The European Payments Union - A Short History

Background

Projects for multilateral clearing in Europe have been discussed ever since the European Recovery Program was launched. From the beginning the Board of Governors of the Federal Reserve System has taken an active interest in these discussions and has played a constructive role. (See, e.g., the paper by J. Burke Knapp on "Intra-European Financial Arrangements" in the Review of Foreign Developments of July 15, 1947.) However, during the first two years of the European Recovery Program, the entrenched position of bilateralism in the postwar trade and payments situation in Europe and the United Kingdom's unwillingness to permit any transfers of sterling that might result in gold obligations, prevented the successful negotiation of any multilateral clearing arrangement. The intra-European payments schemes which have been operating during the past two years were essentially *ad hoc* arrangements providing some essential finance for intra-European trade, but failed to make any substantial advance toward multilateralization of payments or to provide incentives for either debtors or creditors to move away from excessive imbalance in their intra-European relations.

In the course of 1939, it became clear that the main European problem had shifted from the area of production to that of trade and payments. The currency adjustments of September 1949 not only improved the competitive position of the devaluing countries with respect to the dollar, but also served to bring about a greater degree of balance in intra-European payments. At the same time, a number of efforts got under way to relax the most irksome restrictions on trade and payments in Europe. Mr. Hoffman's speech before the OEEC Council in Paris of October 31, 1949, in which he advocated the economic "integration" of Europe through the creation of a single market freed from restrictions, crystallized action in the two related fields of trade and payments. With respect to trade, the OEEC countries agreed (with some exceptions) to lift quantitative restrictions on 50 per cent of their imports from each other. In the field of payments ECA elaborated a blueprint for a European Clearing Union (later renamed European Payments Union) which was presented to the OEEC in December 1949.

Principal characteristics of the European Payments Union

As in all similar previous plans for multilateral clearing, the EPU project consisted of two distinct parts: (1) a clearing mechanism and (2) a settlement mechanism.

1. A clearing mechanism breaks through the bilateral channels within which intra-European trade has been constricted since the beginning of the war. It aims at permitting one country to offset a deficit in one direction by a surplus in another. This is not achieved by making European currencies directly convertible into each other and into the dollar, a step considered as premature by many European countries. The idea is rather that each country will have an account with a central Payments Union, and that the debits and credits accumulated by each country in its bilateral

relations with other countries will be transferred at monthly intervals to its EPU account, which will thereby be debited or credited by the combined net result of its intra-European transactions. The great advantage of this method as contrasted with bilateralism lies in the fact that a country does not have to be concerned by deficits with some countries provided that these deficits are offset by surpluses in other directions. It thus eliminates bilateral bargaining and permits an expansion of useful trade. It also means that a country that experiences a serious deficit with another country but remains in over-all balance will feel no need to resort to quantitative restrictions in order to correct this deficit.

2. The settlement mechanism. The settlement of the net balances emerging from multilateral clearing raises a number of important issues. One hundred per cent settlement in gold or dollars would amount to the establishment of full convertibility of European currencies. It has been generally agreed that such a step would not only be premature, but would also interfere with current efforts to liberalize intra-European trade. In a situation in which countries are faced with the obligation to pay gold for any additional import, they would probably be quite unwilling to undertake new risks by lifting existing trade-barriers, even though this were done on a reciprocal basis.

On the other hand, there also was agreement that the terms of settlement of the net balances emerging from the clearing should not be too "soft." If countries knew that, as a result of large-scale credit facilities, they could run up a considerable net deficit with the other countries in the group without having to make gold payment, they might be tempted to pursue policies of monetary ease that would lead them straight back into the conditions of inflation from which they were just emerging.

These conflicting considerations led to the conclusion that the deficit countries should be granted some credit by the Union, but should make gold payments on an increasing scale as their deficit rose. Creditor countries would finance their surplus partly by credits and would receive gold for the balance. The Payments Union would be endowed with an initial fund in dollars which would serve to make up any differences between gold payments by debtors and gold receipts by creditors.

NAC discussions of the EPU in January 1950

In December 1949, the OEEC Council entrusted its Payments Committee to draft the outlines of a European Payments Union that would start operation on July 1, 1950. A general outline was produced and inserted into the second interim report of the OEEC, which was published in January. In the meantime, however, the project encountered many difficulties. First, within the U. S. Government, several NAC agencies were considerably upset by ECA's fait accompli tactics in presenting its blueprint to the OEEC without prior clearance by the NAC. Besides this point of procedure, there was real concern on grounds of substance: it was feared that the projected Payments Union would in some respects duplicate the functions of the International Monetary Fund, to the support of which the United States is committed; and, more important, there was concern that the arrangement, particularly in view of the inclusion of the whole sterling area, might lead to the establishment of a "high-cost soft-currency area" characterized by permanent tendencies toward inflation and discriminatory restrictions against the dollar.

After a series of long drawn-out and at times violent discussions, agrement was reached within the NAC (thanks largely to the mediation efforts of the Federal Reserve representatives) and was incorporated in NAC Action No. 383 (see Annex II). In short, it was decided that the projected EPU should not prevent any country or any group of countries from progressing toward full convertibility at a faster pace than the rest. This meant implicitly that the EPU arrangement should not be such as to force countries that had already made considerable progress in the direction of convertibility, to go back in the direction of soft-currency arrangements characteristic of (e.g.) the sterling area. The NAC action also provided that the EPU should not in any way trespass on the field of competence reserved to the International Monetary Fund.

British opposition

Shortly thereafter, the EPU project ran into considerable new trouble as the result of British opposition. While British representatives had fully collaborated in outlining the project on a technical level within the OEEC, Sir Stafford Cripps declared during the session of the OEEC Council in January that the United Kingdom would be unable to accept substitution of the proposed clearing mechanism for the bilateral agreements involving sterling. He refused to accept an EPU that would supersede the existing bilateral agreements; rather, he favored one that would be super-imposed upon these agreements as a "lender of last resort." It is easily seen that this concept of the EPU is directly opposed to the NAC directive. At the same time, Sir Stafford declared that the United Kingdom could not agree to restrict its freedom of action with respect to quantitative restrictions on trade. (It should be mentioned here that ECA was trying to obtain commitments from the OEEC countries to make further progress in abolishing quantitative restrictions in intra-European trade. Moreover, once these restrictions had been removed, it was deemed important that countries should not easily and unilaterally be able to restore them. It was in this respect that the United Kingdom served notice that it would have to retain its freedom of action.)

The EPU in Congress

In spite of these difficulties, ECA went ahead with its project and made it the "show-piece" of its Congressional presentation. In order to make it possible to provide the Union with appropriated funds, ECA sponsored an amendment of the Economic Cooperation Act so as to permit a transfer of $600 million from its appropriated funds to

> "any central institution or other organization formed to further the purposes of this Act by two or more participating countries, or to any participating country or countries in connection with the operations

"of such institution or organization, to be used on terms and conditions specified by the Administrator and designed to promote multilateral intra-European trade, to facilitate the transferability of European currencies, and progressively to eliminate the existing systems of bilateral trade, and to liberalize trade among participating countries and between them and other countries."

The Congress accepted this amendment and even provided that the $600 million had to be so used or else was to be returned to the Treasury (ECA had only asked for permission to transfer funds). Through its mandatory provision, the Congress no doubt intended to exert pressure on the United Kingdom, whose hesitations to join had in the meantime become public and had provoked Mr. Hoffman into open acknowledgment of "annoyance."

Agreement on the special position of sterling

With favorable action by the Congress, the principal immediate task was to break the deadlock with the British. It was recognized by United States and Continental officials that sterling was indeed in a special position with respect to the EPU project. In the first place, sterling, unlike any other European currency, is widely used as a means of settlement among third countries. Secondly, many countries have traditionally held sterling as part of their monetary reserve. Thirdly, several European countries had accumulated during or after the war considerable holdings of sterling. These holdings posed a special dilemma for the EPU: neither Britain nor the countries holding these sterling balances would consent to any blocking of such balances; but, in the absence of such blocking, the holders of these balances could continue to settle bilaterally with the United Kingdom and would thereby infringe on the principle that all countries had to settle multilaterally through the EPU.

On their side, the British realized that they could not maintain the negative attitude exhibited by Sir Stafford Cripps in January. In March, they came forward with a proposal of their own which advocated a limited participation of sterling in the scheme. Without going into its details, one may affirm that the proposal constituted considerable progress since, for the first time, the British showed themselves ready to accept transfers of sterling even when such transfers could involve them in losses of gold. The proposal, however, was rejected by both the American and the Continental negotiators since it did not go far enough in the direction of doing away with bilateral payments agreements.

After further intensive negotiations, in the course of which ECA, the Belgians, and the OEEC secretariat each produced tentative proposals, agreement was finally reached in May on the insertion of sterling into the EPU. The agreement provided that Britain would be a full member of the EPU: i.e., that it would establish a net balance with it for all the transactions of the sterling area with the other OEEC countries and would settle this balance through the EPU in accordance with the general procedure for settlements (part in gold and part in credits). The United Kingdom also agreed that it would reintroduce previously-lifted quantitative restrictions only in the case of a serious drain on its reserves and then only on a multilateral as opposed to a discriminatory basis.

On the other hand, the "special" position of sterling was taken into account as follows:

(1) With respect to the use of sterling as a monetary reserve: it was agreed that, instead of holding EPU credits, creditors could keep in the form of sterling that part of their surplus which would correspond to their surplus in sterling;

(2) With respect to the existing sterling balances of the Continental members of the EPU: it was decided that these balances could be used only if the holders were in a net deficit position with respect to the EPU, but could then be used irrespective of whether the holders were in a deficit position vis-a-vis the sterling area. ECA agreed to indemnify the United Kingdom for any actual losses of gold that might result from such multilateral use of sterling balances. (A solution along these general lines had been suggested as early as February in an article published in the Board's Review of Foreign Developments.)

The solution that was thus found to the vexing problem of the special position of sterling was satisfactory to all NAC agencies. It was generally felt that the United Kingdom had indeed come a long way since Cripps' statement in January and that the price paid by ECA for the British concessions was a reasonable one.

The EPU and the International Monetary Fund

In the meantime, it had become clear that the issue of EPU's relationship to the Fund which had caused much concern at an earlier stage, would be disposed of without too much trouble. By general agreement, the EPU would be largely governed by automatic rules and would function under the supervision of the OEEC, a body that can make decisions only by unanimous vote. Any concern that this arrangement might result in a powerful supranational monetary board whose authority would supersede that of the Fund, seemed therefore groundless.

The terms of settlement of EPU balances

One important question, however, remained to be settled: that of the actual terms of settlement of EPU credits and debits. There was agreement that the gold payments by the debtor should increase as his deficit rose and that the creditor should extend some credit. But exactly what the ratio of gold settlement to credit settlement was to be, had been left undecided pending the solution of the sterling problem. Unfortunately, the discussion started around a British proposal that was "soft" in the extreme: it called for a gold-free credit margin for debtors of 10 per cent of each country's total trade turnover (imports plus exports plus invisible current account items) and, in addition, for another 5 per cent of credits which would go hand-in-hand with increasing gold payments. During the subsequent discussions these figures were whittled down to gold-free credit margins of 3 per cent of total turnover, and additional credits to be extended to debtors jointly with gold payment on their part for an additional 6 per cent. Upon inspection of this result of the Paris negotiations, it appeared that the credit margins still resulted in an undesirable degree of "softness" for most prospective debtor countries. Opinion to this effect was unanimous in the NAC Staff Committee.

At the same time, Belgium, the country with the greatest intra-European export surplus found that the agreement would compel it to extend credits far beyond its economic capabilities. In spite of pressure exerted by the Paris office of ECA, the Belgian Cabinet therefore decided to reject the agreement that had been arrived at in Paris. This last-minute crisis was resolved by a series of concessions to the Belgians which considerably reduced their credit commitments. One of the concessions provided for repayment of Belgium's outstanding credits within two years. This had the incidental result of making for somewhat less softness in general since it meant that some of the EPU credits would be used for the repayment of old debts to Belgium and would therefore not be available for the financing of current deficits.

Nevertheless, it is impossible not to feel some concern about this part of our new venture in international finance however great its promises in other respects. These feelings dictated Governor Szymczak's letter to Mr. Hoffman (see Annex III) and his subsequent statement to the other members of the NAC (see Annex IV). They were written in the hope of exerting some influence in the right direction during the final stage of the Paris negotiations.