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Trade and Finance
Directorate

TF-DI-323 (3rd Draft)

SECRET

TRADE AND PAYMENTS ARRANGEMENTS

1. The participating countries should now agree that among their major objectives during the coming year must be :-

(a) The maximum possible liberalisation of trade and payments within the group;

(b) The transferability of the currencies of the group within the group;

(c) The settlement of net debtor and creditor positions in such a way that there shall be incentives to eliminate disequilibrium and not preserve it.

2. These three objectives must be pursued concurrently. Liberalisation of trade and payments involves monetary risks which must be guarded against by appropriate payments arrangements. On the other hand payments arrangements which would be satisfactory if participating countries had liberated their trade and payments might become very dangerous for individual countries if some of their trading partners had not taken such measures of liberation.

3. They should further agree that whatever payments system is established the following gross disadvantages of the existing payments scheme must be avoided :-

(a) it must not be based on detailed bilateral estimates;

(b) it must not, through the establishment of predetermined drawing rights, discourage debtors from improving their position and creditors from helping debtors to do so.

A - LIBERATION OF TRADE AND PAYMENTS.

4. The participating countries should now agree to remove by 1st July 1950 quantitative restrictions from at least 85% of their imports from other participating countries.

5. In order that there may be as great a similarity as possible in the lists of liberated products they should further agree that not less than 75% of their trade in each of the three groups, food and feeding stuffs, raw materials, and manufactured goods, shall be liberated by that date.

6. After 1st July 1950 when this 85% liberalisation has been instituted, it will be necessary to consider what additional measures will be needed in order to make the list of products liberated by all as large as possible.

7. Further, participating countries should now agree to liberate completely payments for current transactions with other participants by 1st July 1950. Some may wish to go further and liberate capital movements, but most will probably not be able to go so far. The need to control capital movements may make it necessary to limit the daily amount of tourist and similar allowances, but it should be agreed that any such limits should be fixed sufficiently high to ensure that legitimate current needs are not hampered. Equally the need to control capital movements will probably make it necessary for many to continue exchange control mechanism and channel all demands for foreign exchange through it. But those participating countries who intend to preserve exchange control should undertake to grant all applications for foreign exchange for current transactions, and to take administrative arrangements to ensure that authorisation is given very quickly.

The risks of Liberalisation -

8. The complete or quasi-complete liberalisation of trade and payments will expose participating countries to varying sorts of risk. The first is that their home industries and services will be exposed to the competition of the other participating countries. This risk the participating countries should be ready to accept, since by no other method can the efficiency of Europe be so quickly increased and resources be made available for economic activities.

9. The second is that the internal demand for imported goods may be so great as to endanger their balance of payments. In so far as this is a temporary phenemonon, a necessary stage in the creation of the European market, the participating countries ahould be ready to assist each other through this difficult period. It is better that the adjustements which must be made should be made now rather than that further delays be accepted. In so far as the internal demand for imported goods is due to internal inflationary pressures they should be determined to take tke necessary steps to bring their internal economy into balance; equally they should be resolved in the interests not only of full employment at home but also of the interests of the group as a whole not to follow such an internal deflationary policy as would tend to make it difficult for the other participating countries to liberate their trade and payments arrangements within the group.

The liberalisation of intra-European trade and payments will provide a partial check on the extent to which the internal financial measures are adequate to make available those resourcesfor export to the outside world, which the Second Interim Report will show to be essential to a satisfactory solution of Europe's difficulties.

10. The third risk that the participating countries run in liberating their trade is that they will incur debts towards one country, surpluses with another, and not be able to use the credit balance to pay the debt. It is therefore essential that the currencies of the participants be made transferable, the one into the other.

B - THE TRANSFERABILITY OF EUROPEAN CURRENCIES.

11. If the European currencies are to be made transferable into each other certain new arrangements are needed. Such an arrangement might be by an understanding between the Central Banks, and if the number of countries concerned were small that might be sufficient. But when the membersare many some form of central arrangement is easier.

12. Such an arrangement might be the creation of a pool of European currencies, each country putting at the disposal of the pool an amount of its own currency equivalent to about 10 per cent of its visible trade.

13. A member who needed European currency would be able to obtain it from the pool either by giving in exchange a third European currency, or by taking a short term advance. The pool would thus perform two functions. It would enable a member to offset a debt against a credit, and that over a wider field than is at present available through the automatic first category compensationsprovided for in the Payments Agreement. It would indeed do all that automatic second category compensation could do if that system had been adopted. Secondly it would enable a country whose payments and receipts fluctuated seasonnally to obtain short term credit during one part of the year without concern whether the particular country to whom its short term indebtedness would be incurred would be willing to accept in settlement later the third currencies it expected to earn.

14. A participating country which was determined to exercise control over its internal economy to keep it in balance and prevent internal inflation generating a demand for more imports than could be paid for would be able with such a system to liberate its intra-European trade and payments without grave risk. So long as it maintained itself in equilibrium it would have no reason to be concerned at the consequences of such measures on its relations with its individual trading partners.

15. After a certain experience the pool might be willing to extend the field of its operation and accept currencies of non-member countries either in liquidation of a debt to the pool or to buy from the pool the currency of a member.

C - THE SETTLEMENT OF NET CREDITOR AND NET DEBTOR POSITIONS.

16. Inside any group of countries who have taken such steps as have been indicated above to liberate tr a d payments and to make their currencies transferable " on current account" it is certain that some net creditor and debtor positions will develop. A few of these would be the result of specialisation, the result of the fact that one or more countries tend to produce goods needed by their partners rather than by the outside world. Some would be fortuitous, and likely to be quickly reversed. Some would be the result of deliberate investment by one country, importing capital from one to more countries, whether by agreement with them or as a result of its trade and payments agreements with them. Such transactions ought properly to be dealt with outside current transactions, but are often confused with them. Some however would result from differing internal policies, differing degrees of inflationary pressures, or in extreme cases

deflation in one country and inflation in a neighbour.

17. All of these resulting credit and debit positions must be dealt with. They would appear in the operation of such a pool as is outlined above in the running down of the pool's holding of the currency of the net creditor and the increased holding of the currency of the net debtor. The European currencies of the pool are for short term operations, not for financing of fundamental disequilibrium, although medium or long term European lending might well play a part in the settlement of deficits in current transactions, when these are not due to an undesirable policy of the debtor.

18. If the operations of the pool are not to be brought to an early end it is essential that the pool have at its disposal a volume of convertible currency with which it can obtain from the net creditor a further supply of its currency. Moreover, the excess holdings of the debtor's currency must be liquidated in order that his right to use the pool may not be impaired.

19. It is essential that there shall be some reasonable degree of automaticity in the operation of the pool so that the creditor can rely on being able to obtain convertible currency from it. The more certain is his right to it, the less is he likely to seek to obtain it unless he needs it. He will be able to treat it as a part of his monetary reserves.

20. It is no less essential that the debtor be able to count on some part of his net deficit being covered in such a way as not to limit the use he can make of the pool for short term accommodation.

21. On the other hand, it is essential that both debtor and creditor should have positive incentives to correct their position. The deficits and surpluses should not be covered so easily, and completely as they have been hitherto by drawing rights.

22. It is also desirable that, while drawing on the pool of convertible currencies to meet legitimate needs of the creditors, the European countries themselves should make an effort to settle, as far as possible, by their own means, differences arising in European current transactions.

23. The reconciliation of these various desiderata, and the elaboration of the necessary rules for the operation of the pool and directives to its managers cannot be quickly completed. (a sketch of a possible arrangement is at Annex I.) The following general principles are suggested:-

(i) The pool should be given a fund of dollars from the next E.R.P. appropriation of an amount to be determined later, but which should probably not be less than $500 million. (@) This dollar pool would not be properly described as a "reserve" since it is most probable that part of it would be used during the year 1950-51. But equally it should not be regarded as "fonds perdus", and the management should have it as a major responsability to safeguard as much of it as possible.

(ii) If full advantage is to be had from the Pool, it is most desirable that the dollars should be free dollars.

(iii) As net creditor positions developed, and the pool holding of the creditor's currency declined of more than an agreed percentage, the pool should, if the position is not likely to be quickly reversed, replenish its holding of the creditor's currency, up to an agreed percentage, either by the sale of dollars from the pool or by borrowing the creditor's currency at an appropriate rate of interest. The two devices could also be applied pari passu. The managers of the pool should have discretion to adopt alternative measures where these were desirable in the light of the policies being followed by the creditor. Possible alternative measures are discussed in Annex I.

(@) This amounnt should suffice to cover the net creditor and debtor positions of all participants, including any countries not participating in the pool. See paras. 25-28 below. The method of establishing the pool will need further discussion, particularly with E.C.A.

(iv) As net debtor position developed, and the Fund accumulates holdings of the debtor's currency exceeding an agreed percentage, the pool should, if the position is not likely to be quickly reversed, liquidate this excess of holding, either by returning its currency to the debtor, or by calling the debtor to pay interest and undertake to repay the Fund within a stated period, perhaps three years, in European currencies or dollars. The two devices might also be applied pari passu. The managers of the pool should have discretion to adopt alternative measures where these were desirable in the light of the policies being followed by the debtor. Possible alternative measures are discussed in Annex I.

24. There would thus be a pool equipped with both European currency and dollars. A mechanism would exist for offsetting debits and credits in European currencies, for providing short term credit to cover temporary fluctuations on a multilateral rather than a bilateral basis, and finally for settling net debtor and creditor positions without the rigidity of drawing rights. Within such a framework the monetary risks of liberalisation of trade are very largely guarded against. The country which remains in or moves into equilibrium with its partners is guarded against any threat to its reserves. The country which is naturally an intra-European debtor, or which runs special temporary risks in connection with intra-European trade can be confident that its deficit will be covered and that to the extent that the deficit is covered by future indebtedness, the debt will be repayable in any European currency.

D - <u>EXCEPTIONS.</u>

25. These general proposals, liberalisation of trade and payments on the one hand, and the pool of European currencies and dollars on the other, must be linked together. Membership in the pool must be limited to those who will accept fully the liberalisation objectives and implement them by the agreed dates. It is most important that the largest possible member of participating countries do accept these obligations and join the pool.

26. But some exceptions there probably must be. It is hard to believe that either Greece or Austria should completely liberalise their trade and payment policy in the immediate future. Some special arrangement should be made in these cases.

27. In the first place such countries should certainly be able to use the pool of European currency to buy currencies they need with currency they do not need. But their own currency would not be dealt with; other participating countries would not be able to sell it to the pool, neither would they themselves be able to obtain any overdraft from the pool.

28. Further, such countries should receive a multilateran drawing right equal to 60% of their net 1949-50 drawing rights (except Greece whose drawing right in 1950-51 the Council has already recommended shall be the same as in 1949-50). This drawing right they would be a able to use to settle any deficit arising with the other participating countries during the year. These drawing rights, - when exercised against a member of the pool,- would be met from the European monetary resources of the pool, thus increasing the net creditor positions or reducing the net debtor positions of the pool members.

E - THE MANAGEMENT OF THE POOL.

29. What should be the arrangements for the management of such a pool ? Are any new institutions needed ?

30. So far as the day to day administration is concerned it is to be hoped that this could be undertaken by the B.I.S. Until the details are worked out perhaps no definite answer can be given, but it would be unfortunate if a second international banking institution had to be created in Europe.

31. Special arrangements must be made for the policy making body. Until general agreement has been reached on the scheme it will be difficult to make decisions, but if a scheme on the lines indicated on this paper were to be adopted it would clearly be necessary to have a Committee empowered to take decisions by something less than unanimity.

32. It will be most desirable to ensure that there should be no divorce between O.E.E.C. and the management of the Pool, and the safest way to ensure this would be for the policy making body to be a Committee of O.E.E.C. Difficult legal questions will be involved here which will need most careful examination at a later stage when the tasks of the management and the discretion it is to exercise have been more clearly defined.

33. On the quality of the men sitting on the special O.E.E.C. Committee to manage the pool will very largely depend its success or failure. However precise the directive given to them, however far the operation be made automatic, there must necessarily be considerable discretion left to them. If that discretion is wisely used the resources of the pool will be husbanded and the participating countries brought into equilibrium with each other. It is unlikely that Committee will succeed unless its members are the officials or their immediate subordinates in the Central Banks or Treasuries who have the highest responsability for financial policy.

CONCLUSION

34. These proposals are far reaching. They suggest that the participating countries take during the first six months of 1950 decisive steps to liberate their trade and payments, and they sketch the outline of payments arrangements to guard against the monetary risks of liberalisation of trade. Both parts are closely linked together, If transferability limits the risks of liberalisation, liberalisation of trade and payments is itself a guarantee that trade will be not artificially controlled to damage a country which established transferability. As between the members of such a system there is no longer need for discrimination, though clearly there will be obligations on the net creditors to go even further than the net debtors in liberating their trade.

35. By its provisions for short term credit by all, coupled with some medium or long term credit by the creditors, such a system provides a framework within which there can be the maximum degree of mutual help.

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ANNEX I

THE SETTLEMENT OF NET CREDIT AND DEBIT POSITIONS

1. The elaboration of the detailed operation of the two pools will need many weeks of discussion. The following is an outline of a possible solution, set out in order to indicate the methods by which the pool might be operated.

2. It would not be desirable to settle all credit and debit positions as they appear since this would make impossible the financing of seasonal movements with short term finance. On the other hand it would not normally be desirable to use up the whole quota of a creditor's currency or allow a debtor to make drawings up to 100 % of his quota without making some settlement. In general therefore settlement should be made regularly whenever the pool's holding of a currency drops below or rises above a fixed percentage, which might be 35 %, of the quota. The settlement should normally bring the pool's holding of the currency in question back to 135 % or 65 % from say 145 % or 55 %.

Credit Positions

3. When the pool's holding of a currency dropped below 65 % of the quota action would normally be taken to bring it back to 65 %. The following methods of dealing with the matter are possible :-

i) No action - on the grounds that the tendency was likely to be quickly reversed.

ii) The pool would purchase the currency in question with dollars from the pool.

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iii) The pool would borrow additional currency from the member in question at an appropriate rate of interest.

iv) The pool would lend dollars to the member against deposit by it of its own currency, charging the member interest.

v) The pool would take no action but allow its holdings of the currency to be further reduced, making it clear that if its supplies became exhausted the member concerned would be exposed to discriminatory measures by the other members.

4. Of these measures (ii) would be appropriate when the creditor was a "structural creditor", or when the credit was small, and provided that the creditor's policy was not prejudicing the efforts of the debtors to reach equilibrium ;

- (iii) would be appropriate in similar circumstances to (ii) when the creditor had no immediate need of dollars, or when it seemed appropriate that he should himself finance some part of his surplus. It would be a loan to the pool, not to any individual member.

- (iv) would be appropriate where the policy of the creditor was held to be exaggerating the credit position.

- (v) would be appropriate when the policy of the creditor was held to be actually causing the creditor position to the detriment of the other members.

Debit Positions

5. When the pool's holdings of a currency rose above 135 % of the quota action would normally be taken to bring it back to 135 %. The following methods are possible :-

1) No action - on the grounds that the tendency was likely to be quickly reversed.

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ii) The pool would hand over to the member the excess holding.

iii) The pool would place the excess holding in a special account and charge interest on it - perhaps at any increasing rate - it being understood that the excess holding must be repurchased by the member within a stated time - say three years - either in transferable currency, dollars or gold.

iv) The pool would demand the immediate repurchase by the debtor of the excess holding, either in transferable currency, dollars or gold.

6. Of these measures (ii) would be appropriate at least in part when the debtor was a "structural" debtor, or where a deficit of a reasonable amount in 1950-51 was acceptable, provided that the debtor's own policy was not contributing to its disequilibrium;

-(iii) would be appropriate where the deficit could be held to be exaggerated by internal policy, or where some contribution by the debtor was desirable;

-(iv) would be appropriate as a last resort where, despite the external evidence showing the necessity, internal policy had not been adjusted.

Automaticity and Flexibility

7. It is desirable to provide as much automaticity as possible in order that countries may have confidence and the work of the committee be not unduly burdened. Various automatic devices are possible:-

a) Solution (ii) in respect of both creditors and debtors might be adopted for an amount equal to 50 % of the actual credit or debit position in 1949, or 1949-50. Thereafter solution (iii) for both creditor and debtor would be the normal rule

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though the management would have discretion to adopt any other solution, whether that most favourable to the country - i.e. (ii), or those unfavourable, i.e. (iv) or (v).

This has the advantage of simplicity. It fails to cover certain important positions including that of a 1949 or 1949-50 net debtor who became a net creditor in 1950-51. Moreover it introduces something like estimates based on past performance ; 1949 would be a bad basis.

b) Each adjustment, whether for creditor or debtor, would be half by solution (ii) and half by solution (iii), subject after a certain point to the discretion of the management.

This also has the advantages of simplicity. Moreover it does put pressure equally on debtor and creditor to restore equilibrium. But it may be questioned whether in fact the burden on the creditor - if no discretion were used by the management - might not become too great. Some upper limit would have to be set.

c) For an amount to be determined - say 25 % of the quota - solution (ii) would be applied, for a further amount, say 25 %, solution (ii) and (iii) would be applied pari passu, and thereafter solution (iii).

This has the grave disadvantage that neither deficits nor credits as they have existed hitherto have borne any relation to the volume of visible trade, on which the quota is based. There is good reason to base short term finance of seasonal swings on the quota, and it is to be expected that apart from a few special cases net credit or debit positions will by 1952 bear a closer relation to total visible trade than they have since the war.

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8. The problem is not easy, and no perfect solution is likely. Some combination of (a), (b) and (c) to provide an automatic basis seems desirable. If all do their part net credits and debits could well be held within the limits of such automatic action, and thus relieve the management from the necessity to take extremely difficult decisions.

1st December 1949.