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TOWARD EUROPEAN CONVERTIBILITY

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Princeton, New Jersey

This is the thirty-first in the series ESSAYS IN INTERNATIONAL FINANCE *published by the International Finance Section of the Department of Economics and Sociology in Princeton University.*

Mr. Hinshaw has long been concerned with convertibility and related problems. Following service in the Division of International Finance at the Board of Governors of the Federal Reserve System, he spent several years in Paris as Special Adviser on International Financial Policy, U.S. Mission to NATO and European Regional Organizations. He has recently resigned from government service and is currently Visiting Professor of Economics at Oberlin College. The views expressed in this essay are his own. They do not pretend to reflect those of any organization with which he has been associated.

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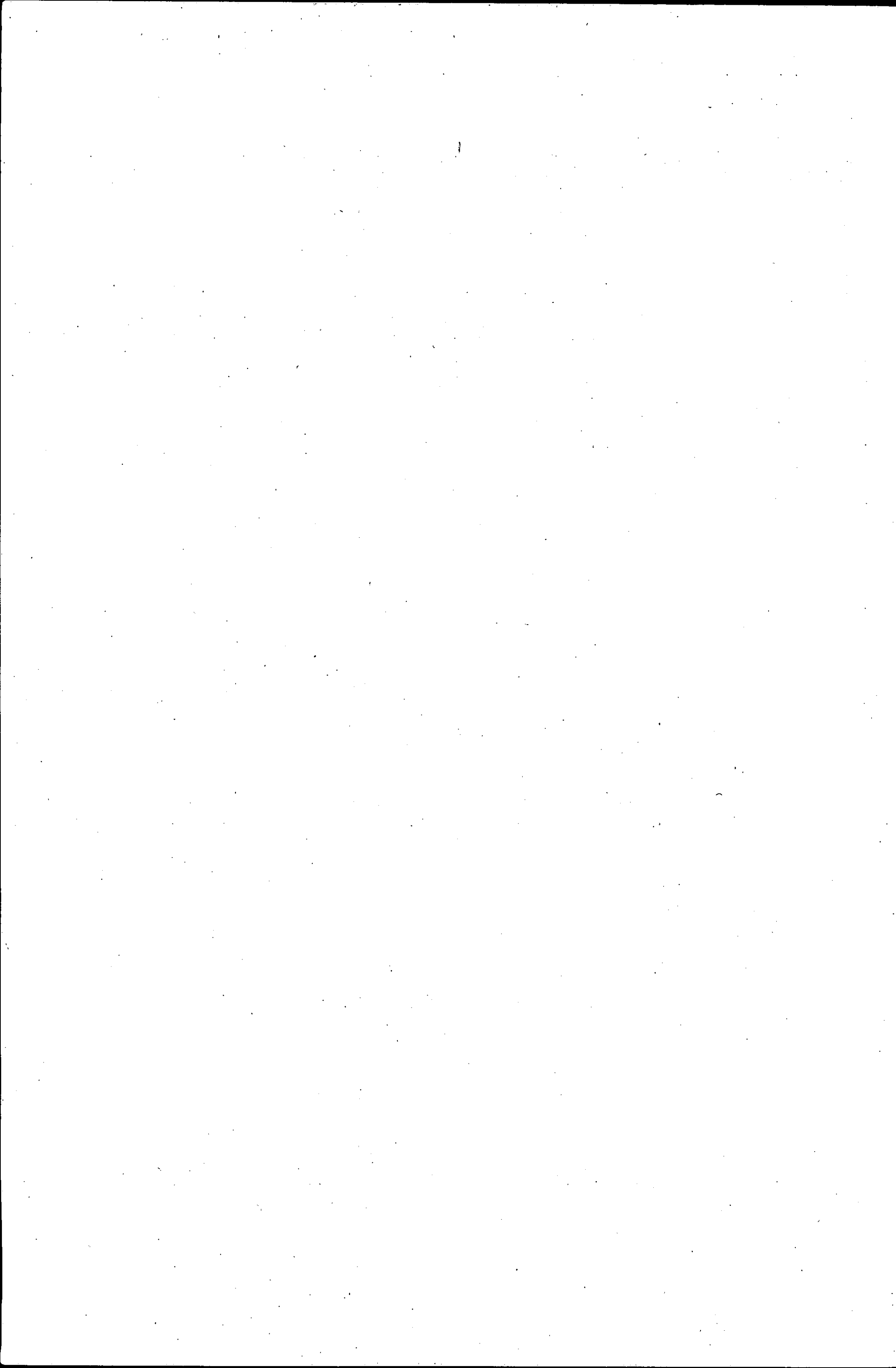

TOWARD EUROPEAN CONVERTIBILITY

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