formerly to discriminate against the Dollar Area since, under present rules, an EPU deficit is not a great deal easier to finance than a dollar deficit.

By many observers, particularly on the Continent, this line of evolution was regarded, in the early 1950's, as the proper approach to full convertibility, the ultimate objective being an EPU with monthly settlements effected 100 per cent in gold. Under such a system of gradually increasing central bank convertibility, the financial incentive for trade discrimination against the outside world would become progressively weaker and finally disappear. At the same time, with the gradual improvement in monetary reserves, EPU countries could progressively increase the degree of resident convertibility.

VII. BRITISH PLANS FOR CONVERTIBILITY, 1952-1953

The approach to convertibility just described was widely favored in such countries as Belgium, Italy, the Netherlands, and Switzerland. This point of view, however, was not shared by the British. In their own approach to convertibility, the British were primarily interested in restoring sterling to its prewar pre-eminence as an international currency. They wished to return to a situation in which the bulk of international trade would be transacted and financed in sterling and in which sterling, like dollars, would be widely held as a convertible monetary reserve. Because of this objective, the British were strongly opposed to a permanent EPU in any form. As a regional clearing system, the EPU tended to make all member currencies of equal importance and to discourage doing business in any particular one. More important, under the EPU system, member countries were not permitted to build up monetary reserves in the form of sterling, since all changes in member currency balances held by member central banks had to be reported monthly to the Union and to be compensated according to the EPU rules (i.e., to be transformed into EPU credit and gold). For these

three fourths of their debt to the Union. Of the $858 million of debt thus consolidated, $224 million was paid immediately to the creditor countries and the remainder in installments over a period of years. Substantial further consolidation of EPU debt has been achieved by subsequent voluntary arrangements of the same nature.

reasons, it was with strong misgivings that the British joined the Union in 1950 and, for the same reasons, the British were rigidly opposed to any approach to convertibility which envisaged a permanent EPU.

Late in 1952, the United Kingdom indicated that it was once more interested in an early return to non-resident convertibility for sterling. This was five years after the disastrous experiment with sterling convertibility in 1947. On the other hand, it was at a time when the monetary reserves, both of the United Kingdom and of Western Europe as a whole, were still at low levels, and it was before there had been any significant reduction in European restrictions on imports from the Dollar Area.

In certain respects, the British conception of sterling convertibility in 1952 was much the same as in 1947; in other respects, the conception was different. As in 1947, the restrictions on imports of goods and services and on capital transfers maintained by the Sterling Area (including the United Kingdom) against the outside world were to remain unchanged. Moreover, with vivid memories of the 1947 disaster, the British did not wish sterling convertibility to be accompanied by an early removal of Western European dollar restrictions and dollar discrimination. That is to say, the British not only intended to retain discrimination themselves, but expressed the hope that continental Western European countries would continue for an indefinite transitional period to maintain their discriminatory restrictions against the Dollar Area.

In two important respects, however, the approach to sterling convertibility in 1952 was different from the approach in 1947. In the first place, there was a different attitude toward the exchange rate. The British in 1952 felt that the enormous loss of dollars during the 1947 experiment could have been avoided if there had not been the attempt at the same time to support a rigid sterling-dollar rate that was badly out of line. Although a more realistic exchange rate had been achieved as a result of the devaluation of 1949, the British in their new approach to convertibility were of the view that the wisest course would be to return to the situation prevailing throughout most of the 1930's, when the United Kingdom was not committed to a fixed exchange rate for sterling.*

In the second place, the British in their new thinking were interested, not simply in setting up a form of convertibility for central banks, but in achieving a return to "market convertibility"—that is to say, con-

* This was the dominant official view. There were, of course, differences of opinion on these matters in both official and academic circles.

vertibility via the foreign exchange market. Under this conception, nonresidents of the Sterling Area (if permitted by their own monetary authorities) could sell sterling for dollars or other currencies at exchange rates determined by the market—i.e., by supply and demand.* To this end, the British authorities had already taken certain steps to restore a private market in foreign exchange and, as will be indicated later, were shortly to take more important steps.†

The British hoped and expected that a number of the financially stronger continental countries would join them in making their currencies convertible for non-residents. They rightly pointed out that the more countries embarking on a move to convertibility, the less would be the risk for any one of them, since each such undertaking would enlarge the possibilities of the group for financing deficits with any part of the world and would of course also enlarge the volume of convertible monetary reserves.

In exchange for sterling convertibility (as thus conceived), the British laid down two conditions. The first, which was perhaps more of a hope than a prerequisite, was large-scale financial backing from the United States or from international financial institutions. The second and more important condition was British withdrawal from the EPU. The British emphasized that, for several reasons, their conception of market convertibility was incompatible with continued membership in the Union. On the one hand, they would no longer be drawing on their EPU line of credit, but would be paying all their bills to EPU members in convertible sterling. Such sterling—if market convertibility were to mean anything—would no longer be thrown into the EPU clearing (as required by the EPU rules), but either would be sold in the foreign exchange market for dollars or other currencies or, like dollars, would be held as a monetary reserve because it could be used for making payments to any part of the world. On the other hand, continental member countries would have a strong incentive to run through their EPU drawing rights to obtain sterling which, being convertible, could be used to finance a dollar deficit. Under such conditions,

* It was contemplated that the British monetary authorities would enter the market from time to time on either the demand or supply side in order to prevent excessive or unwanted movements in the exchange rate.

† The first step in this direction was taken in December 1951, when the British widened the spread of official spot rates for the dollar from a narrow range of 1/8 of a cent on either side of parity ($2.80) to a range of 2 cents on either side of parity. Within the new limits ($2.78-$2.82), authorized banks were permitted to engage in authorized transactions in either the spot or the forward markets. At the same time, the forward exchange rate was unpegged, and was permitted to be determined by market conditions.

the British pointed out, the United Kingdom would tend to develop enormous surpluses in the Union which, under the rules then prevailing, would be financed mainly by the extension of credit. Thus the United Kingdom would be paying all its bills to EPU countries in convertible sterling while extending credit for the greater part of its current claims on such countries. In view of this prospect, it is not surprising that the British authorities insisted on leaving the Union as a prerequisite for sterling convertibility.

The reaction of most continental countries to the British proposals was far from enthusiastic. Apart from strong misgivings about a flexible sterling exchange rate, the continental countries feared that British withdrawal from the EPU (plus the withdrawal of other EPU members induced to undertake non-resident convertibility at the same time) would in effect mean the end of the Union, together with much or all that had been achieved in the removal of intra-European trade restrictions. Moreover, they could see little advantage in disrupting existing arrangements in order to obtain new financial privileges that they could not use as long as they complied with the British request not to relax restrictions on payments to the Dollar Area.

In view of the rather cold continental reception and in view of the unwillingness of the new United States administration to provide any financial backing, the British tabled their plans for an early return to sterling convertibility. The debate which they precipitated, however, was of great value both in leading to a more profound analysis of the issues and in convincing the British as well as the continental countries that each side would have to make adequate allowance for the legitimate interests of the other.

The discussion convinced the British that progress on the financial front should not be made at the cost of retreat on the commercial front—that whatever had been achieved in the sphere of intra-European trade liberalization should not be lightly risked but should be preserved and if possible extended. The British also yielded to the continental position that sterling convertibility should be preceded by a substantial reduction in Western European restrictions against the Dollar Area—i.e., by a substantial increase in *resident* convertibility. Otherwise, sterling convertibility either would be of limited interest to continental countries, because frustrated by trade controls, or would run the risk of disaster, either in the form of a massive loss of gold or dollars, as in 1947, or in the form of a drastic fall in the sterling-dollar rate. On the other hand, the continental countries acquired a new appreciation of the particular interests of the United Kingdom, notably the British interest in restoring sterling to its traditional position of pre-eminence.

While many continental observers did not sympathize with this as an objective, most of them agreed that British aspirations would have to be fully taken into account if effective cooperation on both sides of the channel were to be assured.

VIII. RESTORATION OF MARKET MECHANISM IN FOREIGN EXCHANGE

While thwarted in their efforts to make sterling convertible in 1953, the British have since exercised financial leadership of a very high order, both in sponsoring important reforms in the EPU system and in modifying the sterling system in the direction of convertibility. As will become clear, the British have gradually achieved a degree of *de facto* convertibility substantially equal to, and in some respects surpassing, that unsuccessfully attempted in 1947 and that envisaged in 1952-1953.

The first of these developments was the intra-European arbitrage system, which was introduced as a result of British initiative in May 1953. Because of its rather technical nature, this innovation has not received the attention it deserves, and its role in profoundly altering the character of the European Payments Union has been widely overlooked. Originally confined to eight EPU countries, the arbitrage scheme now embraces all countries in the Union except Greece and Turkey. The new arrangements, by permitting participating countries to re-establish private markets in foreign exchange, have made unnecessary a great deal of activity that had hitherto been performed by central banks. At the same time, they have introduced a measure of flexibility that was badly needed in the EPU system.

Under the new procedures, authorized operators in the participating countries are permitted to sell participating currencies to authorized importers and to buy participating currencies from exporters at exchange rates determined, within agreed limits, by the market. They are also permitted to engage in arbitrage transactions involving participating currencies. Originally, such operations were confined to spot transactions, but after a few months the scope of the scheme was broadened to include forward transactions. Prior to the arbitrage arrangement, EPU exchange rates were in general kept rigidly fixed, and central banks settled their EPU obligations at the official parities of exchange. Under the arbitrage system, central banks continue to settle at par, but exchange rates in the market are permitted to fluctuate by three quarters of one per cent on either side of parity. In the case of the United Kingdom, for example, the Bank of England stands ready to buy all French francs offered by the London market when the market

rate for francs falls to a discount, in terms of the official sterling-franc parity, of three quarters of one per cent; and it also stands ready to sell all francs demanded by the market when the market rate rises to a premium of the same amount.*

At the present time, the monthly net positions in the EPU are to a major extent simply a reflection of such central bank interventions in the foreign exchange market. This is a very different situation from that prevailing in the early years of the Union. It will be recalled that the EPU was superimposed on a system of bilateral payments agreements under which, in principle, *all* payments were channeled through the central banks and were directly reflected in the balances which EPU central banks maintained with one another. Under this system, all *clearing* took place at the monthly settlements. In marked contrast to this situation, payments in most EPU countries are now effected through the foreign exchange market, and much of the clearing function has been taken over on a continuous basis by arbitrage transactions. As before, the monthly net EPU positions are derived from changes in central bank balances, but such changes may now be largely or exclusively the result of stabilization operations arising out of commitments to keep market exchange rates within agreed limits.

This may be understood better by considering specific cases. For many months during the years 1953-1957, Germany was running large monthly surpluses in the EPU. Under the arbitrage system, this meant that in German financial centers foreign EPU currencies were tending to sell at a discount, in terms of their official parities with the deutsche mark, whereas in Amsterdam, London, and Paris the deutsche mark was tending to sell at a premium. The German central bank was committed to buy all EPU currencies offered by the German market when these fell to the agreed floors, while in Paris (for example) the Bank of France was committed to sell deutsche marks to the Paris market when these rose to the agreed ceiling. The Bank of France was able to obtain such deutsche marks by making use of its overdraft facilities with the German central bank; such facilities, as indicated earlier, are unlimited between the monthly settlement dates. The resulting changes in central bank balances, both in Germany and in the other EPU countries, had to be fully reported at the end of each month to the EPU Agent and, in the case of changes of the type just described, yielded a net surplus position.

For a debtor country in the Union, the situation is just the opposite.

* If they wish, participating central banks may enter into agreements with other participating central banks to intervene in the market before the support points are reached.

For example, during the period when Germany was running large surpluses in the EPU, France was frequently running large deficits. Accordingly, the franc was weak in EPU financial centers outside France, requiring support from time to time by the respective central banks, whereas in Paris, the guilder, the deutsche mark, and other EPU currencies tended to be strong, and could be kept from rising above the agreed ceilings only by the commitment of the Bank of France to supply these currencies to the Paris market whenever the market rates reached a premium of three quarters of one per cent. The French deficit in the EPU was largely the result of the changes in central bank balances arising out of these stabilization operations.

These arrangements have been described in considerable detail because they have profoundly modified the character of the European Payments Union. They have made it possible for EPU member countries completely to dismantle their exchange control apparatus so far as non-dollar transactions are concerned. At the same time, countries which do not wish to go as far as this are under no compulsion to do so. Thus there has been a great increase in flexibility. If a participating country wishes, it can require a piece of paper—that is to say, specific permission—for every single exchange transaction. In this case, the level of demand in the country's foreign exchange market is clearly limited by these pieces of paper. A participating country may also require exporters immediately to sell their receipts of participating currencies to the market. On the other hand, if a participating country wishes to do neither of these things, it has no obligation to do so. Actually, the arbitrage arrangements have permitted and encouraged a progressive dismantling of controls, and there has hardly been a month in recent years when important steps in this direction have not been taken by one or more EPU countries. These arrangements, which the EPU owes to British ingenuity and leadership, not only have revived a great deal of pre-war *expertise*, but have demonstrated that a clearing union can operate successfully without exchange control or even exchange surveillance.

IX. PROGRESS TOWARD *DE FACTO* NON-RESIDENT CONVERTIBILITY

In addition to setting in motion the intra-European arbitrage system, the British have taken a series of steps since 1953 that have brought sterling to the very brink—if not past the brink—of (non-resident) convertibility. In March 1954, the United Kingdom abolished bilateral-account sterling, and placed all countries outside the Sterling and

Dollar Areas (with the brief exception of Hungary, Iran, and Turkey) in the transferable-account system. This meant that all sterling flowing from the Sterling Area to countries outside the Dollar Area could be used to make payments to any part of the world except the Dollar Area.

Indeed, the step went further than this. In order to make the new arrangement agreeable to countries that otherwise might not have been willing to accept sterling without limitation, the British authorities in effect gave their blessing to the free markets in transferable sterling that had already been in existence for a number of years on a more or less black-market basis. Moreover, in February 1955, the British authorities made the bold decision to use British monetary reserves to support the transferable-sterling rate when necessary in order to prevent the rate from falling to a significant discount in terms of the official sterling-dollar rate.* Since 1955, the discount has seldom exceeded one per cent, and since September 1957 the rate for transferable sterling has generally been well above the lower limit ($2.78) for official sterling.

These developments have opened the door to *de facto* non-resident convertibility, since holders of transferable sterling—that is to say, all holders of sterling outside the Sterling and Dollar Areas—can use the sterling to buy dollars (if permitted by their own exchange authorities) at an exchange rate which differs little from the official sterling-dollar rate. This is an encouraging situation, and it reflects, among other things, the steady reduction in recent years in the sterling balances held by countries outside the Sterling and Dollar Areas. At the end of 1947, such balances amounted to $5.1 billion at the rate of exchange then prevailing. By the end of 1949—mainly as a result of devaluation—these had dropped to $2.8 billion. From this level of close to $3 billion, sterling balances held by the present transferable area have gradually fallen to a figure of $1.5 billion as of the end of 1957. That is to say, the dollar value of such balances at the end of 1957 was only 29 per cent of the dollar value a decade earlier, despite a virtual doubling in the dollar value of international trade. This development, together with the greatly improved competitive position of the Sterling Area, has enabled the United Kingdom to achieve, on a *de facto* basis, what it disastrously attempted in 1947 and prematurely planned in

* The purpose of this action was to render unprofitable "commodity shunting" operations, in which the Sterling Area was deprived of dollars for exports which were nominally consigned to the transferable area but which were actually destined for the Dollar Area. The nature of such transactions is well described in Roy F. Harrod, "The Pound Sterling, 1951-1958," *Essays in International Finance*, No. 30, pp. 25-26.

1952-1953. Since such convertibility has been accompanied by a much higher degree of resident convertibility within the Sterling Area than in either 1947 or 1952, the achievement has actually been of much wider significance than the earlier efforts, even if they had been successful.

While attention in this discussion has been concentrated on sterling, because of its special position in international finance, it should be pointed out that several continental countries have followed the British lead in increasing the transferability and, in some cases, the effective convertibility of their currencies. Thus, in April 1954, Germany simplified and liberalized its currency arrangements along the lines adopted a month earlier by the United Kingdom, when it abolished bilateral-account sterling. Similar measures to increase transferability have subsequently been taken by such countries as Belgium, France, Italy, the Netherlands, and Sweden. These measures in most countries have been accompanied by a steady relaxation of controls on both current and capital transactions, and consequently have reflected substantial progress toward resident as well as non-resident convertibility.

X. ARRANGEMENTS FOR FORMAL CONVERTIBILITY

In addition to taking important steps in the direction of *de facto* convertibility, the EPU countries in 1955 worked out plans for an orderly return to formal convertibility. These blueprints are embodied in the European Monetary Agreement of July 1955, which is to come into force whenever EPU countries accounting for 50 per cent or more of the combined EPU quotas decide to undertake a joint move to convertibility. At the time of such a move, the Union is to go out of existence, and its credit functions—considerably transformed—are to be taken over by a "European Fund," while its clearing functions—also considerably transformed—are to be taken over by a "multilateral system of settlements." These arrangements, which are spelled out in detail in the Agreement, are the product of a high degree of ingenuity and financial statesmanship. Before describing them further, it will be helpful to review briefly the conflicting interests which they are designed to reconcile.

As indicated earlier, both the United Kingdom and the continental EPU countries had by 1954 reached agreement on the need, in any approach to convertibility, to preserve and, if possible, to extend the progress already achieved in the removal of restrictions on intra-European trade. They had also agreed that this objective would require,

in addition to carefully drafted trade rules,* provision for adequate credit resources to replace those which would disappear with the end of the EPU. Accordingly, during 1954 and 1955, a plan was worked out for the creation of a European Fund of $600 million, consisting in part of convertible assets to be taken over from the EPU and in part of contributions from member countries. The purpose of the Fund was to provide loans, on a non-automatic basis, to member countries confronted with difficulties which, in the absence of financial assistance, might require the imposition of intra-European trade restrictions.

On these matters, there was general agreement on both sides of the channel. There remained, however, a sharp difference of opinion on what further arrangements, if any, would be needed after a move to convertibility. In supporting the European Fund, as well as an appropriately revised body of trade rules, the British felt that they had gone as far as they could go to meet the continental concern that convertibility should not endanger intra-European trade liberalization. In particular, they did not wish to see the EPU replaced by any form of clearing mechanism, because they regarded clearing as incompatible with their conception of market convertibility. As indicated earlier, the British felt that a post-EPU clearing system would reduce sterling to the same status as other member currencies, would prevent or discourage other member countries from holding sterling balances, and would interfere with the British desire to adopt a flexible, or more flexible, sterling exchange rate.

Moreover, the British were strongly of the opinion that clearing, after a general move to convertibility, would be superfluous. From a technical point of view, convertibility, as the British saw it, was simply a matter of introducing the dollar into the foreign exchange market that had already been re-established with the help of the EPU arbitrage system. Under such a system, the British could see no need for a clearing union with systematic settlements, since clearing would be effected on a continuous basis through arbitrage transactions, while "settlement" could be effected at any time in the market by selling surplus holdings of sterling or other convertible currencies for dollars.

The continental countries were by no means persuaded by this line of reasoning. They could see that a clearing system would not be needed by the countries with convertible currencies, but they emphasized that a number of the financially weaker EPU countries would not be prepared to participate in a joint move to convertibility. In the absence of

* Which would have to take into account the obligations which most EPU countries had as members of the International Monetary Fund and as signatories of the General Agreement on Tariffs and Trade.

a clearing system, such countries might be forced back into a regime of bilateralism and intra-European trade discrimination. Moreover, the continental countries had strong misgivings concerning the British desire for a more flexible sterling exchange rate, and they felt that periodic clearing would provide a form of protection against losses resulting from exchange-rate fluctuations. Accordingly, they were highly reluctant to let the clearing features of the EPU disappear without replacing them with a multilateral-settlements mechanism of some kind.

This is how matters stood in the early months of 1955, and it was difficult to see how a compromise could be worked out which would meet the desires and interests of both the British on the one hand and the continental countries on the other. Fortunately, the dimensions of the problem of achieving a satisfactory compromise were reduced by a change in the British position with regard to exchange-rate policy following convertibility. Instead of avoiding, as in 1952-1953, any commitment concerning the future level of the sterling-dollar rate, the British indicated in 1955 that they were willing to confine fluctuations within publicly announced and fairly narrow limits on either side of parity. The British were still opposed, however, to even a voluntary clearing system after convertibility, since such a system—if settlements were to be made at par (as in the EPU)—would induce member countries to unload their sterling balances into the clearing whenever the market rate for sterling was below par.

An ingenious way out of this difficulty was provided by a Dutch proposal put forward in mid-1955. The Dutch financial officials shared the continental desire to retain some form of clearing after convertibility, but they also understood the reasons for the British objections. In particular, they had the insight to realize that the basic British objection to post-EPU clearing would be removed if a system could be devised which dispensed with settlements *at par*. Accordingly, they worked out a system of voluntary clearing under which settlements would take place, not at the official parities of exchange, but, depending on the nature of the transaction, at either the lower or the upper limit within which exchange rates were permitted to fluctuate. As the British were quick to recognize, the great virtue of the Dutch scheme was that, where convertible currencies were involved, a country would almost always find it more advantageous (and would never find it less advantageous) to make use of the facilities provided by the foreign exchange market than to make use of those provided by the periodic clearing.

The Dutch proposal became the basis for the "multilateral system of settlements" of the European Monetary Agreement. This system, which (with the European Fund) is intended to replace the EPU, is designed

to embrace both convertible currencies (defined as currencies which are "quoted" in the foreign exchange market) and inconvertible currencies (currencies which are not quoted in the market). When the system goes into operation, a member country will have three principal obligations: (1) to establish a "buying rate" and a "selling rate" for dollars, the two rates representing respectively the upper and lower limits within which the exchange rate is permitted to fluctuate;* (2) to make available, as "interim finance" between the monthly settlements, an agreed amount of its currency to other member countries requesting such assistance;† and (3) to pay in U.S. dollars its net debt, or to accept in dollars its net claim, in the monthly settlement.‡

At the same time, a member country will have two main privileges. In the first place, it will be permitted (but will be under no obligation) to throw into the monthly clearing any balances that have been acquired of the currencies of other member countries. In this case, the country will be reimbursed at the selling rate for dollars (i.e., at the lower limit for exchange-rate fluctuations) of the country whose currency is involved. In the second place, a member country will be able to draw, between the monthly settlement dates, interim finance in the form of other member currencies up to a total equal to its own lending obligation for such assistance.§ At any time before the next monthly settlement date, amounts drawn as interim finance can be paid back in the same currency as that drawn. If, however, the borrowing country waits until the settlement date, the debt automatically goes into the clearing, and must be repaid, not in the currency drawn, but in dollars at the *buying* rate for dollars (i.e., at the upper limit for exchange-rate fluctuations) of the country extending the assistance.

* Member countries with inconvertible (unquoted) currencies are relieved of this obligation. The Agreement does not set limits to the range within which exchange rates may fluctuate but, according to the preamble, it is the intention of "all" members that the margins on either side of parity should be "as moderate and stable as possible." Member countries which are also members of the International Monetary Fund would, of course, have to take into account their obligations in that organization.

† In the EPU, as indicated earlier, interim finance facilities are in practice unlimited, but both the continental countries and the United Kingdom were opposed to preserving this feature in the post-EPU arrangements.

‡ As in the EPU, clearing will be effected monthly, the net claims and debts being calculated by the Bank for International Settlements, which will also make the appropriate collections and disbursements.

§ The amounts for interim finance are recorded in the Agreement, and in most cases are set at about 10 per cent of the credit element in the original EPU quotas. The figure for each country represents both its monthly lending commitment and its monthly drawing right. This exceedingly temporary assistance, with a maximum term of one month, should not be confused with the loans (having a maximum term of two years) to be made from the European Fund.

Since the system is designed mainly to eliminate British objections to post-EPU clearing, it will be helpful to use sterling as an illustration of how the arrangement would work. As just explained, continental countries will have two privileges, either of which may involve sterling. First, if they so desire, they will be able to throw their sterling receipts into the monthly clearing. If they do so, however, they will receive settlement in dollars, not on the basis of the official parity for sterling, but on the basis of the British selling rate for dollars (the lower limit for fluctuations in the sterling-dollar rate). Since a continental country, under convertibility, will be able at any time to sell its sterling for dollars in the foreign exchange market at a rate which would never be lower—and would generally be higher—than the official floor for sterling fluctuations, it would never have a financial incentive to unload its sterling into the clearing. In this way, the principal British objection to a permanent clearing system is removed.

Continental countries will also have the privilege of drawing sterling as interim finance. Under the Agreement, the United Kingdom has an obligation to provide sterling to other countries wishing such assistance up to a maximum per month of $64 million. A continental country making use of this facility may pay back, *in sterling*, the debt thus incurred, provided it does so before the end of the monthly clearing period. If the country waits until the end of the period, the debt goes into the clearing and must be repaid, not in sterling, but in dollars at the British *buying* rate for dollars—i.e., at the upper limit for sterling fluctuations. Under these conditions, it is clear that member countries would generally wish to pay back such debts before the end of the clearing period.

The system of clearing provided by the European Monetary Agreement is largely of a voluntary character. Thus there is no obligation, as there is in the EPU, to throw balances of member currencies into the clearing. Moreover, there is nothing automatic, as there is in the EPU, about the use of the interim finance facilities; under the Agreement, a country decides when, if ever, it wishes to use these, and if it obtains such assistance it has the option either of repaying the debt before clearing in the currency drawn or of waiting until clearing and making settlement in dollars.

In view of these voluntary features, and in view of the unattractive terms of the monthly settlements, it has been contended that little if any clearing involving convertible currencies would take place under the Agreement. This may well turn out to be the case. It should not, however, be inferred that the system therefore has no real function. On the contrary, the system clearly provides a form of "exchange-rate

guarantee"—not a guarantee against all fluctuations in exchange rates but a framework within which each member country knows the limits within which market rates can move and in which all members undertake to keep these limits "as moderate and stable as possible." To attain such a framework was the principal reason the continental countries were so insistent on maintaining some form of clearing after the end of the EPU.

Moreover, in one important category of cases, clearing under the Agreement is *not* voluntary. The post-EPU clearing system, it will be recalled, embraces both convertible and inconvertible countries. In their relations with convertible countries, the inconvertible countries will doubtless be required to transact their trade in the currencies of the convertible group. In such cases, they will receive payment for their exports in a convertible currency, and will be required to pay for their imports in a convertible currency. But in their relations with each other, the inconvertible countries will probably make use of bilateral payments agreements. If, as might be highly tempting, the balances of inconvertible currencies acquired under such agreements could be voluntarily kept out of the monthly clearing, the way would be paved for a serious reversion to bilateralism within the inconvertible group. Accordingly, the European Monetary Agreement provides that such balances must be thrown into the clearing each month and settled in dollars at exchange rates agreed between the respective bilateral partners. It should be noted that, as a result, the Agreement imposes a form of convertibility (i.e., monthly central bank convertibility) on *all* member countries, including those which decide not to establish "market" convertibility.

XI. POSTSCRIPT

While the countries of Western Europe have not yet been prepared to move to formal convertibility, as defined either in the Articles of Agreement of the International Monetary Fund or in the European Monetary Agreement, a high degree of *de facto* convertibility has been attained by sterling and by several leading continental currencies. For non-residents, such convertibility has been achieved, in the case of sterling, through the transferable market, in which dollars can be bought for sterling at an exchange rate which in recent months has been within the official limits for sterling fluctuations. Since 1952, there has also been a great increase in resident convertibility in Western Europe as a result of the progressive relaxation of restrictions on transactions with the Dollar Area. Indeed, several continental countries have removed almost all direct restrictions on imports of goods and services from

the Dollar Area, and no longer discriminate against dollar transactions.

In one respect, the *de facto* convertibility achieved by sterling and certain other currencies goes beyond the minimum formal obligations imposed by the International Monetary Fund.* With regard to non-resident convertibility, the Fund Agreement stipulates that a member country is under no obligation to convert balances of its currency in the case of capital transactions. Yet it is now possible for a non-resident holder of sterling (if permitted by his own exchange authorities) to buy dollars for any purpose, whether of a capital or a current nature.

In another respect, however, the convertibility thus far achieved by Western European countries falls short of the Fund obligations, since the Fund also has something to say about resident convertibility. Indeed, Article XIX of the Fund Agreement defines a convertible currency as the currency of a member which is no longer making use of its transitional privilege under Article XIV to impose direct restrictions on current transactions. Since most member countries still impose restrictions on current transactions under the authority of the latter Article, they have not yet attained resident convertibility, as conceived by the Fund.†

Obligations under formal convertibility are also spelled out in the European Monetary Agreement, which has been described in detail in the preceding section. This will replace the European Payments Union when countries accounting for at least half of the original EPU quotas decide on a move to convertibility (i.e., on a move to market convertibility as defined in the Agreement). It is now more than three years since the Agreement was drafted, and there appears to be no disposition to introduce the new regime in the immediate future.

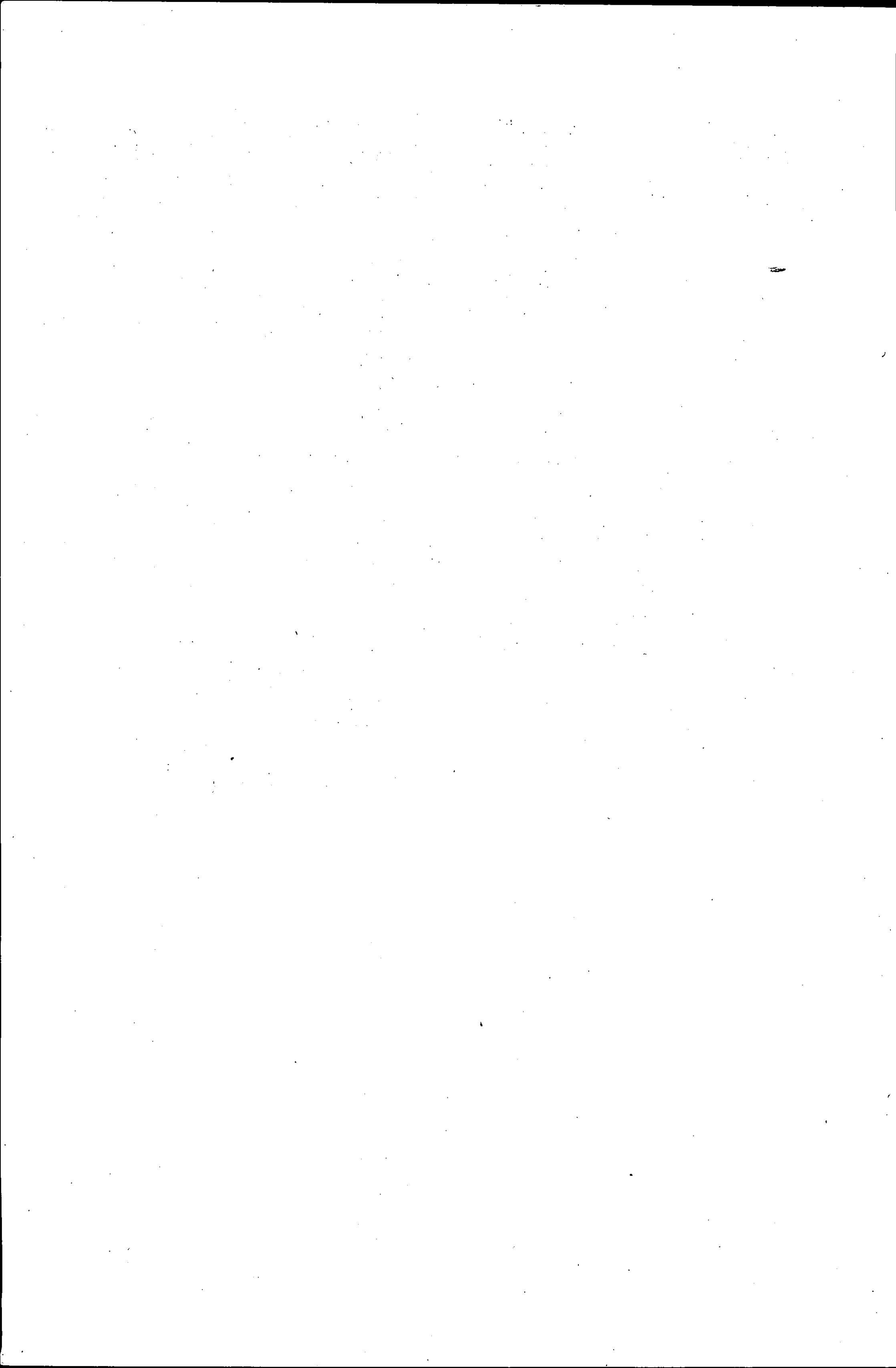
This does not mean, however, that the Agreement is likely to remain a dead letter. As already explained, the Agreement is the product of an exceedingly ingenious compromise, embracing interests which for a time appeared irreconcilable. On the one hand, for those countries which so desire, it makes possible a system of market convertibility in which

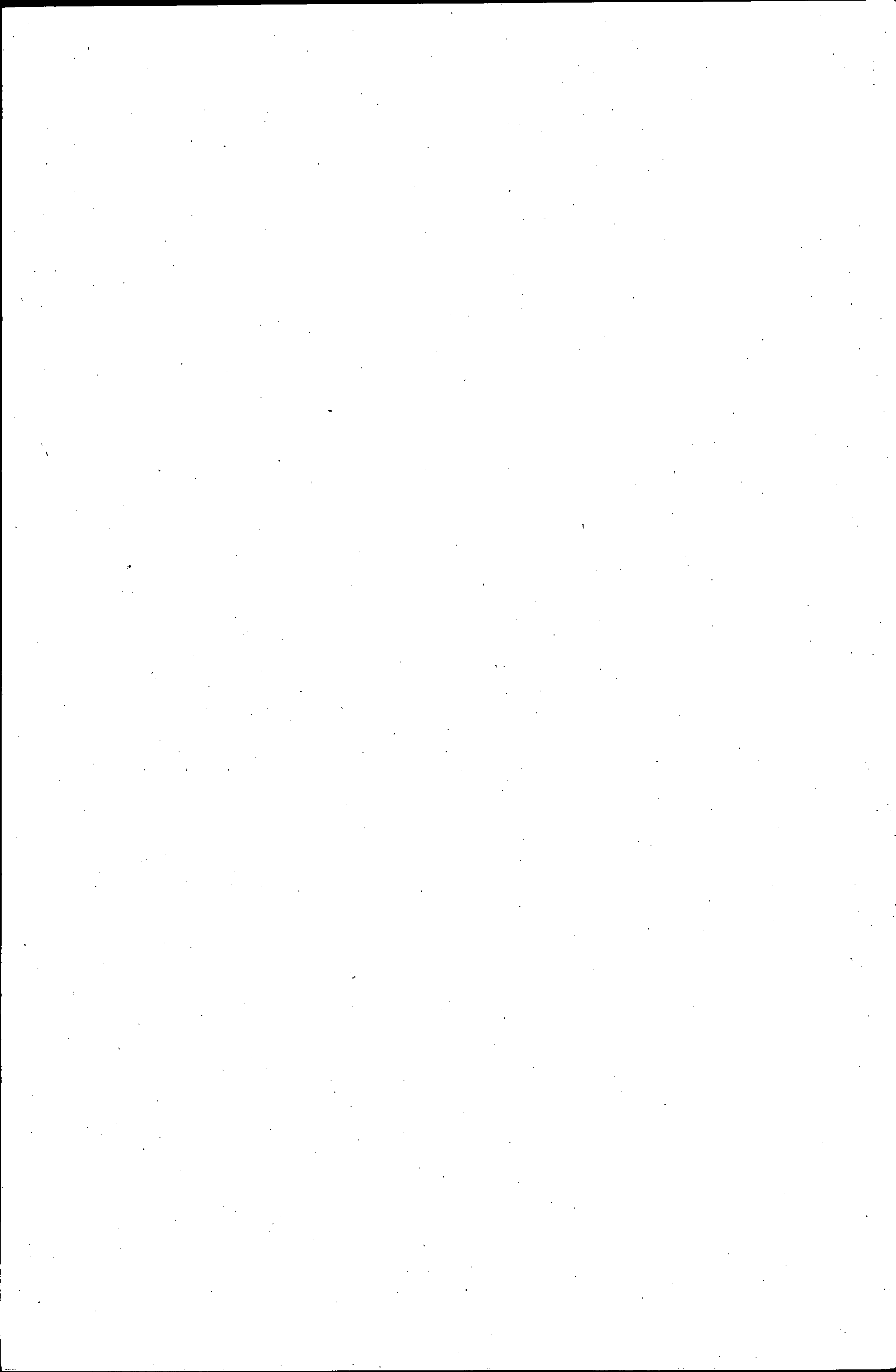
* Because it would greatly expand the scope of this essay, no attempt has been made in these pages to discuss or evaluate the important role played by the International Monetary Fund in helping countries move toward convertibility.

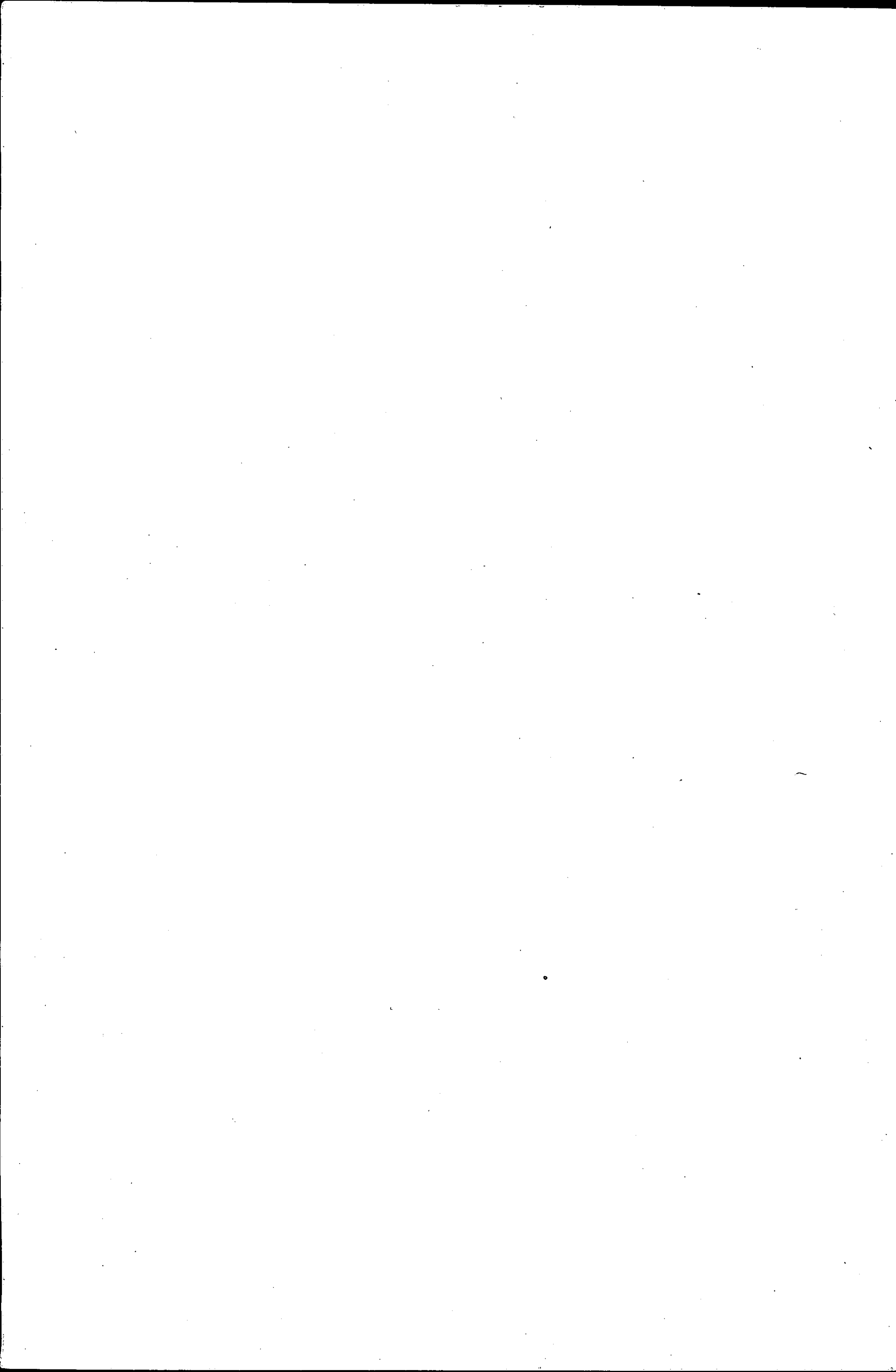
† This may not be a serious legal obstacle to formal convertibility, as defined in the Fund Agreement, since Article VIII, which lists the general obligations of members which are no longer invoking their transitional privileges, prohibits members from imposing restrictions on current transactions "without the approval of the Fund." The language in quotation marks clearly gives the Fund the power, presumably as an exceptional procedure, to authorize members with convertible currencies (i.e., members which are no longer invoking Article XIV) to retain *resident* restrictions on current transactions.

"quoted" currencies can be sold for dollars at exchange rates determined, within announced limits, by supply and demand. On the other hand, it provides a clearing arrangement which preserves two features of the present regime that continental countries feared would disappear with the end of the EPU: first, a form of exchange-rate guarantee and, second, a procedure for preventing a retreat toward intra-European bilateralism on the part of the financially weaker countries. Any collective move to formal convertibility would have to take into account the same interests, and no feasible short-cut to the route laid down in the Agreement appears to have been devised.

In part, the present unreadiness to invoke the Agreement stems from preoccupation with the complex questions of commercial policy relating to the Common Market project involving six Western European countries and to the associated effort to link this with a Free Trade Area embracing all of Western Europe. Negotiations on these matters have been going on for many months, and have usurped much of the time of those officials who would have most to say about developments in international finance. When the negotiations have reached a more definitive stage, it is likely that attention will shift once more to the financial terrain. At that time, in view of the increasing reluctance each year to renew the EPU Agreement and in view of the difficulty of renegotiating complex financial arrangements, there may be a strong inclination to invoke the Agreement with little, if any, change. In the meantime, Western European payments arrangements have gradually evolved to a stage from which, with a little more evolution in the same direction, the transition to formal convertibility may be a small step indeed.







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