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THE EMERGING PATTERN OF INTERNATIONAL PAYMENTS

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INTERNATIONAL FINANCE SECTION

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PRINCETON UNIVERSITY

Princeton, New Jersey

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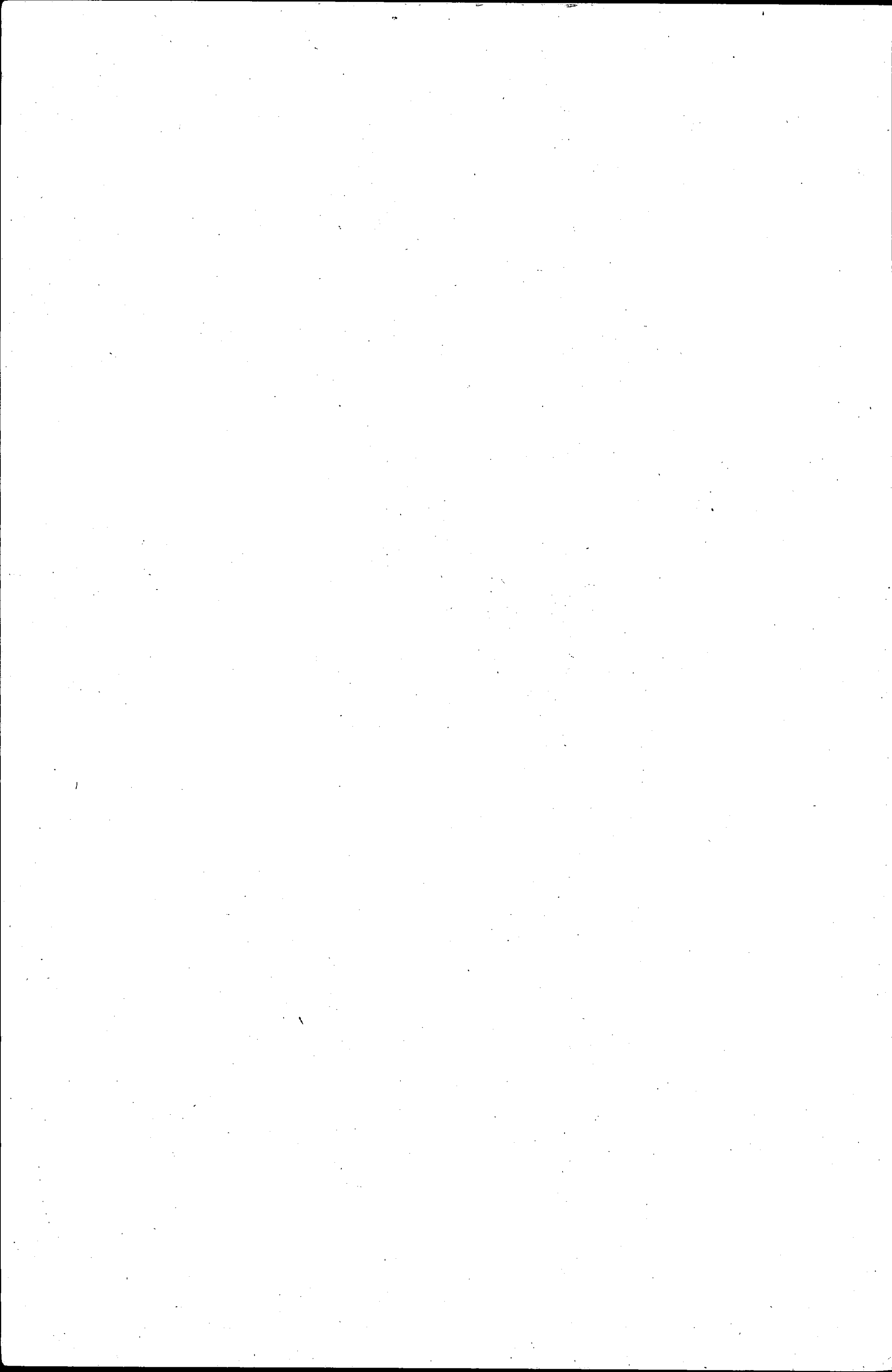

THE EMERGING PATTERN OF INTERNATIONAL PAYMENTS*

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I. INTRODUCTION

ECONOMIC and political conditions are rarely considered as being "normal" by the contemporary generation; "normalcy" is the judgment of a backward look from a position of marked change. The tendency to regard history as a reversible process has permeated the thinking of most planners in every period following a great political and social upheaval. But the idea of "back to normalcy," by definition, looks at the problem of transition from the wrong direction.

The International Monetary Fund Agreement established a code of fair exchange practices and the General Agreement on Tariffs and Trade (GATT) a code of fair trade practices, which were based on the experience of the past and were designed to come into force as soon as conditions in each member country would permit the assumption of the obligations of the codes. This period of readjustment, called the "postwar transitional" period, was of unspecified length and the conditions to be achieved before countries could be expected to assume their obligations were ill-defined. Nearly nine years after V-J day, and after a recovery of world production and trade far above pre-war levels, the vast majority of the signatories are still invoking the transitional period exemptions from the codes. Surely by now the postwar transitional period has lost whatever significance it originally had. The world is always in transition but some periods seem more transitional than others!

Perhaps the major difficulty with the postwar transition formula, however, was the expectation that individual countries could *one by one* assume the obligations of the Fund and the GATT with respect to their exchange and trade practices. For most countries the ability to restore convertibility on current account has not been determined simply by

* Many of the subjects discussed in this essay have been dealt with in greater detail in my *Foreign Exchange in the Postwar World*, The Twentieth Century Fund, New York, 1954.

the degree of economic recovery and financial stability of the individual country but also by the balance of payments position of the group of countries with which it has the closest economic relations.

In recent months there have been encouraging signs that the rigid controls over trade and payments which have characterized much of the world's commerce are being relaxed and that conditions are becoming favorable for some kind of currency convertibility. But the decade and a half of controlled exchanges in most of the nations of the world have left their mark. Direct balance of payments controls often have become as important a set of tools in the bureaucratic kit as the somewhat older fiscal and monetary implements. And while a more favorable international climate may lead nations to relax their use or even lay them aside for a time, they are not likely to be forgotten or to be thrown out of the tool box.

In considering these questions it must be borne in mind that national exchange control policies and techniques have emerged as parts of a system or systems of international trade and payments. Although the sterling area, the European Payments Union (EPU), and the vast network of bilateral trade and payments agreements were established as temporary arrangements for dealing with immediate problems, they have, like the underlying exchange control systems themselves, left their mark and are unlikely to be quickly swept away by a rising tide of multilateralism. As the world moves toward full multilateral settlements, we may expect the retention of institutions and administrative arrangements which will permit an orderly retreat to some form of limited or regional multilateralism should the future bring a less favorable international climate.

It is the purpose of this essay to consider postwar payments arrangements as an emerging process, determined more by the immediate economic and political environment than by a desire to create an ideal international payments mechanism. In addition, by means of a projection of this process as an emerging continuum from the past and the present, alternative courses for the future will be suggested.

II. THE TRANSITION TO THE EARLY POSTWAR PAYMENTS AGREEMENTS

The basic mechanisms employed in the postwar payments systems were developed in the 1930's. Payments agreements, clearing accounts, trade-quota agreements, tied sales or purchases, balances blocked or restricted in use, multiple exchange rates and broken cross-rates, as well as the various techniques for mobilizing and allocating foreign exchange resources, had all been employed by the middle thirties. In spite of the

widespread use of these devices, however, the system of international payments at that time was basically multilateral in character and perhaps 80 per cent or more of the world's trade was financed with generally convertible currencies, principally the dollar and sterling.

The motivations in the early 1930's for certain countries, chiefly Germany and the nations of Central Europe, for using bilateral clearing and payments devices to by-pass the multilateral payments mechanism grew out of a decline in their international liquidity position and the desire to gain commercial advantages in the desperate competition for the depression-shrunk markets. To a considerable degree these motivations were inseparable, just as they have been in the postwar period. And while the so-called Schachtian devices of the Nazis were frowned upon as instruments of economic warfare, countries like Britain, Belgium and Switzerland, whose foreign exchange positions were relatively strong, were not above engaging in practices which undermined the system of multilateral payments in order to further their own commercial advantage. Thus, in January 1939, Britain was a party to nine bilateral payments or clearing agreements, Belgium to thirteen, France to twelve, the Netherlands to seven, and Switzerland to twelve.

The bilateral clearing agreements of the early 1930's provided a means of partially freeing trade and financial payments from the strictures of exchange controls and currency blocking initially imposed by certain countries as temporary measures for dealing with balance of payments crises. They were negotiated between exchange control countries and between the free exchange and exchange control countries, but generally not between countries which maintained free exchange markets. The bilateral clearing agreements enabled creditor countries to collect their frozen credits from the debtor countries by requiring those importing from the debtor country to pay their own currency into a special account, a portion of which was then set aside to make payments to the individual creditors. At the same time, exporters in the creditor countries were anxious to maintain their markets in the debtor country and the debtor country was anxious to obtain imports from the creditor country, provided it could do so without a loss of free exchange. All of these objectives could be realized through the operation of clearing agreements.

But the clearing agreement was not entirely satisfactory to free exchange countries. For one thing, exporters were required to wait for payment until importers made deposits into the account; and free exchange countries had to require importers from the clearing agreement country to make payments into a special account rather than use normal exchange facilities. Both of these objections were obviated by the bilateral payments agreement which came into general use after

the negotiation of the first payments agreement between Argentina and Great Britain in May, 1933.

The bilateral payments agreement was a major innovation embodying a fundamental principle that was carried over into the wartime and postwar exchange systems: governmental control over the use of balances acquired by non-residents. The prewar payments agreements were usually negotiated between a free-exchange and an exchange control country with the currency of the free exchange country being employed as the unit of account. Foreign exchange payments to the exchange control country were made into special accounts in the banks of the free-exchange country and balances in these accounts could be used only for certain purposes. Unlike other balances in the free-exchange country, they were not freely convertible into third currencies and in some cases they were not available for the purchase of all goods and services from the free-exchange country. Most of the payments agreements required that any balances in these special accounts which remained after making certain payments for debt settlement, had to be employed for purchases in the free-exchange country.

With few exceptions, the postwar bilateral payments agreements have been negotiated between two exchange-control countries, both of which require exporters to surrender their foreign exchange earnings to the exchange authorities. Under these conditions either currency or both currencies may be employed as the means of payment, and the problem arises as to how much one partner is willing to hold of the other's currency. This problem did not arise under the typical pre-war payments agreement between a debtor country with exchange controls and a free-exchange country, since only the creditor country's currency was used and the debtor country was required to plan its trade so as to reduce its indebtedness by means of a surplus with the creditor.

The first war-time payments agreement between the Western European countries virtually ignored the problem of balance. Owing to the gravity of the Nazi threat in 1939, Britain and France concluded an agreement which obligated each country to supply without limit its own currency to the other for use within their respective currency areas. Such an agreement was tantamount to a currency union except for the fact that each country maintained trade and payments controls with respect to transactions with the other country. The Anglo-French agreement of December 1939 set the pattern for the Anglo-Belgium agreement (1943) and the other European bilateral agreements negotiated during the war and early postwar periods, with the important exception that these later agreements generally provided limits to the amounts of the partner's currency which each agreed to hold without demanding a gold settlement.

These agreements were thought of as a means of freeing trade from the restrictions temporarily necessitated by the war on residents in their dealings with nationals of the partner countries and on the balances held by non-residents. By limiting the use of the domestic currency paid to non-residents, it was possible to reduce somewhat the restrictions on residents' foreign transactions. Thus there developed out of the old pre-war payments agreements a distinction between controls over payments and transfers by residents on the one hand, and restrictions upon the availability and transferability of domestic balances owned by non-residents on the other.

The practice of controlling the use of non-resident accounts became an especially important feature of international payments arrangements with the formalization of the sterling area. When she first introduced exchange controls in 1939, Britain did not control transfers of sterling between non-residents. This circumstance resulted in a dual rate for sterling: an official rate in London for the dollar and other currencies; and a free market rate for sterling in the New York and other free markets. The free market was soon dried up however, first by gradually reducing the types of payments for which free market sterling could be used and thereby reducing the demand for it; and second, by curtailing the supply of free sterling through the blocking of the proceeds from the sale of foreign-owned British securities and requiring all transfers of resident account sterling to non-residents to take place through British authorized banks. Transactions within the sterling area were financed by resident account sterling which, although freely transferable within the area, could not be legally transferred to a non-resident account except in accordance with the British exchange regulations. Thus the fundamental principle of the payments agreement, namely the control over the disposition of balances held by foreign nationals, became the basic element of the sterling area exchange control system.

Unlike the usual payments agreements between pairs of countries, however, the sterling area was not based on a written agreement. The prewar practice of making international payments by drafts on London banks and their overseas branches provided a ready made mechanism for the control of transfers of the means of payment employed by the Commonwealth countries (except Canada) together with a few other countries with close economic and political ties with Britain. During the war period at least, it was not even necessary for Britain to place formal limitations on the amounts of resident sterling that could be converted to dollars or transferred to (convertible) American account sterling, since commodity and shipping shortages limited the demand. All that was necessary was to prevent unauthorized capital transfers;

this could easily be done with the cooperation of the exchange control authorities of the independent sterling area countries.

Within the sterling area system, which in a sense is an unwritten multilateral payments agreement based on sterling, the problem of balance was avoided by the fact that although Britain became a debtor to the rest of the system the prestige of sterling was such that the other members were willing to hold large amounts of sterling balances. The same thing was true during the war and early postwar periods, with respect to a number of other countries with which Britain had bilateral payments agreements based on sterling as the sole means of payment. But with the revival of postwar trade, the problem of balance soon appeared under the two-currency agreements negotiated between Britain and her continental neighbors.

By the end of the war the bilateral payments agreement had become the accepted mechanism for financing trade among non-dollar countries and during the months following V-E day the network of payments agreements expanded to cover virtually the entire non-dollar world, with only a few gaps in the web. In March 1947 about 200 bilateral payments agreements were in effect and this number had nearly doubled by 1950. There was, to be sure, some variation in the pattern. The sterling area was a self-contained system of multilateral settlements and stood as a unit in payments agreements with other countries. The Dutch, French, and Belgium-Luxemburg currency areas represented smaller pools of multilateral settlements within the larger bilateral framework. Moreover, the bilateral agreements themselves differed in many particulars. Nevertheless, these agreements had certain common features which served the needs of the non-dollar countries in the restoration of their trade. First, they provided liquidity, not in terms of gold or convertible currencies which the countries believed they could not spare, but in terms of credits extended in the form of overdrafts arising out of trade and repayable in terms of goods or inconvertible currencies. Second, the agreements enabled some countries to finance trade in their own currencies, removing the risk of currency depreciation. And, third, they provided a mechanism for conducting trade through normal channels without the necessity of resorting to state trading or barter agreements.

It is interesting to speculate what might have happened if this payments network had not developed and nations had organized their postwar trade on a convertible basis. The low levels of liquidity and the demand for dollar goods would undoubtedly have kept trade between non-dollar countries at a substantially lower level. Competition for markets would probably have forced countries to depreciate and unless internal deflationary steps had been taken, hyper-inflation might have occurred in a number of countries. But the pattern of production and

trade would probably have adjusted itself far more rapidly to a system of non-discriminatory trade and currency convertibility than it has in the nine years since V-E day. However, the social and economic costs of this adjustment would undoubtedly have been more than the non-dollar countries of the world were willing to pay and it would be difficult to prove that they were wrong in adopting the course they did.

A major effort to break through the network of bilateral trade and payments occurred in 1947 when Britain sought to establish a form of sterling convertibility. It is worth noting that the British system of convertibility was attempted within the framework of the sterling payments agreements and of the arrangements which constituted the sterling area itself. Under the terms of a series of new agreements concluded in 1946-1947 following the Anglo-American Financial Agreement of July, 1946, a number of countries agreed to continue to accept sterling in payment for their exports and to limit sales of sterling against other currencies to amounts needed for meeting current deficits with non-sterling countries. Thus the fundamental principle of the payments agreement, namely that of limiting the use of non-resident accounts was preserved. Sterling area countries were of course expected to avoid transfers of sterling outside the sterling area for capital transactions and to continue clearing their financial transactions with non-sterling countries through London. In other words, British convertibility in 1947 did not contemplate the elimination of the sterling dollar pool nor of most of the other sterling arrangements other than the informal agreements to discriminate against the dollar area.

The British convertibility experiment failed. The reasons were many, including the failure of certain countries to live up to their agreements. But in this attempt can be seen a pattern for the more successful, be it more limited, system of multilateral payments which was subsequently developed, and a hint as to the likely pattern for future progress toward a system of full multilateral settlements.

III. FROM BILATERALISM TO LIMITED MULTILATERALISM

The failure of the sterling convertibility experiment in 1947 led to an indefinite shelving of the hope for a quick restoration of a world-wide system of multilateral payments. The dollar shortage began to be accepted as a more or less permanent state of affairs deducible from the structural changes in world production and trade relationships and from differences in economic policies between the United States and the rest of the world. Some economists developed complex and tortured explanations to square their views of a chronic dollar shortage with the

classical theory of international trade, while others saw the problem of international imbalance as being readily amenable to exchange rate adjustments coupled with rigorous fiscal and monetary action in the deficit countries.

More fruitful were the efforts to develop a system of multilateral trade and payments among the non-dollar countries as an intermediate step between bilateralism and full convertibility. One mechanism for such a system was provided by the sterling transferable account system.* However, several important countries dropped out of the transferable account group after August 1947 and those countries which remained in the system conducted the bulk of their trade with other non-sterling countries, not through sterling transfers, but under bilateral payments agreements with their non-sterling partners. Countries like Belgium, Argentina, Canada, Portugal and Switzerland regarded sterling as too weak to warrant their membership in a system which obligated them to accept sterling without limit. Others regarded sterling as too scarce to justify their giving up their bilateral payments agreements with the rest of the non-dollar world.

By the end of 1947 the fundamental weaknesses of the network of bilateral payments agreements had become quite apparent. The target trade balances established by the trade-quota agreements negotiated between the partner countries often were not being realized. The economically weaker countries could not provide the scheduled exports, or their prices were out of line, while the import demands of those same countries often exceeded the target amounts set by the agreements. The total of the individual deficits or surpluses for the soft currency countries usually exceeded by a considerable margin their net deficits with their trading partners as a group, but so long as no mechanism for multilateral settlements existed the bilateral positions could not be reduced. As the credit margins provided by the payments agreements were exhausted the impetus given to non-dollar trade in the early postwar period disappeared and trade between some pairs of countries threatened to grind to a halt.

For the Western European countries the problem of bilateral unbal-

* The sterling transferable account system was originally established in 1946-1947 by a series of bilateral agreements under which a number of countries agreed to accept sterling from the sterling area and from one another in settlement of current transactions and to limit transfers to one another and to the dollar area to amounts needed for settlement of current transactions. After August, 1947, transferable account sterling could no longer be transferred to the dollar area but remained automatically transferable for current payments within the transferable account group. In March, 1954, the British expanded the transferable account system to include nearly all countries outside of the dollar area. Transferable account sterling is now automatically transferable among members of the system and with the sterling area for the financing of both current and capital transactions.

ance was partially solved by a special distribution of Marshall Plan aid, which in effect paid dollars to the bilateral creditors in return for a writing off of their bilateral credits. In addition, during the period 1948-1950, feeble attempts at multilateral settlements were made through the multilateral offset system operated by the Bank for International Settlements. But the establishment of a completely multilateral system for the Western European countries and their associated monetary areas did not take place until the summer of 1950 with the setting up of the European Payments Union.

Payments difficulties have also existed in the trade between Western Europe and Latin America during the postwar period. To some extent Western Europe's deficits with those countries were settled by the repatriation of capital investments and by Marshall Plan purchases in Latin America for delivery to Europe. Nevertheless, trade under the bilateral payments agreements between Europe and South American countries has been subject to even greater difficulties than intra-European trade, a factor which helps to account for the relatively low level of commerce between the two areas. Most of the countries of the Far East, except Japan and the Philippines, are members of European currency areas, and hence their payments facilities for trading with the rest of the non-dollar world have been bound up with the development of the Western European payments system.

The European Payments Union provides a mechanism for multilateral settlements for about 40 per cent of the world's trade, or about two-thirds of the world's non-dollar trade. Moreover, a large portion of this trade has been freed of quantitative restrictions and those which do exist are largely non-discriminatory. Before it was possible to establish this system several conditions were necessary. First, the trade imbalance within the EPU group had to be reduced and the relative degrees of strength or hardness among the currencies of the members narrowed. This was accomplished in large measure by the rapid recovery of production in Western Europe, greatly facilitated by American aid; by the currency revaluations of 1949; and by the achievement of greater internal financial stability. Second, it was necessary for these countries to agree to give up a large measure of their bilateralism in trade relations with one another and to accept the disciplines of competition. Third, it was necessary to provide additional liquidity for the financing of trade. These last two conditions were provided in considerable measure by the Union mechanism itself and by the accompanying OEEC trade liberalization program. Finally, it was necessary for these countries to achieve a greater degree of overall balance, including balance with the dollar area.

These same conditions must also be met if countries are to become